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RESEARCH OF A TRADE FINANCING FACILITY
FOR CENTRAL AMERICA ---
BALANCE OF TRADE, PAYMENTS AND
REAL EXCHANGE RATES IN THE
CENTRAL AMERICAN COMMON MARKET
1965 - 1984

Report Presented to:

REO
Regional Office of Central American Programs
Agency for International Development
Guatemala City

By:

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Subject: Research of a Trade Financing Facility for Latin America ---
Balance of Trade, Payments and Real Exchange Rates
in the Central American Common Market: 1968 - 1984

Dear Mr. Heriot:

Chechi and Company is pleased to provide you with the subject report on completion of Work Order No. 15 of its IQC in Project Design and Evaluation (#PDC-0000-I-15-3082-00).

Fifteen copies of the report are supplied. We trust it meets and surpasses the requirements of the assignment. Please do not hesitate to call me should you require further information or have questions.

Regards.

Sincerely,

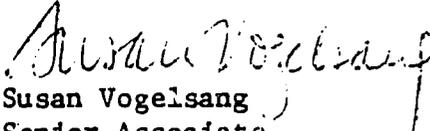

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EXECUTIVE SUMMARY

BALANCE OF TRADE, PAYMENTS AND REAL EXCHANGE RATES IN THE CENTRAL AMERICAN COMMON MARKET, 1965-84

The objective of this study was to evaluate proposals to finance the settlement of trade imbalances arising from trade within the CACM (Central American Common Market), and in so doing, to describe and analyse the forces shaping the recent patterns of CACM trade and payments.

It is useful to separate CACM trade problems into two parts: first, recent developments in the current accounts of each country's balance of payments; second, trade and payments within the CACM.

The current account of the balance of payments of each Central American country has deteriorated since 1980. The primary reasons for this are:

- persistent repatriation of earnings from past investments in the region along with increased interest payments;
- reduced demand for the export items of the region due to the recessions and slow recovery in the developed countries;
- reduction in the terms of trade since 1980; and
- overvaluation of regional currencies.

Within the CACM trade imbalances are primarily due to:

- reduced real incomes in the region; and
- relative misalignment of currencies in the region vis-a-vis each other.

The trade imbalance incurred by Nicaragua alone was enormous. If Nicaraguan data are aggregated with the rest of the CACM, it appears that the region generally had great trade imbalances. An accurate view of trade imbalances within the CACM cannot be gained without removing the effect of Nicaragua's experience on the data. During 1980-1981, Nicaragua's imports from its CACM partners surged, while its exports fell. Since Nicaragua could not pay for its imports at the time, credit was extended by the central banks of the principal sources of Nicaraguan imports, Guatemala and Costa Rica. If one wishes to evaluate the pattern of debt which has arisen as a result of an inability to settle payments imbalances in the CACM, again the influence of Nicaragua must be removed. Nicaraguan debt to the central banks of Guatemala and Costa Rica, accounts for about 80 percent of all debt associated with payments imbalances in the CACM.

When the influence of Nicaragua is removed from the data, the pattern of trade imbalances and associated debt is not striking. Furthermore, the pattern remaining reveals payments imbalances that are almost exclusively associated with El Salvador's excess of imports over exports, with Guatemala and Costa Rica being the primary credit countries. Almost all imbalances can be explained by the pattern of relative overvaluations of currencies within the CACM. Also, the reduced level of trade can be explained by the real income reductions that have occurred since 1980.

A proposal for financing the settlement of trade imbalances within the CACM has been presented to A.I.D. by the Consejo Monetario Centroamericano (the Consejo). The proposal is that payments imbalances be settled 30% in cash by debtor countries, 35% in credit from creditor central banks and the remaining 35% in credit from outside sources. We recommend that the proposed financing not be provided for the following reasons:

- The Consejo has no program to augment regional trade other than the provision of financing to settle trade imbalances.
- The cause of the trade imbalances is inappropriate exchange rates. Financing for settling trade imbalances does not solve the problem.

- There is no evidence that financing for settling trade imbalances is an important barrier to CACM trade.
- Financing for settling trade imbalances removes one of the market pressures encouraging realignment of overvalued currencies. Thus, financing is inconsistent with encouragement of realistic exchange rates.
- The proposed financing would encourage trade within the CACM but not outside the CACM. Thus, it is similar to protecting trade within the CACM and is inconsistent with policies to "open up" these economies to trade with the outside world.

Alternative policies that could be pursued are those that would promote exports in general. Exports should be promoted without regard to whether they are destined to the CACM or outside the region. Furthermore, distinctions should not be made between the promotion of traditional exports and "non-traditional" exports (except insofar as they require different tactics). Export promotion will require that countries pursue reasonable exchange rate policy to become price competitive. Realignment of regional currencies will be required. A side benefit from this realignment will be that trade imbalances within the CACM will be largely eliminated. Specific steps that could be taken are to provide mechanisms for confirming and guaranteeing letters of credit, guaranteeing suppliers credits or the direct provision of buyer's credit. Marketing assistance in the U.S. and Europe should be evaluated. An institutional base for these activities might be found among the private banks of the region, but consideration should also be given to employing banks from outside the region.

Section 1: BACKGROUND

This study was undertaken by Checchi and Company for the Regional Office for Central American Programs of the Agency for International Development. The Scope of Work of the study is provided in Appendix 2.

Before beginning a discussion of trade and payments in Central America, one should hold firmly in mind the character of the recession that Central American countries have been experiencing of late. Income is a main determinant of the demand for imports and, since we are dealing with a closed area - the CACM - where one country's imports are another's exports, income is an important determinant of the level of regional trade.

Tables 1.1 through 1.5 give data on real GDP and per capita income in terms of local currency of 1978. Table 1.6 converts figures for 1980 and 1984 to dollars of 1978 by applying exchange rates* existing in that year. The table also shows changes in real GDP and per capita income between 1980 and 1984. Guatemala's real per capita income (PCY) peaked in 1980 after a decade of growth, interrupted only by a slight recession in 1975. PCY grew at about 2.3% per annum 1970-1980, but since has dropped continually. Real PCY in 1984 was about 16% below 1980 levels. Honduras' growth pattern has been erratic. PCY began dropping in 1969, probably coincident with the brief war with El Salvador. Recovery from that episode was under way by 1973 when a post-oil-embargo recession occurred. Honduran PCY has been falling since 1979 and in 1984 was about 12% below the 1980 level. El Salvador's PCY peaked and has dropped precipitously since 1978. Real 1984 PCY was less than two thirds the 1978 level, and 22% below the 1980 figure. In Costa Rica, PCY began its decline after 1979, bottomed out in 1982-1983 and has recovered slightly in 1984. Nevertheless, real per capita income in Costa Rica in 1984 was 9% below 1980. Nicaragua shows a real PCY decline of only 10% since 1980, but income there began dropping after 1977, and since then their PCY has fallen by about 43%. For the region overall, we see about a 13% drop in PCY since 1980.

* The problem of expressing local values in U.S. dollars is a common one. We pay more attention to it in Section 3.

In the most general sense, recession in the CACM region is clearly associated with a combination of political turmoil and recession in the industrialized countries. The onset of income declines in El Salvador and Nicaragua are clearly associated with political difficulties. Recession in the industrialized countries, which characterized much of the 1979-1983 period, spilled over into Central America in the form of reduced regional exports to the industrialized countries and a deterioration in export prices. Table 1.7 shows the price of Central American exports relative to imports. After relatively favorable movements in the terms of trade in the late 1970's, there were rather sharp deteriorations after 1978. Thus, all Central American countries were caught in the bind of reduced demand for their exports and sliding export prices. This of course was compounded by the political turmoil affecting the region.

Under these circumstances it is not surprising that trade in the CACM has fallen. As discussed in Section 2 of this Report, trade is a function of demand and demand was sharply reduced. In addition, as Section 3 shows, exchange rates became generally overvalued, and as a result large balance of trade deficits appeared. The general picture described in the Interim Summary (Section 4) is one of reduced trade levels, with increased trade deficits. It is within this context that one must ask what policy measures can be taken and whether steps, such as financing facilities for intra-CACM trade deficits, can help stimulate trade and growth.

Section 5 of this Report describes current trade finance operations of the Camara de Compensacion. Section 6 discusses and analyses the proposal of the Central American Monetary Council (the "Consejo") to establish a financing facility for intraregional trade imbalances. Section 7 summarizes the report, lays out its conclusions, and suggests alternative mechanisms to stimulate trade in Central America. Appendix 1 provides the results of statistical analyses of exchange rate movements supporting the report's conclusions, and Appendix 2 is the Study's Scope of Work.

Table 1.1

Guatemala Total and Per Capita Income

	Real GDP		Real GDP	
	<u>Quetzal of 78</u>	<u>Pop</u>	<u>Per Capita</u>	
1958	0.0	3.610	0.0	
1959	0.0	3.720	0.0	
1960	2229.2	3.830	582.0	
1961	2323.3	3.950	588.2	
1962	2405.8	4.060	592.6	
1963	2636.2	4.190	629.2	
1964	2755.9	4.310	639.4	
1965	2878.7	4.410	652.8	
1966	3039.9	4.500	675.5	
1967	3161.0	4.700	672.6	
1968	3439.8	4.840	710.7	
1969	3597.6	5.020	716.7	
1970	3803.5	5.270	721.7	
1971	4022.9	5.420	742.2	
1972	4312.2	5.580	772.8	
1973	4604.4	5.740	802.2	
1974	4901.1	6.050	810.1	
1975	4994.6	6.240	800.4	
1976	5364.9	6.430	834.4	
1977	5785.1	6.630	872.6	
1978	6071.0	6.840	887.6	
1979	6356.2	7.050	901.6	
1980	6594.7	7.260	908.4	
1981	6640.5	7.480	887.8	
1982	6404.0	7.700	831.7	
1983	6234.4	7.935	785.7	
1984	6249.8	8.177	764.3	

Table 1.2

Honduras Real Per Capita Income

	REAL GDP		GDP
	<u>LEMPIRA OF 78</u>	<u>POP</u>	<u>PER CAPITA</u>
1958	0.0	1.750	0.0
1959	0.0	1.800	0.0
1960	1616.9	1.850	874.0
1961	1658.7	1.910	868.4
1962	1742.7	1.970	884.6
1963	1800.6	2.040	882.6
1964	1907.4	2.110	904.0
1965	2106.6	2.180	966.3
1966	2229.2	2.260	986.4
1967	2333.7	2.280	1023.6
1968	2505.6	2.310	1083.7
1969	2508.1	2.450	1023.7
1970	2626.5	2.640	994.9
1971	2769.4	2.720	1018.2
1972	2882.7	2.810	1025.9
1973	3041.4	2.900	1048.8
1974	3039.1	2.990	1016.4
1975	2949.4	3.090	954.5
1976	3186.8	3.200	995.9
1977	3548.9	3.320	1068.9
1978	3814.0	3.440	1108.7
1979	4072.9	3.560	1144.1
1980	4184.8	3.690	1134.1
1981	4235.4	3.820	1108.7
1982	4157.7	3.960	1049.9
1983	4139.0	4.103	1008.8
1984	4251.7	4.251	1000.1

Table 1.3

El Salvador Real Per Capita Income

	<u>Real GDP</u> <u>Colones of 78</u>	<u>Pop</u>	GDP <u>Per Capita</u>
1958	0.0	2.320	0.0
1959	0.0	2.390	0.0
1960	2898.9	2.450	1183.2
1961	3004.1	2.510	1196.8
1962	3362.5	2.630	1278.5
1963	3505.8	2.720	1288.9
1964	3833.0	2.820	1359.2
1965	4036.1	2.930	1377.5
1966	4331.9	3.040	1425.0
1967	4561.7	3.150	1448.1
1968	4718.1	3.270	1442.8
1969	4877.4	3.360	1451.6
1970	5025.1	3.440	1460.8
1971	5258.8	3.550	1481.3
1972	5548.9	3.670	1512.0
1973	5834.8	3.770	1547.7
1974	6204.6	3.890	1595.0
1975	6551.9	4.010	1633.9
1976	6815.5	4.120	1654.2
1977	7223.0	4.260	1695.5
1978	7692.0	4.350	1768.3
1979	7553.1	4.440	1701.1
1980	6901.8	4.750	1453.0
1981	6331.9	4.870	1300.2
1982	5943.3	5.000	1188.7
1983	5935.2	5.160	1150.2
1984	6025.1	5.325	1131.4

Table 1.4

Costa Rica Real GDP Per Capita

	<u>Real GDP</u> <u>Colones of 78</u>	<u>POP</u>	<u>GDP</u> <u>Per Capita</u>
1958	ERR	1.150	ERR
1959	ERR	1.190	ERR
1960	10212.2	1.250	8169.7
1961	10126.7	1.300	7789.8
1962	10969.5	1.350	8125.6
1963	11510.9	1.390	8281.2
1964	11990.4	1.440	8326.7
1965	13170.7	1.490	8839.4
1966	14189.0	1.540	9213.7
1967	15011.8	1.590	9441.4
1968	16267.1	1.630	9979.8
1969	17165.4	1.690	10157.0
1970	18427.7	1.730	10651.9
1971	19722.7	1.800	10957.0
1972	21328.4	1.840	11591.5
1973	22976.3	1.870	12286.8
1974	24203.2	1.920	12605.8
1975	24726.4	1.960	12615.5
1976	26090.3	2.010	12980.3
1977	28393.3	2.070	13716.6
1978	30194.0	2.120	14242.5
1979	31667.8	2.170	14593.4
1980	31924.0	2.250	14188.5
1981	31202.3	2.270	13745.5
1982	28787.3	2.320	12408.3
1983	29606.6	2.377	12457.5
1984	31577.9	2.435	12970.5

Table 1.5

Nicaragua Real GDP Per Capita

	<u>Real GDP</u> <u>Cordobas of 78</u>	<u>POP</u>	<u>GDP</u> <u>Per Capita</u>
1958	ERR	1.330	ERR
1959	ERR	1.370	ERR
1960	5288.0	1.411	3747.7
1961	5691.1	1.453	3916.8
1962	6321.7	1.496	4225.8
1963	6987.3	1.536	4549.0
1964	7817.9	1.579	4951.2
1965	8565.9	1.620	5287.6
1966	8846.5	1.660	5329.2
1967	9469.5	1.700	5570.3
1968	9578.4	1.740	5504.8
1969	10182.2	1.790	5688.4
1970	10342.1	1.830	5651.4
1971	10851.3	1.890	5741.4
1972	11166.5	1.950	5726.4
1973	11885.7	2.010	5913.3
1974	13583.3	2.080	6530.4
1975	13551.1	2.160	6273.6
1976	14273.2	2.240	6372.0
1977	15478.3	2.320	6671.7
1978	14266.0	2.410	5919.5
1979	10492.3	2.640	3974.4
1980	11537.1	2.730	4226.0
1981	12148.8	2.820	4308.1
1982	12010.6	2.920	4113.2
1983	12613.8	3.048	4137.7
1984	12095.3	3.183	3800.4

Table 1.6

Real GDP and Per Capita GDP

	1980		1984		1980-84 Change (%)	
	GDP (000)	GDP Per Capita	GDP (000)	GDP Per Capita	GDP	GDP Per Capita
Guatemala	6595	908	6250	764	-5.2	-15.9
Honduras	2092	567	2126	500	1.6	-11.8
El Salvador	2761	581	2410	452	-12.7	-22.2
Costa Rica	3725	1655	3685	1513	-1.1	-8.6
Nicaragua	1648	604	1727	543	4.8	-10.1
CACM	16821	946	16198	822	-3.7	-13.1

Table 1.7

Relative Price of Exports (PX/PM)
(National Accounts Basis)
1980 - 100

	(1) <u>Guatemala</u>	(2) <u>Honduras</u>	(3) <u>El Salvador</u>	(4) <u>Costa Rica</u>	(5) <u>Nicaragua</u>
1965	144.44	92.03	99.72	119.04	99.88
1966	138.14	86.65	99.72	117.51	92.00
1967	131.84	88.04	94.43	114.10	92.96
1968	133.17	88.13	93.59	105.17	92.33
1969	130.02	90.90	88.58	104.82	85.58
1970	147.26	86.74	103.06	109.87	87.91
1971	132.50	74.44	94.89	98.12	84.82
1972	120.89	79.90	97.96	96.00	87.93
1973	122.88	83.53	105.66	96.12	96.96
1974	111.44	75.82	89.60	80.73	84.42
1975	108.29	82.50	82.63	84.49	64.85
1976	111.77	90.73	120.52	101.17	86.61
1977	136.98	108.23	188.11	120.10	101.82
1978	121.06	110.14	120.61	108.11	90.62
1979	106.63	95.06	108.00	99.76	87.28
1980	100.00	100.00	100.00	100.00	100.00
1981	91.04	85.18	83.94	82.73	79.47
1982	85.90	79.55	80.13	85.31	80.50
1983	87.56	72.88	73.17	89.19	77.70
1984	88.39	72.27	71.77	N.A.	72.60

SOURCE: Central Banks

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Section 2: TRADE IN CENTRAL AMERICA

General Balance of Trade and Payments

An examination of the most basic elements of the balance of payments of Central American countries reveals three striking factors. First, current account balances have been persistently large and negative, with a tendency to be worse in the past five years than before. In most cases, current account balances reached their worst in 1980 or 1981 and have improved only slightly since. Secondly, variations in trade balances seem to explain variations in the current account balance, and third, the balance on services account in most cases, tends to add a larger negative figure to current account balances than does the trade balance. Furthermore, the trend on services account is consistently downward, so that it tends to determine a downward trend for the overall current account balance. In short, for almost all countries it is the balance on services that leads the current account balance lower on average, while it is the goods trade balance that explains variance in current account.

Tables 2.1 to 2.5 show the data on current, trade, services and "other current" accounts. One can easily notice the persistently large negative figures in the services column for each country. Meanwhile, trade balances fluctuate greatly. If one were to plot these variables over time, the relationships mentioned here would stand out even more clearly.

Variations in trade balances can be traced, in part, to fluctuations in the markets in which Central American countries sell their exports. For example, coffee is a major export item for all Central American countries. For Guatemala, coffee prices were particularly depressed during 1978 and 1979, rose somewhat in 1980, then fell by over 25% in 1981 where they have stayed. Guatemala's trade balance reflects these price shifts, showing large negative balances in the years of low coffee prices.

The pattern of trade among trade partners yields several important observations. First, most of the Central American countries have pegged the value of their currency to the U.S. dollar. Since the dollar floats

Table 2.1

GUATEMALA CURRENT ACCOUNT 1969-83

	<u>C.A.</u> <u>Balance</u>	<u>Trade</u> <u>Balance</u>	<u>Services</u> <u>Balance</u>	<u>Other</u> <u>Balances</u>
1969	-19	21.6	-54	13.4
1970	-7.9	30.5	-55.9	17.5
1971	-49.2	-3.1	-71.4	25.3
1972	-11.5	41.1	-82.6	30
1973	7.7	50.7	-85.4	42.4
1974	-103.1	-49.2	-109.3	55.4
1975	-65.7	-31.4	-112.1	77.8
1976	-77.5	-190.3	-86.1	198
1977	-35.3	73.2	-204.3	95.8
1978	-270.5	-191.4	-194.7	115.6
1979	-205.6	-180.3	-151.9	126.6
1980	-163.3	47.2	-320.3	109.8
1981	-572.7	-248.7	-414.9	90.9
1982	-399.1	-113.9	-347.9	62.7
1983	-223.9	35.7	-290.2	30.6

Table 2.2

HONDURAS CURRENT ACCOUNT 1969-83

	<u>C.A.</u> <u>Balance</u>	<u>Trade</u> <u>Balance</u>	<u>Services</u> <u>Balance</u>	<u>Other</u> <u>Balances</u>
1969	-30.6	1.2	-39.1	7.3
1970	63.8	-25.2	-45.2	134.2
1971	-22.7	16.5	-46	6.8
1972	-12.7	35.6	-54.8	6.5
1973	-34.6	23.1	-64.6	6.9
1974	-104	-87.2	-49.3	32.5
1975	-112.1	-62.7	-67.1	17.7
1976	-104.8	-20.8	-97.3	13.3
1977	-128.7	-20.3	-122.6	14.2
1978	-157.2	-28.4	-146.2	17.4
1979	-192.1	-26.9	-185.6	20.4
1980	-316.8	-103.8	-234.5	21.5
1981	-302.7	-114.8	-215.4	27.5
1982	-228.3	-4.2	-254.1	30
1983	-225.2	-66.5	-203.2	44.5

Table 2.3

EL SALVADOR CURRENT ACCOUNT 1969-83

	<u>C.A.</u> <u>Balance</u>	<u>Trade</u> <u>Balance</u>	<u>Services</u> <u>Balance</u>	<u>Other</u> <u>Balances</u>
1969	-19.8	9.1	-42.4	13.5
1970	8.7	41.4	-47	14.3
1971	-14.2	18	-49.4	17.2
1972	12.4	52	-51.7	12.1
1973	-43.9	18.6	-76.1	13.6
1974	-134.2	-57.7	-94.8	18.3
1975	-92.9	-17.7	-102.6	27.4
1976	23.6	63.7	-69.3	29.2
1977	30.8	112.5	-121.2	39.5
1978	-285.8	-149.4	-187.7	51.3
1979	21.4	177.6	-207.6	51.4
1980	30.6	178.4	-196.7	48.9
1981	-250.4	-100.3	-210.4	60.3
1982	-152.4	-121.8	-201.3	170.7
1983	N/A	N/A	N/A	N/A

Table 2.4

COSTA RICA CURRENT ACCOUNT 1969-83

	<u>C.A.</u> <u>Balance</u>	<u>Trade</u> <u>Balance</u>	<u>Services</u> <u>Balance</u>	<u>Other</u> <u>Balances</u>
1969	-50.3	-31.9	-26.8	8.4
1970	-74.1	-55.8	-24.2	5.9
1971	-114.4	-92	-29.9	7.5
1972	-100	-58.3	-48.3	6.6
1973	-112.2	-67.4	-51.7	6.9
1974	-266.1	-208.8	-67	9.7
1975	-217.7	-134.2	-93.1	9.6
1976	-201.5	-103	-111.6	13.1
1977	-225.6	-97.3	-144.1	15.8
1978	-363.2	-185.5	-194.3	16.6
1979	-558.2	-315.1	-255.3	12.2
1980	-663.9	-374.3	-304.1	14.5
1981	-409.1	-88	-348.2	27.1
1982	-297.1	64.1	-324.1	-37.1
1983	-316.2	-22	-359.1	64.9

Table 2.5

NICARAGUA CURRENT ACCOUNT 1969-83

	<u>C.A.</u> <u>Balance</u>	<u>Trade</u> <u>Balance</u>	<u>Services</u> <u>Balance</u>	<u>Other</u> <u>Balances</u>
1969	-36	-0.6	-41.9	6.5
1970	-39.5	0	-45.6	6.1
1971	-44.5	-2.9	-46.6	5
1972	21.7	43.9	-29.2	7
1973	-65.9	-49.1	-74.3	57.5
1974	-257.2	-160.8	-112	15.6
1975	-185	107.2	-94.5	16.7
1976	-39.3	56.8	-105.4	9.3
1977	-181.9	-68	-125.1	11.2
1978	-24.9	92.7	-127.1	9.5
1979	180.2	227	-138.4	91.6
1980	-379.1	-352.5	-150.5	123.9
1981	-514.3	-422.6	-162	70.3
1982	-469	-315.8	-204.7	51.5
1983	-429.6	-349.5	-172	91.9

against all other currencies, the currencies of Central American countries float with the dollar. Since 1981, the dollar has appreciated greatly against all major currencies, thus, so have the currencies of Central America. Therefore, we should expect that export patterns will change. Exports should be relatively less to those countries against which regional currencies have appreciated. Tables 2.6 - 2.10 show the proportion of exports from each Central American country, which was destined for either CACM countries, the U.S., or "other developed countries" (the other DCs are the U.K., Japan, Germany, Italy, the Netherlands, and Belgium.) These trade partners account for about 90% of the Central American countries' exports. Overvaluation of Central American currencies will have occurred against the "other DCs" since the dollar has appreciated against that group as well. Thus, we should be able to observe a proportional shift in exports away from the "other DC" group and toward either the U.S. or CACM.*

The data show, that in all cases, the expected shift occurs. The tables show the average proportion of exports to each trade partner group for 1965-80 and 81-84. For example, in the Guatemalan case, on average 32.8% of exports were to the "other DCs" during the period 1965-80. Since 1980 that proportion has dropped to 24.6%. The relative shift in the Guatemalan case has been toward increased CACM exports, since the proportion of trade with the U.S. has remained constant. The Honduran and El Salvadoran cases are similar, except that the shift away from exports to other DCs has been accompanied by a relative shift in exports to the U.S.

Costa Rica's case is one where the relative shift occurred a bit later than in other countries. While the proportion of exports to the three different trade groups did not change much on average over the 1981-84 period, there seems to be a relative shift away from exports to the "other DCs" which occurred in 1983 and 1984.

*Relative changes in real exchange rates with the U.S. and within the CACM will be discussed below.

