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STATUS REPORT ON TRADE IN CENTRAL AMERICA: A STATISTICAL UPDATE AND A PROPOSED ROLE FOR ROCAP IN IMPROVING REGIONAL TRADE POLICIES

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1. Introduction

The purpose of this report is to analyze recent developments affecting trade in Central America. It updates information on intra- and extra-regional trade flows in Central America and examines several policies aimed at reactivating commerce among the Central American nations. Assuming that AID considers it appropriate to participate in the reactivation of these trade flows, the report proceeds to outline possible programs ROCAP could adopt to further this objective.

Section 2 updates information on trade flows through 1986. The information focuses on intra-regional trade, that is on commerce between the five nations participating in the Central American Common Market (CACM). In addition, data are presented on per capita incomes in the CACM and the relative importance of extra-regional trade flows. In Section 3, attention is shifted to current proposals for expanding trade within the CACM. These include the DICA ("Derecho de Importación Centroamericano") and other recommendations for expanding trade within the region. Section 4 suggests a role for ROCAP within the framework of a program designed to reactivate trade among the CACM nations. This section examines how intra-regional trade may be enhanced without jeopardizing, and hopefully even augmenting, commerce with the rest of the world. A more outward strategy of trade is believed crucial to avoid a repetition of the excess reliance on import substitution policies as occurred during the early stages of the CACM. At the end of this report, Section 5 contains brief conclusions drawn from previous sections.

2. Recent Trends in Commerce Among CACM Nations

a. CACM Trade Up to 1984: The Checchi Study

In a recent study commissioned by ROCAP, two consultants from Checchi and Company traced the evolution of exports and imports in the CACM from its initiation in the early 1960s through 1984. 1/ The figures amply document the sharp decline in intra-regional trade flows within the CACM during the 1980s. For instance, over the 1980 to 1984 time period, intra-regional exports were shown to have plummeted by approximately 34 percent. 2/ The Checchi study identified the following conditions as having played a major role in contributing to the deterioration of trade in the CACM:

- persistent repatriation of earnings from past investments in the region along with increased interest payments;
- reduced demand for the region's exports;
- an unfavorable turn in the terms of trade affecting the region since 1980; and
- overvaluation of regional currencies.

Underlying several of the above conditions, capital flights resulting from the region's political turmoil were recognized as a major determinant of its economic troubles.

1/ Nasser Saidi and William Loehr, "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," Checchi and Company, March 1985.

2/ As will be explained later, there is reason to believe that exports over this time period have fallen by even more than the indicated figure of 34 percent.

Within the CACM, the Checchi study documented major trade imbalances. The heaviest importers, in particular Nicaragua, fell behind in their ability to settle short term obligations arising from persistent balance of payments (BOP) deficits. Although the virtual default of Nicaragua certainly contributed greatly to the economic problems facing the region, the study presented figures showing that, even without accounting for trade flows to and from Nicaragua, exports and imports among the other four countries of the CACM dropped sharply between 1980 to 1984. Imports among these nations, measured in terms of Central American pesos, fell by almost 17 percent in nominal terms. The fall is even greater in real terms; in fact it would reach 35 percent if the Central American peso (which is tied to the dollar) were deflated by movements in the U.S. wholesale price index over the same five year time period.

Along with the decline in intra-regional commerce among the CACM nations, some of the institutions associated with the common market entered in decline. Especially noteworthy was the failure of the Cámara de Compensación to continue serving as a clearing house for intra-regional financial flows arising from regional trade. This institution, established by the central banks of the CACM nations in 1961, facilitated payments arising from commerce among member nations by recording the value of trade flows in hard currency and requiring settlement of outstanding balances semi-annually - or sooner if one of the nations reached a credit position of $12 million or more before the completion of the six month period. This institution avoided the necessity of settling individual transactions in hard currency. Clearings of the Cámara declined from 1,256 million Central American pesos in 1980 (108.1 percent of CACM exports) to 391 million pesos (50 percent of exports) in 1984. The decline was due to the lack of a mechanism to settle the chronic deficits of debtor nations, in particular Nicaragua. However even without Nicaragua, the failure of the other four nations to allow the values of their currencies to decline in response to deteriorated balance of payments was also enough to severely weaken the clearing mechanism set up by the Cámara.

The Checchi study carefully documented a growing divergence between official and parallel exchange rates from the end of the 1970s to 1984. They converted nominal exchange rates of the five Central American nations into real rates (correcting for variations in the relative prices between the CACM and the US) and to real effective (trade-weighted) exchange rates. The study demonstrated the distortions arising from overvalued currencies. Given the existence of these distortions, it is not surprising that chronic trade deficits appeared along with the eventual disruption of CACM exports and imports.

The Checchi study adamantly rejected programs designed to fund the imbalances arising from intra-regional trade without effectively addressing the issue of misaligned exchange rates. Such funding schemes were correctly criticized as representing little more than short term palliatives failing to cope with the underlying causes of region's structural imbalances. The Checchi study was also correct in stressing the need to avoid export promotion with a purely inward focus. That is, any scheme of export promotion must seek to develop the productive areas in which CACM nations possess comparative advantages without resorting to the extreme forms of import substitution practiced during the beginning of the CACM.

The present report fully endorses the above conclusions of the Checchi study. However, two other conclusions of the Checchi study are assigned lesser importance by the author of this report. One concerns the importance of regularizing the debt situation of the CACM nations. While the Checchi study states that this situation should be regularized, and the authors are correct in suggesting such a regularization would be helpful to reactivating regional trade, the settlement of past debts is not a prerequisite to achieve the rennovation of trade. In fact exports are still being realized, albeit at reduced levels, by creditor nations to those in arrears. For instance, Guatemala is still exporting to Nicaragua. As will be discussed later, this trade may even be increasing.

A second observation made on a conclusion of the Checchi study concerns its steadfast opposition to schemes designed to finance trade imbalances. While the authors are basically correct in recommending against any such assistance without first achieving a market-based alignment of exchange rates, they appear to come down too hard against stabilization programs. Perhaps it should be mentioned that a mechanism to finance short term imbalances would indeed be justifiable if the exchange rates were aligned or if appropriate measures were taken to align them expeditiously. Under these circumstances, a financing mechanism designed to support the measures needed to correct the short term difficulties could be most useful. Such a program could finance precisely the type of measures recommended by the authors of the Checchi study.

b. CACM Trade Up to 1986: An Update of the Checchi Study

The same trends documented in the Checchi study for the 1980 to 1984 period generally persisted through 1986. Both intra- and extra-regional imports declined during the latter two years. Intra-regional exports also continued to fall. However, exports to the rest of the world have been increasing after reaching their lowest point in 1982. Per capita GDP maintained its downward trend in 1985 and 1986.

Although this section attempts to update the statistics presented in the Checchi study, it should be noted that the updates are not necessarily consistent with the figures of the cited study. This is partially due to the failure of the Checchi researchers to adequately document their sources of information. Moreover, their tables often failed to cite the units of measurement utilized and what, if any, modifications or corrections were made on the original data. Despite these problems, the present report and the Checchi study do not differ markedly on the overall statistical trends observed for the 1980 to 1984 period. Thus it is assumed that the update through 1986 is likely to be consistent with the results presented for the five preceeding years.

