Contents

Intal

Central American Report
Nº 1

CENTRAL AMERICAN REPORT

SIECA

2000

Inter-American Development Bank
Integration and Regional Programs Department
Institute for the Integration of Latin America and the Caribbean IDB - INTAL
Esmeralda 130, 16th and 17th Floors C1035ABB Buenos Aires, Argentina
tel 54 114 320-1871 fax 54 114 320-1872
E-mail: INT/INL@iadb.org. http://www.iadb.org/intal

Printed in Argentina

IDB - INTAL
Central American Report
Buenos Aires, 2001. 76 pages.
Report Nº 1. 2000.

I.S.B.N. 950-738-105-8

Cover-Editing:
Alicia Pinotti
Susana Filippa

The Subregional Integration Reports Series, to which this first Central American Report belongs, represents an effort by INTAL to promote understanding of and disseminate information about the dynamic process of integration under way in Latin America and the Caribbean.

As part of this integrationist trend the Central American Common Market, comprising Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua, signatories of the General Treaty on Economic Integration in 1960, is a test case for assessing the achievements and challenges of the initiative.

In publishing this annual report, INTAL aims to facilitate access to information for a broad potential readership interested in the Central American integration process, from the public and private sectors as well as from among the subregion's general public. It also seeks to go beyond the interest that the process arouses at the subregional level by making the report available to a broader international community through this version in English.

This Report Nº 1, covering the year 2000, was written by Eduardo Alonso Guzmán, an economist who is currently Professor of the International Center of Economic Policy for Sustainable Development at the National University of Costa Rica, and a consultant to the United Nations Industrial Development Organization.

Juan José Taccone, Director of INTAL, and Uziel Nogueira, INTAL's Integration Economist, were responsible for the coordination of the report and for its general and technical editing. Thanks are due to Ennio Rodríguez, Chief Economist in the IDB's Division of Integration, Trade and Hemispheric Issues, for his valuable comments.

In order to meet the expectations raised by the Reports in this Series, readers are invited to send their comments and/or suggestions for the purposes of improving the scope or focus of these publications in the future.

CONTENTS

EXECUTIVE SUMMARY

The Central American Common Market (CACM) comprises Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua, the signatories of the General Treaty on Economic Integration in 1960. The basic pattern of economic integration in Central America was based on a free trade area, with a common external tariff and standardized customs rules, a preferential payments system[1] that operated until the start of the 1980s, and a scheme for the subregional coordination of economic policy.

Although at the outset Central American integration sought to develop an industrial base through tariff protection, the process lost impetus at the end of the 1970s and relative trade levels reached a nadir in the mid-1980s. However, the economic integration scheme was able to survive all manners of political, economic, social and cultural difficulties. In the new, wider and more ambitious stage that began in the 1990s, efforts were made to preserve and strengthen the scheme so as to improve subregional trade conditions.

The new stage is marked by trade liberalization. This has been a key element in Central America's development process and the main force for integration in the isthmus. The recovery of CACM trade in the 1990s was matched by a slow but increasing diversification of exports, which has been particularly evident in recent years. Better access to third markets, as well as the use of fiscal and customs incentives, are among the reasons for this better insertion in the world economy. A recovery in volumes and greater diversification are also manifest in intra-subregional trade. This has fostered development and growth, especially among small and medium companies.

The new context of globalization and trade liberalization obliged the CACM countries to agree on tariff reduction in the framework of the World Trade Organization (WTO), and to embark on external trade negotiations in which, to some degree, they pledged to develop a common external trade policy in the subregion. In light of the other trade instruments that have been transposed into the basic juridical order of the Common Market (such as the laws or regulations on customs valuation, safeguards, unfair trade and the origin of goods) the challenges to deepening Central American integration appear even more complex.

The Macroeconomy in the Subregion

The economic strategies of the five Central American countries feature similar positions on opening up, deregulation, privatization, attracting investment, and enhancing the efficiency of the productive apparatus, among other things. However, the countries differ as to the speed and scope of change in some of these areas. This divergence impedes the deepening of integration in the CACM and demands greater efforts to effect the kind of macroeconomic policy harmonization that would help create a climate more propitious for the facilitation of trade and investment flows.