Table 2.6

GUATEMALA: PERCENTAGE OF EXPORTS TO MAJOR TRADE PARTNERS

	<u>CACM</u>	<u>US</u>	<u>OTHER DC</u>
1965	21.5	41.1	37.4
1966	27.1	37.5	35.4
1967	32.8	35.0	32.2
1968	36.5	31.9	31.6
1969	37.0	32.0	31.0
1970	39.1	31.4	29.5
1971	36.3	34.2	29.5
1972	34.6	33.6	31.8
1973	34.5	38.8	26.6
1974	33.3	38.4	28.3
1975	32.1	27.1	40.8
1976	29.1	41.1	29.9
1977	22.9	39.4	37.7
1978	27.5	34.2	38.3
1979	29.9	36.0	34.1
1980	35.2	33.5	31.3
1981	46.2	25.3	28.5
1982	38.1	34.6	27.3
1983	38.3	40.5	21.2
1984	37.7	40.9	21.4
AVERAGE (65-80)	31.8	35.3	32.8
AVERAGE (81-84)	40.1	35.3	24.6

Table 2.7

HONDURAS: PERCENTAGE OF EXPORTS TO MAJOR TRADE PARTNERS

	<u>CACM</u>	<u>US</u>	<u>OTHER DC</u>
1965	16.6	63.2	20.2
1966	14.7	58.8	26.6
1967	16.1	46.1	37.8
1968	18.5	46.8	34.7
1969	13.5	48.3	38.2
1970	12.3	61.1	26.7
1971	3.3	72.1	24.6
1972	5.2	67.0	27.9
1973	5.5	66.2	28.3
1974	13.6	60.5	25.9
1975	12.0	61.1	26.9
1976	11.0	63.7	25.3
1977	9.4	54.5	36.1
1978	9.1	64.2	26.7
1979	9.6	63.8	26.6
1980	12.1	58.1	29.8
1981	11.0	61.7	27.3
1982	9.6	60.5	29.8
1983	10.2	64.2	25.6
1984	8.7	65.2	26.0
AVERAGE (65-79)	11.4	59.7	28.9
AVERAGE (80-84)	9.9	62.9	27.2

Table 2.8

EL SALVADOR: PERCENTAGE OF EXPORTS TO MAJOR TRADING PARTNERS

	<u>CACM</u>	<u>US</u>	<u>OTHER DC</u>
1965	25.7	26.7	47.6
1966	31.7	27.2	41.1
1967	39.3	27.3	33.3
1968	45.3	21.9	32.7
1969	39.4	22.7	37.8
1970	34.6	23.0	42.4
1971	37.5	24.2	38.3
1972	36.7	17.4	45.9
1973	34.4	36.2	29.4
1974	36.9	30.4	32.7
1975	30.7	30.1	39.2
1976	27.3	36.5	36.1
1977	24.2	35.5	40.3
1978	31.0	25.7	43.3
1979	23.0	29.6	47.3
1980	30.2	44.9	24.9
1981	36.6	24.2	39.2
1982	24.5	47.1	28.4
1983	23.9	47.2	28.9
1984	23.4	47.5	29.1
AVERAGE (65-80)	33.0	28.7	38.3
AVERAGE (80-84)	27.1	41.5	31.4

Table 2.9

COSTA RICA: PERCENTAGE OF EXPORTS TO MAJOR TRADE PARTNERS

	<u>CACM</u>	<u>US</u>	<u>OTHER DC</u>
1965	21.2	52.9	26.0
1966	21.2	52.9	26.0
1967	23.2	57.7	19.2
1968	25.6	57.0	17.4
1969	22.8	56.5	20.7
1970	23.8	49.2	27.0
1971	23.9	47.8	28.3
1972	21.9	48.1	30.0
1973	25.5	41.6	32.9
1974	28.8	39.2	32.0
1975	25.8	49.9	24.3
1976	27.4	49.4	23.2
1977	26.8	39.7	33.5
1978	26.7	40.1	33.3
1979	23.4	46.2	30.5
1980	33.1	40.6	26.3
1981	30.4	41.8	27.8
1982	24.7	43.0	32.4
1983	24.2	52.0	23.8
1984	23.1	52.7	24.1
AVERAGE (65-80)	25.1	48.0	26.9
AVERAGE (81-84)	25.6	47.4	27.0

Table 2.10

NICARAGUA: PERCENTAGE OF EXPORTS TO MAJOR TRADE PARTNERS

	<u>CACM</u>	<u>US</u>	<u>OTHER DC</u>
1965	9.5	28.6	61.9
1966	13.0	25.8	61.2
1967	13.4	30.6	56.0
1968	17.0	32.1	50.9
1969	22.0	36.8	41.2
1970	27.9	36.1	36.0
1971	27.7	38.5	33.8
1972	25.7	37.8	36.5
1973	25.6	40.0	34.4
1974	31.3	25.2	43.6
1975	28.9	32.7	38.4
1976	26.0	36.8	37.2
1977	25.6	28.8	45.6
1978	27.7	30.6	41.7
1979	20.3	43.1	36.6
1980	21.3	45.2	33.6
1981	20.3	42.7	36.9
1982	20.2	36.7	43.1
1983	14.7	36.9	48.4
1984	16.4	36.2	47.4
AVERAGE (65-80)	22.7	34.3	43.0
AVERAGE (81-84)	17.9	38.1	44.0

The Nicaraguan case must be considered a special one. The Cordoba has been pegged to the dollar and has therefore appreciated against "other DC" currencies. However, the trade proportions must be interpreted in light of the sharply reduced trade between Nicaragua and the rest of the CACM in 1983 and 1984*, which would tend to throw the proportion of exports in favor of one of the other two groups -- either to the U.S. or "other DC." Furthermore, when that relative shift occurs, one would expect a greater relative shift toward the U.S., since, as with other Central American currencies, the Cordoba was appreciating against currencies of "other DCs" along with the dollar.

Indeed, that is what one finds. In Table 2.10 we can see that Nicaragua's proportion of exports to the CACM fell, and the proportion to the U.S. and other DC's rose. But the proportion rose more with the U.S. (from 34.3% to 38.12% of exports) than it did with other DCs (from 43% to 44%).

We consider this appreciation of Central American currencies against the currencies of "other DCs" to be a major problem. The "other DC" group is the market for between about 25% and 40% of Central American exports. In most cases, the "other DCs" are a more important trade partner than other CACM countries, and are almost as important as the U.S. The exceptions are Guatemala, for which CACM countries are predominant, and Honduras and Costa Rica where trade with the U.S. is more significant than trade with other DCs.

Trade Within the CACM

Table 2.11 shows exports by each CACM country to other CACM countries. For all countries with the exception of Nicaragua, exports to the CACM peaked in 1980 and fell thereafter. Total intraregional exports hit \$1,174 million in 1980, but by 1984 had fallen to \$779 million -- almost a 43% drop. One can note in the table that 1980 may be a poor year against which to make comparisons. Guatemala, Honduras and Costa Rica experienced extraordinary export expansion between 1979 and 1980, amounting to 44%, 30% and 54% respectively. Therefore, statements comparing 1984 with 1980 exaggerate the extent to which trade in the Region has declined. Indeed,

*We will pay attention to this phenomenon later.

Table 2.11

EXPORTS IN THE CACM

	<u>GUATEMALA</u>	<u>HONDURAS</u>	EL <u>SALVADOR</u>	COSTA <u>RICA</u>	<u>NICARAGUA</u>	<u>TOTAL</u>
1965	35.7	20.6	45.3	25.5	12.4	139.5
1966	50.9	19.6	59.0	25.5	16.2	171.2
1967	57.8	24.3	79.2	27.4	18.2	206.9
1968	70.7	30.3	85.6	36.5	24.6	247.7
1969	83.8	22.1	74.7	37.8	31.7	250.1
1970	102.3	18.0	73.6	46.1	46.0	286.0
1971	92.0	5.3	80.9	47.1	47.3	272.6
1972	99.0	8.5	93.2	51.5	56.1	308.3
1973	129.9	11.5	113.1	70.5	60.3	385.3
1974	163.2	27.8	147.2	104.2	91.6	534.0
1975	169.0	30.8	141.7	107.2	92.6	541.3
1976	189.1	38.6	176.1	130.6	118.7	653.1
1977	222.4	43.5	215.5	173.8	134.0	789.2
1978	255.0	49.2	233.8	178.6	146.2	862.8
1979	306.5	63.8	263.7	175.5	90.2	899.7
1980	440.8	91.4	295.8	270.4	75.4	1173.8
1981	407.2	70.8	206.6	237.9	65.8	988.3
1982	337.4	55.8	157.9	167.2	49.2	767.5
1983	347.1	62.7	166.8	191.2	39.2	807.0
1984	338.4	53.0	162.4	180.4	44.8	779.0

in 1984 Guatemalan and Costa Rican exports are higher in nominal terms than they were in 1979, and have been for most of the recent period. However, in both cases, if one were to adjust for price changes over the period, exports for Guatemala and Costa Rica would be about 8-14% below 1979 levels.* Honduras, El Salvador and Nicaragua have experienced declines in nominal exports, even in comparison with 1979. Export declines in the latter two countries correspond to the periods of political instability in each.

The extraordinary jump in exports between 1979 and 1980 is due largely to events in Nicaragua. After the revolution there, in 1980 and 1981, Nicaragua imported extraordinary amounts of goods from regional neighbors. Thus, exports for all other Central American countries were up sharply. Most of the balance of trade deficits that Nicaragua ran with other CACM countries was financed by short and medium term credits extended by central banks, particularly those of Guatemala and Costa Rica. By 1982 and 1983 it became clear that Nicaragua was not going to be able to service the regional debt that it had accumulated in this way and so, other CACM countries began to impose restrictions on exporting to Nicaragua. Thus, CACM exports fell sharply as exports to Nicaragua were cut back from the extraordinary levels of 1980-81. Currently, other CACM countries, particularly Guatemala and Costa Rica, permit exports to Nicaragua only if matched by imports from Nicaragua, in an attempt to force bilateral balance. This barter type arrangement has cut trade between Nicaragua and neighboring countries to extremely low levels at present.

*The proper way to adjust for real changes in trade within the CACM is to use a price index for exports and imports for goods traded within the CACM. No such index exists. We have therefore used the U.S. wholesale price index as representative of the price changes of traded goods. Use of the U.S. WPI is likely to bias downward the trade figures for 1981-84 since terms of trade figures for overall trade for Central American countries show that export prices have fallen, not risen as would be implied by use of the WPI. Thus, when we say that "between 1980 and 1984, exports in real terms have fallen by X%", we are probably overestimating the percentage decline.

We have designed Table 2.12 to show exports within the CACM after having removed the effect of Nicaragua. We will refer to the CACM countries without Nicaragua as the "CACM-N". The Table shows that collectively exports to the Region still peaked in 1980, though El Salvador's peaked in 1979 and Costa Rica's in 1981. Since 1980, total CACM-N internal exports are down about 18% in nominal terms (compared to being down 34% when Nicaragua is included). In real terms this is a decline of about 29% (compared to 43%).

The Regional export decline is not shared equally by all countries. El Salvador's exports are down about \$90 million since 1979, accounting for \$40 million more than the nominal drop in total CACM-N exports between 1979 and 1984. Since the peak for both CACM-N and El Salvadoran exports in 1980, total exports have fallen by \$139 million and El Salvador's alone by \$91 million. Thus, El Salvador accounts for over 65% of the change in the total.*

Excluding the effect of Nicaragua, Guatemala's 1984 exports were down about 11% in nominal terms below 1980 levels, and about 23% in real terms. Compared to 1979, Guatemala's exports to the CACM-N are up 11% in nominal terms, but in real terms this represents a drop of 16%. In 1984, Costa Rica exported more in nominal terms to the CACM-N than in any prior year, though the 1984 amount is 6% below the 1980 amount in real terms. Honduran exports are down sharply by 1984, standing at 63% of the 1980 nominal levels.

One must place the decline in trade within the CACM within the context of the declines in real income that occurred in the Region in recent years. As we pointed out in Section 1 above, real per capita income in the region declined by about 13% between 1980-84. This fact alone would cause trade to decline since it is a well-established empirical fact that imports are a function of per capital income levels. The data in Table 1.12 indicate

*We could have performed another exercise like the one we did with Nicaragua, but this time removing El Salvador as well. El Salvador ran large deficits with other CACM countries in 1980-82, thus, much of the export peak that we see for the remaining countries in 1980 would be removed. The result would show that the remaining countries experience stagnating exports, rather than sharply declining exports.

Table 2.12

EXPORTS WITHIN THE CACM EXCLUDING THE EFFECT OF NICARAGUA

	<u>GUATEMALA</u>	<u>HONDURAS</u>	<u>EL SALVADOR</u>	<u>COSTA RICA</u>	<u>TOTAL</u>
1965	30.5	19.5	39.1	15.5	104.6
1966	43.0	17.2	49.0	15.5	124.7
1967	47.2	21.7	65.6	16.1	150.6
1968	59.4	26.1	70.8	23.0	179.3
1969	71.1	18.8	63.8	25.4	179.1
1970	87.8	13.9	59.2	33.2	194.1
1971	75.3	3.6	65.3	31.7	175.9
1972	81.4	5.2	77.1	34.0	197.7
1973	103.1	5.3	87.2	44.6	240.2
1974	123.1	15.5	110.9	64.7	314.2
1975	135.1	18.4	112.4	71.9	337.8
1976	151.2	24.2	139.4	85.4	400.2
1977	181.9	29.6	176.3	118.2	506.0
1978	217.4	37.3	204.8	132.8	592.3
1979	274.9	48.6	240.2	136.0	699.7
1980	344.4	58.8	241.1	146.3	790.6
1981	338.1	50.0	176.6	154.1	718.8
1982	292.5	47.5	130.9	120.6	591.5
1983	288.8	51.9	147.9	155.6	644.2
1984	306.0	37.1	149.8	158.6	651.5

that trade has declined in the CACM-N. In real terms the decline between 1980 and 1984 is about 29%. However, 1980 was a particularly high year for intra-Central American trade. In real terms the trade decline for the period 1979-84 was about 17%, and for 1981-84 it was 14%. Thus, a decline of between 14% and 17% probably is a better indicator of the declines in trade that should be analyzed since the 1980 level was so extraordinary. One must then ask whether or not a 14% to 17% decline in trade is something that could be expected to accompany a 13% decline in real income. The answer is clearly yes. Elasticities of imports with respect to income tend to be rather high on the order of 1 to 2. The income elasticity implied by the above figures (assuming for the moment all else is equal) is around 1.1 to 1.3. Thus, the level of trade among Central American countries is consistent with the income changes that have occurred in the region when compared to common empirical findings.

Trade balances within the CACM-N reflect traditional relationships for Guatemala and Honduras, but changes for El Salvador and Costa Rica. Trade balances are shown in Table 2.13. Guatemala has traditionally been a surplus country. Large positive balances for Guatemala since 1980 reflect in large part the deficits being run by El Salvador. After 1980, El Salvador shifted from being roughly in balance to running a large deficit, most of which is with Guatemala. Costa Rica ceased being a deficit country and began running surpluses in 1981. Costa Rica's switch to a positive balance is also partly attributable to increased exports to El Salvador. Honduras has always been a deficit country, and continues to be so, though negative balances in 1984 are somewhat larger than they have been before.

Trade and Exchange Restrictions in the CACM

The idea has surfaced that new barriers to trade among Central American countries are a partial cause of the reduction in trade among CACM members. Indeed, some barriers to trade have arisen in recent years and these will be inventoried below. Even in the presence of trade barriers one must ask whether the barriers are effective in distorting and inhibiting trade. If they are not, then one should look to other areas for policy initiatives.

Table 2.13

TRADE BALANCES WITH THE CACM-N

	<u>GUATEMALA</u>	<u>HONDURAS</u>	<u>EL SALVADOR</u>	<u>COSTA RICA</u>
1965	0.4	-3.9	-0.2	-11.5
1966	11.2	-13.9	2.5	-3.7
1967	7.2	-15.4	16.5	-11.1
1968	20.7	-17.8	11.8	-14.3
1969	24.4	-18.7	9.9	-12.3
1970	30.0	-26.9	7.4	-15.5
1971	17.4	-9.4	12.3	-18.4
1972	21.2	-9.3	16.7	-18.8
1973	25.9	-17.8	10.4	-15.1
1974	20.5	-16.2	15.6	-16.1
1975	46.3	-19.5	0.2	-5.7
1976	59.6	-17.5	-0.4	-6.0
1977	92.4	-22.7	1.4	-1.2
1978	39.0	-32.3	6.1	-13.5
1979	31.1	-31.8	9.3	-33.8
1980	142.9	-30.2	-67.9	-40.7
1981	159.2	-55.0	-117.9	35.6
1982	91.7	-30.4	-126.3	29.8
1983	85.0	-48.7	-81.5	55.5
1984	100.0	-57.6	-100.2	55.1

If changes in trade barriers are effective they will shift trade away from items upon which the barriers fall and toward items for which barriers have remained fixed. If the hypothesis is true, that Central American countries are effectively restricting trade among themselves, then there should be a proportionate shift in import patterns. Countries effectively increasing restrictions on their imports from the Region should see that relatively fewer imports come from the region.

Tables 2.14 through 2.18 show, for each CACM country, total imports and imports from the U.S. They then show the proportion that imports from the CACM is of total and U.S. imports. If the proportion of imports from the CACM has fallen, it indicates that trade barriers within the CACM may have risen. At the bottom of the tables, the average proportion of CACM to total imports is shown, for the entire period and for 1975-84. For Guatemala, Honduras and El Salvador, the proportions of imports from the CACM are higher than they have been earlier, indicating that not only do we lack evidence of effective trade barriers, but on the contrary, that imports have tended to emphasize those coming from the CACM. In Costa Rica, the proportion of imports coming from other CACM countries has indeed fallen, but this is not a recent trend. The decline in proportional imports from the rest of the CACM seems to have started at least as long ago as 1972 and perhaps as far back as 1968. Thus, rather than indicating something new in Costa Rican trade restrictions, we seem to be seeing a continuous restructuring of Costa Rican imports. (Though as we note below, there are some new restrictions in the Costa Rican case.) In Nicaragua (Table 2.18), there has been a sharp reduction in imports from other CACM countries, but this is not necessarily due to Nicaraguan import barriers. Rather it is due to the response of Nicaragua's creditors, mainly Guatemala and Cost Rica, to Nicaragua's inability to pay for her imports. Both creditor countries have placed temporary restrictions on exports to Nicaragua until the latter can arrange payment.

Table 2.14

GUATEMALA IMPORTS

	<u>TOTAL</u>	<u>U.S.</u>	CACM AS % OF <u>TOTAL M</u>	CACM AS % OF <u>M FROM US</u>
1965	229.0	96.9	13.8	32.5
1966	207.0	86.6	16.4	39.1
1967	247.0	100.6	17.0	41.8
1968	249.0	102.1	16.5	40.4
1969	250.2	86.0	20.5	59.7
1970	284.3	100.4	22.9	64.7
1971	296.5	97.5	22.4	68.2
1972	324.0	104.7	21.3	65.8
1973	431.0	135.7	20.8	66.0
1974	700.5	222.9	17.4	54.8
1975	732.7	252.4	14.1	40.9
1976	838.9	305.7	12.7	34.8
1977	1052.5	366.9	10.0	28.7
1978	1285.6	386.2	16.2	53.8
1979	1503.9	484.4	17.5	54.4
1980	1598.2	551.8	13.6	39.5
1981	1673.5	565.9	11.6	34.3
1982	1388.0	432.3	15.5	49.8
1983	1056.0	347.3	20.4	62.1
1984	1153.2	N/A	19.5	
AVERAGE =			16.9	49.9
AVERAGE SINCE 1975 =			15.1	

Table 2.15

HONDURAS IMPORTS

	<u>TOTAL</u> <u>IMPORTS</u>	<u>FROM</u> <u>U.S.</u>	<u>CACM M AS %</u> <u>OF TOTAL</u>	<u>CACM M AS %</u> <u>U.S.</u>
1965	121.9	NA	20.9	ERR
1966	149.1	74.2	22.8	45.8
1967	164.8	79.1	24.8	51.6
1968	184.7	84.6	26.3	57.4
1969	184.3	79.6	23.8	55.2
1970	220.7	91.2	24.8	60.1
1971	193.4	91.1	8.4	17.9
1972	193.3	85.1	11.5	26.2
1973	262.3	107.2	12.4	30.2
1974	391.2	153.9	10.7	27.3
1975	400.1	170.9	12.9	30.3
1976	458.9	198.2	12.7	29.5
1977	579.4	248.7	12.3	28.6
1978	699.2	293.1	13.1	31.3
1979	825.8	358.1	11.8	27.3
1980	1008.7	426.0	10.3	24.3
1981	949.1	391.9	12.5	30.2
1982	700.5	273.5	12.4	31.7
1983	733.8	328.5	14.2	31.7
1984	814.0	NA	12.3	
AVERAGE =			15.6	35.6
AVERAGE SINCE 1975 =			12.5	29.4

Table 2.16

EL SALVADOR IMPORTS

	<u>TOTAL</u> <u>IMPORTS</u>	<u>FROM</u> <u>U.S.</u>	<u>CACM AS % OF</u> <u>TOTAL</u>	<u>CACM AS % OF</u> <u>U.S.</u>
1965	201.0	62.6	21.1	67.9
1966	220.0	71.5	23.7	72.9
1967	224.0	69.8	24.3	78.1
1968	213.0	61.8	31.0	107.0
1969	209.5	60.9	28.7	98.7
1970	214.4	63.3	28.3	95.7
1971	249.4	70.1	25.5	90.6
1972	278.4	76.3	26.6	97.1
1973	374.2	109.0	24.7	84.8
1974	563.5	173.8	20.8	67.5
1975	597.9	188.3	22.9	72.7
1976	718.0	205.1	23.7	83.1
1977	929.1	277.2	22.6	75.9
1978	1027.4	317.3	23.4	75.6
1979	1039.1	295.0	24.7	87.1
1980	961.7	194.2	33.3	165.0
1981	984.6	249.8	30.9	122.0
1982	883.0	320.9	30.2	83.0
1983	830.9	401.3	28.1	58.1
1984	898.3	N/A	28.2	
AVERAGE =			26.0	89.7

Table 2.17

COSTA RICA IMPORTS

	<u>TOTAL</u> <u>IMPORTS</u>	<u>IMPORTS</u> <u>U.S.</u>	<u>FROM CACM AS %</u> <u>OF TOTAL</u>	<u>FROM CACM AS %</u> <u>OF U.S.</u>
1965	178.0	NA	8.3	ERR
1966	178.4	69.6	13.3	34.1
1967	190.7	74.1	18.1	46.7
1968	213.9	80.9	23.0	60.7
1969	245.1	85.7	20.9	59.9
1970	329.1	110.3	20.8	62.2
1971	349.7	114.2	21.9	67.0
1972	372.8	123.0	21.3	64.6
1973	455.3	160.0	18.4	52.3
1974	719.7	248.3	15.8	45.9
1975	694.0	239.1	16.5	48.0
1976	770.4	266.6	17.6	50.9
1977	1021.4	343.7	16.4	48.9
1978	1165.7	374.9	17.4	54.1
1979	1396.8	425.2	15.1	49.8
1980	1540.4	503.8	14.3	43.6
1981	1208.5	402.7	12.6	37.8
1982	893.2	318.2	12.6	35.3
1983	991.5	396.3	12.1	30.3
1984	1105.0	NA	10.9	
AVERAGE =			16.7	49.6
AVERAGE SINCE 1975 =			14.6	44.3

Table 2.18

NICARAGUA IMPORTS

	<u>TOTAL</u> <u>IMPORTS</u>	<u>FROM</u> <u>U.S.</u>	<u>CACM AS % OF</u> <u>TOTAL</u>	<u>CACM AS % OF</u> <u>U.S.</u>
1965	165.0	75.4	13.0	28.5
1966	181.9	83.1	17.4	38.1
1967	202.4	87.6	20.9	48.3
1968	184.6	70.2	25.0	65.8
1969	177.0	67.0	23.8	62.8
1970	198.7	72.3	25.1	69.0
1971	210.4	69.7	25.5	77.0
1972	218.5	69.2	27.8	87.9
1973	327.0	112.5	27.5	79.9
1974	561.7	179.0	23.3	73.0
1975	516.9	167.7	21.8	67.1
1976	532.1	164.6	26.4	85.2
1977	762.0	219.7	21.6	74.8
1978	596.0	186.2	23.3	74.5
1979	360.2	91.0	30.8	122.1
1980	887.2	242.1	33.9	124.1
1981	999.4	202.5	22.4	110.7
1982	775.6	130.5	18.0	106.9
1983	778.1	145.1	15.9	85.2
1984	737.8	NA	11.2	
AVERAGE =			22.7	80.7

Table 2.19

	<u>CACM-N</u> <u>CACM-N IMPORTS</u>	<u>CACM-N IMPORTS</u> <u>AS % TOTAL</u>
1965	104.3	14.3
1966	128.6	17.0
1967	153.4	18.6
1968	178.9	20.8
1969	175.8	19.8
1970	199.1	19.0
1971	174.0	16.0
1972	187.9	16.1
1973	236.8	15.6
1974	310.4	13.1
1975	316.5	13.1
1976	364.5	13.1
1977	436.1	12.2
1978	593.0	14.2
1979	724.9	15.2
1980	786.5	15.4
1981	696.9	14.5
1982	626.7	16.2
1983	633.9	17.5
1984	654.2	16.5

Nicaragua so distorts the data that we have made up a summary Table 2.18, which shows total imports by the CACM-N as a percentage of their total imports. Generally the proportion rises, with the rise beginning in about 1973, and moving upward with small variance from year to year. In general, since the proportion of CACM-N imports is rising, there is indication that even if new trade barriers are in place, they have not had an effect on trade patterns.

The evidence reviewed above on the time path of trade shares among the countries of the CACM, and controlling for the effects of Nicaragua, do not lend credence to the notion that new trade barriers have hampered trade between the CACM countries. Instead, two other factors appear important in explaining the reduction in the level of trade. First, the reduction in real income in all the countries of the CACM which implied a reduction in the demand for imports from all sources, including the members of the CACM. Second, the pattern and movements of bilateral real exchange rates between the countries of the CACM (discussed in detail in Section 3 below), that implied an incentive for certain members with overvalued real exchange rates to run persistent deficits. However, given the expectations that the cumulative deficits and ensuing debt arrears were unlikely to be repaid over the foreseeable future, the creditor countries, justifiably, unilaterally decided to reduce the level of trade and trade credit.

We have prepared an appendix to this section to provide a synopsis and summary of the various restrictions on exchange and payments in each of the countries of the CACM since 1978. To read the tables note that in each case, we have summarized the existing state of restrictions and controls on payments for goods and invisibles, and on capital flows as of 1978, on the eve of the introduction of controls. For the following years we show the more significant changes that occurred.

These tables call forth following general comments:

1. In 1978, most of the countries had fairly non-restrictive trade and payment regimes, regarding capital flows and payments of invisibles in particular. However, the reliance in all the countries of the region on indirect taxation as a major source of government revenue also meant that taxes on imports and exports -- particularly non-traditional exports -- were an important item in the panoply of existing restrictions. Table 2.20 below shows the share of trade tax revenue (taxes on imports plus taxes on exports) in central government total indirect revenue for each of the CACM countries. The remarkable fact is that in all cases the share of indirect revenue arising from trade revenue has gone down. For the region as a whole the share has declined from 53.4% of indirect tax revenue in 1977 to 28.5% in 1983. This declining trend reflects the decline in trade and in the trade tax base relative to other indirect tax bases, and that some of the trade taxes are specific not ad valorem tax rates. Perhaps more important and significant is the implication that had trade barriers become more important we should have observed an increase in the share of trade taxes, not a generalized decline. Hence, this evidence does not support the notion that trade barriers have become more restrictive.