Before presenting and analyzing the information for 1985 and 1986, it is important to look carefully at some of the characteristics of the data presented in this report. In particular, it should be noted that the basic data are generally expressed in Central American pesos. This unit of measurement is pegged to the dollar and serves as an adequate measure of trade, incomes and other statistics during the early years of the CACM and up to the appearance of problems in the late 1970s and early 1980s.

However, with the emergence of these problems, and in particular the overvaluation of official exchange rates, the Central American peso begun to introduce serious biases in the statistical series expressed in terms of this unit of measurement. Income data, for instance, converting domestic currencies into pesos at overvalued exchange rates are overstated in terms of hard currency. The same is true of trade data and several other figures. This problem is especially complicated for regional data series combining basic statistical information for several nations each with its own reporting policies - either on the basis of overvalued exchange rates, market determined rates or a combination of the two. As the official rates diverged more and more from the parallel rates in the early 1980s, this problem assumed greater importance.

In 1986, however, the bias was partially corrected. In January of this year, the official exchange rate corresponding to the colón of El Salvador was devalued by 100 percent, thereby eliminating a large part of the spread between its official at parallel market values. Even more important, in the same month, Guatemala abandoned the official rate of exchange for reporting purposes, substituting in its place, a market determined exchange rate. During the 1980s, Costa Rica has progressively liberalized its exchange rate practices and also its reporting policies. Both Honduras and Nicaragua stick to converting local currency to pesos at overvalued official exchange rates.

The above reporting practices have a severe impact on transactions whose original prices are based in domestic currency and are then expressed in hard currency on the basis of any one of several rates of conversion. This is especially true for non-traditional trade - the type which is of most importance between the CACM nations. Since certain exports - usually traditional exports - are denominated in hard currency from the start, the direct conversion of these values to pesos would introduce no special bias. The same is generally true of imports from outside the region.

Assuming that the parallel rates of exchange more closely reflect the economic values of Central American currencies than the overvalued official rates, then the previously mentioned biases overstating basic statistics grew in importance with the divergence of official and parallel rates up to 1985. Since Guatemala abandoned the official rate for reporting purposes in January 1986 and since earlier figures were not restated to reflect the more realistic parallel rates, Guatemalan data (and, therefore to a lesser extent, that of the combined figures for all the CACM nations) are somewhat difficult to compare effectively between 1986 and the years just prior to 1985. This problem is complicated even more by the devaluation of the colón of El Salvador in January 1986.

The major implication of this bias is that it tends to overstate the values of figures expressed in terms of official exchange rates. Thus, this is most likely to affect non-traditional trade and, since this is the type of trade most realized within the CACM, the bias is especially important for intra-regional trade flows.

i. Intra-regional Trade Flows

Figures for total exports and imports within the CACM are presented in Table 1. It can be seen that the basic data were provided by SIECA (Secretaría Permanente del Tratado General de Integración Económica Centroamericana). Although the figures presented for 1985 are classified as "preliminary", the Director of SIECA's Department of Statistics affirmed that the data are almost in final form. They only lack several very minor adjustments. The "estimated" figures for 1986 are also likely to be close to their final values. For Guatemala and Nicaragua, the figures are preliminary, that is, they are based on information for the whole year. In the case of Costa Rica, the estimates are based on a comparison of the results of the first nine months of 1986 and 1985 while the Honduras and El Salvador results compare the first six months of the same two years to derive the estimate for all 1986.

Table 1 shows a fall in intra-regional CACM exports from 1,129 million Central American pesos in 1980 to 719 million pesos in 1984, a drop of about 36 percent. Although both of the total cited SIECA export figures are about nine percent less than the export data presented in the Checchi study, the percentage changes are almost the same. In 1986, Table 1 shows a further decline in exports to 396 million pesos, a drop of 45 percent from 1984. Even though the magnitude of the latter decline may be somewhat exaggerated due to biases in the data overstating 1984 figures relative to those of 1986, the biases are unlikely to have been sufficiently great to call into question the fact that intra-regional trade continued to plummet in 1985 and 1986. This has been amply verified in several interviews with professionals familiar with trade patterns prevailing in the region. Although it is still too early to obtain figures for 1987, it is worth noting that a high level Guatemalan authority claimed that exports from his country to the CACM region are picking up in 1987.

Table 1 also shows that exports over the first seven years of the 1980s declined by 65 percent. Over the same seven year period, intra-regional CACM imports declined from 1,100 million pesos in 1980 to 441 million pesos in 1986, a fall of 60 percent. The decline from 1984 to 1986 alone is registered at 40 percent.

TABLE 1

EXPORTS AND IMPORTS IN THE CACM, 1980-1986

(in thousands of Central American pesos)

Country	1980	1981	1982	1983	1984	(P) 1985	(E) 1986
EXPORTS							
Guatemala	403,728	355,501	320,067	308,690	285,238	205,127	185,043
El Salvador	295,796	206,484	174,228	164,895	156,218	95,727	84,725
Honduras	83,889	65,912	51,877	61,380	47,722	19,893	22,188
Nicaragua	75,419	70,872	52,085	33,476	37,091	24,162	11,100
Costa Rica	270,328	238,023	167,197	198,184	192,914	143,528	92,559
Total CACM	1,129,161	936,793	765,455	766,625	719,182	488,436	395,615
IMPORTS							
Guatemala	155,348	186,408	219,912	229,426	186,576	99,457	84,425
El Salvador	320,333	304,832	260,849	233,053	251,366	216,771	161,338
Honduras	103,540	118,382	86,841	104,741	98,958	74,846	56,749
Nicaragua	300,561	210,507	116,947	123,571	74,496	56,742	43,000
Costa Rica	219,788	152,293	112,389	120,165	114,878	92,655	95,786
Total CACM	1,099,570	972,422	796,938	810,956	726,274	540,471	441,298
BALANCE OF TRADE							
Guatemala	+248,380	+169,093	+100,155	+79,264	+98,662	+105,669	+100,618
El Salvador	-24,538	-98,348	-86,621	-68,158	-95,148	-121,044	-76,613
Honduras	-19,651	-52,470	-34,964	-43,361	-51,236	-54,953	-34,561
Nicaragua	-225,142	-139,635	-64,862	-90,095	-37,405	-32,579	-31,900
Costa Rica	+50,540	+85,730	+54,808	+78,019	+78,036	+45,291	-3,227
UNEXPLAINED RESIDUAL	+29,589	-35,629	-31,483	44,331	-7,092	-52,035	-45,683

Source: SIECA, "El Comercio Intracentroamericano en el Período 1980-1986," May 1987.
(P) Preliminary
(E) Estimated

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It should be noted that the above figures are expressed in current Central American pesos. If they were corrected for inflation (by a price index tied to the dollar since the peso is linked to that currency), the drop in intra-regional trade among the CACM countries would appear even greater than it does in the figures already presented.

Turning to the trade patterns of individual Central American nations, Table 1 shows that Guatemala was the most important exporter to the CACM region throughout the 1980s. El Salvador was the second most important exporter in 1980 but by 1986 was overtaken by Costa Rica. In most of the seven years, Nicaragua was in last place in relation to exports; however, it was the second most important importer in 1980. In 1986, Nicaragua imported less than any other nation. This coincides with the failure to normalize its payments. Guatemala had a surplus in its regional trade in each of the seven years. Costa Rica was also a surplus nation in every year with the exception of the last. The remaining three nations registered deficits in each of the seven years.