Economic considerations are fundamental, but they are not the only factors required by the subregional integration process. Hence the analysis of the five CACM countries' macroeconomies, as well as a comparison of the main economic aggregates and an emphasis on those issues that amount to symmetries or asymmetries in economic policymaking, are decisive in facilitating or hampering greater integration in the subregion.

[1] The outbreak of armed conflicts in the subregion and non-payment by some countries brought this initiative to an end.

From the output perspective, 1999 were not a good year. Growth was 3.7%, lower than the 4.6% recorded in 1998. This owed much to the impact of Hurricane Mitch on some countries, which significantly cut export capacity in agricultural products. It also stemmed from low international prices for the subregion's main export products and the high cost of fuels, which adversely affected internal demand in the subregion.

The effects of the hurricane varied. Honduras suffered most, and its agricultural production fell by 8.7% in 1999. In subregional terms, agricultural production grew by barely 1.7% in 1999. It is worth noting that, as a subregional trend, the relative size of the agricultural sector fell in the 1990s in all the Central American countries.

Economic performance has not been particularly satisfactory in recent years and there has been some stagnation, mainly in production unrelated to exports from free zones and *maquiladora* companies. This has significant repercussions for the subregion's economies, especially in the small and medium company sector. The latter accounts for over 60% of all Central American firms, not counting the microenterprise sector where growth has contracted substantially.

In terms of convergence, the Central American economies have similar production structures but their economic performance was volatile in the 1990s, with growth rates of between 2% and 6%. There were years in which economic performance was uniformly poor (like 1996) and others when performance was satisfactory (like 1992). This poses significant challenges to the attainment of more sustained growth rates that help resolve the subregion's needs for growth and human development.

Average inflation in the subregion stood at 6.1% in 1999, evidencing substantial efforts by the five countries' economic authorities. Nevertheless, economies such as Costa Rica and Honduras still face difficulties in bringing inflation down to single digits. Guatemala had inflation of 5% in 1999, while El Salvador's consumer price index fell by 1%. The results reflect stability, in line with a greater fiscal and monetary discipline that contrasts with the 1980s.

In 1999 the fiscal deficits stood at between 2.4% and 5%, and internal credit fell by 2.3% as a subregional average. Despite the apparent stability, significant macroeconomic imbalances persist, since Costa Rica, Honduras and Nicaragua have found it difficult to reduce their fiscal deficits. El Salvador and Guatemala have thus far not suffered from major fiscal problems, but to comply with the commitments of their peace agreements they must make further efforts to improve tax collection, make the allocation of public spending more efficient, and increase the tax take.

The fiscal authorities are therefore in a dilemma: to limit public spending in the face of the low tax take (between 10% and 15%), or to press for bigger state budgets given the crucial requirements in such areas as infrastructure, health and fighting poverty in a context of fragile subregional fiscal stability.

Subregional convergence is evident in exchange rate policy, although in 1999 the rate weakened in Honduras and Guatemala. El Salvador recently agreed on a partial dollarization of its economy, whereby both the US dollar and the Salvadorean *colón* circulate.[2]

Interest rate policy is also more attuned to market criteria and international conditions. Real rates were not negative, as they had been in the past, which shows greater financial depth. There are, however, some appreciable differences in intermediation margins and the size of local financial systems relative to GDP. Costa Rica and El Salvador have the smallest gross margins (about 5%) and the biggest relative financial systems, which are equivalent to between 40% and 45% of their respective GDP.

---

[2] Through the Law on Monetary Integration, El Salvador agreed as of 2 January 2001 on the free circulation of the US dollar at par with the Salvadorean colon. The aim is to of foster the voluntary and gradual dollarization of the economy in the short term.

There are no explicit institutions for subregional economic policy coordination, but the countries' economic performances in the 1990s are consistent with an auspicious atmosphere for business and investment promotion.