Table 2.20
Revenues From Trade Taxes As A Fraction Of
Indirect Tax Revenue (In Percent)
1977 - 1983

	<u>C.A.</u>	<u>Guatemala</u>	<u>Honduras</u>	<u>El Salvador</u>	<u>Costa Rica</u>	<u>Nicaragua</u>
1977	53.4	52.4	61.6	69.0	40.3	38.2
1978	48.7	51.1	61.9	57.6	39.1	31.2
1979	49.7	46.0	59.1	63.8	42.1	31.2
1980	45.6	46.3	60.4	54.7	38.3	34.3
1981	40.0	32.7	61.4	46.0	51.7	21.0
1982	33.5	24.9	53.3	42.4	54.0	16.0
1983	28.5	25.2	54.3	35.0	40.0	11.0

Source: SIECA, Series Estadísticas Seleccionadas de Centroamérica, No. 19, Diciembre, 1984.

2. Beginning in 1979/1980, nearly all the countries of the CACM introduced controls and restrictions on imports, invisibles, capital flows and to a less extent on exports. However, the important fact is that the restrictive measures introduced did not discriminate against the other CACM countries. Indeed, in most cases the other CACM countries were exempt from the newly introduced restrictions. For example, when Costa Rica slapped on a 30% surcharge on import duties and a temporary 10% to 15% import surcharge in 1978, and a temporary surcharge on imports in 1980, the CACM countries were exempt from these measures. It is easy to understand why the CACM countries did not attempt to impose restrictions on other member countries. The reason is that they would be more likely to retaliate than other countries outside the CACM. If Costa Rica imposes import surcharges on the exports of the industrialized countries, the latter are not likely to retaliate since Costa Rica represents a small proportion of their exports. However, the same would not be true for the other members of the CACM. Hence, correctly and rationally, the CACM countries typically exempted each other from import restrictions. Finally, it should be noted that by 1983/1984 restrictions (typically in the form of temporary licensing, administrative delays in processing applications and voluntary export restrictions) were imposed on intra-CACM trade. However, our discussions with the central banks indicate that these restrictions were intended to enforce bilateral balance with Nicaragua (and to a lesser extent El Salvador) and avoid the extension of trade credit and the further accumulation of trade payment arrears. Clearly, it does not make sense to export scarce real resources if the probability of repayment is close to zero, at least over the relevant horizon.

3. It is important to note that the controls introduced on trade payments, surrender of export and invisibles proceeds and the various restrictions on capital flows are symptomatic of countries with overvalued exchange rates. To be sure, the overvaluation of exchange rates viz a viz the rest of the world (which we discuss in more detail in Section 3 below) was not the only factor or cause leading to an excess demand for foreign exchange at the ruling official exchange rates.

Indeed, political development in the region probably played an important role in encouraging the enormous capital outflows experienced by all the countries in the CACM. Certainly, the politically-induced capital flight exacerbated incipient payments imbalances and led to further pressure which the monetary authorities attempted to stem through the various controls and regulations.

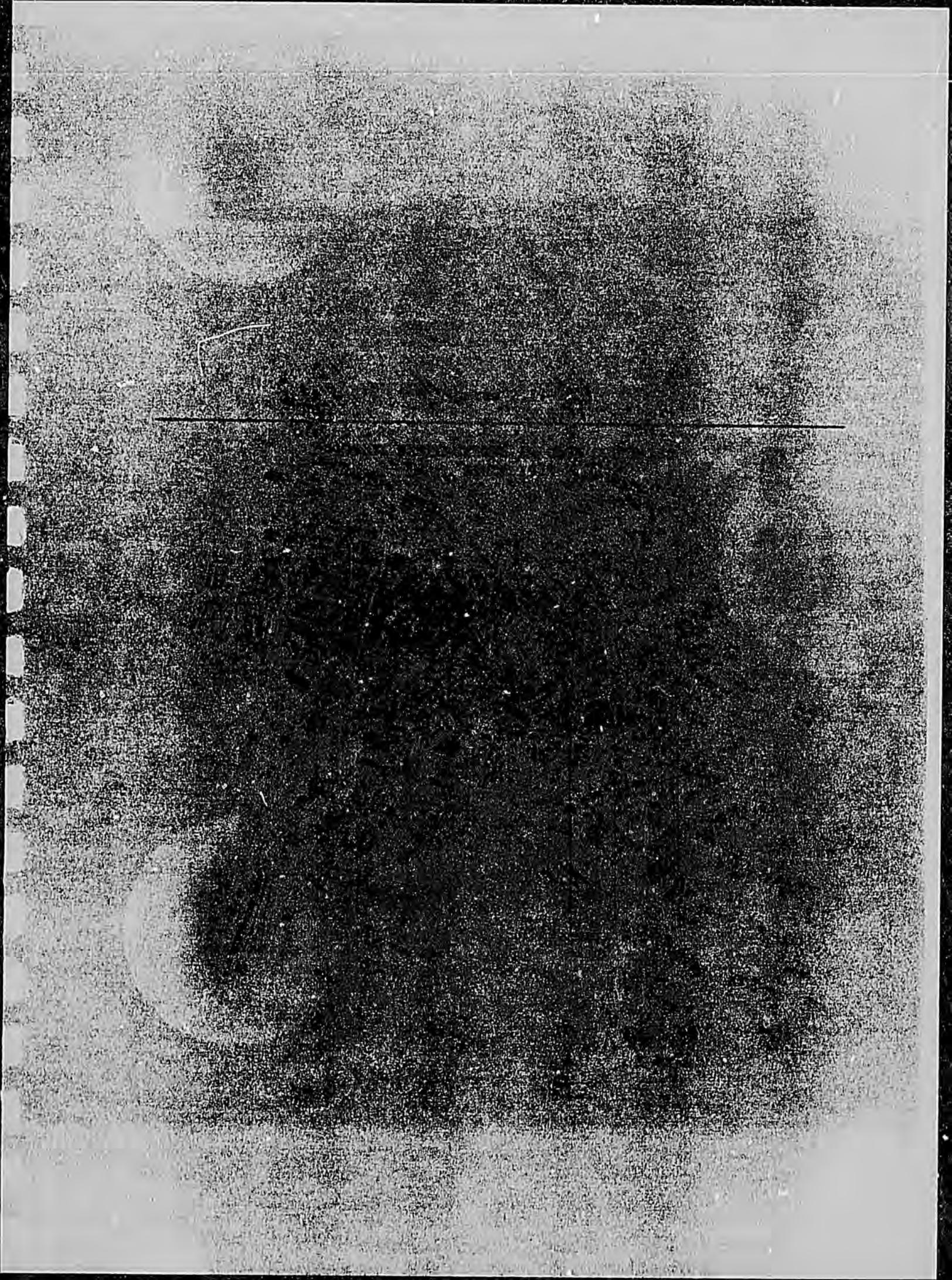


Figure 2.1

Costa Rica

Imports and Import Payments

	Import Control Mechanism		Surcharge or Advance Deposits	Foreign Exchange for Imports	Preferential Treatments
	Quotas	Licensing or Prohibition			
1978	None	Specific items	Stamp tax 3% of customs duty not covered by CET of CACM Ad valorem sales tax. 10% to 100% consumption tax on imports from outside CACM. 30% surcharge on applicable duty. Temporary 10% to 15% import surcharge.	Free	CACM origin goods exempt from 30% surcharge. CACM exempt from temporary surcharge.
1979	"	"	Exemptions from selective consumption tax	"	"
1980			Temporary 15% to 25% surcharges Advance import deposit from 10% to 50% ad valorem blocked for 6 months	50% of payments obtained at official exchange rate	CACM countries exempt from temporary surcharge
1981	"	Import licensing for CACM countries introduced and abolished	Deposit Requirements eliminated. Selective consumption taxes from 6% to 100% ad valorem introduced	nearly all imports at parallel market exchange rate	
1982	"	"	"	"	"
1983			10% sales tax. 1% general surcharge. 10% surcharge on capital goods from outside CACM and 12.5% on non-CACM consumer goods. 2% surcharge on capital goods from CACM		

Figure 2.1

Costa Rica

Exports and Export Proceeds

	<u>Taxes</u>	<u>Type of export Licenses</u>	<u>Repatriation or Surrender Requirement</u>	<u>Export Promotion</u>
1978	General	General and specific	Surrender Tax Credit (CAT) for non-traditional exports	Tax credit (CAT) 15% of fob value for non-traditional exports and 10% for increase in exports over previous year
1979	Cocoa sugar taxes modified	"	"	Fish products eligible for CAT's
1980	"	"	50% or proceeds surrendered at official rate	"
1981	10% exchange tax on proceeds from traditional exports. 5% exchange tax on non-traditional exports to CACM countries		Surrender within 15 days 9% of export proceeds surrendered at official rate lowered to 1% and gradually raised to 4% and 10%	"
1982	"		Surrender 5% at official rate, 10% at banking rate	"
1983			Surrender 1% at official 99% at banking rate	

Figure 2.1

Costa Rica

Treatment of Invisibles

	Approval of Authorization	Payments			Taxes	Proceeds Surrender Requirement
		Travel	Remittances	Profits		
1978	Approval	Yes	Yes	No	10% to 15% withholding tax on dividends and interest 5% travel tax	Yes specific exemptions
1979	"	"	"	"	"	Free
1980	"	"	"	"	"	"
1981		No forex at banking rate				
1982						
1983					1% stamp tax on most payments	

Figure 2.1

Costa Rica

Control on Capital Flows

	<u>Capital Outflows</u> <u>Types of Control</u>	<u>Borrowing</u>	<u>Capital Inflows</u> <u>Foreign Investment</u>
1978	Authorization	Free	Free
1979	"	Regulation of interest rates on forex deposits	"
1980	"	Registration of foreign capital entering at official rate to ensure access to that market for remittance of interest, profit amortization. To be eligible, capital must remain for at least two years	
1981	For external private payment arrears, central bank introduced system under which it would take the counterpart deposits in colones and in return issue negotiable CD's in US\$ of a maturity of three years, redeemable in 6 semestral installments.	"	
1982	"	"	
1983/84	"	"	

Figure 2.2

El Salvador

Imports and Import Payments

	<u>Import Control Mechanism</u>		<u>Import Surcharge Surcharge or Advance Deposits</u>	<u>Foreign Exchange for Imports</u>	<u>Preferential Treatment of CACM Imports</u>
	<u>Quotas</u>	<u>Licensing</u>			
1978	None	Specific approval for non-CACM imports	Advance deposit of 100% on CIF value for specific items. 10% prior deposit on value of advance payments. 30% surcharge on duty for non-CACM countries. Selective consumption tax (5% to 30%) on non-essential items	Free	Exempt from exchange controls
1979	None	Same	10% advance deposit on all imports	Approval	Same
1980	"	"	Prior deposit requirement raised from 100% to 200% for specific items. Increased coverage of 100% prior deposit scheme	"	"
1981			Imports of agricultural goods and industrial inputs exempt from 10% prior deposit		
1982	"	Specific imports prohibited	No change	All non-essential imports go through parallel market	
1983/84		Previously prohibited imports reauthorized		"	

Figure 2.2

El Salvador

Exports and Export Proceeds

	Taxes	Type of Export Licence	Repatriation or Surrender Requirement	Preferential treatment of CACM
1978	Coffee sugar	Specific Items	Surrender	None
1979	"	"	"	"
1980	"	Registration	"	"
1981	"	Registration tightened	Specific proceeds allowed through parallel market	"
1982	"	"	Proceeds from non-traditional exports to non-CACM sold to parallel market	"
1983/84	"	"	"	"

Figure 2.2

El Salvador

Treatment of Invisibles

	Approval or Authorization Required	Payments Limit on:					Proceeds
		Remittances	Travel	Profits Repatriation	Salary Transfers	Taxes	Surrender Requirement
1978	Approval	Yes	Yes	None	None	Sea, air 10% travel tax	Yes
1979	"	"	Reduced allowances	"	"	"	"
47 1980	"	Reduced	Reduced allowances	Authorization	Authorization	"	Surrender to central bank
1981	"	Reduced	"	"	"	"	"
1982							Proceeds to be sold in parallel market
1983/84	Payments not approved at official market rate except for specific items						

Figure 2.2

El Salvador

Controls on Capital Flows

	<u>Capital Outflows</u>	<u>Capital Inflows</u>	
	<u>Type of Exchange Control</u>	<u>Borrowing</u>	<u>Foreign Investment</u>
1978	Licenses required except for CACM investments	Approval	Registration to ensure free repatriation
1979	"	"	"
1980			
1981			
1982			
1983/84	Payments for repatriation through parallel market		

Figure 2.2

El Salvador

Prescription of Currency

1978 Payments to other members of the CACM must be settled in the
 currencies of those countries or in Salvador Colones through CACH.
 Payments to Mexico are also settled through CACH.

1979 No change

1980 No change

1981 .. No change

1982 No change

1983/84 No change

Figure 2.3

GUATEMALA

IMPORTS AND IMPORT PAYMENTS

	<u>Import Control Mechanism</u>		<u>Import Surcharge or Prohibition</u>	<u>Foreign Exchange for Imports</u>	<u>Preferential Treatment for CACM</u>
	<u>Quotas</u>	<u>Licensing or Prohibition</u>			
1978	None	Specific	30% surcharge on import duty for non-CACM	Free	Duty exonerations on raw materials and capital goods
1979	"	"	"	"	"
1980	"	General and specific	25% deposit guarantee	Licensed	"
1981	"	"	"	"	"
1982	Import quotas for 6 product groups. Allowances from 100% to 20% of 1981 levels. Non-discriminatory	"	"	"	"
1983/84	"	"	"	Purchase of sta- bilization bonds required to be eligible for forex licenses for foreign payments	Temporary licensing requirements on imports from CACM

Figure 2.3

GUATEMALA

Exports and Export Proceeds

	Taxes	Type of Export License	Repatriation or Surrender Requirement	Preferential Treatment of CACM
1978	Export taxes on traditional exports (coffee, cotton, sugar, beef, shrimp, bananas)	Specific items	None	No
1979		"	"	"
1980		General	Surrender within 3 months	Surrender within 6 months
1981		"	"	"
1982		"	"	"
1983/84	Schedule for gradual elimination of export taxes on traditional exports, spread over July 1983 to July 1985. Tax credit certificate nontraditional exports. Benefits up to 10% of fob value.	General plus licensing requirements for exports to CACM countries		

Figure 2.3

GUATEMALA

TREATMENT OF INVISIBLES

	Approval or Authorization Required	Payments Limits on:				Taxes	Proceeds Surrender Requirement
		Remittances	Travel	Profits	Salary Transfers		
1978	No	No	No	No	No	10% on international travel	No
1979	"	"	"	"	"	"	"
1980	Approval	Yes	Yes 10% refundable deposit on all purchases of foreign exchange	Yes	Yes 1/3 or 2/3 of salary	"	Yes
1981	"	Lower limits	25% deposit	"	Lower maximum limits	"	"
1982		Lower limits	50% deposit				"
1983/84	"	"	Foreign exchange for travel to CACM authorized		"	"	"

Figure 2.3

Guatemala

Controls on Capital Flows

	<u>Capital Outflows</u>		<u>Capital Inflows</u>
	<u>Type of Control</u>	<u>Borrowing</u>	<u>Foreign Investments</u>
1978	Free	Free	Approval for investment for construction of private housing
1979	"	"	"
1980	Approval registration of all foreign assets and liabilities precondition for authorizing remittances or profits, interest, dividends	Approval required	"
1981	"	"	"
1982	"	"	"
1983/84	"	"	"

Figure 2.3

Guatemala

Currency Prescription

1978	All exchange transactions must be carried through banks. Payments to and from CACM countries made in currency of country concerned through CACH.
1979	"
1980	"
1981	"
1982	"
1983	Bank of Guatemala restricted acceptance of Nicaraguan Cordobas to settlement of exports, and up to a specified portion of export receipts.

Figure 2.4

Honduras

Imports and Import Payments

	<u>Import Control Mechanism</u> <u>Licensing or Prohibition</u>	<u>Import Surcharge</u> <u>or Advance Deposit</u>	<u>Foreign Exchange</u> <u>for Imports</u>
1978	Specific licensing	Surcharge 10% of duty	Free
1979	"	"	"
1980	"	"	Approval for all non-merchandise imports
1981	Approval for specific categories	Import tax rate raised 10 percentage points for final goods and 5 percentage points for others	
1982	Import permits required for all items	Deposit guarantee requirement equivalent to 100% of transactions value	
1983/84	Licensing approval subject to fixed waiting time. Imports from CACM subject to prior authorization		

Figure 2.4

Honduras

Treatment of Invisibles

	Approval or Authorization Required	Payments					Proceeds Surrender Requirement
		Remittances	Travel	Limits on:			
	:	:		Profits	Salary Transfers	Taxes	:
1978	No	No	No	No	No	No	No
1979							
1980	Approval	Approval	Yes	Approval	Approval	Approval	
1981	"	"	"	"	"	"	Yes
1982	Authorization	Authorization	"	"	"	"	"
1983/84							

Figure 2.4

Honduras

Exports and Export Proceeds

	<u>Taxes</u>	<u>Type of Export</u>	<u>Repatriation or Surrender License Requirement</u>
1978	No	No	Repatriation
1979	1% of value except for coffee, minerals, meat, sugar	"	"
1980	"	"	Limited surrender
1981	"	General authorization	Surrender within 90 days
1982	"	"	"
1983/84	"	"	"

Figure 2.4

Honduras

Controls on Capital Flows

	<u>Capital Outflows</u>	<u>Capital Inflows</u>	
	<u>Type of Control</u>	<u>Borrowing</u>	<u>Foreign Investment</u>
1978	Authorization for receipts and payments relating to investments in mutual funds, real estate or seminar activities	Approval Reserve requirement of 40% on foreign liabilities of commercial banks	Free
1979		Reserve requirement raised to 45%	
1980	"	"	"
1981	"	Reserve requirement reduced to 30% on sight and term deposits, and 20% on certificates of deposit	"
1982	"	"	"
1983/84	"	Commercial banks must surrender on a daily basis 30% of previous day's forex purchases	"

Figure 2.4

Honduras

Prescription of Currency

1978	Payments to other CACM countries with respect to trade and invisibles may be settled in Lempiras through CACH
1979	"
1980	"
1981	"
1982	Monthly quotas on amount of Lempira notes that could be purchased by other CACM Central Banks
1983/84	All Lempira denominated payments greater than L.1,500 processed through CACH with respect to trade require prior authorization

Figure 2.5

Nicaragua

Imports and Import Payments

	Licenses	Import Control Mechanism Quotas	Import Surcharge or Advance Deposit	Foreign Exchange for Imports	Preferential Treatment for CACM
1978	Commerical and industrial importers registered		Imports from non-CACM subject to 30% import surcharge on on applicable duty. Selective consumption tax. 8% general sales tax. 2% municipality tax	Authorization according to list of priorites. Other imports through parallel market	
1979	List of priority imports established		50% of merchandise imports subject to 100% of CIF prior import deposit for 60 days, earning interest	All sales temporarily prohibited	
1980	"		"	"	
1981			Taxes from 30% to 100% on imports of luxury goods. Advance deposit requirement abolished		
1982				Tax of C5 per U.S. \$1 on purchases of foreign exchange for non-essential imports	
1983/84					

Figure 2.5

Nicaragua

Exports and Export Proceeds

	<u>Taxes</u>	<u>Type of Export License</u>	<u>Repatriation or Surrender Requirement</u>
1978	coffee, cotton, cattle	3 categories: - Specific authorization - General authorization - No authorization	Surrender of most proceeds within 30 da
1979		Ministry of Foreign Trade affects exports of coffee, cotton, meat, sugar	
1980	Graduated tax on exports of coffee, cotton, meat		Surrender in 20 days
1981			
1982	Ad valorem export tax rates lowered		
1983/84			

Figure 2.5

Nicaragua

Treatment of Invisibles

	Approval or Authorization Required	Payments				Taxes	Proceeds from Invisibles Surrender Requirement
		Remittances	Travel	Limits on: Profits	Salaries		
1978	Authorization. Other may be made at parallel rate	Yes	Yes	Yes	Yes		Surrender at official rate for certain items others at free rate
1979	"	"	Reduced	"	"		"
1980							
1981							Restriction on categories sold in parallel market
1982							
1983/84	Authorized purchases allowed at parallel rate						Tourism charges paid in U.S.\$

Figure 2.5

Nicaragua

Controls on Capital Flows

	<u>Capital Outflows</u>	<u>Capital Inflows</u>	
	<u>Type of Exchange Control</u>	<u>Borrowing</u>	<u>Foreign Investment</u>
1978	Authorization Proceeds converted at official rate	Approval	Approval provides repatriation guarantee
1979			All foreign banks nationalized
1980	All financial institutions consolidated into 5 banks administered by state-owned Corporation Financiera Nacional	Authorization	
1981			
1982			
1983/84			

Figure 2.5

Nicaragua

Currency Prescription

- 1978 Payments to CACM countries may be settled in Nicaraguan Cordobas through CACH. Central bank does not accept banknotes of El Salvador for compensation through CACH in excess 400,000 S.Colones a month.
- 1979 No change
- 1980 No change
- 1981 No change
- 1982 Member countries of CACM agree to accept payment in local currencies for local trade.
- 1983/84 For compensation through CACH Central Bank does not accept notes of El Salvador in excess of 100,000, of Guatemala in excess of Q200,000, of Honduras in excess of L50,000 a month.

Section 3: NOMINAL AND REAL EXCHANGE RATES
IN THE CACM COUNTRIES, 1965-1984

This section examines the evolution of nominal and real exchange rates in the CACM region over the twenty year period 1965-1984. A historical perspective is important in judging whether and to what extent there is a divergence between observed nominal and real exchange rates on the one hand, and some measure of equilibrium exchange rates. Further, examination of the historical record allows one to gain a perspective on whether observed current movements in exchange rates are a temporary phenomenon or reflect more permanent, trend-like movements.

The major questions/issues addressed in this section are.

(a) To what extent are nominal exchange rates among the CACM misaligned, leading to under or over-evaluation of currencies, and imply movements in real exchange rates that distort incentives in intraregional trade?

(b) What are the required changes in the set of nominal exchange rates that would help correct any existing misalignments?

(c) What has been the evolution of bilateral and effective (that is, multilateral) exchange rates following the large monetary, real and political disturbances occurring in the region since 1977/78? Further, what qualitative movements in real rates (between countries in the CACM and relative to the rest of the world) are required to adjust and help correct the pattern of intra-regional and extra-regional payments imbalances that have arisen since 1978?

To address these issues, we begin by examining the evolution of nominal exchange rates over the period 1965-1984.

Nominal Exchange Rates, 1975-1984

Table 3.1 below contains data on bilateral rates for each of the CACM countries relative to the U.S. dollar over the period of generalized floating since 1975. For the recent period, 1979-1984, the table shows both the official rates and some data on exchange rates in the parallel or black markets that have emerged since 1979 following the virtual suspension of currency convertibility and/or the institution of controls on trade and capital account payments.

There are several features of this table that deserve comment. First, three countries (Guatemala, Honduras and El Salvador) have maintained an official fixed peg to the U.S. dollar, while Nicaragua has devalued twice (1979, 1980), and Costa Rica has maintained a more exotic multiple exchange rate system. It is important to note that maintaining a fixed peg to the U.S. dollar also means floating rates against all other currencies. Thus, although the CACM countries (Costa Rica being the exception) have maintained fixed dollar rates (and consequently fixed cross-rates among themselves), the currencies have effectively been floating along with the U.S. dollar against other major currencies. This is an important observation since it implies (again with the exception of the Costa Rica Colon) the the CACM currencies depreciated along with the U.S. dollar through the period 1973-1980, but followed through accompanying the more than 30% nominal appreciation of the U.S. dollar against all major currencies from 1980 to 1984. As the bottom row of Table 3.1 shows, the U.S./SDR rate hit a peak in 1980 at \$1.30 and then strongly appreciated over the following four years to reach a low of \$1.02 in 1984. The relevant implication of this fact for the CACM countries is that to the extent that the nominal exchange rate appreciation implied an appreciation of real exchange rates versus extra-regional trading partners, it implied a loss of competitiveness in international trade.

Second, all the currencies are trading at a discount relative to the U.S. dollar in the unofficial parallel markets. As the table shows the premium on the dollar has varied from country to country, but all the premia have been large and display a tendency to increase over time. The

Table 3.1

Ti-----Paths of Nominal Exchange
Rates, 1975-1984 in the CACM Countries

(Domestic currency per U.S. dollar; period averages)

<u>Country</u>		<u>Year</u>									
		<u>1975</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
<u>Guatemala</u>	Official	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
	Parallel	n.a.	n.a.	n.a.	n.a.	1.05	1.24	1.26	1.20	1.23	1.30
	Premium (Par./OH.)%	--	--	--	--	5	24	26	20	23	30
<u>El Salvador</u>	Official	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
	Parallel	n.a.	n.a.	n.a.	n.a.	3.26	3.68	5.85	4.27	3.70	4.38
	Premium (%)	--	--	--	--	30.4	47.2	134.0	70.8	48.0	75.2
<u>Honduras</u>	Official	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
	Parallel	n.a.	n.a.	n.a.	n.a.	2.17	2.31	2.42	2.27	2.71	2.80
	Premium (%)	--	--	--	--	8.7	15.5	21.0	13.5	35.5	40.0
<u>Nicaragua</u>	Official	7.026	7.026	7.026	7.026	9.255	10.05	10.05	10.05	10.05	10.05
	Parallel	n.a.	n.a.	n.a.	n.a.	11.30	16.9	36.17	43.25	46.0	134.5
	Premium (%)	--	--	--	--	22.1	68.16	260.0	330.3	357.7	1238.0
<u>Costa Rica</u>	Official	8.57	8.57	8.57	8.57	8.57	8.57	8.95	20.2	20.25	--
	Interbank						9.55	19.37	38.69	41.50	--
Memo item:											
U.S./SDR rate		1.214	1.154	1.167	11.25	1.292	1.301	1.179	1.104	1.069	1.021

existence of parallel markets for foreign exchange is the counterpart of government-imposed foreign exchange controls, and reflects the excess-demand for foreign exchange. Note that the dollar premia displayed a tendency across currencies, to rise in 1981 and 1984, reflecting political developments and -- as we shall see below -- adverse developments in domestic inflation rates in real economic activity relative to the experience in the U.S. Further, the gradual tightening of controls on foreign exchange transactions that has taken place in most of the countries since 1980, has reflected itself in the higher premia on the U.S. dollar. Certainly, the parallel market exchange rates are an indicator -- albeit an imperfect indicator -- of the extent of over-valuation of the CACM currencies. From this vantage point the policy changes in Guatemala (and to a lesser extent in El Salvador) of quasi-legalizing the parallel markets and allowing a larger flow of payments through these markets should be viewed as a necessary and healthy move that should help correct past payment imbalances. To illustrate this, consider the price of the SDR basket of currencies (representing currencies of countries that are important trading partners for the CACM countries) in terms of Quetzals at the official and parallel market rates.