The reader should be reminded that the information presented in Table 1 was prepared by SIECA on the basis of data furnished by the Central Banks of the five CACM nations. In general, the figures do not capture the effects of over-the-border transactions realized by individuals. Neither does the table fully account for the importance of barter transactions, occasionally reported to be on the upswing in Central America (this opinion, however, was disputed by an official of the Bank of Guatemala). Although the Bank of Guatemala attempts to measure the importance of barter transactions, this may not be true of the figures corresponding to other nations. Even in the case of Guatemala, it is possible that barter transactions may be underestimated. It is known that the little trade now realized between Nicaragua and the rest of the region is usually carried out in barter or hard currency. However, as shown in Table 1, Nicaraguan exports in 1986 represented less than 3 percent of the total while the latter's imports were accounted for than 10 percent of CACM intra-regional imports originating in the region.

Table 2 establishes 1980 as a base year and constructs a series of index numbers showing the declines in intra-regional trade corresponding to each of the five nations. The drop in intra-regional exports and imports for Nicaragua is especially noteworthy. However, the changes in the trade figures affecting that nation are also influenced by its exaggerated level of imports in the years proximate to 1980. In the first six years of the decade of the 1980s, Table 2 clearly shows how the downward trend of intra-regional CACM exports and imports has affected each of the five nations. The downward trend is especially strong in 1985 and 1986.

The relative participation of each nation in CACM intra-regional trade is demonstrated in Table 3. It is seen Guatemala's relative importance grew both in respect to exports and imports over the 1980 to 1986 period.

Table 4 shows that, for each of the five Central American nations, intra-regional exports and imports declined as a percentage of total exports and imports. The shares of intra-regional exports and imports dropped respectively from 25.4 percent and 18.5 percent in 1980 to 9.8 percent and 8.8 percent in 1986. The annual growth rates of exports and imports for each nation are presented in Table 5. Given the results presented in Tables 1 through 4, it is certainly not surprising

TABLE 2

INDICES OF CACM EXPORTS AND IMPORTS, 1980-1986

(1980 = 100)

Country	1980	1981	1982	1983	1984	(P) 1985	(E) 1986
EXPORTS							
Guatemala	100.0	88.0	79.3	76.5	70.6	50.8	45.8
El Salvador	100.0	69.8	58.9	55.7	52.8	32.4	28.6
Honduras	100.0	78.6	61.8	73.2	56.9	23.7	26.4
Nicaragua	100.0	90.0	69.1	44.4	49.2	32.0	14.7
Costa Rica	100.0	88.0	61.8	73.3	71.4	53.1	34.2
Total CACM	100.0	83.0	67.8	67.9	63.7	43.3	35.0
IMPORTS							
Guatemala	100.0	120.0	141.5	147.7	119.5	64.0	54.3
El Salvador	100.0	95.1	81.4	72.7	78.5	67.7	50.4
Honduras	100.0	114.3	83.9	101.2	95.6	72.3	54.8
Nicaragua	100.0	70.0	38.9	41.1	24.8	18.9	14.3
Costa Rica	100.0	69.3	51.1	54.7	52.3	42.2	43.6
Total CACM	100.0	88.4	72.5	73.7	66.0	49.2	40.1

Source: SIECA, "El Comercio Intracentroamericano en el Período 1980-1986," May 1987.

(P) Preliminary
(E) Estimated

TABLE 3

PARTICIPATION OF EACH NATION IN CACM EXPORTS AND IMPORTS, 1980-1986

(percentages)

Country	1980	1981	1982	1983	1984	(P) 1985	(E) 1986
EXPORTS							
Guatemala	35.7	38.0	41.8	40.3	39.7	42.0	46.8
El Salvador	26.2	22.0	22.8	21.5	21.7	19.6	21.4
Honduras	7.4	7.0	6.8	8.0	6.6	4.1	5.6
Nicaragua	6.7	7.6	6.8	4.4	5.2	4.9	2.8
Costa Rica	24.0	25.4	21.8	25.8	26.8	29.4	23.4
Total CACM	100.0	100.0	100.0	100.0	100.0	100.0	100.0
IMPORTS							
Guatemala	14.1	19.2	27.6	28.3	25.7	18.4	19.1
El Salvador	29.1	31.4	32.7	28.7	34.6	40.1	36.6
Honduras	9.4	12.2	10.9	13.0	13.6	13.8	12.9
Nicaragua	27.4	21.6	14.6	15.2	10.3	10.5	9.7
Costa Rica	20.0	15.6	14.1	14.8	15.8	17.1	21.7
Total CACM	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: SIECA, "El Comercio Intracentroamericano en el Período 1980-1986," May 1987.

(P) Preliminary
(E) Estimated

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TABLE 4

PARTICIPATION OF THE CACM IN EACH MEMBER NATION'S TOTAL EXPORTS AND IMPORTS, 1980-1986

(percentages)

Country	1980	1981	1982	1983	1984	(P) 1985	(E) 1986
EXPORTS							
Guatemala	27.4	32.1	29.5	27.6	26.1	20.1	17.4
El Salvador	41.1	42.1	42.7	35.2	25.7	12.7	10.9
Honduras	10.3	9.2	7.9	9.3	6.8	2.8	2.6
Nicaragua	17.3	14.2	12.8	7.8	10.2	8.1	5.0
Costa Rica	27.0	23.6	19.2	22.7	19.6	15.1	8.2
Total CACM	25.4	24.5	22.4	21.6	19.1	13.1	9.8
IMPORTS							
Guatemala	10.0	11.5	15.5	19.9	12.9	8.5	8.8
El Salvador	32.8	29.2	27.6	24.2	19.1	21.3	16.1
Honduras	10.3	12.5	12.5	12.7	12.1	8.6	6.2
Nicaragua	33.9	21.1	15.1	15.3	9.0	6.4	4.9
Costa Rica	14.4	12.6	12.6	12.2	10.5	9.0	7.6
Total CACM	18.5	16.7	16.9	17.1	13.2	10.0	8.8

Source: SIECA, "El Comercio Intracentroamericano en el Período 1980-1986," May 1987.

(P) Preliminary
(E) Estimated

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TABLE 5

ANNUAL GROWTH RATES OF EXPORTS AND IMPORTS WITHIN THE CACM, 1981/80-1986/85

(percentages)

Country	1985/80	1982/81	1983/82	1984/83	1985/84	1986/85
EXPORTS						
Guatemala	-11.9	-10.0	-3.5	-7.6	-28.1	-9.8
El Salvador	-30.2	-15.6	-5.3	-5.2	-38.7	-11.5
Honduras	-21.4	-21.2	+18.3	-22.2	-58.3	+11.5
Nicaragua	-6.0	-26.5	-35.7	+10.8	-65.1	-10.2
Costa Rica	-11.9	-29.7	+18.5	-2.6	-24.7	-35.5
Total CACM	-17.0	-18.3	+0.1	-6.2	-31.8	-19.0
IMPORTS						
Guatemala	+20.0	+18.0	+4.3	-18.6	-46.7	-15.1
El Salvador	-4.8	-14.4	-10.6	+7.8	-13.7	-25.6
Honduras	+14.3	-26.6	+20.6	-5.5	-24.3	-24.2
Nicaragua	-30.0	-44.4	+5.6	+39.7	-23.8	-24.2
Costa Rica	-30.7	-26.2	+6.9	-4.4	-13.1	+3.4
Total CACM	-11.5	-18.0	+1.7	-10.4	-24.6	-18.3

Source: SIECA, "El Comercio Intracentroamericano en el Período 1980-1986." May 1987.