Trade Flows in the Subregion

The 1990s saw the start of subregional economic reactivation and the revitalization of the Central American integration process, the result of increasing political stability and of the economic reforms that all the countries began in the late-1980s in order to secure the subregion's greater insertion in the world economy.

Trade liberalization, accompanied by better market access and fiscal incentives, triggered the recovery and diversification of the Central American Common Market's (CACM)[3] trade flows with the rest of the world. Trade recovered not only with non-traditional markets (which are subject to incentives) but also within the subregion. This is important since it amounts to a broadening of the local market base that supports many small and medium companies.

In the 1990s, all countries reduced and standardized their external tariffs with a view to adopting a common external tariff (0% -15%). They began to dismantle their protection schemes and to move toward a more complete free trade area, including even agricultural products. Despite some setbacks in tariff reduction policy and continued protection for certain (mainly agricultural) goods, current levels of protection are substantially lower than those of a decade ago. Despite this, the greatest obstacles to subregional trade arise precisely from agricultural products and relate to discrepancies on rules of origin. This issue, and dispute resolution at the subregional level, are the main obstacles to the intensification of trade relations within the CACM.

Great efforts have also been made to boost exports, although the most positive developments relate to extra-subregional trade (simplified bureaucratic procedures for export formalities). Steps remain to be taken to remove the obstacles to intra-subregional trade, especially as regards subregional norms and facilitating procedures at borders.

The subregion's trade flows declined in 1999 as a result of Hurricane Mitch and lower export prices, but trade grew throughout the decade, from US$ 10.448 billion in 1990 to US$ 31.719 billion in 1999. Intra-subregional trade was also dynamic, growing 2.8 times in the same period and totaling US$ 4.828 billion in 1999.

In 1998 trade was equivalent to 71% of subregional GDP, revealing the openness of the Central American economies to extra-subregional commerce. The subregional market is growing in importance but there is still a significant gap with the global market, since in 1998 subregional flows were equivalent to barely 8.6% of Central America's output.

In 1999 the subregion as a whole exported goods worth US$ 13.81 billion, 4.4% more than the previous year, including sales effected through free zones and *maquiladora* companies. If the latter are excluded there was a decline of 11.9%. In the same year Costa Rica accounted for 50% of Central American exports. The United States remains the subregion's main trade partner, despite efforts to diversify markets and products. There has been a substantial increase in light manufactures and new agricultural products but traditional goods remain very significant, accounting for about 60% of total exports.

[3] What is known as the Common Market in Central America is really a free trade area that has a common external tariff on most products, with some agricultural exceptions.

Because of the special circumstances in Central America during the 1980s, and given the small size of the Central American market in comparison to the opportunities offered by the world market, it is unsurprising that national policies to promote and attract investment (as well as the incentives granted) center on non-traditional products going to extra-subregional markets, and that the subregional market has therefore been neglected.

Nevertheless, the subregion absorbs a fifth of Central American exports (not including exports from free zones and *maquila*), of which 60% is accounted for by El Salvador and Guatemala. In contrast to total exports, most of which are traditional goods, intra-subregional sales are mainly products of the foodstuffs industry and light manufactures, which represent 70% of the total.

Imports tripled during the 1990s, reaching US$ 18 billion in 1999. The growth rate that year was 2.3%, lower than in previous years. In contrast to exports, imports changed little in the 1990s in terms of their composition by country. Costa Rica, El Salvador and Guatemala continue to be the subregion's main importers. Intra-subregional imports represent about 13% of total purchases, since there is a clear dependence on manufactured goods, raw materials and fuels from outside the subregion. The import substitution model was unable to reverse this pattern.

The subregional trade deficit stood at US$ 4.1 billion in 1999, reflecting the fact that productive structures such as those in Central America are highly dependent on imports of inputs and raw materials that come, for the most part, from beyond the subregion. As regards the intra-subregional trade balance, Costa Rica and Guatemala are net exporters, El Salvador has a small deficit with the subregion, and Honduras and Nicaragua are in deficit. The latter circumstance was accentuated in 1998 and 1999 as a result of the effects of Hurricane Mitch.