Table 3.2

	<u>Quetzal/SDR/Rate</u> <u>(Annual Averages)</u>				
	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Official	1.301	1.179	1.104	1.069	1.021
Parallel	1.613	1.485	1.325	1.315	1.327

Source: Table 3.1

At the official rate the price of the SDR declines by more than 24% over 1980-84, and by 19% at the parallel rate, reducing the otherwise large appreciation of the Quetzal versus currencies outside the CACM region. Further, the parallel rates offer an indicator of the over or undervaluation of currencies within the CACM region. It is clear the the situation that prevailed prior to 1978 no longer corresponds to current economic conditions and that a realignment of exchange rates is necessary within the CACM.

In sum, for all the countries maintaining a fixed peg to the U.S. dollar a parallel or black market for foreign exchange has surged into existence. There have been large and variable premia on the U.S. dollar suggesting an excess-demand for foreign exchange and an over-evaluation of the official exchange rates. The important policy conclusion is the the CACM countries require an adjustment of their parities versus the U.S. dollar and major currencies, and that there is a need for a realignment of parities and exchange rates between the CACM currencies.

Bilateral Real Exchange Rates

Turn now to examine the evolution of real exchange rates. There are a wide variety of definitions of "the" real exchange rate. Essentially, the basic idea is to correct the nominal exchange rate for movements in domestic and foreign prices. Let E denote the nominal (spot) exchange rate defined as the domestic currency price of the foreign currency, P the domestic price (an index) of a bundle of domestic goods and P^* the foreign price (index) of a bundle of foreign goods. The real exchange rate is defined as $RER = (EP^*/P)$, or the price of the foreign bundle of goods expressed in domestic currency relative to the price of the domestic bundle of goods. Thus, suppose that the domestic currency price of the U.S. dollar is equal to 2, the price of a U.S. bundle is \$15, and the domestic price of the domestic bundle is 30, then the real exchange rate is $(EP^*/P) = (2 \times 15/30) = 1.0$. Now suppose the nominal exchange is devalued to 2.5 domestic currency units per \$ while prices are unchanged. Then the real exchange rate becomes $RER = (2.5 \times 15/30) = 1.25$. The RER has gone up, and the price of the U.S. bundle of goods has increased by 25% compared to the home bundle of goods. Typically, rather than prices, we use index numbers, with given base years. So in our example, the domestic and U.S. price bundles might be (on a base, say, of 1978 = 100), $P^* = 100$ and $P = 200$, so the real exchange would be $RER = (2 \times 100/200) = 1.0$. The important thing to recall is that an increase in the RER means an increase in the relative price of foreign goods, while a fall in the RER means a decline in the relative price of foreign goods, which would appear cheaper than domestic goods.

With rigidly fixed nominal exchange rates, movements in the RER are entirely due to movements in the domestic and foreign price levels. The RER for the domestic economy would fall (appreciate) or rise (depreciate) according to whether the inflation rate at home is higher or lower than the inflation rate in foreign countries. With floating exchange rates or adjustable nominal exchange rates, changes in the RER are attributable to both nominal exchange rate fluctuations and to movements in relative prices. The empirical evidence for the major industrial countries over the floating rate period 1973-1984 clearly suggests that monthly, quarterly and annual changes in RER's are dominated by movements in nominal exchange rates and not by changes in relative prices. Nominal exchange rates tend to show much more volatility than the stable behavior of relative prices.

For the CACM countries that have maintained fixed exchange rates vis a vis the U.S. dollar, it is clear that bilateral RER changes will be attributable to movements in relative prices. However, for Costa Rica over 1981-1984, both nominal exchange rate changes and relative price level movements will contribute to RER fluctuations.

Measures of RER's obviously depend on a choice of measures of prices. It is well known that published price indexes (whether consumer price index, CPI, wholesale prices, WPI, or implicit GDP price deflators, PGDP) are typically, though not strictly, comparable across countries. The non-comparability arises for a variety of reasons, including differences in the coverage of goods and services, the frequency of observation and collection, differences in weighting patterns across countries and over time, price controls and taxes, public sector goods, etc. For the purposes of this study the price measures used were dictated by the need to use price measures that would be broadly comparable across the five countries of the CACM. This necessity dictated the choice of the CPI and the PGDP. Further, for the purpose of price level comparisons with the U.S. on a bilateral basis, we have used the U.S. WPI since it is the most representative of traded goods prices.

Prior to examining the evolution of bilateral real exchange rates, it is useful to consider some summary data for price inflation rates in the CACM countries, Table 3.3 below shows average annual inflation rates for each of the CACM countries based on alternative price measures. In addition to published data on the CPI and the PGDP, we have also constructed an alternative, a general implicit price level, IGPL. The latter was obtained as the ratio of the broad measure of the money stock (Money plus Quasi-Money) per unit of real output. The basic idea underlying the IGPL measure is that an increase in the money stock raises nominal aggregate demand, and given real aggregate supply will tend to put upward pressure on the general level of prices. The empirical evidence from a large number of countries shows that sustained inflation is nearly always accompanied by a rise in the money stock per unit of output. Further, the IGPL is a highly useful indicator of inflation for cases in which published data on prices suffers from various inadequacies such as under-reporting, non-representative weighting patterns, suppressed inflation and price controls, etc.

(There are two objections to the use of the IGPL. One is that increases in the money stock need not show up during the same period of measure as increases in the price level; that is, there may be a lag in the effect of money on prices which is longer than the period of analysis. The results below are based on annual data using an average of end-of-period money stocks.¹ This procedure should minimize measurement problems arising from a lagged impact of money on prices. The second objection arises for cases in which there are large, sustained changes in the income velocity of money. This could be due, for example, to technical progress in the transactions and payments technology, or over long time-spans when countries are systematically evolving away from barter payments systems to a money-exchange economy. However, in the case of the CACM countries and over the period of analysis, such trend-like changes in velocity would not appear to present a problem for the use of the IGPL indicator. In the final analysis, the proof of the pudding is in the eating, and as we shall see below, the evolution of the IGPL is consistent with that of the other price measures and yields interesting results.)

1. The exact definition of the IGPL for any particular year, t , is, $IGPL_t = (BM_{t-1} + BM_t)/2Y_t$ where BM_{t-1} and BM_t refer to the broad measure of the money at the end of year $t-1$ and t , and Y_t denotes output at constant prices for year t .

Table 3.3
Inflation Rates in The
CACM Countries, 1972-1984
(Growth Rates, % Per Year)

<u>Country/Price Measure</u>		<u>Period</u>		<u>Year</u>					
		<u>1972-78</u>	<u>1978-84</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984*</u>
<u>Guatemala</u>	CPI	11.7	7.6	10.9	10.2	10.8	4.9	6.2	2.4
	PGDP	12.0	6.7	8.2	9.5	8.2	5.0	6.1	3.2
	IGPL	13.2	8.5	5.6	5.0	10.1	16.6	8.6	5.2
<u>Honduras</u>	CPI	7.0	9.9	11.8	14.5	9.7	9.5	9.1	4.7
	PGDP	9.0	6.7	7.2	10.1	5.0	7.9	5.0	5.2
	IGPL	11.0	10.5	6.4	5.2	7.0	15.7	17.6	10.7
<u>EL Salvador</u>	CPI	11.6	13.0	13.7	16.0	13.8	11.1	12.4	10.9
	PGDP	10.9	10.2	13.1	12.5	5.5	9.4	9.1	11.6
	IGPL	12.3	14.5	11.7	15.7	16.1	19.4	12.4	11.8
<u>Costa Rica</u>	CPI	11.6	26.8	8.9	16.6	31.5	64.2	28.2	11.3
	PGDP	15.9	26.1	8.8	17.2	34.4	61.0	23.6	11.8
	IGPL	22.2	26.6	20.6	13.8	26.0	53.1	35.0	11.4
<u>Nicaragua</u>	CPI	10.3	28.1	39.3	30.2	21.4	22.1	27.0	28.2
	PGDP	10.2	21.8	32.4	31.6	11.1	15.3	13.7	26.6
	IGPL	11.4	36.7	40.6	31.6	34.7	27.6	29.3	56.5
<u>U.S.</u>	WPI	9.4	6.6	11.8	13.1	8.7	2.1	1.3	2.4
<u>CACM</u>	CPI	11.0	15.4						
	PGDP	12.1	13.2						
	IGPL	14.5	17.0						
<u>Max-Min</u>	CPI	4.6	20.5	30.4	20.0	21.8	59.3	22.0	25.8
	PGDP	6.9	19.4	25.2	22.1	29.4	56.0	18.6	23.4
	IGPL	11.2	28.2	35.0	26.6	27.7	37.4	26.4	51.3

* Provisional data

SOURCE: IMF, International Financial Statistics and SIECA.

There are several features of table 3.3 requiring comment. First, the average inflation rate in the region as a whole (see the rows referring to the CACM) and for all countries except Guatemala (Honduras' record is mixed) has risen over the subperiods 1972-78 and 1978-84. This contrasts with the experience of the U.S. and that of most other industrialized countries. Further, the fact that inflation rates in the CACM countries have exceeded the U.S. rate over 1978-84 implies an appreciation of bilateral real exchange rates relative to the U.S. dollar, unless corrected for by a devaluation or a depreciation of nominal exchange rates. However, as Table 3.1 demonstrates only Costa Rica (and Nicaragua in 1978 and 1979) has taken the course of allowing a depreciation of the nominal exchange rate.

Second, the cross-country differences in inflation rates have more than doubled between the highest and lowest inflation rate country (bottom rows in the table). Using the CPI inflation rates the difference between highest and lowest has risen from an average level of 4.6% per year to more than 20% per year, a fourfold increase. Further, as the annual differences show, the variance of inflation rates across countries does not show any tendency to decline over time. The important implication and policy conclusion is that it is neither feasible nor desirable to attempt to maintain fixed exchange rates between the countries of the CACM in the face of widely varying inflation rates and the absence of any long-term convergence of inflation rates. Attempting to maintain fixed exchange rates under such conditions only leads to the emergence of wide and growing payments imbalances among the countries of the region. Indeed, other things equal -- in particular, absent adjustment of nominal exchange rates and foreign exchange controls -- the observed differences in inflation rates would lead us to predict that a relatively low and stable inflation country such as Guatemala would tend to run a balance of payments surplus with other CACM countries, whereas Nicaragua would tend to run a deficit. Below, we note that the time path and pattern of real exchange rates among the CACM countries goes a long way in explaining the pattern and evolution of trade payments that has emerged since 1979.

Third, there are substantial differences in inflation rates depending on the price measure used. Typically, over long periods of time it does not matter which price measure is used to calculate inflation rates. However, over the short and medium-run differences can be substantial. For the CACM countries and during the relatively high inflation period 1978-84, the PGDP based inflation rate is systematically lower than either the CPI or IGPL based inflation rates for all the countries of the region. It appears that PGDP based inflation rates are not reliable as indicators of inflation rates. In the remainder of this report, we shall use the CPI and the IGPL inflation rate measures. Note also that in cases where the reliability of the CPI is in doubt (for Nicaragua and El Salvador in particular), the IGPL would tend to provide a more accurate indicator of inflation trends.

Turn now to the implications of cross-country inflation differentials for the time path of bilateral real exchange rates in Table 3.4 and based on the official exchange rates. (Tables 3.8 through 3.17 at the end of this section show individual country bilateral real rates for the alternative price measures).

The bilateral RER's relative to the U.S. dollar suggest a number of important conclusions. First, relative to 1978, all the currencies in the CACM except for the Costa Rica Colon have appreciated in real terms, with the largest real appreciations occurring in Nicaragua and El Salvador. For example, in 1978 it took 1 Quetzal to purchase \$1 worth of U.S. goods and services. But, by 1984 it cost only Q.0.89 to purchase the same dollar's worth of goods. For the extreme case of Nicaragua, it costs Cordobas 7.03 to buy \$1 worth of U.S. goods in 1978. By 1984 the relative cost had fallen to C 1.64. Given the time path of real exchange rates in Table 3.4 we should expect -- other things equal -- that the countries with appreciating real exchange rates would tend to run balance of trade deficits.

Table 3.4
Bilateral Real Exchange Rates
vs the U.S. dollar
1965-68, 1978-1984

		<u>1965-68</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
RQ/\$	IGPL	1.40	1.00	1.06	1.15	1.14	0.98	0.91	0.89
	CPI	1.03	1.00	1.00	1.04	1.02	0.99	0.94	0.94
RL/\$	IGPL	3.02	2.00	2.11	2.28	2.32	2.03	1.70	1.58
	CPI	1.68	2.00	2.00	1.97	1.95	1.81	1.68	1.64
RCRC/\$	IGPL	18.50	8.57	7.85	7.80	16.65	17.20	13.49	13.35
	CPI	7.62	8.57	8.83	8.52	17.22	15.91	13.35	13.23
RSC/\$	IGPL	3.10	2.50	2.50	2.44	2.25	1.91	1.70	1.55
	CPI	2.56	2.50	2.45	2.38	2.26	2.07	1.85	1.70
RNC/\$	IGPL	8.42	7.03	6.94	6.26	4.83	3.74	2.83	1.64
	CPI	6.65	7.03	7.03	6.44	5.67	4.64	3.58	2.77

NOTE: A rise in the value of the real exchange rate indicates a depreciation, while a fall indicate an appreciation.

SOURCE: See Tables 3.8 to 3.12

Second, with the period 1965-68 taken as a benchmark all the countries including Costa Rica have had large real exchange rate appreciations. Consider two cases at each end of the spectrum, Guatemala and Nicaragua. By 1984, the RER for Guatemala had appreciated by 11% (IGPL basis) relative to 1978 and by 36% relative to its average value over 1965-68. Although these would indicate an overvaluation of the Quetzal/\$ exchange rate, the required adjustment pales by comparison to Nicaragua. By 1984, the RER for Nicaragua had appreciated by 76.7% relative to its 1978 value and by over 80% relative to the 1965-68 average (IGPL base).

Third, the only country that has actively sought to adjust its nominal exchange rate since 1980, Costa Rica, was only moderately successful in reversing the large overvaluation of its exchange rate. Although the successive devaluations of the Colon since 1981 have led to a real depreciation (rise in the RER) relative to the 1978 value, the RER remains lower than the 1965-68 average, implying a continuing overvaluation. The large 1982 devaluation of the Colon brought the RER to about 93% of its 1965-68 value. However, despite further devaluations, the high domestic inflation rate relative to the U.S. rate led to an appreciation of the RER so that by 1984, the RER was 72 % of the 1965-68 average.

Fourth, the data in Table 3.4 also indicate how bilateral real exchange rates have evolved within the CACM region,¹ and help explain the pattern of payments imbalances that has evolved since 1979. Consider the case of Nicaragua which has been running large trade balance deficits with Guatemala and Costa Rica. The values of the Nicaraguan real exchange rate with the Quetzal and the Colon since 1978 are as follows:

1. See the time paths of RER;s in Tables 3.9 to 3.18 at the end of this section.

Table 3.5

Nicaragua/Bilateral RER
with Guatemala and Costa Rica
1978-1984

	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
RNC/Q	7.03	6.52	5.42	4.24	3.80	3.09	1.85
RNC/CRC	0.82	0.88	0.80	0.29	0.22	0.21	0.12

SOURCE: Table 3.12 IGPL based RER.

From the Nicaragua vantage point the relative costs of Guatemalan goods has fallen from C.7.03 to C.1.85, or by an average rate of 22.3% per year, while the relative price of Costa Rican goods has been falling at an average annual rate of 32% per year. There is no magic in the fact that Nicaragua has been running large trade deficits with Guatemala and Costa Rica. Even in the absence of other contributing factors the enormous appreciation of the Córdoba real exchange rate implied a large incentive to run trade deficits.

Finally, the data in Table 3.4 also provide indicators of possible changes in parities that would help in correcting payments imbalances. As an example of this, Table 3.6 contains the hypothetical values of the nominal exchange rates (domestic currency units per U.S. dollar) that would have maintained real exchange rates close to their 1965-68 average values. Thus, by 1984 the the Q/\$ rate would have to be about 1.57, the Costa Rica Colon at about 62, while the Córdoba would be at 51.5. These of course are merely indications of the suggested parity changes. Arriving at "equilibrium" exchange rates would require further analysis of the trade and balance of payment patterns, as well as projections of the time paths of a number of variables such as government budget deficits and finance, the terms of trade, real income and the evolution of domestic credit and interest rates.

It is of interest to note that the hypothetical values of the exchange rates in Table 3.6 are close to the values of the parallel market exchange rates (See Table 3.1) for Guatemala and Costa Rica, the two countries that have allowed these markets to emerge. It is difficult to directly relate the exchange rates on the parallel markets with the theoretical values in Table 3.6 because of the existence of foreign exchange controls, and to the extent that the parallel rates incorporate participants' expectations of the future course of economic conditions. However, the broad concordance of the theoretical values with the parallel rates is consistent with the notion that the CACM currencies are overvalued relative to the U.S. dollar, and that a realignment of parities within the region is necessary. For example, by 1984, the value of the other currencies in terms of the Quetzal would be (on the basis of the cross-rates implicit in Table 3.6). $Q/L = 0.41$, $Q/CRC = 0.025$, $Q/SC = 0.31$, $Q/NC = 0.03$. Note that these would all imply a nominal appreciation of the Quetzal compared to official parities, even though the Quetzal would depreciate against the U.S. dollar.

In summary, the time path of real exchange rates in the CACM countries since 1978 suggests two important policy conclusions.

A. At the current official exchange rates, all the currencies of the CACM region appear over-valued relative to the U.S. dollar. The results of our simple theoretical exercise imply substantial devaluations for all the countries, in particular for Nicaragua and El Salvador. (See Table 3.6).

B. The exchange rates of the currencies within the CACM are misaligned. The failure of Nicaragua, El Salvador and Honduras to realign their parities against Costa Rica and Guatemala has implied large appreciations of their real exchange rates and is the major reason for the emergence of large trade and payments imbalances for these countries. It is a matter of some urgency that official parities are realigned and/or that "parallel" markets be allowed to operate without constraints and with the largest possible share of total payments flows. Unless a move in this direction is effected the pattern of payments imbalances observed in the recent past will tend to persist and, indeed, the problems are highly likely to increase in intensity and severity.

Table 3.6

Hypothetical Values of Nominal
U.S. \$ Values Maintaining Constant
1965-68 Real Exchange Rates (IGPL Base)
1978-1984

	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Q/\$	1.40	1.32	1.22	1.23	1.43	1.54	1.57
L/\$	3.02	2.86	2.65	2.60	2.97	3.51	3.82
CRC/\$	18.5	20.2	20.3	24.2	33.8	56.4	61.7
SC/\$	3.10	3.10	3.18	3.43	4.06	4.56	5.00
NC/\$	8.42	11.20	13.51	17.51	22.68	29.9	51.47
MEMO ITEM:							
<u>DM/\$</u>	<u>2.009</u>	<u>1.833</u>	<u>1.818</u>	<u>2.260</u>	<u>2.427</u>	<u>2.553</u>	<u>2.848</u>

SOURCE: Table 3.4

Nominal and Real Effective Exchange Rates

The discussion above has focused on the time path of bilateral nominal and real exchange rates. It is also useful to consider the evidence from multilateral nominal and real exchange rates. It is also useful to consider the evidence from multilateral or effective nominal and real exchange rates, NEER and REER respectively. Essentially, the nominal effective rate is the price in domestic currency of a relevant basket of foreign currencies, just like a price index is the price of a basket of goods and services. Considering the price of a basket of currencies avoids possible pitfalls or hasty conclusions based merely on the price of a single bilateral exchange rate. One does not want to conclude that the price

inflation rate is, say, 50% per year merely because the price of one particular good has risen by 50%. Similarly, one does not want to conclude that the domestic currency is heavily overvalued in the foreign exchange market merely because it appears overvalued relative to one specific currency. Thus, in the case of the CACM countries, one has to be careful in concluding that the currencies are generally overvalued merely because they appear overvalued relative to the U.S. dollar. It is for this reason that effective exchange rates are useful indicators.

Further, the NEER and REER have to be "relevant" prices of baskets of currencies. Obviously what the price of the Fiji dollar is doing on the foreign exchange market is irrelevant to the CACM countries if there is no trade in goods, services or assets with the Fiji Islands. This raises two methodological issues. Which currencies enter the basket of relevant currencies, and what weight should be attached to the chosen currencies? These questions are identical to those that arise when one is constructing, say, the Consumer Price Index, and deciding on the coverage of goods and services and the weighting pattern.

For the purpose of this report we have chosen to weight currencies according to their share in a country's exports. Hence, if the U.S. represents 25% of total Guatemalan exports, the weight of the U.S. dollar in the Guatemalan NEER or REER is 0.25, and so on for other countries. For each of the CACM countries, the relevant currencies chosen represent over 80% of total exports. It should be added that other weighting schemes could have been chosen, such as imports shares, or total trade shares. However, for our purposes the export share weights appear the most relevant since they are more closely related to the competitiveness of the CACM countries in regional and extra-regional trade. Finally, a choice has to be made whether to use fixed weights or variable weights over time. Variable weights have the advantage of being more representative of evolving trade patterns,

just as changing weights in the CPI would generally represent a more accurate representation of expenditure shares. The disadvantage is that export shares may randomly change from year to year because of exogenous events totally unrelated to competitiveness, such as natural catastrophes, strikes, etc. We have experimented with both moving and fixed weights. The major tenor of the results is not sensitive to this methodological choice. Here, we shall report the results of using the fixed weights scheme. (Tables 3.18 to 3.22 at the end of this section contain the country by country tables for alternative price measures).

The formula for the nominal effective exchange rate, NEER, which we shall denote E (to distinguish it from the bilateral exchange rate) is, $E = \sum (\theta_i E_i)$, that is, the weighted sum of the domestic currency prices of each of the foreign currencies. The weights θ_i are the exports shares, and sum to one. A country with a high share of our export receives a large weight, contributing more substantially to movements in the nominal effective exchange rate. At the limit if all our exports went to one country, there would be no difference between the bilateral rate and the effective rate.

Table 3.7 below contains summary data on the NEER and the REER for each of the CACM countries, with the REER based on the IGPL price measure. The figures are expressed as index numbers. A decline in the number means appreciation of the currency.

As is clear from the table, the evidence from examining the NEER's and REER's is fully consistent with the picture that emerged from considering the bilateral exchange rates. The major results are.

1. All the countries of the CACM region except for Costa Rica have experienced a sharp and persistent appreciation of Nominal Effective Exchange Rates since 1980. This is not a surprising result, since the CACM currencies were pegged to the U.S. dollar and with the dollar strongly appreciating against the other trading partners of the CACM countries, the currencies show an appreciation of their nominal exchange rates. By contrast Costa Rica, which devalued, shows a depreciation of its nominal effective rate.

Table 3.7
Nominal, Real Effective
Exchange Rates,
1965-68, 1978-84

<u>Country</u>		<u>Period</u>	<u>Year</u>						
		1965-68	1978	1979	1980	1981	1982	1983	1984
Guatemala	NEER	0.92	1.00	1.00	1.00	0.90	0.86	0.85	0.83
	REER	1.13	1.00	1.06	1.13	1.04	0.95	0.96	1.04
Honduras	NEER	0.89	1.00	1.01	1.01	0.94	0.92	0.91	0.89
	REER	1.35	1.00	1.04	1.11	1.07	0.97	0.85	0.84
El Salvador	NEER	0.87	1.00	1.01	1.00	0.90	0.86	0.85	0.82
	REER	0.95	1.00	0.98	0.93	0.79	0.70	0.67	0.67
Costa Rica	NEER	0.69	1.00	1.00	1.00	2.37	3.97	4.29	4.53
	REER	1.84	1.00	0.91	0.89	1.85	2.06	1.73	1.97
Nicaragua	NEER	0.88	1.00	1.34	1.45	1.28	1.20	1.19	1.15
	REER	0.96	1.00	0.97	0.85	0.64	0.53	0.44	0.30

SOURCE: Tables 3.18 - 3.22. REER based on IGPL price measures

2. The appreciation of the NEER's was accompanied by an appreciation of REER's both relative to 1980 levels and relative to the 1965-68 average. Indeed, the appreciation of REER's has exceeded the appreciation of bilateral real exchange rates (See Table 3.4). The reasons are clear. The REER reflect the double impact of the nominal dollar appreciation against major currencies and the fact that inflation rates in the CACM countries have been higher than inflation rates in their trading partners. To see this clearly, let us look at the formula for the Real Effective Exchange Rate. This is $REER_j = (E_j P_j^* / P_j)$ where E_j is the nominal effective exchange rate for country j in the CACM, P_j^* is the weighted price level of country j 's trading partners and P_j is the domestic price level. The double impact on the REER derives from the fact that E falls (an appreciation) whereas P increases more than P^* . Hence the CACM countries have experienced a large appreciation of their real exchange rates relative to the U.S. and relative to non-CACM trading partners. This is consistent with the fact discussed in Section 2 above that there has been a systematic decline in the share of exports going to the industrialized countries (minus the U.S.), and implies an important loss of competitiveness in international markets.

3. The appreciation of REER's has been the largest in precisely those countries that required it: the least, namely El Salvador, Nicaragua and -- to a lesser extent -- Honduras. The higher than average inflation rates in Nicaragua and El Salvador accompanied by a policy of a fixed peg to the U.S. dollar have implied even sharper REER appreciations and a loss of competitiveness both within the CACM and in the extra-regional international market.

Some Policy Implications

The large appreciations of real exchange rates in the CACM countries have had a negative impact on trade and payments balances within and out-

side the region. It is necessary to arrive at realistic values for the exchange rates in order to correct existing and prospective imbalances. The evidence on the time path of real exchange rates, and the evidence on the pattern of trade and payments imbalances that have emerged since 1979 suggests the following recommendations for economic policy and exchange rate policy in particular.