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that the annual growth rates of Table 5 are predominantly negative.

ii. Extra-regional Trade Flows

Table 6 compares intra-regional CACM exports and imports with extra-regional trade flows. While the nominal value of exports to the CACM fell 64.9 percent from 1980 to 1986, exports to the rest of the world grew by 9.8 percent. Although the latter figure is positive, it should be remembered that it would turn negative if the nominal values of Central American pesos in Table 6 were expressed in real terms. CACM imports fell both from outside the region as well as inside it. However, the fall in imports was much sharper within the CACM.

In 1985 and 1986, exports to the rest of the world, increased by 20 percent while imports fell by 4 percent. It is during these same two years that intra-regional trade registered its sharpest downturns (perhaps partially due to the statistical biases associated with utilizing overvalued exchange rates). Under any circumstances, Tables 4 and 6 amply document the decline in intra-regional trade in relation to the commerce realized outside the borders of the CACM.

Upon looking more carefully at the extra-regional export figures, it is readily seen that exports outside the CACM region have consistantly increased since 1982. From 1982 to 1986, they went from 2,650 million Central American pesos to 3,645 million pesos - an increment of almost 38 percent. Even upon correcting these nominal figures to express them in real terms, total extra-regional exports would still demonstrate an important increment. This is one of the few positive signs affecting the recent trade patterns of the CACM nations.

TABLE 6

CENTRAL AMERICAN EXPORTS AND IMPORTS TO THE CACM
AND THE REST OF THE WORLD, 1980-1986

(in millions of dollars)

	EXPORTS			IMPORTS		
	CACM	REST OF THE WORLD	TOTAL	CACM	REST OF THE WORLD	TOTAL
1980	1,129	3,320	4,449	1,100	4,846	5,946
1981	937	2,887	3,824	972	4,848	5,820
1982	765	2,650	3,415	797	3,919	4,716
1983	767	2,784	3,551	811	3,932	4,743
1984	719	3,045	3,764	726	4,774	5,500
1985(P)	488	3,237	3,725	540	4,860	5,400
1986(E)	396	3,645	4,041	441	4,570	5,011
Change: 1980 to 1986	-64.9%	+9.8%	-9.2%	-59.9%	-5.7%	-15.7%

Source: Tables 1 and 4.

(P) Preliminary
(E) Estimated

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c. CACM: Per capita GDP

Turning to Table 7, it is seen that the declines in per capita GDP registered by the Checchi study for 1980 to 1984 continued in 1985 and 1986. Over the latter two years, Nicaragua suffered an especially sharp decrease in per capita GDP (-10.5 percent) while the mildest decline was registered by Honduras (-0.7 percent). In general, 1985 witnessed harsher reductions in per capita GDP than 1986. In the latter year Costa Rica even experienced a small increment (+1.5 percent) in its per capita GDP.

Although it is still far too early to draw even tentative conclusions, the continuation of the relative improvements in per capita production associated with 1986 to later years may signify a reversal of the lengthy economic problems affronting Central America. Perhaps an eventual improvement in GDP could be related to an acceleration of the increase in extra-regional exports observed since 1982. Of course, any such improvement in GDP would require a much better economic performance than was registered in 1986.

d. The Breakdown of Regional Institutions Designed to Promote Trade

Along with the troubles of the region and the ensuing break-down of trade, some important regional institutions are feeling the effects of the economic situation. Financial support of regional institutes is now generally assigned a low priority by the Central American nations. Consequently, these entities are underfunded and threatened by retrenching.

TABLE 7

PER CAPITA INCOMES OF CACM NATIONS, 1984 - 1986

(in Central American pesos of 1970)

	YEAR			PERCENTAGE CHANGES		
	1984	1985	1986	1985/84	1986/85	1986/84
Guatemala	405	390	379	-3.7	-2.8	-6.4
El Salvador	233	231	226	-0.9	-1.0	-3.0
Honduras	276	275	274	-0.4	-0.4	-0.7
Nicaragua	276	256	247	-7.2	-3.5	-10.5
Costa Rica	677	665	675	-1.8	+1.5	-0.3

Source: SIECA, preliminary data.

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With the persistent overvaluation of currencies and the failure of member nations to settle accounts, the clearing house functions of the Cámara de Compensación have now virtually come to a halt. Exporters are understandably reluctant to accept local currencies and barter transactions may be on the rise, especially with Nicaragua. 1/

Despite the generally unfavorable trends in trade and production, other recent events may be somewhat more favorable for the economies of Central America. Most important among these is modest progress in the direction of aligning exchange rates.

e. Progress on Currency Alignments

In Guatemala, the official exchange rate was virtually abandoned (only limited debt service payments are still governed by the former rate establishing parity between the quetzal and dollar). This was accomplished by progressively passing transactions from the official to parallel rate during 1985 and 1986. However, some restrictions still remain. These include impediments on the repatriation of profits and capital by foreign corporations.

In Costa Rica, transactions have also been progressively passed from the official exchange rate to the parallel market. The latter rate is currently close to that prevailing on the black market (see Table 8).

1/ While some barter transactions between Guatemala and Nicaragua are known - for instance, Guatemalan textiles exchanged for peanuts or steel - no hard data could be attained either on the magnitude or trends of this type of trade.

TABLE 8

CENTRAL AMERICAN EXCHANGE RATES
JULY 1987

(expressed in units per dollar)

	Market		
	Official	Parallel	Black
Guatemala (Quetzal)	2.50	2.70	2.70
El Salvador (Colón)	5.00	-	5.30
Honduras (Lempira)	2.00	-	2.30
Nicaragua (Córdoba)	70.00	4,500.00	7,000.00
Costa Rica (Colón)	20.00	60.50	63.50

Source: INFORPRESS CENTROAMERICANO, July 9, 1987.

In 1985, El Salvador devalued the colón by 100 percent, permitting the official rate to move close to the black market rate. Nevertheless, little progress was realized in Honduras or Nicaragua.

By consulting Table 8, it is readily seen that the current misalignment of the CACM exchange rates is much narrower than that cited by the Checchi study in 1984. Moreover, the Central American governments are becoming increasingly tolerant of the existence of parallel markets.

However, much progress still remains to be accomplished. It is especially important that the legality of the presently tolerated parallel market rates be clarified. These markets should be formerly recognized by their respective governments as the correct standard for accounting purposes. Otherwise, there still remain excessive pressures on exporters and importers to restrict trade due to the failure of their respective governments to allow commercial transactions to be recorded at the parallel rates. This situation is complicated by requirements forcing exporters to make deposits in their corresponding central banks equivalent to the dollar value of exports. This discourages Guatemalan exporters from accepting quetzales (the national currency) as payment for intra-regional exports and places an excessive importance on hard currency as a basis for regional trade. It is one of the reasons why the Guatemalan DICA is likely to meet a favorable reception within the CACM. 1/ The acceptance of the quetzal as the basis for the

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1/ Since Guatemala has a trade surplus in the CACM region and the Bank of Guatemala will accept Guatemalan DICAs in the place of hard currency to settle the liquidation of the foreign exchange required of exporters, the Guatemalan DICA will probably be favorably received within the CACM.

liquidation or, even better yet the complete elimination of the liquidation requirement, would obviate the need for a Guatemalan DICA.

f. Other Recent Developments

The concept of the DICA, currently in the process of implementation, may become increasingly important over time in the CACM. It is a scheme aimed at facilitating trade by enabling CACM nations to avoid the use of hard currencies on internal transactions. If successful, it would replace the now defunct clearing house (Cámara de Compensación) as a mechanism for settling accounts with a minimum of hard currency requirements. This topic will be discussed in further detail in Section 3.