Investment Flows in the Subregion

Since the 1993 signing of the Protocol to the General Treaty on Central American Economic Integration, known as the Guatemala Protocol, sub-regional integration has been marked by modest progress, both in the official government sphere and among Central American business organizations. The concrete efforts evident in this area have in fact been undertaken by the subregion's private sector, and have taken the form of intra-subregional investment.

In this situation, reform of the current subregional institutions, both public and private, is an important requirement for the purposes of deeper economic integration and attracting investment.

Central American companies with investments in three or more countries argue that the main factors promoting greater economic integration are speedy and uniform processes for establishing companies; an effective Central American registry of trademarks and patents; the harmonization of labor legislation; a registry of sanitary norms for medical and food products; business organizations with a subregional approach; the elimination of trade barriers and of protection to national industries; a subregional monetary policy and the harmonization of financial legislation; capital markets with a subregional vision; uniform fiscal regimes, incentives and investment promotion policies; and improvements in border post services to facilitate transport.

These factors constitute a necessary condition for improving the subregional business climate. The latter, in turn, is a key determinant of the capacity to attract new intra-subregional investment and foreign direct investment (FDI).

Investment in the CACM countries by Central American firms increased during the 1990s and, although the contribution of this output of goods and services is not fully reflected in the subregional trade statistics, its importance is growing.

Most investment by Central American businesses in the subregion has gone to the following sectors: trade (supermarkets, household supply stores, sale of parts), industry (food, beverages, construction materials), the services sector (airlines, hotels, restaurants), and the financial sector (banks, financial investments). Progress has been more limited in the agricultural sector because of food safety considerations and the protectionist interests of local groups. There has been substantial Mexican investment, mainly in the trade and food sectors, and Mexicans have shown growing interest in the subregion's foreign exchange houses.

In the period 1990-1998, FDI inflows into the subregion amounted to US$ 6.5 billion, most of it in the latter year. Costa Rica was the main recipient of FDI in Central America as a result of investment by multinational companies such as Laboratories Abott, Procter & Gamble and Phillip Morris. These have transferred their operational management centers to Costa Rica, and INTEL has established a plant.

This growth of FDI in Central America during the 1990s springs from a combination of factors, chief among them a higher degree of economic and political stability throughout the subregion, national FDI promotion policies using special fiscal or customs regimes and, in the case of El Salvador and Guatemala, the privatization of electricity and telecommunications companies.

As mentioned earlier, significant improvements in the business climate are becoming much more important for attracting FDI than fiscal incentives, since there are no great differences between the investment incentives in Central America.

Access Conditions and Other Aspects of the CACM

The general legal framework of subregional integration laid down by the Protocol of Guatemala in 1993 entailed the definition and formal start of a new subregional economic agenda. The Protocol's main aim was to complete the different stages of the economic integration process, which were divided into five sections: the Central American free trade area; external trade relations; the Central American customs union; the free movement of the factors of production; and Central American monetary and financial integration.

The recent efforts at greater subregional integration suggest more political will on the part of governments to consolidate the free trade area, to undertake the reforms necessary to deepen it, and to ensure the operation of a customs union. The free trade area, however, requires further coordination to resolve a series of issues that hinder the free movement of goods in the subregion. In that regard, the countries have shown some resistance to foregoing their national interest for the sake of greater subregional trade integration.

There are significant differences in the countries' perceptions of the benefits accruing from deeper integration. Hence, instead of making efforts to improve the scope of the free trade area, the countries have concentrated on trade relations with third countries, making concessions that they were unwilling to grant within the CACM.