1. The currencies of the CACM countries are overvalued relative to the U.S. dollar and other major currencies. This requires correction through a generalized devaluation of all the currencies relative to foreign currencies. The extent of the required devaluations differs across countries, and the exact parity changes require a detailed country-by-country analysis. However, the overall pattern and direction of change is clear. Nicaragua and El Salvador, followed by Honduras require the largest devaluations. For Guatemala the current fluctuating rates on the parallel market appear to be of the correct order of magnitude. In Costa Rica's case, further devaluation or depreciation would appear necessary.

2. It is fundamental and necessary that the existing set of official parities between the members of the CACM be realigned. The existing parities have led to the emergence of large bilateral real exchange rate changes that have distorted the trade and payments patterns. Obviously, the realignment of parities or exchange rates within the CACM would take place automatically if all the countries allow their exchange rates to float freely against the U.S. dollar and major currencies. However, the necessary realignment would not take place automatically if a common rate of devaluation were adopted, or if fixed cross-rates were maintained while the currencies were collectively floating against the dollar or major currencies. The problem is similar to that of European Common Market countries that are members of the European Monetary System, (EMS). Within the EMS only limited parity changes are allowed for the participating countries,

while all of them are floating against the dollar. Problems arise however if, say, the French franc has a tendency to depreciate more than the Deutsche mark versus the U.S. dollar. In such a case the parity between the FFr and DM would need to be altered. If the cross-rate is rigid then the Central Banks are forced to intervene, supplying DM and buying FFr.

Hence, given that monetary and fiscal coordination among the CACM countries is probably difficult to achieve, the aim should be to have exchange rate flexibility within the CACM region and vis a vis the rest of the world. Without a realignment and exchange rate flexibility, it will not prove feasible nor desirable to finance trade within the CACM. Such financing will merely allow the countries to postpone the inevitable and will simply be approving and sustaining the overvalued exchange rates.

3. The monetary authorities and governments of the CACM countries should be encouraged and supported in actively fostering the development of parallel exchange markets, and increasing the flow of payments at parallel rates. Ideally, no transactions should be allowed at the heavily subsidized official exchange rates. The liberalization of foreign exchange markets will reduce the pressure on the low levels of international reserves of the CACM central banks, and allow the removal of the panoply of controls on foreign exchange receipts and payments.

4. The countries of the CACM require large real exchange rate depreciations, to correct the current large appreciations. The nominal exchange rate devaluations recommended in (1.) and (2.) above can only have a temporary impact on the real exchange rates. As Costa Rica's experience makes clear, unless devaluations are accompanied by other policy measures to lower domestic price inflation rates the effect of nominal devaluations on real exchange rates will be transitory. The nominal exchange rate depreciations will have to be associated by restrictive monetary and fiscal policies (lower domestic credit and money growth, reductions in budget deficits) in order to achieve sustained real exchange rate depreciations.

Table 3.8

Bilateral Exchange Rates
Real Exchange Rates, Quetzals Per Unit
Implicit Price Based

<u>Honduras</u>	<u>El Salvador</u>	<u>Costa Rica</u>	<u>Nicaragua</u>	<u>US</u>
ERR	ERR	ERR	ERR	0.0
ERR	ERR	ERR	ERR	0.0
0.4008	0.5028	0.0986	0.1462	0.0
0.4167	0.4942	0.0949	0.1430	0.0
0.4292	0.4583	0.0815	0.1452	0.0
0.4704	0.5091	0.0872	0.1595	0.0
0.4607	0.5031	0.0841	0.1568	0.0
0.4533	0.4860	0.0772	0.1652	1.4495
0.4644	0.4626	0.0722	0.1795	1.4378
0.4532	0.4302	0.0751	0.1651	1.3370
0.4809	0.4301	0.0791	0.1561	1.3730
0.5436	0.4300	0.0760	0.1377	1.3740
0.5726	0.4281	0.0734	0.1422	1.3528
0.5815	0.4210	0.0814	0.1477	1.3269
0.5703	0.4224	0.0877	0.1591	1.2557
0.5546	0.4205	0.0854	0.1768	1.2346
0.5585	0.4188	0.0776	0.1763	1.3225
0.5297	0.4067	0.0830	0.1639	1.2443
0.5095	0.4217	0.0923	0.1551	1.1100
0.4966	0.4192	0.0982	0.1464	1.0271
0.5000	0.4000	0.1167	0.1423	1.0000
0.5041	0.4251	0.1355	0.1532	1.0638
0.5052	0.4729	0.1480	0.1842	1.1537
0.4897	0.5019	0.0683	0.2356	1.1372
0.4854	0.5161	0.0572	0.2631	0.9841
0.5315	0.5363	0.0678	0.3237	0.9148
0.5618	0.5728	0.0666	0.5410	0.8894

Table 3.9
Real Exchange Rates with Honduras,
Lempiras Per Unit
Implicit Price Based

<u>Guatemala</u>	<u>El Salvador</u>	<u>Costa Rica</u>	<u>Nicaragua</u>	<u>U.S.</u>
ERR	ERR	ERR	ERR	0.0
ERR	ERR	ERR	ERR	0.0
2.4951	1.2544	0.2461	0.3648	0.0
2.3996	1.1859	0.2278	0.3431	0.0
2.3301	1.0678	0.1898	0.3382	0.0
2.1257	1.0823	0.1853	0.3391	0.0
2.1706	1.0920	0.1826	0.3404	0.0
2.2062	1.0722	0.1704	0.3645	3.1978
2.1532	0.9961	0.1554	0.3865	3.0958
2.2063	0.9491	0.1658	0.3644	2.9499
2.0796	0.8943	0.1644	0.3247	2.8553
1.8395	0.7909	0.1398	0.2533	2.5275
1.7463	0.7477	0.1282	0.2483	2.3625
1.7196	0.7239	0.1400	0.2540	2.2819
1.7535	0.7407	0.1538	0.2789	2.2019
1.8031	0.7582	0.1540	0.3188	2.2261
1.7905	0.7499	0.1389	0.3157	2.3680
1.8879	0.7678	0.1567	0.3094	2.3491
1.9625	0.8276	0.1812	0.3043	2.1785
2.0139	0.8442	0.1977	0.2949	2.0684
2.0000	0.8000	0.2334	0.2847	2.0000
1.9838	0.8433	0.2689	0.3040	2.1104
1.9796	0.9361	0.2929	0.3647	2.2839
2.0423	1.0249	0.1394	0.4812	2.3224
2.0600	1.0632	0.1179	0.5421	2.0272
1.8814	1.0089	0.1276	0.6090	1.7212
1.7800	1.0195	0.1186	0.9630	1.5833

Table 3.10

Real Exchange Rates for El Salvador,
Colones Per Unit
Implicit Price Based

<u>Guatemala</u>	<u>Honduras</u>	<u>Costa Rica</u>	<u>Nicaragua</u>	<u>U.S.</u>
ERR	ERR	ERR	ERR	0.0
ERR	ERR	ERR	ERR	0.0
1.9891	1.9600	0.1962	0.2908	0.0
2.0235	1.8529	0.1921	0.2893	0.0
2.1822	1.6684	0.1778	0.3168	0.0
1.9641	1.6910	0.1713	0.3133	0.0
1.9876	1.7063	0.1672	0.3117	0.0
2.0577	1.6752	0.1590	0.3400	2.9826
2.1616	1.5564	0.1560	0.3880	3.1079
2.3246	1.4830	0.1747	0.3839	3.1080
2.3253	1.3974	0.1838	0.3630	3.1927
2.3258	1.2358	0.1768	0.3202	3.1956
2.3357	1.1682	0.1715	0.3321	3.1598
2.3755	1.1311	0.1934	0.3508	3.1521
2.3673	1.1573	0.2077	0.3766	2.9728
2.3780	1.1848	0.2031	0.4204	2.9359
2.3876	1.1718	0.1852	0.4209	3.1576
2.4589	1.1996	0.2041	0.4030	3.0596
2.3714	1.2931	0.2189	0.3678	2.6323
2.3855	1.3191	0.2342	0.3493	2.4501
2.5000	1.2500	0.2917	0.3558	2.5000
2.3524	1.3177	0.3188	0.3605	2.5025
2.1147	1.4627	0.3129	0.3896	2.4397
1.9926	1.6015	0.1360	0.4695	2.2659
1.9376	1.6612	0.1109	0.5099	1.9068
1.8648	1.5764	0.1265	0.6037	1.7059
1.7459	1.5930	0.1163	0.9445	1.5529

Table 3.11

Real Exchange Rates with Costa Rica,
Colones Per Unit
Implicit Price Based

<u>Guatemala</u>	<u>Honduras</u>	<u>El Salvador</u>	<u>Nicaragua</u>	<u>U.S.</u>
ERR	ERR	ERR	ERR	0.0
ERR	ERR	ERR	ERR	0.0
10.1396	4.0638	5.0977	1.4825	0.0
10.5328	4.3893	5.2052	1.5060	0.0
12.2739	5.2675	5.6246	1.7817	0.0
11.4693	5.3955	5.8394	1.8295	0.0
11.8858	5.4759	5.9799	1.8642	0.0
12.9457	5.8678	6.2912	2.1388	18.7644
13.8537	6.4339	6.4090	2.4867	19.9183
13.3067	6.0313	5.7244	2.1976	17.7917
12.6493	6.0827	5.4398	1.9749	17.3679
13.1544	7.1510	5.6559	1.8112	18.0741
13.6182	7.7982	5.8305	1.9365	18.4231
12.2841	7.1434	5.1713	1.8143	16.3002
11.3975	6.5000	4.8145	1.8131	14.3124
11.7078	6.4931	4.9234	2.0698	14.4545
12.8933	7.2008	5.4001	2.2731	17.0514
12.0487	6.3821	4.9000	1.9747	14.9921
10.8312	5.5190	4.5674	1.6797	12.0228
10.1874	5.0586	4.2706	1.4919	10.4633
8.5700	4.2850	3.4280	1.2198	8.5700
7.3782	3.7192	3.1364	1.1307	7.3490
6.7585	3.4141	3.1960	1.2451	7.7974
14.6461	7.1715	7.3504	3.4509	16.6550
17.4768	8.4839	9.0198	4.5990	17.1987
14.7455	7.8374	7.9073	4.7732	13.4893
15.0150	8.4352	8.6000	8.1231	13.3550

Table 3.12

Real Exchange Rates with Nicaragua,
Cordobas Per Unit
Implicit Price Based

<u>Guatemala</u>	<u>Honduras</u>	<u>El Salvador</u>	<u>Costa Rica</u>	<u>U.S.</u>
ERR	ERR	ERR	ERR	0.0
ERR	ERR	ERR	ERR	0.0
6.8397	2.7412	3.4387	0.6745	0.0
6.9937	2.9145	3.4562	0.6640	0.0
6.8888	2.9564	3.1568	0.5613	0.0
6.2690	2.9491	3.1918	0.5466	0.0
6.3757	2.9374	3.2077	0.5364	0.0
6.0527	2.7435	2.9415	0.4675	8.7733
5.5712	2.5874	2.5773	0.4021	8.0100
6.0551	2.7445	2.6049	0.4550	8.0960
6.4050	3.0800	2.7545	0.5063	8.7942
7.2628	3.9482	3.1227	0.5521	9.9790
7.0323	4.0270	3.0108	0.5164	9.5136
6.7708	3.9373	2.8503	0.5512	8.9844
6.2862	3.5850	2.6554	0.5515	7.8938
5.6564	3.1370	2.3786	0.4831	6.9834
5.6720	3.1678	2.3756	0.4399	7.5012
6.1015	3.2319	2.4814	0.5064	7.5920
6.4484	3.2857	2.7192	0.5954	7.1578
6.8286	3.3908	2.8626	0.6703	7.0136
7.0260	3.5130	2.8104	0.8198	7.0260
6.5253	3.2893	2.7739	0.8844	6.9417
5.4282	2.7421	2.5670	0.8032	6.2627
4.2442	2.0782	2.1300	0.2898	4.8263
3.8002	1.8448	1.9613	0.2174	3.7397
3.0892	1.6419	1.6566	0.2095	2.8260
1.8484	1.0384	1.0587	0.1231	1.6441

Table 3.13

Real Exchange Rates with Guatemala,
Quetzales Per Unit CPI Based

<u>HONDURAS</u>	<u>EL SALVADOR</u>	<u>COSTA RICA</u>	<u>NICARAGUA</u>	<u>U.S.</u>
0.5253	0.3978	0.1391	0.0000	
0.5337	0.3976	0.1403	0.0000	
0.5295	0.4007	0.1429	0.1435	
0.5410	0.3922	0.1389	0.1443	
0.5365	0.3849	0.1258	0.1404	
0.5519	0.3897	0.1292	0.1400	
0.5786	0.3977	0.1338	0.1466	
0.6017	0.4032	0.1340	0.1490	1.0049
0.6067	0.3954	0.1329	0.1534	1.0301
0.6077	0.3991	0.1339	0.1544	1.0266
0.6254	0.4020	0.1368	0.1588	1.0330
0.6261	0.3927	0.1376	0.1574	1.0513
0.6173	0.3947	0.1408	0.1567	1.0655
0.6336	0.3978	0.1459	0.1604	1.1058
0.6646	0.4024	0.1516	0.1556	1.1494
0.6131	0.3760	0.1528	0.1735	1.1407
0.5940	0.3771	0.1432	0.1684	1.1648
0.5573	0.3970	0.1374	0.1600	1.1244
0.5274	0.3838	0.1284	0.1482	1.0617
0.5084	0.3814	0.1189	0.1469	1.0021
0.5000	0.4000	0.1167	0.1423	1.0000
0.5045	0.4114	0.1144	0.1435	1.0097
0.5267	0.4361	0.1220	0.1615	1.0390
0.5210	0.4494	0.0591	0.1796	1.0180
0.5456	0.4782	0.0622	0.2134	0.9901
0.5613	0.5089	0.0706	0.2628	0.9424
0.5746	0.5544	0.0712	0.3403	0.9423

Table 3.14
Real Exchange Rates with Honduras,
Lempiras Per Unit CPI Based

<u>GUATEMALA</u>	<u>EL SALVADOR</u>	<u>COSTA RICA</u>	<u>NICARAGUA</u>	<u>U.S.</u>
1.9038	0.7573	0.2648	0.0000	
1.8737	0.7450	0.2630	0.0000	
1.8886	0.7568	0.2698	0.2711	
1.8485	0.7250	0.2567	0.2667	
1.8640	0.7175	0.2345	0.2616	
1.8120	0.7061	0.2342	0.2537	
1.7282	0.6873	0.2312	0.2533	
1.6620	0.6702	0.2227	0.2476	1.6701
1.6482	0.6517	0.2191	0.2528	1.6979
1.6456	0.6567	0.2204	0.2541	1.6893
1.5990	0.6428	0.2188	0.2540	1.6517
1.5972	0.6272	0.2198	0.2513	1.6793
1.6200	0.6395	0.2282	0.2539	1.7262
1.5783	0.6279	0.2302	0.2532	1.7453
1.5048	0.6055	0.2282	0.2341	1.7295
1.6311	0.6132	0.2492	0.2831	1.8606
1.6836	0.6348	0.2411	0.2835	1.9610
1.7944	0.7123	0.2465	0.2872	2.0177
1.8959	0.7276	0.2434	0.2811	2.0130
1.9670	0.7502	0.2338	0.2890	1.9711
2.0000	0.8000	0.2334	0.2847	2.0000
1.9822	0.8156	0.2267	0.2845	2.0014
1.8988	0.8280	0.2316	0.3067	1.9739
1.9194	0.8626	0.1134	0.3440	1.9539
1.8330	0.8765	0.1141	0.3912	1.8149
1.7814	0.9066	0.1258	0.4682	1.6788
1.7404	0.9649	0.1240	0.5922	1.6399

Table 3.15

Real Exchange Rates with El Salvador
Colones Per Unit CPI Based

<u>GUATEMALA</u>	<u>HONDURAS</u>	<u>COSTA RICA</u>	<u>NICARAGUAN</u>	<u>U.S.</u>
2.5138	1.3204	0.3497	0.0000	
2.5151	1.3423	0.3530	0.0000	
2.4956	1.3214	0.3565	0.3582	
2.5496	1.3792	0.3540	0.3679	
2.5980	1.3938	0.3268	0.3647	
2.5662	1.4162	0.3316	0.3593	
2.5145	1.4549	0.3364	0.3685	
2.4799	1.4921	0.3323	0.3695	2.4920
2.5293	1.5345	0.3362	0.3879	2.6054
2.5059	1.5228	0.3356	0.3869	2.5725
2.4875	1.5557	0.3403	0.3951	2.5695
2.5466	1.5944	0.3505	0.4007	2.6773
2.5333	1.5637	0.3568	0.3970	2.6993
2.5137	1.5926	0.3667	0.4032	2.7796
2.4853	1.6517	0.3769	0.3866	2.8565
2.6599	1.6308	0.4063	0.4616	3.0342
2.6521	1.5753	0.3798	0.4466	3.0891
2.5192	1.4039	0.3460	0.4032	2.8327
2.6057	1.3744	0.3345	0.3863	2.7666
2.6218	1.3329	0.3116	0.3852	2.6274
2.5000	1.2500	0.2917	0.3558	2.5000
2.4305	1.2262	0.2780	0.3489	2.4540
2.2932	1.2077	0.2797	0.3704	2.3839
2.2253	1.1593	0.1315	0.3998	2.2652
2.0912	1.1409	0.1301	0.4463	2.0106
1.9649	1.1030	0.1387	0.5165	1.8517
1.8037	1.0364	0.1285	0.6137	1.6996

Table 3.16

Real Exchange Rates with Costa Rica
Colones Per Unit CPI Based

<u>GUATEMALA</u>	<u>HONDURAS</u>	<u>EL SALVADOR</u>	<u>NICARAGUA</u>	<u>U.S.</u>
7.1887	3.7759	2.8596	0.0000	
7.1251	3.8026	2.8329	0.0000	
6.9992	3.7061	2.8047	1.0045	
7.2017	3.8959	2.8247	1.0392	
7.9499	4.2650	3.0600	1.1159	
7.7382	4.2705	3.0154	1.0833	
7.4749	4.3252	2.9727	1.0955	
7.4621	4.4899	3.0091	1.1117	7.4985
7.5222	4.5638	2.9741	1.1536	7.7487
7.4678	4.5381	2.9801	1.1530	7.6663
7.3095	4.5714	2.9384	1.1609	7.5505
7.2655	4.5487	2.8530	1.1433	7.6385
7.1001	4.3827	2.8027	1.1127	7.5653
7.8551	4.3432	2.7271	1.0996	7.5803
6.5950	4.3828	2.6536	1.0259	7.5800
6.5460	4.0133	2.4610	1.1360	7.4672
6.9835	4.148	2.6332	1.1759	8.1341
7.2806	4.057	2.8900	1.1651	8.1866
7.7909	4.109	2.9899	1.1550	8.2719
8.4128	4.2771	3.2088	1.2362	8.4308
8.5700	4.2850	3.4280	1.2198	8.5700
8.7418	4.4102	3.5967	1.2548	8.8264
8.1997	4.3184	3.5756	1.3244	8.5240
16.9193	8.8147	7.6032	3.0394	17.2231
16.0687	8.7665	7.6838	3.4294	15.9102
14.1642	7.9510	7.2085	3.7229	13.3483
14.0404	8.0673	7.7841	4.7774	13.2299

Table 3.17

Real Exchange Rates with Nicaragua,
Cordoba Per Unit CPI Based

<u>GUATEMALA</u>	<u>HONDURAS</u>	<u>EL SALVADOR</u>	<u>COSTA RICA</u>	<u>U.S.</u>
ERR	ERR	ERR	ERR	
ERR	ERR	ERR	ERR	
6.9675	3.6893	2.7920	0.9955	
6.9299	3.7489	2.7181	0.9623	
7.1239	3.8219	2.7420	0.8961	
7.1429	3.9420	2.7834	0.9231	
6.8233	3.9481	2.7136	0.9128	
6.7121	4.0386	2.7066	0.8995	6.7449
6.5207	3.9562	2.5781	0.8669	6.7170
6.4771	3.9360	2.5847	0.8673	6.6492
6.2964	3.9378	2.5311	0.8614	6.5039
6.3550	3.9787	2.4955	0.8747	6.6813
6.3810	3.9389	2.5189	0.8987	6.7991
6.2342	3.9498	2.4801	0.9094	6.8936
6.4284	4.2721	2.5865	0.9747	7.3885
5.7624	3.5329	2.1664	0.8803	6.5734
5.9391	3.5277	2.2394	0.8504	6.9176
6.2486	3.4822	2.4804	0.8583	7.0262
6.7454	3.5578	2.5887	0.8658	7.1619
6.8056	3.4600	2.5958	0.8090	6.8201
7.0260	3.5130	2.8104	0.8198	7.0260
6.9668	3.5147	2.8664	0.7970	7.0342
6.1913	3.2607	2.6998	0.7551	6.4362
5.5667	2.9002	2.5015	0.3290	5.6666
4.6855	2.5563	2.2406	0.2916	4.6393
3.8046	2.1357	1.9363	0.2686	3.5855
2.9389	1.6886	1.6294	0.2093	2.7692

Table 3.18

	<u>GUATEMALA NER</u>	<u>PGDP GUATEMALA REER</u>	<u>CPI GUATEMALA REER</u>	<u>IMPLICIT GUATEMALA REER</u>
1965	0.920	0.887	0.932	1.161
1966	0.920	0.919	0.946	1.151
1967	0.919	0.934	0.963	1.096
1968	0.915	0.943	0.979	1.125
1969	0.916	0.966	0.993	1.133
1970	0.921	0.978	1.021	1.151
1971	0.930	1.043	1.078	1.170
1972	0.951	1.125	1.140	1.160
1973	0.976	1.101	1.120	1.142
1974	0.957	1.060	1.069	1.138
1975	0.955	1.029	1.050	1.089
1976	0.936	0.991	0.988	1.003
1977	0.955	0.951	0.964	0.972
1978	1.000	1.000	1.000	0.997
1979	1.003	1.022	0.994	1.058
1980	1.000	1.045	1.006	1.133
1981	0.903	0.953	0.914	1.045
1982	0.862	0.945	0.920	0.956
1983	0.850	0.929	0.933	0.957
1984	0.828	0.948	0.971	1.036

Table 3.19

	<u>HONDURAS NER</u>	<u>PGDP HONDURAS REER</u>	<u>CPI HONDURAS REER</u>	<u>IMPLICIT HONDURAS REER</u>
1965	0.894	0.869	0.787	1.408
1966	0.894	0.877	0.799	1.367
1967	0.894	0.866	0.814	1.337
1968	0.894	0.889	0.808	1.306
1969	0.895	0.901	0.826	1.167
1970	0.900	0.938	0.866	1.124
1971	0.907	0.971	0.894	1.114
1972	0.925	0.987	0.900	1.102
1973	0.953	1.026	0.951	1.096
1974	0.948	1.024	0.927	1.088
1975	0.955	1.032	0.963	1.091
1976	0.944	1.003	0.961	1.022
1977	0.961	0.962	0.960	0.996
1978	1.000	1.000	1.000	1.000
1979	1.009	1.032	0.976	1.045
1980	1.007	1.042	0.925	1.106
1981	0.943	1.021	0.865	1.073
1982	0.917	0.982	0.823	0.969
1983	0.906	0.962	0.790	0.854
1984	0.887	0.944	0.785	0.836

Table 3.20

	<u>EL SALVADOR NER</u>	<u>PGDP EL SALVADOR REER</u>	<u>CPI EL SALVADOR REER</u>	<u>IMPLICIT EL SALVADOR REER</u>
1965	0.869	0.791	0.883	0.898
1966	0.869	0.822	0.918	0.942
1967	0.869	0.842	0.924	0.975
1968	0.868	0.870	0.932	1.001
1969	0.869	0.903	0.970	1.004
1970	0.876	0.921	0.994	1.026
1971	0.884	0.960	1.039	1.064
1972	0.908	1.014	1.089	1.060
1973	0.944	1.055	1.174	1.065
1974	0.929	1.064	1.120	1.066
1975	0.933	1.095	1.043	1.058
1976	0.922	0.953	1.026	0.939
1977	0.946	0.898	1.011	0.919
1978	1.000	1.000	1.000	1.000
1979	1.006	0.963	0.960	0.985
1980	1.002	0.943	0.901	0.927
1981	0.901	0.879	0.785	0.792
1982	0.860	0.827	0.733	0.700
1983	0.849	0.786	0.691	0.668
1984	0.825	0.726	0.649	0.672

Table 3.21

	<u>COSTA RICA NER</u>	<u>PGDP COSTA RICA REER</u>	<u>CPI COSTA RICA REER</u>	<u>IMPLICIT COSTA RICA REER</u>
1965	0.691	1.089	0.820	1.837
1966	0.691	1.103	0.843	1.964
1967	0.691	1.103	0.852	1.796
1968	0.690	1.116	0.849	1.751
1969	0.691	1.113	0.857	1.830
1970	0.696	1.100	0.860	1.928
1971	0.701	1.127	0.874	1.757
1972	0.716	1.121	0.884	1.605
1973	0.740	1.097	0.867	1.626
1974	0.883	1.192	0.881	1.790
1975	0.964	1.139	0.903	1.601
1976	0.948	1.038	0.911	1.312
1977	0.963	0.979	0.957	1.182
1978	1.000	1.000	1.000	1.000
1979	1.001	1.018	1.017	0.908
1980	0.997	0.962	0.957	0.886
1981	2.371	1.776	1.858	1.854
1982	3.968	1.742	1.789	2.056
1983	4.292	1.573	1.597	1.734
1984	4.532	1.600	1.657	1.972

Table 3.22

	<u>NICARAGUA NER</u>	<u>PGDP NICARAGUA REER</u>	<u>CPI NICARAGUA REER</u>	<u>IMPLICIT NICARAGUA REER</u>
1965	0.884	0.834	0.851	0.978
1966	0.884	0.824	0.839	0.902
1967	0.884	0.835	0.848	0.935
1968	0.882	0.821	0.839	1.013
1969	0.883	0.848	0.861	1.152
1970	0.888	0.886	0.891	1.136
1971	0.897	0.918	0.919	1.110
1972	0.925	0.971	1.014	1.031
1973	0.959	0.938	0.900	0.930
1974	0.932	0.846	0.886	0.934
1975	0.932	0.911	0.916	0.957
1976	0.916	0.893	0.936	0.923
1977	0.940	0.930	0.923	0.945
1978	1.000	1.000	1.000	1.000
1979	1.338	1.047	0.976	0.967
1980	1.449	0.915	0.864	0.849
1981	1.280	0.788	0.678	0.643
1982	1.201	0.690	0.558	0.530
1983	1.186	0.625	0.449	0.436
1984	1.154	0.489	0.346	0.298

Section 4: AN INTERIM SUMMARY

We have identified several variables which could explain the reduction in trade levels which have occurred in Central America. The variables of interest are:

- trade barriers
- depressed incomes
- terms of trade
- overvalued exchange rates

The proper way to sort out the relative effect of each is to conduct a statistical analysis relating trade (the dependent variable) to this set of variables (the independent variables). ROCAP would need additional software to perform such statistical analysis. The consultants performed this analysis upon their return to the U.S.