There are reports that increased quantities of goods are being traded among CACM nations with payments in local currencies which are eventually traded on black or parallel markets. Some of these markets appear to be developing outside the borders of the countries issuing the currency. The major problem with these developments is that the markets are thin and do not always function effectively. As mentioned earlier, the markets are informal and their legality remains to be tested. They are subject to rapid price fluctuations. Excessively high spreads sometimes prevail between buying and selling rates.

3. Current Proposals to Expand Trade Within the CACM

An expansion of trade within the CACM appears quite viable. Undoubtedly, the process of reactivation could be hurried along considerably by a resolution or the underlying political problems present in the region. However, even with the persistence of the region's political uncertainty, there is some reason to hope that the region's economic performance could show some improvement. An improvement in the region's economic policies could provide an important inducement to an eventual recovery. Any recovery, even if it is only partial in nature, would almost certainly be accompanied by increased trade - some of it intra-regional in nature but another part would be with the rest of the world.

As emphasized in the Checchi study, a realignment of exchange rates is of utmost importance to reactivating trade in the CACM. This reform now apprears to be within the grasp of the political authorities governing the region. It calls for the abandonment of administratively controlled exchange rates and replacing them with an exchange rate regime determined by market forces. This reform has been implemented in Guatemala (even though there still exists an official exchange rate scheduled to be phased out over time and some restrictions on the free convertibility of quetzales) with considerable initial success.

Despite the determination of the value of the quetzal by market forces, much remains to be done to effectively align CACM exchange rates according to market forces. An idea for a specific measure to accomplish this objective is proposed in Section 4. However, before turning to that topic, it is important to review a different proposal in more detail - the previously mentioned DICA - which has also been recommended as a stimulant to trade flows in the CACM. Attention will also be given to other proposals recently made by SIECA to reactivate trade within the region.

a. The DICA

The DICA ("Derecho de Importación Centroamericano") was proposed as a mechanism to reopen the channels of payments among Central American nations. It became officially (but not in practice) effective in November 1986 with accords reached between the central banks of the region.

A DICA is an instrument, denominated in dollars (but redeemable only in local currency), emitted by a Central Bank in an importing country. It would be used to pay for the CIF cost of imports. A country issuing DICAs would be expected to accept them from its exporters, in place of hard currencies, as the basis for the liquidation of foreign currencies derived from exporters (as explained in section 2).

A DICA essentially represents a claim against the imports of the issuing nation. Since it is denominated in dollars, it affords the holder limited protection against devaluations of the currency of the issuing nation. However, since officially sanctioned exchange rates are used as the basis for conversion of the DICA to the local currency of the issuing nation, the instrument is no guarantee that its future value will be determined by freely determined market forces. In fact the holder of a DICA issued by the central bank of a nation suffering chronic balance of payments problems and a highly overvalued currency would still be likely to suffer losses. This is especially true because, even though the DICA is denominated in dollars, it can only be redeemed in local currency. If the redemption is not made effective by importing from the issuing nation, the DICA could be redeemed at the issuing central bank without interest 18 months after the original date of issue.

Each participating country can extend its own DICAs. They would be provided to domestic importing entities in exchange for local currency at the prevailing legal exchange rate. The DICAs, in turn, would be utilized to pay for the imported goods.

The exporter receiving them has several options for their disposition. They could be used directly to import goods or services from the issuing country; they could be sold to another importer in the same country as the recipient of the DICAs (either of the previous two transactions essentially represent a form of barter); they could be sold to someone in a third nation who could import from the country issuing the instruments; or, if markets develop sufficiently, the DICAs could be sold for hard currency. The DICAs could also be held for the 18 month waiting period for redemption, but there would be little incentive to do so because DICAs perceive no interest. However, speculators may have an interest in purchasing them at discounts.

It is contemplated that DICAs may be traded on the capital market recently established in Guatemala. However, the future of these transactions is still uncertain. To date, no concrete evidence could be found concerning the issuance of DICAs, however one trader expressed his belief that El Salvador may have issued a few. The same trader stated that he would not be interested in purchasing El Salvador DICAs because he has not been able to identify a market for them. Moreover, he expects that there will be little demand for the DICAs of the nations with trade deficits. In fact, their principal value will likely be tied to redemption possibilities at the end of the 18 month waiting period. Given the economic uncertainties prevalent in the deficit nations of the region, the values of their DICAs are subject to deep discounts.

The usefulness of DICAs is complicated by requirements specifying that an exporter make dollar deposits in his or her central bank equal to the value of the exported goods. Since the DICAs of nations other than that of the exporter may not satisfy these dollar liquidation requirements 1/, exporters will be pressured not to accept such DICAs. However, if such DICAs were accepted, then the exporter will have a strong incentive to sell them either for hard currency or for DICAs from his or her own country.

Considerable information is now available on the nature of the DICA. 2/ Some widely varying opinions have also been

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1/ Guatemala, however, is expected to accept some other DICAs to satisfy these requirements. Considerable uncertainty is expressed here and elsewhere in the treatment of DICAs because the definition of the rules concerning their issue and utilization are still to be defined by the central banks expected to issue them. To date, few DICAs (if any at all) have been issued.

2/ For more information on the nature of the DICA and opinions concerning its usefulness in reactivating trade flows, see Enrique Delgado, "El Mecanismo de los DICA en la Reactivación del MCCA," SIECA/ECID/Ap. 001-87, January 1987; R. Adler, "The DICA," Memorandum to D. A. Chaij and R. Archi dated Sept. 10, 1986; J. Herriot, "The DICA: A New Instrument for CACM Payments," Unclassified cable dated Oct. 22, 1986; three documents by the Secretaría Ejecutiva del Consejo Monetario Centroamericano: "Normas del Sistema Especial del Pago Applicable a los Transacciones Intracentroamericanas Mediante el Uso del Derecho de Importación Centroamericano," Managua, August 20, 1986, "Notas sobre la Confección del DICA para Efectos Estadísticos," undated, and "Información sobre el Derecho de Importación Centroamericano (DICA)," San José, September 19, 1986;

expressed concerning its effectiveness as a stimulant of trade within the region. The concensus of opinion seems to indicate that the DICA will do little harm; however, its usefulness will be quite marginal unless solutions are found to the fundamental problems leading to the reduction of regional trade flows.

Unfortunately the DICA offers little hope of resolving these underlying problems. It merely permits importing nations to issue a new type of currency which may be just a little more acceptable than that currently circulating in the issuing nation. It also avoids the necessity of requiring the importing nation to extend letters of credit in hard currency. These advantages of increased liquidity, however, will be quite short-lived if the issuing nation can not cope with imbalances in its trade flows. The existence of such imbalances would discourage the acceptance of DICAs corresponding to deficit nations. Such DICAs would tend to suffer discounts in relation to their dollar denominated face values.