With respect to Central American legislation, there has been a radical change of approach. Very general framework legislation now prevails, with great adaptability to domestic laws. Most progress has been made in the agreements that the Central American countries have signed with multilateral organizations and with extra-subregional partners, but the subregion has been unable to improve the Central American legislative frameworks. This is because much Central American legislation in force is consistent with the previous approach, and because there is no uniform and shared vision of a common project at the Central

American level. Some view integration as an outward-oriented negotiating mechanism, and others as a means of protecting the subregional market. Hence the Central American countries have not assumed concrete commitments to harmonize their customs or trade legislation, despite the fact that there are common regulations governing certain aspects of the subregion's trade relations with the rest of the world in issues such as industrial property, customs and customs valuation, unfair trade, safeguards, and the codification and classification of goods.

The vast bulk of intra-subregional imports are subject to a tariff of 0%, but some sensitive agricultural products remain to be liberalized. The exclusions common to the five countries are in just two products, unroasted coffee and cane sugar. As for wheat flour, roasted coffee, ethylic alcohol, petroleum by-products and distilled alcoholic beverages, the Central American countries have negotiated bilateral restrictions.

The common external tariff (CET) has been one of the main achievements of the Central American integration process and covers 95% of subregional trade. Nevertheless, this has suffered setbacks because the agreements that the countries have been signing with extra-subregional partners do not require the application of common tariffs to conduct negotiations, which undermines the logic of the CET. In the negotiations that the subregion has conducted jointly, such as with the Dominican Republic, the countries were able to resolve issues such as access, restrictions and the tariff reduction schedule bilaterally. This poses serious difficulties for the CACM because of the substantial disparity between the commitments. That in turn is a fundamental challenge for the management of the agreements, and entails a practical need for joint efforts to standardize many of the stipulations established.

Another challenge to the CET concerns the countries' ability to impose "safeguards" unilaterally, within the framework of Central American legislation; this has enabled them to move away from the CET. There are further problems with the pace of the tariff reduction agreed upon and the disparity of tariffs following tariffication,[4] since the countries have moved forward at different speeds. There have even been cases in which tariffs were cut before the agreed date. The Temporary Protection Tariff is another obstacle to the CET, since for reasons related to immediate economic conditions Nicaragua was allowed to levy duties on goods that had already been liberalized in Central America; it is now difficult to return to the previous situation. The negotiations for the Free Trade Area of the Americas (FTAA) have caused the countries to question the need to make additional efforts to complete the CET in the subregional context. Standardization of the common external tariff must await the end of the tariff reduction processes agreed upon in the various bilateral and multilateral trade agreements that the Central American countries have signed.

The Central American CET specifies that raw materials, as well as intermediate and capital goods not produced in the subregion, are exempt. A duty of 5% is levied on raw materials produced in the subregion, 10% on intermediate and capital good produced in Central America, and 15% on finished products.

As regards rules of origin, Central America's problem lies not in the legislation, since this is based on the principles of the North American Free Trade Agreement (NAFTA) – although the subregion's regulations are a little less restrictive. The difficulties in this field arise from the application of and compliance with the rules in the context of a weak institutional framework. Indeed, the greatest problems with agricultural products are prompted by the arbitrary application of rules of origin. Sanitary and phytosanitary regulations face the same institutional problem, since government bodies have been unable to create permanent technical groups. In this field there are significant deficiencies in the regulatory framework, which is little developed.

[4] The conversion of all taxes and duties on trade to a single tariff.

Trade between the Central American countries is marked by very slow procedures in customs and at border posts, mainly the result of technical obstacles to trade. This is despite the commitments made multilaterally and in two trade agreements with extra-subregional partners. The problem stems from Central America's scant institutional capacity to manage subregional processes for drawing up and harmonizing technical norms and regulations, since there are national bodies for standardization, technical regulation, metrology and assessment with no proper subregional coordination.

Similar conditions prevail in the area of unfair trade. The Central American regulation is generally compatible with the Uruguay Round commitments, but its application falls to national institutions and significant procedural vacuums are evident. There are two methods of subregional dispute settlement: consensus-based agreements among directors and vice-ministers, or the Central American Court of Justice. Trade issues, however, should necessarily be dealt with using non-traditional methods such as arbitration, and in this respect the countries have been unable to establish a subregional legislative body.