In the absence of statistical work, one must examine variables one at a time to determine the likelihood that trade has been affected by each. We have done this in the discussion above. In summary:

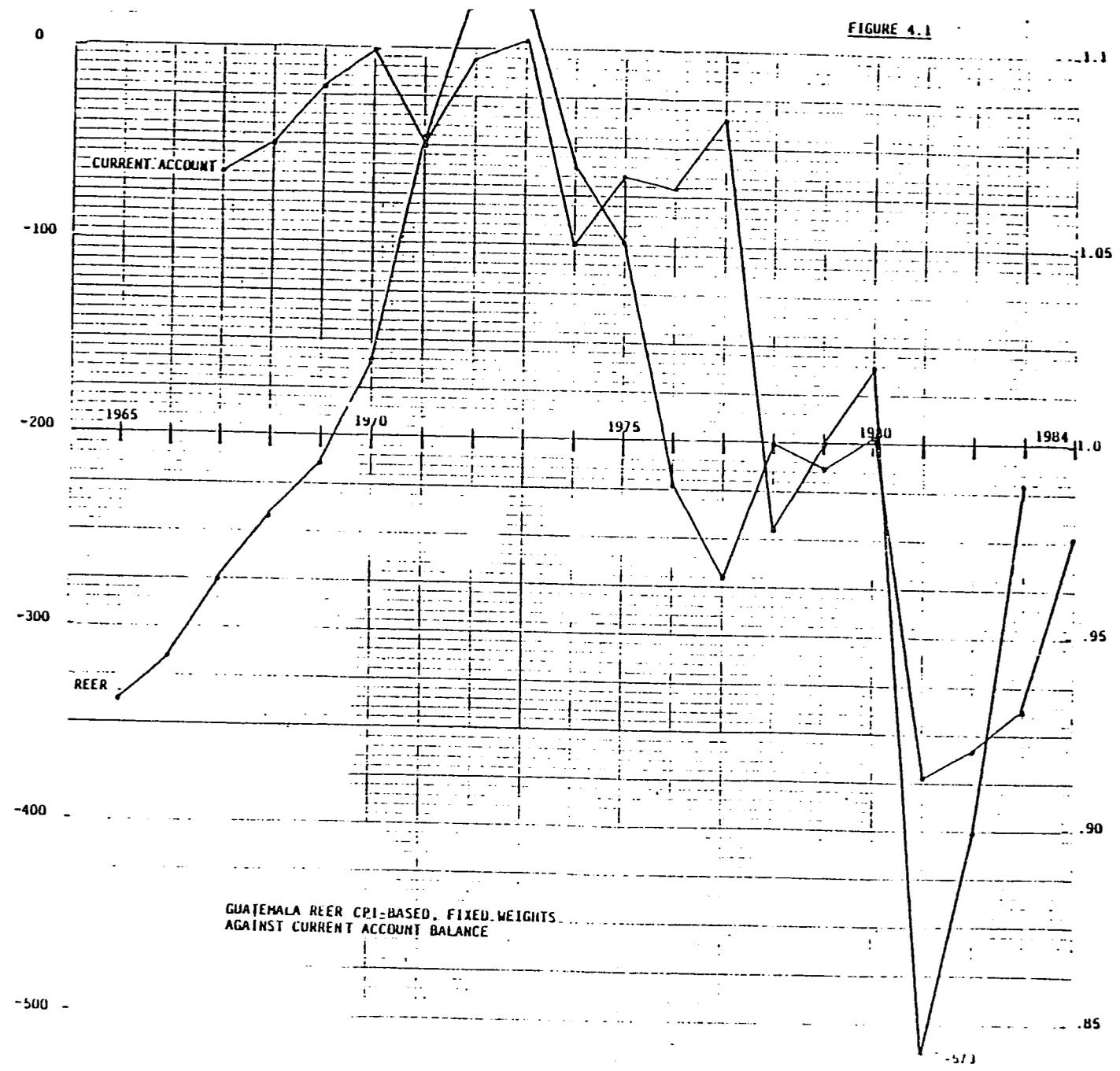
1. Trade barriers per se do not seem to be a significant influence on trade levels, at least through 1984. Variables which should reflect shifts due to trade barriers do not show responses that would result from a proliferation of barriers. Indeed, this same observation has been made recently by Cline (1984).
2. Depressed incomes seem to be an important explanatory variable. Furthermore, the extent to which trade has been depressed is consistent with relationships that are normally found between trade levels and income.
3. Terms of trade have shifted against Central America and probably explain a significant part of the overall current account deficits in the region.

4. Overvalued exchange rates exist for all CACM countries vis a vis the rest of the world. Furthermore, relative overvaluations exist within the CACM. These overvaluations are probably the most important variables in explaining overall deficits for CACM countries, and for explaining the patterns of deficits within the CACM. Ballestero and Thoumi (1983) have also singled out real effective rates as determinants of trade imbalances in the 1970's.

The depressed incomes and terms of trade deteriorations have rather straightforward links to trade and trade balances. Overvalued currencies make imports look cheap and exports expensive, therefore causing an increase in the demand for imports and a decrease in the demand for exports. A balance of payments deficit is the result.

As an illustration of the effect of currency overvaluation, consider Figure 4.1. On the lefthand vertical axis we show Guatemala's current account balance in dollars. The horizontal axis measures the period 1965 to 1984. On the right we have superimposed another axis measuring Guatemala's real effective exchange rate (CPI-based) that was calculated in Section 3. The higher the REER, the more expensive imports are relative to exports and therefore a high REER should correspond to a higher current account balance (and vice versa). One can easily see that there is rough correspondence between the REER and the current account balance, with pronounced overvaluation coinciding with extreme current account deficits in recent years. In figure 4.1 one can also see that other influences are at work along with the exchange rate. Peaks in the current account around 1972-73 correspond to favorable terms of trade, as does the peak around 1977. The world recession in 1974 corresponds to a drop in the current account balance, as does the drop after 1980.

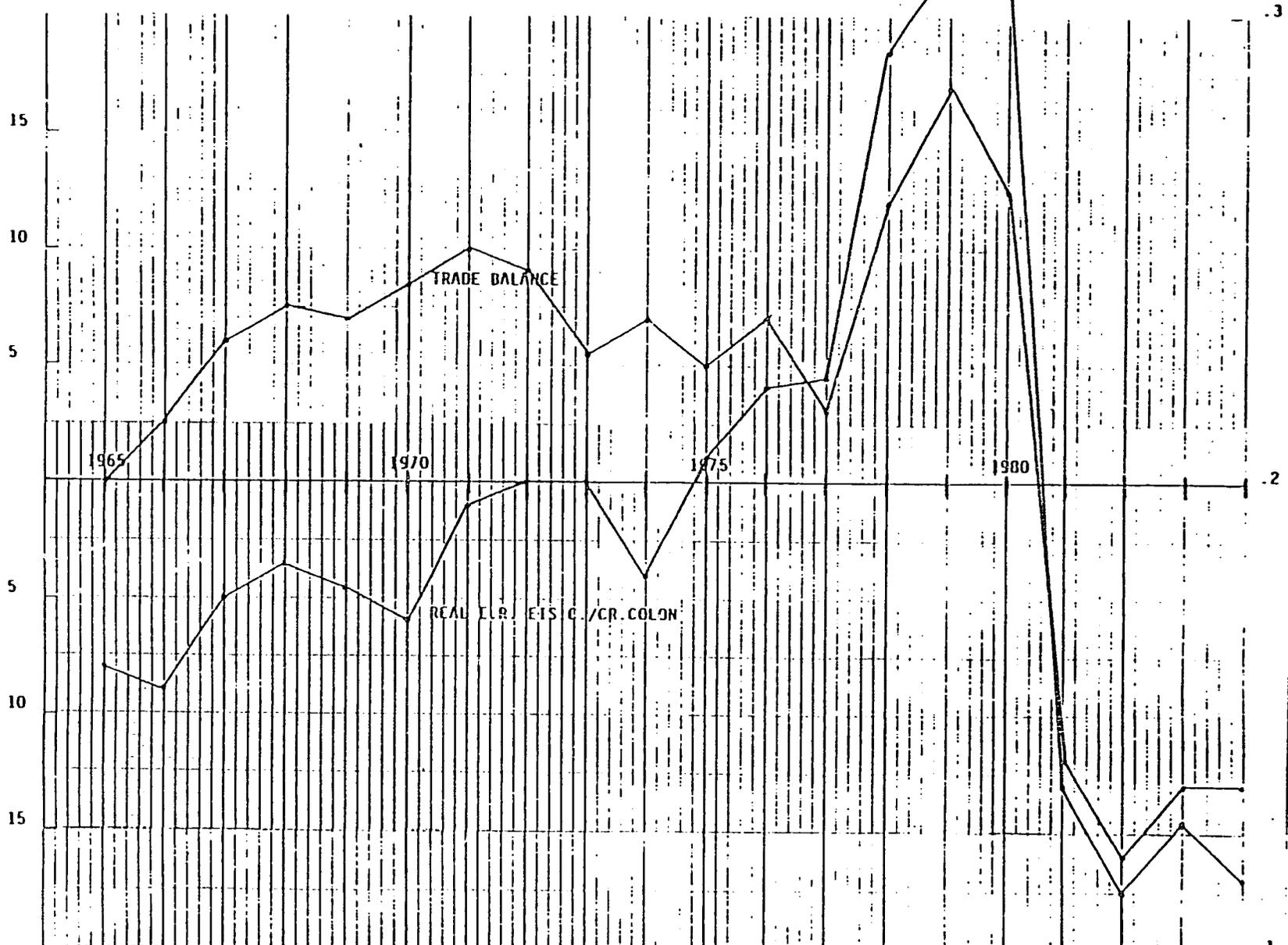
Overvaluation among CACM countries can also be used to explain bilateral balances. To illustrate, see Figure 4.2 which shows the bilateral balance that El Salvador experienced with Costa Rica and the real exchange rate of the Salvadoran Colón against the Costa Rican Colón. The period



EL SALVADOR WITH COSTA RICA

FIGURE 4.2

104



.3

.2

.1

1975-80 represents a continual appreciation of the Costa Rican Colón and thus a depreciation of the Salvadoran Colón. As the Salvadoran Colón depreciated, the trade balance moved sharply positive. After 1980 when the Salvadoran Colón appreciated, the trade balance reversed itself.

Clearly there are other forces at work which influence trade balances. Only statistical work can sort them out. It is clear, however, that relative currency values play an important role in this picture.

Section 5: CÂMARA DE COMPENSACION

The Càmara de Compensaciòn Centroamericana ("The Càmara") is designed to replace a network of payments among all Central American countries with a centralized system of settlements. The Càmara provides for the mutual compensation of intraregional transactions and for two periodic settlements of net outstanding balances. The Càmara maintains an account for the Central Bank of each participating country, in which all regional transactions flowing through The Càmara are recorded. Thus, the Càmara maintains a running record of the respective position of each Central American country vis-a-vis the others, and at agreed-upon intervals (each six months) ordinary settlements are made (extraordinary settlements occur at any time and these are explained below). At the time of settlement, each country is informed of its net balance. Balances are then settled, with debtor central banks reimbursing creditors in dollars.

In this way the main purpose of the Càmara is achieved. Instead of settling each payment in foreign exchange, at the time transactions occur, intra regional settlements are postponed until ordinary settlements occur, in mid-June and mid-December.

At those times only net balances need be settled in dollars, thereby reducing the total amount of foreign exchange needed to effect intraregional trade.

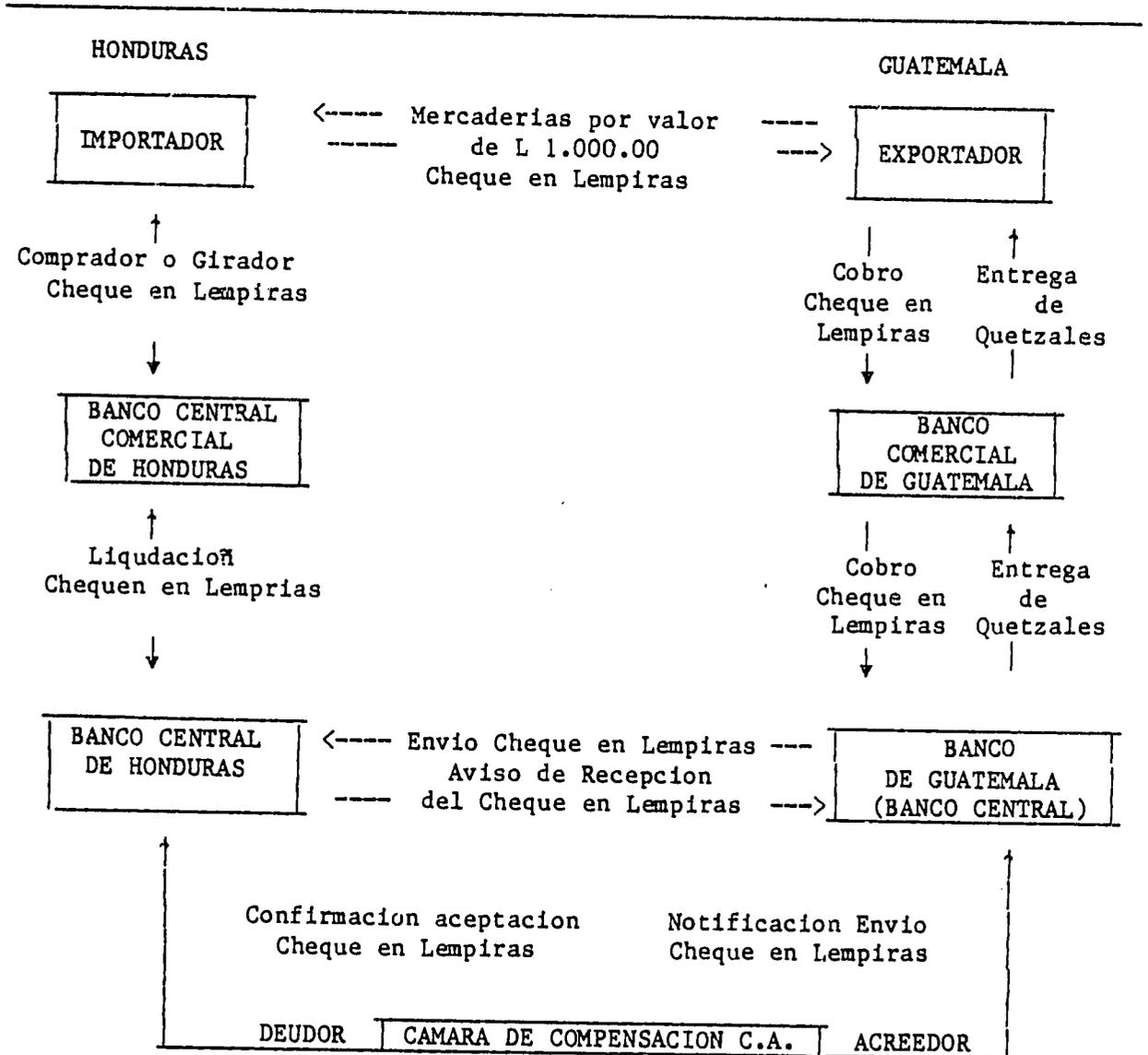
The Càmara itself is not a source of credit. Rather, it is mechanism through which the region's central banks provide short term credit to each other to facilitate trade. When a transaction occurs, the central bank of the exporting country provides the credit necessary to perform the transaction. A simple example will illustrate how payment is effected and the nature of the short-term central bank credit.

Figure 5.1 illustrates a situation where a Honduran imports goods from Guatemala worth 1 million lempiras. The top of the diagram shows goods

Figure 5.1

REPRESENTACION GRAFICA DE UNA OPERACION A TRAVES DE LA CAMARA
DE COMPENSACION CENTROAMERICANA CON CHEQUE EMITIDO
EN LA MONEDA DE HONDURAS

(El ciclo se completa durante un periodo de 10 a 12 dias)



flowing from Guatemala to Honduras, and a check in lempiras being delivered to the Guatemalan exporter. The Guatemalan exporter then cashes his lempira check with his commercial bank, receiving quetzales and the commercial bank in turn performs the same transaction with the Central Bank of Guatemala. The Central Bank of Guatemala now holds the lempira check, drawn on a Honduran bank. If there were no clearing house, the Guatemala Central Bank would then clear the transaction by presenting the check to the Honduran Central Bank, demanding payment in foreign exchange (normally US dollars).

Since there is in this case a clearing house, the Central Bank of Guatemala, instead of demanding settlement immediately, does two things simultaneously. First, it sends the Lempira check to the Honduran Central Bank, which in turn confirm its receipt. Second, it notifies the Cámara that the check has been sent to the Honduran Central Bank. The Cámara then records that the Central Bank of Honduras owes the Central Bank of Guatemala the dollar equivalent of 1 million lempiras. In this case the 1 million lempiras, at the official exchange rate amounts to \$500,000 which is the amount debited to Honduras and credited to Guatemala.

Note that in the absence of the Cámara, the full \$500,000 would have to have been available to effect the transaction. With the Cámara, no foreign exchange is needed until the eventual settlement dates and the offsetting effect of debit and credits reduce the total amount of foreign exchange needed for a given volume of trade.

The amounts generated in this way are accumulated over a six-month period, and each June 15 and December 15, net balances are settled.

Settlements are of two types, "ordinary" and "extraordinary" settlements. The central banks participating in the Cámara have placed limits upon the amount of credit that they will automatically extend to each other. Each central bank has agreed to extend a total of \$12 million automatically to the others. An ordinary settlement is one which occurs each six months, in June and December, and is designed to clear imbalances occurring within the \$12 million automatic credit limit. At those settle-

ment dates, the Càmara informs each central bank of its balance outstanding, and each debtor central bank is required to compensate fully, each of its creditor central banks, in dollars and within eight working days. Thus, after each settlement date, all credit and debit balances seen by the Càmara return to zero.

Extraordinary settlements can occur at any time. They occur when any creditor central bank extends more than \$12 million to the other central banks collectively. When credit extended by any one central bank exceeds \$12 million, debtor central banks are required to compensate the creditor for the credit extended in excess of \$12 million. Payment must be made in dollars and within 3 working days.

Table 5.1 provides an example of a case calling for an extraordinary settlement. The Table represents a situation where various amounts of debits and credits have been accumulated among the central banks since the last ordinary settlement date. The situation shown is one where Costa Rica has extended \$15 million in credit and is therefore eligible to receive immediate compensation for the \$3 million excess credits which have been extended to the other regional central banks. The Table is set up to show that El Salvador is a net debtor to the other central banks. El Salvador has a net debt of \$1 million, resulting from its debts of \$4 million to Costa Rica and \$2 million to Guatemala, partially offset by credit that it has extended of \$1 million to Honduras and \$4 million to Nicaragua. In the example, Guatemala is a net creditor (\$5 million) and Honduras and Nicaragua net debtors (\$1 million and \$18 million respectively).

A question immediately arises as to which central banks pay what amounts to Costa Rica in order to reduce Costa Rica's net credit to \$12 million. Traditionally, the Càmara has used what they refer to as a "multilateral" system of clearing. It is multilateral in that payment is based upon the proportion of total debt owed by each debtor central bank for the period in question.

Table 5.1
Example of Extraordinary Balances

		TOTAL
Guatemala Position With:		+5
Honduras	+2	
El Salvador	+2	
Costa Rica	-5	
Nicaragua	+6	
Honduras Position With:		
Guatemala	-2	-1
El Salvador	-1	
Costa Rica	-1	
Nicaragua	+3	
El Salvador position with:		-1
Guatemala	-2	
Honduras	+1	
Costa Rica	-4	
Nicaragua	+4	
Costa Rica Position With:		+15
Guatemala	+5	
Honduras	+1	
El Salvador	+4	
Nicaragua	+5	
Nicaragua position with:		-18
Guatemala	-6	
Honduras	-3	
El Salvador	-4	
Costa Rica	-5	

Table 5.2 illustrates the multilateral clearing of extraordinary balances. Total net debt for the period is \$20 million owed by El Salvador, Honduras and Nicaragua. Of the total \$20 million only 5% has been incurred by El Salvador and by Honduras, and 90% by Nicaragua. Thus, compensation to Costa Rica of \$3 million is shared by the three net debtor countries in proportion to the net debt that they incurred vis-a-vis the region (thus the term "multilateral"). El Salvador and Honduras each compensate Costa Rica \$150,000, and Nicaragua compensates Costa Rica \$2,700,000. Note that though Guatemala is a net creditor to the region, no compensation is required of that country.

In recent years it has been felt that the traditional, multilateral clearing of extraordinary balances is not equitable because it does not base the clearing of the extraordinary balance upon the relative contribution that each country makes to the particular balance being cleared. Returning to Table 5.2, note that Guatemala shared in credits extended by Costa Rica, yet under multilateral clearing had no responsibility to compensate Costa Rica for credits extended in excess of \$12 million. Indeed, Guatemala's responsibility for credit extended by Costa Rica is greater than either El Salvador's or Honduras. Thus, a system of "bilateral" clearing has been devised to address this element of inequity.

Table 5.3 illustrates the bilateral clearing of the extraordinary credits of \$3 million extended by Costa Rica shown in Table 5.1. The weighting system used to determine what part of the \$3 million is to be paid by each country is now determined by the proportion of the debt with Costa Rica owed by each. These proportions are shown in column 3 and the payments in the last column. In this case, Guatemala shares in the compensation to Costa Rica, since Guatemala contributed to Costa Rica's extension of credit in excess of the \$12 million limit.

Table 5.2

Extraordinary Settlements:

"Multilateral" Basis

<u>Debtor Countries</u>	<u>NET Debt (MILLIONS)</u>	<u>Proportional Debt</u>	<u>Payment</u>
El Salvador	1.0	.05	150,000
Honduras	1.0	.05	150,000
Nicaragua	<u>18.0</u>	<u>.90</u>	<u>2,700,000</u>
Total	20.0	1.00	3,000,000

Table 5.3

Extraordinary Settlements:
"Bilateral" basis

<u>Costa Rica's Debtor Countries</u>	<u>Net Debt to Costa Rica (Millions)</u>	<u>Proportional Debt to Costa Rica</u>	<u>Payment</u>
El Salvador	\$4.0	.27	\$810,000
Guatemala	5.0	.33	990,000
Honduras	1.0	.07	210,000
Nicaragua	<u>5.0</u>	.33	<u>990,000</u>
Total	\$15.0		3,000,000

Table 5.4

Camara Clearings and Trade in the CACM
Trade and Transactions in the Camara

	<u>Total Imports</u> <u>Within CACM</u>	<u>Total Clearings</u> <u>by Camara</u>	<u>Clearings As</u> <u>Percent of Imports</u>
1965	135.7	112.3	82.8
1966	175.4	153.2	87.3
1967	214.3	180.5	84.2
1968	251.2	222.6	88.6
1969	248.7	227.2	91.4
1970	298.9	279.3	93.4
1971	276.5	276.3	99.9
1972	305.5	299.7	98.1
1973	388.0	322.0	83.0
1974	526.1	467.9	88.9
1975	519.0	541.5	104.3
1976	611.3	705.7	115.4
1977	719.2	898.2	124.9
1978	880.9	971.3	110.3
1979	941.0	1037.4	110.2
1980	1162.0	1256.2	108.1
1981	993.4	979.6	98.6
1982	820.2	644.0	78.5
1983	796.7	579.5	72.7
1984	781.7	391.1	50.0

The Càmara had used the multilateral system for clearing extraordinary balances until 1982. Before 1982, bilateral imbalances in the region had not been great, and the issue of equity in clearing extraordinary balances was not a great issue. After about 1980 sizeable bilateral imbalances did occur and foreign exchange became relatively scarce (more on this below); thus, the central banks agreed in early 1982, to shift to the bilateral system of clearing extraordinary balances. The original agreement to do this was for only six months, but since that time they have routinely renewed that agreement. In May 1985, the agreement to proceed with bilateral clearing will be extended for another year. Since ordinary clearings occur each six months, the main effect of a shift from multilateral to bilateral clearing of extraordinary balances is purely a temporal one. That is, the amounts that individual countries must pay during the six month period may change, but at the end of the period, total payments made are the same.

Evaluation of the Càmara de Compensaciòn

The Càmara was created by the central banks of Central America and began on October 1, 1961 with the participation of the banks of El Salvador, Guatemala and Honduras. The Central Bank of Nicaragua began participation on May 1, 1962, and the Central Bank of Costa Rica on June 16, 1963. All clearing transactions occur through the Central Bank of Honduras.

While the Càmara was established primarily to facilitate trade in goods in the region, transactions among central banks are not limited to those associated with trade in goods. Indeed, many transactions may be associated with capital transfers, payment for services, etc. In general, whenever intra-regional payments are made, which involve payment of foreign exchange by a central bank, the transaction becomes a candidate for clearing via the Càmara.

In Table 5.4 we show the amounts of transactions that have "flowed through" the clearing house, for the period 1965-84. Total transactions cleared reached a peak in 1980 and have declined since. Note from the table that, relative to total intraregional imports, the transactions

cleared have dropped precipitously. Between 1975-1980 there were a greater number of transactions being cleared by the Càmara than would be implied by goods trade alone (represented here by intraregional imports). Now (1984) transactions being cleared by the Camra are much less than goods trade, and it is apparent that much trade is occurring without the Càmara being notified, and without Camara's service as a clearing house.