Up to now it is still too early to draw conclusions concerning the effectiveness of the DICAs. This is partially because few, if any, have been issued; however, the central banks of three nations (Costa Rica, El Salvador and Guatemala 1/) have approved their issuance. In my opinion, the DICA system could prove advantageous to the region - especially if the establishment of a regional market in DICAs leads to open trading of the individual currencies of Central America. The latter type of trading could represent an important step in

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1/ Since trading in the Guatemalan quetzal is being progressively liberalized, the value of the Guatemalan DICA is likely to be tied closely to the prevailing dollar value of the quetzal.

the direction of achieving the alignment of currencies so urgently needed to reactivate trade flows both inside as well as outside the CACM region. An excess of DICAs issued by a nation with trade imbalances would likely lead to deep discounts in the values of these instruments. This would provide a clear signal to the issuing nation concerning the value of its currency. Perhaps it would even encourage a needed devaluation. While this in itself is useful, it is even more important (in my opinion) that Central American nations become accustomed to having their currencies (or, for the time being, an instrument related to the values of their currencies - the DICA) traded on regional markets.

Thus, it is reasonable to suppose that the system of DICAs may indeed be worthwhile, especially it they are traded on a regional market. This is not because DICAs are, in themselves, likely to reactivate trade in the CACM as argued by their proponents (to the contrary, the DICAs are unlikely to be worth much more than the currency of the issuing nations), but because this instrument represents a step toward openly trading Central American currencies on regional markets. This is a topic of overwhelming importance to the region. It will be treated in more detail in Section 4.

b. Other Proposals to Reactivate the CACM

The other proposals to reactivate the CACM refer chiefly to recommendations in a document written by an interinstitutional group and published by SIECA in June 1986. It is not considered necessary to review recommendations for settling short term trade imbalances without resolving the causes of the imbalances. In my opinion, these proposals have been effectively discredited in the Checchi study.

The Interinstitutional Group (IIG) document 1/ is noteworthy in that it recognizes the need to establish new means of payments and and exchange rate policies. It correctly acknowledges the trade distortions provoked by the maintenance of rigidly overvalued official exchange rates and calls for the introduction of market forces as the basis for an improved system of determining the values of Central American currencies. However, the document is disappointing in that it stops short of recommending an effective mechanism to align the prices of CACM currencies in a market operating independently of administrative controls.

The IIG document calls for financing deficits (presumably chronic deficits) partially in dollars and partially in local currency to the BCIE to cancel outstanding obligations (if such obligations exist). The remaining obligations, if any, would be financed by a fund in the BCIE to support projects in the debtor nation. Such a scheme offers little in terms of resolving the causes of the underlying payments difficulties of the deficit nations. To the contrary, it would place excessive pressure on the BCIE to invest in deficit nations and might well contribute to the decapitalization of the Bank. The latter would be especially likely if the deficit nation took advantage of the new financing facility to rún up larger deficits without addressing the underlying causes of the problem. This would distort the general macroeconomic environment of the nation and,

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1/ SIECA, "Reactivación del Mercado Común Centroamericano," June 1986 (Preliminary version for interinstitutional discussion). This document incorporates the work of an interinstitucional group comprised by SIECA, CMCA (Secretaría Ejecutiva del Concejo Monetario Centroamericano), BCIE (Banco Centroamericano de Integración Económica) and CEPAL (Comisión Económica para América Latina).

consequently, would jeopardize the ability of the BCIE to make viable investments in its economy.

The IIG paper also stresses the importance of settling outstanding debts within the region, perhaps even before attempting to reactivate the CACM. Apparently bad feelings arising from the existence of arrears constitute a major barrier against resuming more normal trade relations between affected CACM nations. In response to this problem, the IIG paper calls for a financing scheme to extend current obligations into long term credits with "reasonable" - presumably low - interest rates and the conversion of part of the debt into investments mutually acceptable both to the creditor and debtor nations. If accepted, the suggestion would certainly constitute one way of clearing up an annoying problem. However, the nation most heavily in debt, Nicaragua, appears to perceive little reason to address the question of its accumulated arrears.

While attempts are being made to settle debt problems on a bilateral level, up to now little progress has been achieved. It is known that Guatemala, the creditor nation most affected by bad debts 1/, attempted to reach a solution to this problem last year. The solution would permit the cancellation of the certificates in return for Nicaraguan goods. Nicaragua, however, has been reluctant to accept such a solution.

1/ Guatemala holds about $150 million of Nicaraguan certificates of reserves denominated in dollars, purportedly backed by dollar deposits in the Nicaragua central bank.

4. Role of ROCAP in Promoting a More Effective Trade Policy in Central America

The previous sections of this report document the continued sharp decline in intra-regional commerce among the nations of Central America up to 1986. The shear magnitude of these drops, in itself, is probably enough to suggest that something could be done to reverse these tendencies and perhaps even encourage the reactivation of commerce among Central American nations. The magnitude of the drops does not, however, mean that the CACM should be reactivated along the lines which led to its rise and fall in the past. At the outset, it should be mentioned that at no point does this report recommend the adoption of protectionist policies designed to promote import substitution. To the contrary, it concludes that a series of measures could be taken to promote intra-regional flows of goods and services among the CACM nations while, at the same time, encouraging more outward looking policies of international trade.

If such measures can be effectively designed and implemented - and the basic argument of this report is that this is indeed feasible - then ROCAP is situated in an especially advantageous position to play a major role in furthering these efforts. This is because the measures generally call for actions crossing the borders of the individual nations of the CACM. Since ROCAP has considerable experience in coordinating the efforts of Central American nations, it should be encouraged to utilize its expertise in promoting economic policies which contribute to the region's overall economic growth and development.

Given the importance of improving economic policies on the regional level and, as will be seen later in this section, the gamut of areas in which the promotion of coordinated regional policies (as opposed to individual country policies which can be more effectively promoted by the individual USAID missions), ROCAP may even wish to consider the improvement of CACM economic policies as the centerpiece of its forthcoming CDSS. The adoption of such a strategy would necessarily require an appropriate staffing policy for ROCAP.

Efforts to promote more effective trade policies among the nations of Central America are considered important to AID. While it would probably not be advantageous to promote a reactivation of the CACM on the same bases upon which it grew and apparently prospered for many years before virtually collapsing in the early 1980s 1/, it is believed that a program to strengthen the trade relationships linking the CACM both to other nations within the region as well as to those in the rest of the world would contribute greatly to the economic growth and development of Central America. A new strategy must avoid the reestablishment of high protective tariffs restricting the region's economic ties with the rest of the world (as happened in the past). Instead, an effective trade policy would seek to

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1/ Since the inception of the CACM in the early 1960s, .mport substitution played too important a role in the growth of the region. Even though these policies contributed to the early prosperity of the Common Market, they encouraged a poor allocation of resources behind the walls of high protective tariffs. Excessive import substitution encouraged inefficiency and weakened the economies of the CACM relative to those of the rest of the world. Due to the failure of the CACM nations to achieve a more efficient productive base and their consequent failure to compete effectively on world markets, inappropriate economic policies are blamed for exacerbating the problems accompanying the general economic downturn of the Common Market in the 1980s.

maintain the absence of tariffs on intra-regional trade as established by the CACM more than twenty years ago 1/. At the same time, it would seek to overcome some of the barriers currently contributing to the sharp reduction in trade (both within and outside the region) witnessed during the 1980s.

The remainder of this report dwells in more detail on what may be key elements of a regional thrust to improve economic policies in Central America. Given the nature of the region, it will be seen that these measures revolve about the theme of trade. It should be emphasized that some of the points in this paper are only in the "idea" stage. More time is needed to follow them up and, if they appear viable, to develop them in more detail.