On intellectual property, customs valuation and customs procedures there is a general legislative framework. What is lacking is for the countries to make the corresponding changes to their domestic laws or ratify the agreements. With regard to trade in services and investment, the trade agreements negotiated with countries beyond the subregion impose a fundamental constraint on the deepening of the free trade area, since the access conditions between the CACM countries differ substantially from the concessions that the subregion itself would want to grant to other extra-subregional trade partners (such as Mexico) by virtue of the most favored nation clause. Hence these matters will probably be resolved in the multilateral FTAA framework.

Finally, as regards progress toward a Central American customs union, the subregion has neither a common account for tariff collection, nor a mechanism to facilitate the free intra-subregional movement of goods from outside the subregion once they have been admitted and paid the corresponding tariffs. The lack of progress has induced El Salvador, Guatemala, Honduras and Nicaragua to agree on the free movement of people. It also prompted El Salvador and Guatemala to plan a true customs union for 1 January 2001, with a common external tariff, joint tariff collection, and the free internal movement of goods and people.

Other Relevant Issues for Central American Integration

The entrepreneurs of the subregion and foreign investors have argued that the improvement of the business climate is one of the basic issues to be addressed, and that this should be done from a subregional perspective. That perspective should also inform attention to the problems of transport infrastructure, communications, ports, airports, customs and border posts, electrical interconnection and other constraints on trade and investment flows in Central America.

The redefinition of policies to attract investment, given legal commitments in the WTO to dismantle investment subsidies and other support measures, is an issue that should be reviewed because of the importance to the subregion of incentives schemes for free zones and industrial parks.

Central America should address labor mobility and temporary work permits, as well as the standardization of criteria to assess knowledge and teaching quality. Deficiencies in these fields limit the transfer of human and technological resources between countries, as do training systems, which have basically been the responsibility of national institutions.

The subregion’s institutional system to support the deepening of integration also needs to be redefined in terms of its financial, organizational and political dimensions. It should be endowed with the capacity to devise and implement subregional cooperation projects. This demands a clear vision of the approach that Central America wants to adopt in the integration process. The institutional system is of paramount importance, since the countries demand help in negotiating and managing their trade agreements, information technology to link the various institutions in the network supporting subregional integration, and better coordination – ranging from matters of economic policy to the environment, territorial organization, human development and other issues that are also among the goals of Central American integration.

CHAPTER I. INTRODUCTION

Central American integration has prompted an increase in intra-subregional trade in recent years. This is understandable in a context of globalization and market opening, as well as of commitments made in the Guatemala Protocol. The increase in intra-subregional trade, however, has not matched the levels of the early-1970s; it could be argued that the trade growth of recent years owes more to a change in business perceptions of the Central American market than to the impetus of formal economic integration. The fall in intra-regional trade's share of total commerce is therefore partly the result of the successful diversification of exports to third markets, not of a lack of dynamism in intra-regional trade.

Economic integration in Central America has survived all manner of political, economic, social and cultural difficulties, and the countries' domestic conflicts have not interrupted intra-subregional trade flows. This evidences the Central Americans' interest and determination to maintain and strengthen the conditions needed to boost such commerce by integrating small domestic markets, and by exploiting the additional growth opportunities offered by access to extra-subregional markets. There is significant agreement on purely commercial issues in the subregion, but on other matters Central American interests diverge. Greater efforts are required to secure deeper integration, particularly as regards the free movement of factors and people, monetary union, and even political union.

Trade flows are now more diversified in terms of markets and products, while tariff protection and dispersion has lessened. The fact that Central American economies are small, and that the subregional market itself is insufficiently large to stimulate growth, demands further progress on subregional integration and on integration with extra-subregional trade partners. The deepening of subregional integration must therefore reconcile the completion of a free trade area with progress in free trade negotiations with third countries. Although significant progress has been made, deeper integration and negotiations with third countries remain important points of discussion.