Several factors may explain the great number of transactions that are occurring outside the Càmara's clearing system. First, much trade is border trade, where importers and exporters, usually along country borders, deal in local currency. No checks are presented to central banks and therefore the Càmara remains unnotified that a transaction has occurred. Secondly, active black markets exist in several regional currencies and trades would not need to pass through normal banking systems where foreign exchange is purchased on black markets. Finally, liberalization of exchange markets, has probably had the dual effect of allowing settlement to occur at the time the transaction occurs and to reduce the incentive for central banks to track and report all transactions to the Càmara. If importers buy foreign exchange directly in parallel markets, they can effect payments in foreign exchange, thus eliminating the clearing process described above. Also, to the extent that central banks have removed controls on foreign exchange transactions, they probably have less of an interest in reporting all transactions to the Càmara, compared to the days when strict control of exchange transactions was the rule.

The fact that relatively fewer transactions occur through the Càmara should not be of great concern. Certainly, if private parties have found ways of settling transactions outside the system that keeps the Càmara informed, it is an indication that it must be either easier or cheaper to do

so. If our concern is with stimulating trade, it should be considered a favorable change that people have discovered ways that they prefer to conduct business rather than go through formal institutions. Secondly, even if the Cámara clears only a small proportion of trade, this part may be a very important one. In cases where transactions are large, one could not reasonably expect clearing to take place as easily and automatically as it might with the Cámara's help. Also, where some countries are retaining consistent surpluses or deficits, the Cámara may play an important role in helping them manage these conditions, due to the short-term credit implied by Cámara activities.

Tables 5.5. to 5.9 show, by country, the debits and credits that have been cleared by the Cámara since 1965. In those tables, the right-hand columns show the balances that have resulted for each country for each year. Guatemala (table 5.5) has been a consistent creditor for almost the entire period. Since 1980, Guatemala has offered short term credits of about \$534 million. Indeed most of Guatemala's credits were offered before 1981, with about \$635 million in short term credits being offered during the period 1979-81. From 1982 until the present, Guatemala's strong creditor position has shifted so that the country is roughly in balance with her neighbors.

Honduras (Table 5.6) has normally been a debtor in its transactions through the Cámara and has not experienced much of a change in that position of late. El Salvador had been a consistent creditor country until 1972 and has been a debtor since. Indeed, particularly in the years 1977-81, El Salvador ran unprecedented deficits with neighboring countries. Since 1980, El Salvador has had to clear negative balances through the Cámara which amounted to almost \$150 million. Costa Rica had been generally in a small debtor position until 1979, but then shifted into a strong creditor position. Since 1980, Costa Rica has had balances cleared in its favor of about \$346 million. Finally, Nicaragua seems to have gone on a regional spending spree after 1977. Since then Nicaragua has been extended short term credits by other regional central banks amounting to almost \$600 million.

Table 5.5

Guatemala: Settlements within the Camara

	DEBITS	CREDITS	BALANCE
1965	28.8	29.5	0.7
1966	38.6	39.5	0.9
1967	43.0	50.8	7.8
1968	52.9	60.3	7.4
1969	56.1	69.2	13.1
1970	70.1	89.8	19.7
1971	73.4	89.0	15.6
1972	77.6	97.3	19.7
1973	96.4	109.6	13.2
1974	131.3	148.0	16.7
1975	137.4	173.5	36.1
1976	185.8	222.8	37.0
1977	228.5	294.0	65.5
1978	262.2	337.3	75.1
1979	295.7	437.7	142.0
1980	286.3	560.8	274.5
1981	216.4	436.0	219.6
1982	191.6	249.2	57.6
1983	204.4	185.4	-19.0
1984	125.4	126.9	1.5
		SUM 1965 - 1979 =	470.5
		SUM 1980 - 1984 =	534.2

Table 5.6

Honduras: Balances within the Camara

	DEBITS	CREDITS	BALANCES
1965	20.7	16.9	-3.8
1966	28.1	19.8	-8.3
1967	33.3	22.5	-10.8
1968	40.1	26.9	-13.2
1969	42.7	21.7	-21.0
1970	53.2	21.9	-31.3
1971	32.0	18.5	-13.5
1972	25.1	11.3	-13.8
1973	36.1	17.8	-18.3
1974	47.3	29.8	-17.5
1975	53.3	40.5	-12.8
1976	63.0	56.5	-6.5
1977	85.3	71.3	-14.0
1978	113.9	109.7	-4.2
1979	122.9	143.8	20.9
1980	114.5	151.8	37.3
1981	119.0	83.6	-35.4
1982	81.3	58.6	-22.7
1983	59.5	63.3	3.8
1984	59.6	37.0	-22.6

SUM TO 1980 = -168.1

SUM 1980 + = - 39.6

Table 5.7

El Salvador: Balances within the Camara

	DEBITS	CREDITS	BALANCES
1965	32.2	33.9	1.7
1966	37.8	45.5	7.7
1967	39.4	60.8	21.4
1968	48.3	73.0	24.7
1969	46.8	67.9	21.1
1970	52.9	65.2	12.3
1971	63.3	66.7	3.4
1972	66.9	78.5	11.6
1973	84.9	79.9	- 5.0
1974	115.4	109.0	- 6.4
1975	121.6	119.5	- 2.1
1976	165.9	144.7	-21.2
1977	222.3	174.2	-48.1
1978	228.1	189.1	-39.0
1979	263.8	215.5	-48.3
1980	339.0	233.3	-105.7
1981	262.5	176.2	-86.3
1982	140.0	122.8	-17.2
1983	124.4	112.9	-11.5
1984	108.6	80.6	-28.0

SUM 1965 - 1979 = -66.2

SUM 1980 - 1984 = -248.7

Table 5.8

Costa Rica: Balances within the Camara

	DEBITS	CREDITS	BALANCES
1965	8.5	23.8	15.3
1966	14.7	34.8	20.1
1967	28.9	27.6	-1.3
1968	39.0	38.2	-0.8
1969	42.5	38.4	-4.1
1970	57.8	51.8	-6.0
1971	57.7	50.0	-7.7
1972	81.8	49.6	-32.2
1973	34.5	59.8	25.3
1974	52.6	99.1	46.5
1975	114.9	109.1	-5.8
1976	154.1	135.9	-18.2
1977	188.6	185.1	-3.5
1978	215.2	182.2	-33.0
1979	231.6	183.5	-48.1
1980	229.5	246.7	17.2
1981	174.2	224.9	50.7
1982	101.5	169.2	67.7
1983	70.6	197.8	127.2
1984	54.6	137.6	83.0
		SUM 1965 - 1979 =	-53.5
		SUM 1980 - 1984 =	345.8

Table 5.9

Nicaragua: Balances within the Camara

	DEBITS	CREDITS	BALANCES
1965	22.1	8.2	-13.9
1966	34.0	13.6	-20.4
1967	35.9	18.7	-17.2
1968	42.3	24.2	-18.1
1969	39.1	30.0	-9.1
1970	45.3	51.2	5.9
1971	49.9	52.2	2.3
1972	48.3	62.8	14.5
1973	70.1	54.8	-15.3
1974	121.3	82.3	-39.0
1975	114.3	99.0	-15.3
1976	136.9	145.8	8.9
1977	173.5	173.6	0.1
1978	151.9	153.0	1.1
1979	123.4	56.9	-66.5
1980	286.9	63.6	-223.3
1981	207.5	58.8	-148.7
1982	129.6	44.2	-85.4
1983	120.6	20.0	-100.6
1984	42.9	9.1	-33.8

SUM 1965 - 1979 = -182.0

SUM 1980 - 1984 = -591.8

In summary, what we see over the past four or five years is the traditional creditor (Guatemala) being joined by Costa Rica. Most of the credits extended by these two countries is attributable to the very large deficits run by Nicaragua during the period and to a lesser extent to those incurred by El Salvador. Indeed, when one views the aggregate transaction occurring, through the Càmara, the picture is greatly distorted by the fact that most of the total regional deficit has been due to Nicaraguan imports, and most of the credit given has been extended by the central banks of Guatemala and Costa Rica to Nicaragua.

Current Intraregional Debt

To this point we have discussed regional clearing activities as if, at the end of each ordinary clearing period, countries settle all balances in dollars. This has not been the case. At the end of clearing activities, whether ordinary or extraordinary, debtor countries have sought longer term credit from creditor countries, rather than settle in dollars. Creditor countries have on many occasions simply continued to carry the amounts owed, rather than demand immediate payment. Note that it is not the Càmara that becomes involved in these "loans". Rather, it is a matter between central banks to either settle in dollars immediately (was the original intention) or for creditor central banks to extend payment over longer time periods. In the event of the latter, the terms of repayment (interest, amortization, etc.) are a bilateral matter between central banks. Generally credits have a three-year term at rates of interest slightly above the U.S. prime rate.

Table 5.10 shows the amounts that have been converted into these longer-term credits between central banks for the period 1982-84. Before 1982 a trivial amount of credit of this type existed. The columns show the Central Banks that have extended credit (Nicaragua has not been a creditor) and the rows show countries that have received credit. The column labeled

Table 5.10

Debt Outstanding as a Result of
Payments Clearing the Camara

DEBTOR COUNTRIES	CREDITOR COUNTRIES				TOTAL	TOTAL WITHOUT NICARAGUA
	GUATEMALA	HONDURAS	EL SALVADOR	COSTA RICA :		
Guatemala	-	-	-	4.1	265.1	43.0
Honduras	-	-	-	-	4.1	
El Salvador	33.7			5.2	38.9	
Nicaragua	110.4	16.7	3.9	91.1	222.1	
1983					439.0	99.3
Guatemala			.3	45.5	45.8	
Honduras				3.7	3.7	
El Salvador	39.0	-	-	10.8	49.8	
Nicaragua	136.9	34.8	16.7	151.3	339.7	
1984*					506.4	110.1
Guatemala				38.3	38.3	
Honduras	1.1			11.5	12.6	
El Salvador	39.4			19.8	59.2	
Nicaragua	149.5	38.9	17.1	190.8	396.3	
Totals as of Sept. '84	190.0	38.9	17.1	260.4		
Totals as of Sept. 84 excl. Nicaragua	40.5	.0	.0	69.6		

*Through September

SOURCE: Cuadro 7, pag. 27. Estudio Relativo a Las Formas de Pago
Intracentroame

"total" shows, by year, the total amounts of credit. We have highlighted the total amount of credit extended for the region, which as of September 1984, stood at \$506.4 million. In the total column one can also read off the total amount of credit that have been extended to each country.

Failure to recognize the special position of Nicaragua distorts the view of the indebtedness that has developed in the region. During the years 1980-83, Nicaraguan imports from other CACM countries were extremely high, while exports fell. The very large Nicaraguan deficits with the region were converted into three-year credits by creditor central banks, mainly the central banks of Guatemala and Costa Rica. During 1983 and 1984, as it became clear that Nicaragua could not service these debts, the creditor central banks ceased extending new credits, and so Nicaraguan imports from the region were curtailed sharply.

Referring again to Table 5.10, we can see the effect of considering Nicaragua separately from the rest of the region. The right-hand column shows total debts within the region that are associated with trade balances cleared via the Cámara. As of the end of 1984 only \$110.1 million in debt has been incurred by the region without Nicaragua (we will refer to this region as the CACM-N, for CACM minus Nicaragua). That is, of the total debt within the region of \$506.4 million, over 78% of it (\$396.3 million) has been incurred by Nicaragua. The main creditors' positions can be seen in the last two rows of the table. Whereas Guatemala has extended credits to the region of \$190 million, \$149.5 million of that (79%) has been extended to Nicaragua. Costa Rica has extended \$260.4 million in credits to regional trading parties, but \$190.8 of that (73%) has been extended to Nicaragua.

In summary, the view that we get when excluding Nicaragua from the credit picture is much different from the aggregate. Costa Rica and Guatemala have both extended substantially dollar-dominated credits to Nicaragua. The foreign exchange position of both of these creditors has been weakened considerably, by these loans. In both cases, the presidents of the central banks have said that they do not expect payment by Nicaragua, and both cases, the inclusion of loans to Nicaragua in foreign

reverses overstates the latter. It is true that CACM trade has created a financing problem in the region, but it is also true that the problem is due almost entirely to trade between Nicaragua and her neighbors.

Financing Needs for Clearing Payments

Foreign exchange required to clear payments within the CACM is only a small part of total trade. Also, the foreign exchange which has been required in the recent past has been strongly affected by the role of Nicaragua, since Nicaragua has been largely responsible for the imbalance in the region. Table 5.11 shows the foreign exchange that has been required for settlement since 1979. To place the amounts in perspective we will relate the dollars required for settlement with total trade as measured by imports. The first rows of the table show imports by country, for the CACM and CACM-N. The second tier of rows shows the total transactions that have occurred through the Cámara, and the third set of rows shows the payments, in dollars, that have been required to make settlement payments. In this latter category the role of Nicaragua is again preponderant. Indeed in all years from 1980 through 1983, more than half the foreign exchange needed for settlement was needed by Nicaragua, largely to settle payments owed to Guatemala and Costa Rica. The fact that Nicaragua simply did not have the foreign exchange, gave rise to the credits that Guatemala and Costa Rica have extended and that have already been discussed above.

The distortion created by Nicaragua is evident when one relates dollar payments required for settlement to total transactions to be settled. This is done in Table 5.12. Columns 1 and 2 show dollars required for settlement as a percentage of total settlements managed by the Cámara. This is done for the CACM overall and for the CACM-N. Note that when the effect of Nicaragua's settlement needs are removed from the data, the proportion of settlements requiring dollars drops substantially (from averages of 27.2% to 16.6%). Perhaps more important is the need for dollars for settlement

Table 5.11

Foreign Exchange: Requirements for Settlement

	1979	1980	1981	1982	1983	1984
Regional Imports:						
Guatemala	264	218	194	215	216	225
Honduras	98	104	118	87	104	100
El Salvador	259	320	305	266	233	253
Costa Rica	212	220	152	212	120	120
Nicaragua	111	300	224	139	124	83
Total CACM	944	1162	993	919	797	781
Total CACM-N	725	787	697	627	634	654
<u>Compensatory Transactions via Camara*</u>						
Guatemala	296	286	216	192	204	125
Honduras	123	115	119	81	59	60
El Salvador	264	339	263	140	124	109
Costa Rica	232	230	174	102	71	55
Nicaragua	123	287	207	130	121	43
Total CACM	1038	1257	979	645	579	392
Total CACM-N	915	970	772	515	458	349
<u>Dollar Payments Required for Settlement</u>						
Guatemala	-	-	-	5	43	26
Honduras	2	-	31	28	15	41
El Salvador	53	104	80	25	24	46
Costa Rica	47	17	-	-	-	-
Nicaragua	68	215	151	88	103	39
Total CACM	170	336	262	146	185	152
total CACM-N	102	121	111	58	82	113

* Measured as total debits within the Camara

Table 5.12

Dollar Payments Required on Percentages of

	<u>Settlement within Camara</u>		<u>Total CACM Trade*</u>	
	CACM	CACM-N	CACM	CACM-N
1979	16.4	11.1	18.0	14.0
1980	26.7	12.4	28.9	15.4
1981	26.7	14.4	26.4	15.9
1982	22.6	11.2	15.9	9.3
1983	32.0	17.9	23.2	12.9
1984	38.7	32.4	19.5	17.3
Averages	27.2	16.6	22.0	14.1

* Measured as total imports within CACM

as a proportion of total trade, measured here as total imports. Again, the table displays figures for the overall CACM and the CACM-N, in column 3 and 4 respectively. When Nicaragua's influence on the data is removed, the percentage of regional imports that have required settlement in dollars drops from 22.0% to only about 14%. One should keep in mind that the settlements occurring through the Cámara in 1984 were much smaller than they had been in early years. As indicated earlier, transactions passing through the Cámara amountd to only about 50% of total regional imports in 1984, compared to over 100% in 1980. One would expect that transactions remaining within the Cámara are those which have proportionally a greater need for settlement in foreign exchange (since transactions outside the Cámara must "automatically" settle).

Section 6: TRADE IMBALANCES AND FUNDING PROPOSALS

1. Proposal for Funding Trade Imbalances Within the CACM

The Central American Monetary Council (The "Consejo") has proposed a program for funding imbalances that arise from intraregional trade. The proposal is described in some detail in the ROCAP -- "DAM EXERCISE" and in the document produced by the Consejo entitled "The Need for International Financial Support for Intra-Central American Trade" (n.d.). In summary, the plan is to fund trade imbalances from three sources. Thirty percent of imbalances will be paid for out of the cash reserves of debtor central banks. Creditor central banks will offer medium-term (5 year) credit for 35% of imbalances and the remaining 35% will be financed from international sources. The latter will also be amortized over five years.

Institutionally, the capital to be provided by international sources will reside with the Central American Fund for Economic Integration (the "Fund") which in turn is housed within the Central American Bank for Economic Integration (CABEI). Under the proposal, the monies in the Fund would be entirely separate from those of CABEI, and administration of the Fund would be directly under the Consejo. The Camara de Compensacion would continue to perform ordinary clearing operations twice per year, and extraordinary clearings as required. All amounts to be cleared would be automatically settled, 30% in cash from debtor, 35% from creditor central banks and 35% from the Fund.

In their funding proposal, the Consejo set as a goal the return to \$1 billion of intraregional trade by 1985. The figures that the Consejo has put forward in support of the proposal are reproduced here in Table 6.1. The figures show trade increasing to \$1,000 million by 1986 (i.e., in the second year of the program) and deficits requiring financing fixed at 22.4% of total trade. The means of financing show the amounts that debtor central banks would be required to pay in cash, the credits to be extended by creditor central banks and the credits supported by extra-regional sources. The latter would be expected to provide about \$70.40 million annually over the second through fifth year. The original Consejo proposal amortized all credits over five years and did not include

Table 6.1

Original Proposal

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Annual Trade Assumptions	800	1000	1000	1000	1000					
Deficit Assumptions	179	224	224	224	224					
Means of Financing										
Cash Payment by Central B	53.70	67.20	67.20	67.20	67.20					
Financing	125.30	156.0	156.80	156.80	156.80					
By Central Banks	62.65	78.40	78.40	78.40	78.40					
By Extraregional Source	62.65	78.40	78.40	78.40	78.40					
Amortization: Principal	0.00	25.06	56.42	87.78	119.14	150.50	125.44	94.08	62.72	31.36
Interest	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Net Financing	125.30	131.74	100.38	69.02	37.66	-150.50	-125.44	-94.08	-62.72	-31.36
Cumulative Financing	125.30	257.04	357.42	426.44	464.10	313.60	188.16	94.08	31.36	0.00
From Extraregional Source	62.25	128.52	198.50	213.22	232.05	156.50	94.08	47.04	15.68	0.00

interest. Given this pattern of disbursement and amortization, the cumulative amounts of funding anticipated peak in 1989 at about \$464 million, one half of which (\$232 million) would come from extraregional sources. Since the original proposal did not include interest, we have modified the original to include interest at 8%, leaving all other assumptions the same. These calculations appear in Table 6.2. Interest charges to debtors would peak in 1990 at about \$37 million per year.

2. Critique

The figures for total trade shown in Tables 6.1 and 6.2 are not forecasts. Both the ROCAP-DAM EXERCISE and the Consejo documents use the term "Estimated Transactions." This term greatly overstates what these figures represent. The figures have no estimation procedure whatsoever supporting them and they are better termed "assumptions," as we have done here. The total amount of trade in the region will depend upon terms of trade with countries outside the region, exchange rate policies, economic growth in the region and in the major trading partners and a number of other factors. None of these have been considered in generating the numbers shown in these Tables. Furthermore, the proposal put forward by the Consejo is only for financing deficits. There is no program at all to stimulate trade directly. Rather, the Consejo assumes that if financing is available, trade will expand. Finally, the figures presented by the Consejo include the influence of Nicaragua. As we have shown in Section 5, the presence of Nicaragua in the data distorts the relationships that pertain to the other countries.

We have prepared Table 6.3 to show the implications of removing the effect of Nicaragua from the data. Otherwise, the method behind Table 6.3 is exactly the same as that used by the Consejo. As shown earlier, in Tables 2.12 and 2.19, trade for the CACM-N peaked in 1980 at about \$790 million, bottomed out at about \$626 million in 1982, and rose slightly to \$650 million in 1984. Thus, rather than seeing the 33% drop in trade in nominal terms between 1980 and 1984 -- which occurs when Nicaragua is included -- the drop is only 18%. Furthermore, Table 5.12 reveals that the amount of foreign exchange required to clear payments passing through the

Table 6.2

Original Proposal with 8% Interest

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Annual Trade Assumptions	800	1000	1000	1000	1000					
Deficit Assumptions	179	224	224	224	224					
Means of Financing										
Cash Payment by Central B	53.70	67.20	67.20	67.20	67.20					
Financing	125.30	156.0	156.80	156.80	156.80					
By Central Banks	62.65	78.40	78.40	78.40	78.40					
By Extraregional Source	62.65	78.40	78.40	78.40	78.40					
Amortization: Principal	0.00	25.06	56.42	87.78	119.14	150.50	125.44	94.08	62.72	31.36
Interest	0.00	10.02	20.56	28.59	34.12	37.13	29.09	15.05	7.53	2.51
Net Financing	125.30	131.74	100.38	69.02	37.66	-150.50	-125.44	-94.08	-62.72	-31.36
Cumulative Financing	125.30	257.04	357.42	426.44	464.10	313.60	188.16	94.08	31.36	0.00
From Extraregional Source	62.25	128.52	198.50	213.22	232.05	156.50	94.08	47.04	15.68	0.00

clearing house averaged about 22% of total trade when Nicaragua is included in the data. This 22% then became the proportion of total trade which was assumed to require financing in the Consejo proposal as presented in Tables 6.1 and 6.2. When the effect of Nicaragua is removed, the foreign exchange required to clear payments drops to only about 14% of total trade. Thus, Table 6.3 has been prepared, assuming that trade rises from the 1984 level (\$650 million) to regain the 1980 level (\$790 million) by 1986. We start by assuming a 1985 level of \$700 million. The deficit assumed to require settlement in foreign exchange is 14% of trade.

Removing Nicaragua's influence on the data has a significant impact upon the amount of funding that would be required. Extraregional sources would be providing \$38.7 million rather than \$78.40 million annually (a 51% reduction). Total cumulative extraregional financing would peak at \$115 million in 1989, rather than \$232 million in that year.

To regain the 1980 nominal level of trade in 1986 is to return to a much lower level of trade in real terms. Over the period 1980-84, the U.S. wholesale price index rose about 15.56%. On the assumption that the U.S. WPI will rise by about 2% per year, as it has since 1981, nominal trade in 1986 must be about 20.02% higher than it was in 1980. Thus, if trade in the CACM-N is to reach this level in 1986, total trade must reach \$948 million. Table 6.4 has been prepared to show what the effect of this will be on the financing of trade balances as proposed by the Consejo. We have assumed that the real level of trade of 1980 will be maintained, by installing a 2% per year increase in the dollar prices of tradeable items. Under this scenario, cumulative financing required would peak at almost \$284 million in 1989. One half of this, or about \$142 million, would come from sources outside the region.

All discussion so far has been oriented around the kind of proposal offered by the Consejo, which shows trade occurring only through 1989. Obviously, trade and deficits will occur after that time. If the funding program is to be a five year one, with termination after 1989, then it is

Table 6.3

Recovery of 1980 Trade Level
for CACM-N, by 1986

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Annual Trade Assumptions	700.00	790.00	790.00	790.00	790.00					
Deficit Assumptions	98.00	110.60	110.60	110.60	110.60					
Means of Financing										
Cash Payment by Central B	29.40	33.18	33.18	33.18	33.18					
Financing	68.60	77.42	77.42	77.42	77.42					
By Central Banks	34.30	38.71	38.71	38.71	38.71					
By Extraregional Source	34.30	38.71	38.71	38.71	38.71					
Amortization: Principal	0.00	13.72	29.20	44.69	60.17	75.66	61.94	46.45	30.97	15.48
Interest	0.00	5.49	10.58	14.44	17.06	18.44	12.39	7.43	3.72	1.24
Net Financing	68.60	63.70	48.22	32.73	17.25	-75.66	-61.94	-46.45	-30.97	-15.48
Cumulative Financing	68.60	132.30	180.52	213.25	230.50	154.84	92.90	46.45	15.48	0.00
From Extraregional Source	34.30	66.15	90.26	106.62	115.25	77.42	46.45	23.23	7.74	0.00

Table 6.4

Recovery of Real 1980 Trade Level
by 1986 for CACM-N
Real Level Maintained

Proposal with CACM-N, Interest at 8%

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Annual Trade Assumptions	700.00	948.00	966.96	986.30	1006.03					
Deficit Assumptions	98.00	132.72	135.37	138.08	140.84					
Means of Financing										
Cash Payment by Central B	29.40	39.82	40.61	41.42	42.25					
Financing	68.60	92.90	94.76	96.66	98.59					
By Central Banks	34.30	46.45	47.38	48.33	49.30					
By Extraregional Source	34.30	46.45	47.38	48.33	49.30					
Amortization: Principal	0.00	13.72	32.30	51.25	70.58	90.30	76.58	58.00	39.05	19.72
Interest	0.00	5.49	11.82	16.82	20.45	22.69	15.47	9.34	4.70	1.58
Net Financing	68.60	79.18	62.46	45.40	28.01	-90.30	-76.58	-58.00	-39.05	-19.72
Cumulative Financing	68.60	147.78	210.25	255.65	283.66	193.35	116.77	58.77	19.72	0.00
From Extraregional Source	34.30	73.89	105.12	127.82	141.83	96.68	58.38	29.38	0.86	0.00

possible that subsequently, countries will have to settle imbalances out of cash reserves and service the loans granted them under the program. Table 6.5 develops this scenario. The table is the same as Table 6.4 except that it continues the same real level of trade and proportional deficits through 1994. However, in 1990 and thereafter there is an assumption that the lending program under discussion ends, and that countries revert to the former system used by the Camara, that is, payment in cash for outstanding deficits. Principal, interest and cash settlement payments, in foreign exchange, would amount to about \$256 million in 1990, and would decline thereafter. This cash requirement is about 92% higher than the cash requirement of 1989 (principal + interest + settlement equal to \$133.3 million). Clearly, if there were to be a program like the one under discussion, some means must be found to phase the program out, to avoid the shock of increased cash needs following termination.