It is my opinion that the ideas presented in this paper only represent a start at the formulation of initiatives to promote a regional effort aimed at improving economic policies in the CACM nations. Even if some of the suggested ideas are eventually rejected, it could be highly advantageous to continue pursuing new ideas and perhaps supporting those which appear likely to be truly useful in promoting improved economic policies.

1/ Contrary to what some people may believe, there is nothing wrong with maintaining a free trade zone covering the Central American countries. The whole area spanned by this zone could be envisioned as an entity similar to a nation with free and unencumbered trade taking place over the borders of its subdivisions. The "nation" would, of course, adopt a common tariff policy pertaining to goods entering from the outside.

a. Currency Alignment

This is probably the key area in which policy reforms are needed in Central America. Without interfering in the programs of individual USAID missions to encourage the adoption of market determined exchange rates for their corresponding host countries, it is believed that regional efforts can and should also be promoted in this direction.

The regional efforts would focus on the creation of a widely recognized currency market specializing in purchases and sales of Central American currencies. The market would, of course, be free to deal in hard currencies and it would be expected to do so.

The beginnings of this type of market already exist, but it is still informal in nature. Consequently, its legality is questionable in most of the CACM nations. In Guatemala, for example, CACM currencies are frequently exchanged for dollars or quetzales both in the capital as well as on the borders. Existing regulations apparently do not conflict with current informal currency swaps. 1/

Guatemala is an especially attractive initial location for the establishment of the Central American currency market. This is not only due to the existence of its nascent capital market, but also because exchange rate controls on the quetzal are being progressively removed. Although some controls remain, they are

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1/ It should also be mentioned that currency swaps also occur in the other CACM nations. Although generally considered illegal, they are tolerated for some transactions.

expected to continue to be relaxed. 1/ There appear to be no insurmountable barriers to expanding the functions of the Guatemalan capital market to formerly open it up to trading in Central American currencies. In fact, this would entail little more than formalizing and recognizing what already exists. Some of the member firms of the capital market are already dealers in regional currencies. While at present the capital market's activities are oriented about trading dollar denominated Guatemalan stabilization bonds, member entities of the market are actively searching for new and broader activities. At least one of them, "Multivalores", has expressed an interest in trading DICAs.

It would be convenient for the regional currency market to be fully operative in several or all of the CACM nations. This would not only imply free trade in all the region's currencies, but it would also provide the market with a certain degree of security in case new exchange controls are imposed by one or more of the member nations.

By accomplishing the objective of institutionalizing currency trades on an open and widely recognized market, the values of regional currencies would be determined according to market forces. Though exchange controls in some of the individual nations might not permit the full recognition of the prices assigned to their currencies by this market, it would provide exporters and importers with clear values of the individual currencies, thereby facilitating trade. The appearance of the currency market would also reduce what are sometimes reported to be excessive spreads between the buying

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1/ It is interesting to note that the value of the quetzal appreciated with the removal of major exchange controls.

and selling rates of Central American currencies on the existing "under-the-table" markets.

Of course, some of the other four nations might well object to the establishment of an open offshore market for their currencies. Even though these markets already exist informally both inside and outside the borders of the affected nations, it is easy to comprehend the consternation of a country attempting to maintain exchange controls as it witnesses the formation of a more formal market for its currency outside its borders. Hopefully, the nations trying to maintain exchange controls would not be able to stymie the appearance of the market for their currencies. The success of the proposed currency market would, in all likelihood, exert considerable pressure on the CACM nations to fully recognize the market exchange rates while downplaying and hopefully eliminating the importance of overvalued official exchange rates.

This would imply the acceptance of the market determined exchange rates as the basis for all trade. It would also imply their acceptance for trade-related administrative purposes. That is, enterprises would be permitted to utilize the floating values of their corresponding domestic currency for accounting purposes. In the absence of exchange controls, there would be little point in requiring hard currency deposits in the central bank to accompany exports.

The dismantling of the complicated series of exchange controls still being practiced in Central America would probably be the single most effective policy reform needed to promote an effective trading policy for the region. Although the dismantling of these controls would require much more than the formalization of currency markets, it is believed that the latter would represent a step in this direction. The dismantling of controls might well be attractive to the CACM nations, especially to those interested in expanding regional trade. This is because it would set a basis for the acceptance of their own currencies (since they would be freely convertible into hard currency) in place of dollars as payment for imports.

It should be mentioned that the formalization of a Central American currency market would clearly interfere with the efforts of individual nations to maintain exchange controls. In fact, this is one of the prime arguments in favor of its existence. Even though these controls could be still practiced within the borders of one individual nation, the knowledge of the existence of an effective offshore market would effectively thwart attempts to limit access to foreign currencies.

If the recommended type of market were successfully established for Central American currencies, there would be no role for DICAs. In their place, traders could freely buy and sell whatever currency were assigned to an export or import without having to resort to the more complicated, and perhaps more risky, mechanism implied by the DICA system. A free market for regional currencies would prove much simpler than the onerous and risky DICA system. The establishment of a free currency market would also provide a much more effective basis for encouraging both intra- and extra- regional trade flows.

b. Stabilization Policy

Once the currencies of the CACM nations are aligned according to market forces, there may be a need for a mechanism to assist individual nations overcome temporary balance of payments difficulties. The International Monetary Fund is, of course, charged with fulfilling this function. However, for several reasons many nations, including those of Central America, are reluctant to enter into Fund agreements. In some circumstances, the Fund may also be excessively reluctant to approve such agreements.

There exists a regional mechanism set up specifically to assist CACM nations overcome temporary balance of payments difficulties. Reference is made to a stabilization fund, managed by the Consejo Monetario Centroamericano, empowered to provide temporary financial resources in support of stabilization programs of CACM nations. These programs could call for the conditionality needed to achieve the desired return to equilibria in the affected nation's balance of payments. With the economic difficulties of the CACM nations, the management of the stabilization fund ceded to the pressures of individual nations for straight balance of payments support without realistic programs designed to correct the causes leading to the underlying problems. Unfortunately, the credits granted by the fund are now permanently rolled over. Thus it is now unable to comply with its original objectives.

Despite the apparent failure of this entity, it might be worthwhile examining this experience more carefully. At the same time, it would be also be useful to assess the advantages and disadvantages of reconstituting a new stabilization fund capable of supporting the efforts of nations endeavoring to carry out effective programs to deal with short term disequilibria. In the absence of this type of entity (and the IMF may well be the only one needed), nations run the risk of succumbing to the temptation of compounding short term difficulties by recurring to poor policies (such as exchange rate controls) which only cause damage over the longer run.

c. Private Sector Support

An efficient private sector is fundamental to the promotion of policies designed to assist nations improve their trade positions. Given the severe problems affronting the Central American economies in the 1980s, a program of industrial reactivation could form an important element in a comprehensive program designed to restore the economic well-being of the CACM. 1/ It is believed that an effective private enterprise program on the regional level in Central America might focus on three levels: (1) export promotion, (2) reorganizing troubled firms having a with potential to resolve their problems and (3) encouraging the initiation of new ventures. ROCAP is currently participating in these three areas.

With the success of the Regional Executive Management Training Project (596-0124), ROCAP is already active in promoting exports. Under the auspices of INCAE, high level managers of Central American firms have attended seminars on production, marketing and other topics aimed at creating a more effective export mentality. These seminars have even been expanded to touch on the major issues of a regional macroeconomic policy dialogue and have been attended by the presidents of several Central American nations.