The Central American countries have based their economic strategies on economic opening, deregulation, the transfer of state functions to the private sector, attracting investment, increasing the efficiency of the productive apparatus and enhancing competitiveness. The pace and scope of these changes has varied, and the subregion faces significant challenges if it is to achieve sustainably high growth and undertake the endeavors necessary for development.

Economic, social, environmental and institutional demands pose real tests for the subregional economies, in which poor infrastructure, low per capita income levels, high poverty rates and incipient institutional development constrain the benefits of integration. Hence the need to develop a subregional action plan to boost the countries' national capacity to resolve their basic structural problems.

Although it faces acute constraints in addressing the problems of growth, investment and human development, Central America is making great efforts in the context of commercial globalization to stabilize and consolidate an environment conducive to investment, and to guarantee the latter's juridical security.

The issue of the political will to advance with integration, by eliminating the distortions of various national legislative arrangements, reveals the difficulty of making speedier progress. Although much remains to be done to eliminate non-tariff barriers, the tariff problem has largely been resolved. Thus it can be argued that Central America is a functioning but incomplete free trade area.

The creation of a harmonized economic area conducive to Central American integration requires great subregional endeavors to complete the free trade area, introduce business facilitation measures, harmonize regulatory frameworks, and improve subregional infrastructure (Ballestero and Rodríguez [1997]). Central American economic integration has a general legal framework but, in practice, progress has been slow in recent years – particularly as regards economic policy harmonization, the customs union[1] (on which concrete commitments for negotiations have yet to be made), the free movement of factors, and monetary and financial integration.

Changes in the economic environment also demand revision of the Central American countries' export strategy, since their WTO commitments entail the elimination of some of the benefits of free zones,[2] which have been very important for the subregion's trade relations with the world. There is also a need to examine trends among the subregion's small and medium firms, since they play an important role in the countries' productive structures. Their performance must be improved substantially if the subregion is to confront the challenge of globalization.

Despite the vicissitudes of subregional integration, regionalization is evident in trade (supermarkets), industry (foodstuffs, beverages, construction materials), services (airlines, hotels, restaurants) and finance (banks, financial investment), and in the efforts of those subregional institutions supporting the creation of a unified and inter-connected electricity market to integrate such areas as the hydrocarbons markets, the construction and maintenance of infrastructure, and transport services.

This report seeks to offer a detailed analysis of the current status, progress and challenges of Central American integration, and to identify the most salient subregional issues. Chapter Two analyzes the macroeconomy, as well as the main symmetries and imbalances that foster or hinder the operation of the free trade area and its development into a customs union. The scale and direction of subregional trade flows and the impact of the free trade zone are examined in Chapter Three. Chapter Four analyzes intra- and extra-subregional investment in Central America, as well as its determinants. Chapter Five examines conditions of access, exclusion, tariffs and other international trade instruments that characterize the CACM as an incomplete free trade zone. Chapter Six reviews other key issues in subregional integration, such as improving the business climate, policies to attract investment, trade facilitation through improvements in the customs system, greater opening in the fields of services trade and investment, the current state of infrastructure and subregional challenges, labor markets, and human resource training. This final chapter also examines the degree of institutional development, particularly support for trade negotiations, information, economic cooperation, environmental issues, and the importance of small and medium companies in integration.

---

[1] This is defined as the creation of a common external tariff for at least a significant share of trade, the free intra-subregional movement of goods from third countries, and the subregional distribution of tariff revenue. The need to negotiate internal rules of origin since 1994 shows how far the CACM is from developing into a customs unions.

[2] Although some countries in the subregion are classified as less developed, this only means a longer deadline for eliminating subventions and subsidies (2006 instead of 2003).

CHAPTER II. THE MACROECONOMY IN THE SUBREGION

The central aim of this chapter is to place the macroeconomy of the five CACM countries[3] in the subregional context, so as to allow a comparison of the main economic aggregates and to underline the symmetries and asymmetries in economic policy management.