Problems with the Consejo Proposal

The main problem with the proposal is that there is no plan to increase exports per se. The proposal is one of finance alone, yet the problem is one of foreign exchange earnings. Certainly a program of this type relieves one demand on scarce foreign exchange and would provide an incentive for countries to try to stimulate trade among themselves rather than trade elsewhere. Whether this is an efficient move is open to question. The same amount of foreign exchange could be provided as general balance of payment support. Then, if countries decided that trade among themselves was the best use to which foreign exchange could be put, then indeed greater regional trade is efficient and the provision of foreign exchange acts as a stimulant.

The dual problem of a general lack of foreign exchange and of some large bilateral imbalances within the CACM, is largely caused by inappropriate and generally overvalued exchange rates. The deficits and debt patterns that we examined in Section 5 are largely the result of past exchange rate misalignments. Financing for a scheme as put forward by the Consejo would simply remove some of the pressures for currency realignment.

Table 6.5

Real 1980 Trade Level Maintained
1986-1984 for CACM-N
Proposal with CACM-N, Interest at 8%

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Annual Trade Assumptions	700.00	948.00	966.96	986.30	1006.03	1026.15	1046.67	1067.60	1088.95	1110.73
Deficit Assumptions	98.00	132.72	135.37	138.08	140.84	143.66	146.53	149.46	152.45	155.50
Means of Financing										
Cash Payment by Central B	29.40	39.82	40.61	41.42	42.25	256.66	238.58	216.80	196.20	176.80
Financing	68.60	92.90	94.76	96.66	98.59					
By Central Banks	34.30	46.45	47.38	48.33	49.30					
By Extraregional										
Source	34.30	46.45	47.38	48.33	49.30					
Amortization: Principal	0.00	13.72	32.30	51.25	70.58	90.30	76.58	58.00	39.05	19.72
Interest	0.00	5.49	11.82	16.82	20.45	22.69	15.47	9.34	4.70	1.58
Net Financing	68.60	79.18	62.46	45.40	28.01	-90.30	-76.58	-58.00	-39.05	-19.72
Cumulative Financing	68.60	147.78	210.25	255.65	283.66	193.35	116.77	58.77	19.72	0.00
From Extraregional Source	34.30	73.89	105.12	127.82	141.83	96.68	58.38	29.38	9.86	0.00

Financing, as proposed, would allow regional imbalances to become less of a concern than they now are, and as such would encourage the retention of relative exchange rate positions. Also, to the extent that financing carried below market interest charges, currency misalignment would be subsidized.

There is another perverse incentive implied in the Consejo proposal. It has generally been a part of AID policy to reduce trade restrictions in the Region. To grant preferential credits for internal but not extraregional trade is a form of protection for goods that are traded internally. Thus, provision of credits on preferential terms is not consistent with policies aimed at opening up Central American economies in general.

Since there is no program to increase trade under the Consejo proposal, one must ask what happens if trade does not increase. Table 6.6 shows what would occur if the financing program were put in place, and if trade stayed at the 1984 level of \$650 million in the CACM-N. Extraregional sources would have lent almost \$96 million for no purpose whatsoever. The loans would turn out to be equivalent of general balance of payments support loans. Thus, there could be substantial cost even where nothing changes. Another way to look at this concern is to ask how much extraregional sources would have to lend to get an increment of trade. Reflect back on Tables 6.3 and 6.4. In the scenario of Table 6.3, trade rises to \$790 million and loans from extraregional sources would be about \$115 million. The increment in trade above the 1980 level (\$650 million) is \$140 million. Thus, in effect, it takes \$115 million of loans to support \$140 million of increased trade. In the case of reestablishing the real 1980 level of trade (Table 6.4), the trade increment of \$365 million by 1989 comes at a total cost of about \$142 million in loans from extraregional sources. In any case, even if the trade increment occurs, the amount of lending that extraregional lenders would have to commit themselves to is extraordinarily high compared to increments in trade.

Table 6.6

No Increase in CACM-N Trade

Proposal with CACM-N, Interest at 8%

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Annual Trade Assumptions	650.00	650.00	650.00	650.00	650.00					
Deficit Assumptions	91.00	91.00	91.00	91.00	91.00					
Means of Financing										
Cash Payment by Central Bank	27.30	27.30	27.30	27.30	27.30					
Financing	63.70	63.70	63.70	63.70	63.70					
By Central Banks	31.85	31.85	31.85	31.85	31.85					
By Extraregional Source	31.85	31.85	31.85	31.85	31.85					
Amortization: Principal	0.00	12.74	25.48	38.22	50.96	63.70	53.70	38.22	25.48	12.74
Interest	0.00	5.10	9.17	12.23	14.27	15.29	10.19	6.12	3.06	1.02
Net Financing	63.70	50.96	38.22	25.48	12.74	-63.70	-53.70	-38.22	-25.48	-12.74
Cumulative Financing	63.70	114.66	152.88	178.36	191.10	127.40	73.70	35.48	10.00	-2.74
From Extraregional Source	31.85	57.33	76.44	89.18	95.55	63.70	36.85	17.74	5.00	-1.37

A second question that can be raised is whether or not the trade imbalances in the region are of such a size as to cause a foreign exchange burden that would discourage trade. Surely the size of the recent deficits accumulated by Nicaragua was not consistent with the ability of the creditors (Guatemala and Costa Rica) to extend credit nor the ability of Nicaragua to service its debt. Thus, trade between Nicaragua and her neighbors has almost stopped. However, under the circumstances trade should be stopped. With the overvalued Cordoba pegged at 10 = \$1 rather than the 60 to 70 = \$1 that would probably occur in a relatively free parallel market, countries that import from Nicaragua get fewer real resources when they import than Nicaragua gets when it imports. Non-Nicaraguan importers should get 60-70 Cordobas worth of real resources when they buy \$1 worth of goods from Nicaragua, yet they get only 10. Nicaraguan importers should be giving up claims on 60-70 Cordobas worth of resources when they import \$1 worth of goods. Rather, they give up only 1/6 to 1/7 of this amount. The problem in this case has nothing whatever to do with whether or not there is a financing scheme in place to cover foreign exchange needs. The problem is that the central bank of Guatemala (or any other one) is correctly reluctant to give Nicaragua credit, when Nicaraguan importers are paying in real terms, only 1/6 to 1/7 of what Guatemalan goods are worth. Imbalances of this kind should not be financed by any publicly supported program.

The Nicaraguan case is an extreme one. Absent Nicaragua, are imbalances so large that trade is likely to be damaged by them? Reflecting back on Tables 5.5 through 5.9, we recall the overall deficit and surplus positions of each CACM country. Guatemala and Costa Rica run surpluses. Honduras runs a deficit, but it always has and the Honduran deficit now is not much different from what it usually has been in the past. Indeed, for several recent years, Honduras has run a non-traditional surplus. El Salvador has long been a deficit country. During 1979-81 its deficits were very large, but the situation improved considerably in 1982-84, with deficits running less than they were in the late 1970's, on average. In short, the main deficit problem has been associated with Nicaragua. Removing consideration

of that country leaves a picture of deficits and surpluses which is not striking and not much different from what was seen before 1980. El Salvador takes some responsibility for the deficit situation, but that is small compared to Nicaragua. Also, Table 5.11 reveals that, absent Nicaragua, foreign exchange required for settlement was generally less in 1982-84, than it was in 1979-81, though there was an increase in 1984. Again, it is El Salvador which is in greatest need of foreign exchange for settlement purposes, and in 1984 Honduras too had sharply increased needs.

The data provide no overwhelming case that trade has been retarded by the lack of funding to cover imbalances per se, when the effect of Nicaragua is removed. Trade with El Salvador is probably retarded somewhat due to the large imbalances that have been run recently, particularly during 1979-81. However, other balances do not seem extraordinary.

It is also true that intraregional trade is not independent of extraregional trade. If there is an increase in extraregional trade, there is more foreign exchange available to finance intraregional trade. One must keep in mind that the balance of trade and payments is not designed to balance item-by-item, nor bilaterally, nor is it intended to be in balance as long as there are private capital inflows. Countries like Honduras which traditionally run deficits with the region should not object to that fact if foreign exchange earnings from outside the region are sufficient to clear regional payments. Thus, one cannot separate regional foreign exchange needs from overall foreign exchange earnings. Simply financing regional trade imbalances does not go to the heart of the problem -- overall foreign exchange earnings.

Section 7: CONCLUSIONS AND RECOMMENDATIONS

There is a general need for export promotion rather than a specific need for promoting intra-CACM trade only. Two broad principles are important in this connection. First, any trade or export promotion should not discriminate between so-called traditional and non-traditional exports. Traditional exports have been systematically discouraged through various domestic fiscal disincentives as well as through trade taxes. The case for taxing traditional exports is unclear and remains to be proven. Certainly, it distorts the allocation of resources as dictated by comparative advantage and tends to skew the internal distribution of income against low-skill categories. Second, trade or export promotion should not, as a matter of policy, discriminate for or against extra-regional trade. Any export promotion scheme should strive to be neutral in the incentives it provides to develop intra and extra-regional trade. Indeed, overall trade policy consistency would require that export promotion should not be directed solely at within-CACM trade, since that would work against the reform and lowering of the Common External Tariff (CET).

Conclusion

It is our conclusion that the proposal put forward by the Consejo not be given financial support by AID. The proposal is one which would provide support only for trade within the region. The proposal has not demonstrated that it contains any adjustment program to increase trade, nor does the proposal address the reasons or suggest remedies for the depressed level of trade in the region and the widened trade imbalances. The latter symptoms appear to be associated with four fundamental forces: depressed real incomes in the region, deterioration in the terms of trade, overvalued exchange rates relative to the rest of the world, and misaligned currencies within the countries of the CACM. Thus, any program to revive regional trade must address these issues directly.

If AID chooses to provide financial support to the Consejo proposal in any event, several points of organization, conditionality and leverage should be kept in mind. These include:

- a. CABEI may not be the most appropriate institution to house the Central American Fund for Economic Integration. As a development bank, CABEI is not motivated by the same forces as the Fund. The latter would need to monitor and enforce performance on its lending activities with a modus operandi and goals quite different from those of CABEI.
- b. The legal and organizational structure of the Consejo poses problems for the efficient functioning of a credit fund. Central Bank presidents of the CACM are the control body within the Consejo, and may not possess the necessary incentives to control and monitor trade financing. In general, the tenure of Central Bank presidents is short, and borrowing (or lending) by a Central Bank under one president will typically involve servicing a debt (or redeeming a debt) under a different president. This may create obvious "moral hazard" problems and prevents commitment to a given course of economic policy. In short, Central Bank presidents may have a lot to gain in the short term and little to lose in the medium term. Thus, any funding program should consider allocating control and monitoring of lending activities to a wider body than Central Bank presidents alone. Short-time horizons of Central Bank authorities have certainly contributed to the current bottleneck situation where past performance has led to the accumulation of large trade and payments arrears and forced a virtual moratorium on new trade credit.
- c. If something like the Consejo proposal were to be funded, some strengthening of Consejo personnel would be required. Consejo personnel are now well-suited to the functions they handle. However, the administration, evaluation and monitoring of loan funds would involve a different set of tasks for which the Consejo is not now equipped.

- d. Conditionality should be linked to the causes of trade imbalances and the low level of trade in general. While few specific steps can be taken to solve the current depressed level of economic activity, steps can be taken to encourage the establishment of realistic exchange rates and well-functioning foreign exchange markets. Any aid should be tied to the elimination of multiple exchange rate systems, progressive movement of transactions into parallel markets and the elimination of exchange rate subsidies for special categories of transactions. Establishing special overvalued exchange rates for "essential" imports has the effect of providing a direct subsidy to the consumption of the "essential" item. However, it can be shown that providing the subsidy through distorting the exchange rate is inefficient compared to a direct subsidy. Parallel markets should be allowed to establish free market values for the regional currencies. The monetary authorities should be encouraged (and supplied with the technical expertise where needed) to provide the institutional and legal structure for the establishment of broad-based markets for foreign exchange. This may necessitate, in some cases, a substantial liberalization of the financial structure (for example, in allowing residents to hold and freely transact in foreign currency deposits), and this should also be encouraged.
- e. An important aspect of conditionality concerns the status of outstanding debt arising from the clearing of past trade transactions. Debtor countries should be required to regularize their debts to creditor countries and either confirm or renegotiate terms and maturities of payment. Adequate performance in servicing debt should become a condition for any form of aid or finance.

Alternatives

Some form of export credits could be devised to promote exports of all kinds, whether within the CACM or to the outside. A major incentive to exporters would be the right to retain the proceeds and/or to convert at free or parallel market exchange rates. Requiring conversion and surrender of export proceeds at official or controlled exchange rates acts as a tax on exports and discourages trade. This could be a point of conditionality for any funding, in addition to performance on service of debt, as mentioned above.

Institutionally, export credits would be channeled through a variety of organizations, public or joint public-private, depending on the exact nature of the export credit scheme. For example, the Consejo could team up with a private international bank (or a consortium of private banks). The latter would provide the technical and administrative know-how, while the Consejo would participate in setting policy guidelines and ensuring cooperation with the CACM monetary authorities, and continuing to supervise clearing within the region. Further, being a multilateral organization, the Consejo could take on new tasks such as providing export credit guaranty services (which could cover political and commercial risks and, potentially, with adequate management, exchange risks guarantees), refinancing facilities, etc.

Teaming up public and private institutions provides a mechanism for policy design and commitment that avoids policies dictated by short-run considerations -- such as arise when executive power lies only with Central Bank presidents. Control groups (e.g., a board of directors) could be composed of Central Bank presidents and private parties.

An export promotion effort may also involve banks from outside the region. Foreign banks could serve as sources of private funds from outside the region, or as a means of attracting back to the region some of the capital that has flowed out in the past five years.

Finally, the U.S. should examine its own trade barriers to determine the extent to which they discriminate against and limit exports from Central America. Since trade with the U.S. is large in all cases, a small percentage increase in exports to the U.S. market results in a large absolute increase in foreign exchange earnings. Unfortunately, many of the traded goods that would be of interest to Central American exporters have traditionally faced high tariff and non-tariff barriers in the U.S. Textiles, shoes and leather products are examples.

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Appendix 1

Statistical Appendix to "The Balance of Trade, Payments and Real Exchange Rates in the Central American Common Market, 1965-1984"

In the main body of our report two generalizations about the pattern of trade in the Central American Common Market (CACM) were made. First, the decline in the level of trade that had occurred since 1979 could be explained by a decline in real incomes that had afflicted the Region since that time. Secondly, the trade imbalances within the Region were attributed to the relative overvaluation of some of the Regional currencies. This appendix tests these hypothesis statistically, using the data that were collected during our research and which appear in the main body of the report.

1. Level of Trade in the CACM

Here the hypothesis that the level of trade in the CACM is largely determined by the level of income in the region is tested. Both income and trade have declined sharply since about 1979, and before one can make policy prescriptions about boosting trade levels one should inquire as to the causes of the trade "problem." To test whether or not the change in the level of trade could be explained by changes in income, we estimate:

$$\text{trade level} = \text{fn} (\text{income}, \text{time})$$

The time variable is inserted to check for a time trend, since, over the time period under study (1965-84), the economic integration process in Central America would have provided an impetus to trade which is separate from income alone.

All data were adjusted for inflation, and all statistical procedures were run with monetary values expressed in dollars of 1978. The trade level was represented by total exports. Income was represented by both real GDP and real GDP per capita. Separate analyses were conducted for the five-country CACM and for the CACM minus Nicaragua (CACM-N). To check for a

lagged response between exports and income, observations on income were lagged one period (i.e. one year) and results compared to the unlagged case. All variables (except year) were expressed in their natural logarithms so that coefficients could be interpreted as elasticities. Also, fits obtained using natural logs were somewhat better than those obtained when using the unlogged values.

In general, the best results were obtained by specifying the log of real exports as a function of the log of real per capita income (PCY) lagged one period, and the year. The equations resulting from this specification are:

$$(1) \text{ In (CACM exports) } _t = -34.732 + 3.147 \ln (\text{PCY})_{t-a} + .0102(\text{year}), R^2 = .92$$

(9.27) (1.97)

$$(2) \text{ In (CACM-N exports) } _t = -40.404 + 2.413 \ln (\text{PCY})_{t-a} + .0154(\text{year}), R^2 = .90$$

(6.01) (2.30)

All coefficients are of the expected sign and all are statistically significant at better than the .05 level. Figures in parentheses below the coefficients are t values. The explanatory power of the equations is also very high, with R = .9 or better. As expected there is a strong relationship between per capita incomes and regional exports. Since all variables are in their natural log form, the coefficients can be interpreted as elasticities. For example, for the CACM-N, the coefficient on the per capita income variable, +2.413, means that for every one percent increase in per capita income in a period, there is a corresponding 2.413% increase in regional exports in the next period. The proportions hold in reverse for decreases in per capita income. Furthermore, the positive sign on the time variable indicates that, after taking into account the effect of income, there is a tendency for trade within the Region to increase over time.

One could use these equations for predictive purposes. For example, one might ask, if real incomes had not declined since 1979, what would trade levels have been, all else equal? The table below (Table A-1) shows that for the CACM, total exports would have been approximately 51% higher if income had not declined. For the CACM-N, exports would have been about 48% higher.

In summary, the statistical work strongly supports the idea that declines in trade over the past five years is largely due to a drop in real incomes in the Region.

Table A-1
Actual and Estimated 1984 Trade Levels
(millions of \$)

	1984 Actual	1984 Estimate at 1979 Income Level
CACM	779.0	1174.1
CACM-N	651.1	967.3

2. Trade Imbalances within the CACM

Whatever the levels of trade, there are still likely to be bilateral trade imbalances within the region. Here we test the hypothesis that bilateral trade imbalances are due to the pattern of relative overvaluations of some of the regional currencies vis-a-vis each other. Trade imbalances could be caused by one or all of the following:

1. Overvalued currencies: The more overvalued its currency, the further into deficit a country's balance of trade will move.

2. Economic growth differentials: The faster a country grows relative to a trade partner, the further into deficit that country's trade balance with that partner will move.

3. Instability: The countries of Central America have experienced instability of many kinds. It is not possible a priori to predict how this will affect trade balances, but one should recognize that an effect can exist.

4. Other variables such as a general change in competitiveness, trade barriers, natural disasters, etc.

The data that were used to check for these effects are:

1. Trade balances were calculated bilaterally for all pairs of countries within the CACM. These were put into dollars of 1978.

2. Real Exchange Rates (RERs) were calculated for each pair of CACM countries. These appear in the body of our main report in which two alternative price indices were used to compute RERs. Here we use the one based upon the implicit general price level (IGPL).

3. Real income growth differentials were calculated for each pair of countries.

4. A "Dummy Variable" was constructed where Dummy = 1 for years 1979 and after, and Dummy = 0 before 1979. 1979 was chosen as a watershed year, during and after which most of Central America's instability occurred.

5. The year was used as a variable to reflect any other changes which might be occurring simultaneously, such as a general loss of competitiveness, etc.

In the statistical results that follow, variable number three, the real income differential, failed to enter any equation significantly. Further discussion of that variable will therefore be dropped.

Our procedure was to move in steps, first looking for equations relating Guatemala's trade balance with Honduras, El Salvador, Costa Rica and Nicaragua. Since this step gives both Guatemala's balance with Honduras and vice versa, in step two we estimated equations representing Honduras' balance with El Salvador, Costa Rica and Nicaragua. Step three estimated Costa Rica's balance with El Salvador and Nicaragua and in the final, fourth step, El Salvador's balance with Nicaragua. These four steps provided consideration of all bilateral balances in the five-country CACM.

In no case were good statistical fits obtained for balances with Nicaragua. When attempts were made to relate balances with vis-a-vis Nicaragua with the variables being considered, the only variable to play a role was the Dummy variable. All this tells us is that since 1979, Nicaragua's balance with all the other countries has become sharply more negative. Since this is not very enlightening, and since it is clear that the Nicaraguan case is probably dominated by the political events occurring there, it was dropped from further analysis.

For the four-country CACM-N, there are six bilateral trade balances. Equations estimating the relationship between these balances and the independent variables listed above are found in Table A-2. When expressing the real exchange rate (RER) we use units of the currency of the first country shown per unit of the currency of the second country shown. For example, in the first equation we examine Guatemala's trade balance with Honduras. There the RER is expressed as Quetzales per Lempira. Therefore, a rise in the RER indicates a depreciation of the first currency (in the example, a rise in the RER is a depreciation of the Quetzal, and appreciation of the Lempira) and should improve the trade balance of that country. Thus, coefficients on the RER should be positive, which indeed they are in four of the six cases.

Table A-2

Bilateral Trade Balances

	Constant	RER	Year	Dummy D=1 After 1978	R ²
Guatemala Balance With:					
Honduras	-39.91	103.757 (3.32)	--	9.158 (3.39)	.55
El Salvador	-5878.97	209.361* (1.61)	2.941 (2.78)	--	.54
Costa Rica	-1304.36	330.867 (5.54)	.656 (1.69)	-23.597 (-4.93)	.80
Honduras Balance With:					
El Salvador		No Statistical Fit			
Costa Rica	1567.74	--	-.799 (-7.94)	--	.78
Costa Rica Balance With:					
El Salvador	-2372.34	4.046 (4.90)	1.188 (3.33)	-8.399 (-1.78)	.72

* Significant at .06

Note: A "--" indicates that the variable was excluded for each of statistical significance.

In two cases the RER did not play a statistically significant role, and both cases involved Honduras. First, no statistical fit could be obtained relating the trade balance of Honduras and El Salvador. For eleven of the twenty years under consideration there was no trade between these two countries, thus, balances were zero. Too few observations remained for statistical purposes. In the equation relating Honduran and Costa Rican balances, only time was important. The negative coefficient on the time variable probably shows a continual deterioration of Honduras' competitive position with Costa Rica.

Generally the coefficients tell us that the RER's are important determinants of trade balances, especially among the three largest trading countries, Guatemala, El Salvador and Costa Rica. The coefficients are all of the expected sign (positive), all are of reasonable statistical significance and the explanatory power of the equations is fairly high for equations of this type.

As an illustration of how this information might be used, consider Table A-3. In that table, for each country of the CACM-N, we show what the actual trade balance was in 1984 and what the equation would estimate the balance to be, had the RER's of 1978 been maintained in 1984. In the Guatemalan case the positive balance with El Salvador would have been much smaller had not El Salvador's Colon appreciated so much 1978-1984. Guatemala's balance with Costa Rica would have been positive rather than negative. This is apparently related to the overvalued condition of the Costa Rican Colon in 1978, and subsequent devaluations. El Salvador's balance with the CACM-N would have been much less negative had it not allowed the Colon to appreciate so over the 1978-84 period. The actual positive balance with the CACM-N, for Costa Rica in 1984, contrasts sharply with the negative balance that it would have registered had Costa Rica maintained the overvalued Colon of 1978.

The equations shown in Table A-3 are also useful for explaining turning points in the bilateral balances of pairs of countries. For example, one of the main changes in the bilateral balances that the region has seen in recent years is the sharp improvement in Costa Rica's balances following the devaluations of the Colon beginning in the early 1980s. Those devaluations caused a depreciation of the Colon vis-a-vis other currencies and turned Costa Rica's negative balances with Guatemala and El Salvador (her major regional trade partners) into positive ones. Table A-4 shows Costa Rica's actual balances (in dollars of 1978) and the balances estimated by the relevant equations from Table A-3. Note that in both cases the equations are able to pick up the sharp reversal in the trade balances as a result of the changes in the RER brought about by devaluations.

The equations that we have estimated are still rather crude. Additional time and attention could improve upon their accuracy and their sensitivity to the idiosyncracies of individual countries. Nevertheless, they present convincing evidence that real exchange rates are an important determinant of bilateral trade balances and that, as in Costa Rica's case, devaluation of overvalued currencies can improve upon trade balances in predictable ways.

Table A-3

Actual 1984 and Estimated 1984 balances:
Estimates based on 1978 RERs
 (in millions \$)

	Honduras	El Salvador	Costa Rica	CACM-N
Guatemala				
Estimate	31.16	58.54	17.93	107.63
Actual	34.10	82.50	-16.60	100.01
	Guatemala	El Salvador	Costa Rica	CACM-N
Honduras				
Estimate	-31.16	4.9*	-25.77	-52.03
Actual	-34.1-	4.9	-25.30	-54.50
	Guatemala	Honduras	Costa Rica	CACM-N
El Salvador				
Estimate	-58.54	-4.9*	14.55	-48.89
Actual	-82.50	-4.9	-13.20	-100.60
	Guatemala	Honduras	El Salvador	CACM-N
Costa Rica				
Estimate	-17.93	+25.77	-14.55	-6.71
Actual	16.60	25.30	+13.20	55.10

* No estimate available

Table A-4

Actual and Estimated Balances
for Costa Rica

Costa Rica's Balances with:

	Guatemala		El Salvador	
	Estimated	Actual	Estimated	Actual
1978	-8.2	-20.4	-17.0	-12.6
1979	-15.1	-19.3	-17.0	-19.9
1980	19.9	-20.7	-15.6	-12.7
1981	5.8	.2	2.4	4.9
1982	8.8	4.8	10.4	7.9
1983	4.7	13.3	7.1	9.2
1984	4.4	11.3	11.1	9.0

Appendix 2

SCOPE OF WORK

- A. Analyze the historical pattern of trade and payments imbalances among the five CACM trading partners and give an exact description of how, through the operations of the clearing house, such imbalances have been cleared.
- B. Detail the various tariff and non-tariff barriers that have been applied to intra-regional trade since 1979.
- C. Analyze the movements of the real effective exchange rates among the CACM trading partners with respect to intra-regional trade.
- D. Based on the analysis in C above and under the assumption that each CACM trading partner maintains a bilateral balance with Nicaragua, determine the likely impact of a resumption of unrestricted free trade among Guatemala, El Salvador, Costa Rica and Honduras on:
(1) the volume of intra-regional trade, (2) the pattern of surpluses and deficits among the four, (3) the extra-regional import bill, (4) production and employment in key manufacturing industries and (5) economic growth in each trading country.
- E. With the participation of the ROCAP staff, discuss various alternative financial facilities through which the U.S. Government could help increase intra-regional trade flows.
- F. Based on the assumption that U.S. participation will be based on a set of conditionality that will seek to reform key items in the regional trade regime, review the current USAID regional and bilateral programs in Central America to determine whether the macroeconomic policy objectives will yield possible points of bilateral and regional leverage.
- G. Based on the analysis in E and F, discuss, with the participation of the ROCAP staff, an appropriate set of conditionality for U.S. participation in an intra-regional trade financing facility and recommend a course of action to implement it.
- H. Prepare and present a report for the Mission Director's meetings.