The second area offering ample possibilities for expanding exports as well as the general productive capacity of the region concerns the rehabilitation of troubled enterprises with

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1/ Especially interesting are the possibilities for expanding nontraditional exports. See SRI International, "Nontraditional Export Expansion in the Central America Region," March 1987. This document was prepared for the LAC Bureau under contract number PDC-0000-I-00-6133-00.

potential for better economic performance. These efforts would seek to strengthen firms which have been hurt by the economic troubles of the 1980s. If such firms exist (they almost undoubtedly do) and the financial performance of some could be turned around with an infusion of capital and/or improved management, it might be interesting to consider setting up a project which would support a highly trained management group engaging in operations such as the purchase of assets (probably at discounted prices) of companies offering a potential for improved performance. After gaining an equity position, the management group would then proceed to improve the ailing firm's performance with the eventual objective of selling it at a profit. Equity interests in these firms could be obtained either by direct purchases or by acquiring debt (at a discount) with the understanding that it would be converted to equity on favorable terms. 1/

Again, ROCAP is already participating in these efforts. In this case it is through its Regional Economic Recovery Project (596-0114) which supports efforts of the the Central American Bank for Economic Integration to rehabilitate promising, but sometimes troubled, enterprises. The work is being carried out through a contract with Robert R. Nathan Associates (in combination with the MAC Group).

The advantage of carrying out this type of program on the regional level is that it would provide the management group

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1/ AID is already promoting similar schemes to assist with the divestiture of public sector enterprises (including in Costa Rica). A proposal to set up an entity to strengthen the performance of private firms capable of having their operations improved is currently being proposed for Egypt by the USAID Industrial Support Division.

with a wider variety of firms to choose from. It might also open up the management group to more extensive sources of capital for its operations. A regional focus is especially important when considering how to best take advantage of possible economies of scale.

The third thrust of a private enterprise program would focus on support for new ventures. Several suggestions for pursuing projects in this area were included in a recent report submitted to ROCAP on Central American capital markets. 1/ The cited document contains numerous suggestions ranging from the expansion of insurance against risk and terrorism to the establishment of conditions necessary for tapping the savings of Central Americans. These savings would be channeled toward new investments. The latter area could be especially important not only for creating institutions capable of expanding regional trade but also for raising the level of incomes and employment in the region.

d. Tariff Policy

ROCAP has already initiated efforts to determine the role of the common external tariff of the CACM as a constraint to exports outside the region. 2/ The study summarizes the tariff

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1/ Arthur Young, "Central American Capital Markets," (preliminary draft prepared for ROCAP), April 27, 1987.

2/ Julio Berlinski, Juan J. Fernández and Daniel M. Schydlowsky, "The Relative Significance of the Common External Tariff of the Central American Common Market as a Constraint to Extra-regional Exporting," prepared for ROCAP under IQC PDC-0000-I-23-3082-00, February 14, 1986. The second chapter of the report (written by Berlinski) affords a good summary of the tariff and issues related to its current structure.

regime affecting Central America, showing that non-tariff restrictions and the multiplicity of exchange rates among the CACM nations have led to tariff policies with considerable variation within the region.

The World Bank is also participating in the design of a more effective regional trade policy. It is studying alternative tariff policies of the CACM nations. In order to take advantage of tariffs as instruments which balance protection and revenue raising objectives against the broader advantages of freer trade and export enhancement, it may be useful for ROCAP to maintain a close working relationship with the World Bank group studying the common external tariff. Perhaps a joint effort could be undertaken which would support the objectives of the two institutions. Up to now most of the AID coordination with the Bank group has been handled by Mary Ott in the USAID/Guatemala Mission.

e. The Settlement of Regional Debts

As stressed by the IIG (see section 3, page 31), this is an important barrier causing hard feelings among several Central American nations. Although perhaps not essential to the reactivation of regional trade, it might nevertheless be worthwhile examining alternative solutions to the problem of arrears (keeping in mind that there may be no mutually satisfactory way of dealing with those of Nicaragua). Possible grounds for settlement might call for write-downs of interest and/or principal. An acceptable solution could also contemplate the sale of these debts, along with agreements from the debtor nations to make at least partial payments. Perhaps these sales could be realized through the newly established capital market in Guatemala. This would be especially appropriate if the sales were to be realized to persons or entities within the CACM region. This would imply an extension of the market's current focus revolving about trades in Guatemalan stablilization bonds.

f. <u>Support to Regional Institutions</u>

There are two ways in which ROCAP can support regional institutions which, in turn, encourage the expansion of trade and the economic well-being of the region. One calls for the continued and perhaps increased support of SIECA while the other area for action would seek to stimulate regional entities (including, but not limited to SIECA) with the objective of proposing ideas for better coping with Central America's problems while taking advantage of its economic potentials for growth and development. The latter proposal could represent an especially important manner of supporting useful regional institutions.

SIECA is probably an institution worthy of continued and perhaps even greater support. Due to the difficult times affronting Central America and the urgency of other problems affronting the CACM nations, it is not surprising that regional institutions such as SIECA have suffered heavily from budgetary problems.

The statistical functions alone of SIECA may be sufficient to warrant continued support. It currently serves to gather and refine (although perhaps not enough) valuable statistical information on the CACM nations. At present the importance of these functions appears to be declining due to a lack of funds and inadequate computer facilities.

SIECA is also an important source of ideas. It serves to bring leading regional entities and professionals together to search for improved ways of improving the economies of the Central American nations. It also serves to create a regional mentality, assisting regional leaders to seek common solutions to improve the performance of their economies.

The other support to regional institutions calls for the promotion of the IESCARIBE project currently being proposed by LAC/DP. This project would assist regional entities interested in making concrete proposals for the improvement of Central America's economies.

Through encouragement of contacts with leading persons formulating regional policies (or with the potential for doing so), this project offers an invaluable instrument for ROCAP to enhance its role in the regional policy dialogue. An active ROCAP role in this endeavor would also provide ideas for new topics to be placed on the agenda for improving the performance of the region's economic performance. Moreover, it would serve to identify new projects for ROCAP support.

5. Conclusions

This report concludes that there is much that an entity with a regional focus could do to encourage growth and development in Central America. Perhaps the area in which this growth and development could most effectively be promoted is through the establishment of a favorable trade regime. This would call for a multi-facited program affecting several distinct parts of the economies of the CACM members.

Continued progress toward the alignment of the region's currencies according the market forces is of primary importance for the establishment of an effective trade policy. Even though some progress has been realized in this area during the past two years, much remains to be accomplished in this area. Especially important is the establishment of a open and formal market trading the currencies of the CACM nations.

Further consideration should also be given to the possibilities of reestablishing a regional stabilization fund, maintaining and perhaps expanding support to the private sector, cooperating with the World Bank on the improvement of tariff policies, assisting the CACM nations resolve their internal conflicts over arrearages and expanding support to regional institutions. All of these activities would contribute directly or indirectly to the central theme of this report - supporting the economic performance of the CACM nations through improving their trading effectiveness.

This report suggests that especially careful attention be directed to the role ROCAP could play in improving the economic policies of the Central American nations. It is recommended that ROCAP enhance its ability to engage in a policy dialogue on the regional level. There appear to exist ample and, indeed, promising possibilities for ROCAP in this area.