It is clear that the deepening of subregional integration requires greater efforts to harmonize macroeconomic policy, with a view to creating a more auspicious environment for trade and investment. Although economic considerations are fundamental, however, they are not the only factors at play.

Trends in Output

Table 1 shows that subregional gross domestic product increased by an average of 3.7% in 1999, lower than the 4.6% recorded in 1998 and below the average for the 1990-94 and 1995-99 periods.

TABLE 1
CENTRAL AMERICA: REAL GDP GROWTH
(percentages)

	Subregion	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1998	4.6	6.2	3.2	5.1	3.0	4.0
1999	3.7	8.3	2.1	3.5	-1.9	7.0
Average 1991-95	4.2	4.9	5.9	3.9	2.8	0.6
Average 1995-99	3.8	4.0	3.5	4.2	2.8	5.0

Source: IDB, Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit

One of the main reasons for the subregion's poorer economic performance in 1999 was the impact of Hurricane Mitch, particularly on Honduras, which grew by 5.1% in 1997 and then recorded negative growth of 1.9% in 1999. Only Costa Rica and Nicaragua had higher growth in 1999 than in 1998. Box A summarizes the key determinants of Central America's output performance in 1999.

[3] The Central American Common Market consists of Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua, which all signed the General Treaty of Economic Integration.

BOX A

CENTRAL AMERICA: OUTPUT PERFORMANCE IN 1999

Country	Relevant Issues
Costa Rica	The free zones, which accounted for 4 percentage points of total growth, were responsible for a significant share of growth, since the other sectors were not particularly dynamic.
El Salvador	The Salvadorean economy grew at a slower rate because of the introduction of restrictive monetary policies and the lower dynamism of the external, construction and commercial sectors, which offset growth rates of 3%-4% in manufacturing, agriculture and energy.
Guatemala	The slower growth of Guatemalan output stemmed from a significant downturn in domestic demand, a restrictive credit policy that affected foreign trade, the impact of Hurricane Mitch, the management of expectations related to the solvency problems of some companies in the financial sector, and the concerns typical of an election year.
Honduras	Honduran output suffered a general slowdown as a result of Hurricane Mitch. This led to a sharp fall in domestic demand. Exports also declined because of Mitch's impact on agricultural production, which fell by 8.7%, the sharpest drop in recent years. This affected the production of bananas, livestock and shrimp.
Nicaragua	Nicaragua's substantial dynamism sprang from a sharp increase in investment. This was made possible by an increase in public spending for rehabilitation and reconstruction in the wake of the hurricane, as well as by an increase in social projects.

Table 2 shows that Central America's average per capita income[4] is US$ 1,518, ranging from almost US$ 2,900 per year in Costa Rica to US$ 1,600-2,000 in Guatemala and El Salvador, and to less than US$ 900 in Nicaragua and Honduras. This, together with the wide disparities in income distribution, will pose significant future challenges to economic growth prospects and social stability.

TABLE 2

CENTRAL AMERICA: PER CAPITA OUTPUT

(US$)

	Subregion	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
GDP 1990 a/	935	1,873	1,043	874	625	581
GDP 1999 a/	1,518	2,873	1,977	1,633	853	459
GDP 1998 b/	3,218	6,062	2,822	3,651	2,073	2,045

a/ GDP in current US$.
b/ GDP purchasing power parity.
Source: *The Central America Competitiveness Report*, 1998 and IDB, Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit.

The unsatisfactory performance of 1999 was all the more severe in view of the fact that the increase in per capita gross national product was lower than in 1998, and below the average for the 1991-94 and 1995-98 periods. Guatemala recorded growth of 4.2% in 1998 but contracted by 7.1% in 1999. Similarly, after growing by 3.9% in 1998, the Costa Rican economy contracted by 5.6% in 1999, mainly because of payments for factors from abroad (Table 3).

---

4 Even if per capita GDP is adjusted by purchasing power parity (PPP), the gaps are still significant and correspondingly wide.

TABLE 3
CENTRAL AMERICA: PER CAPITA GROSS NATIONAL PRODUCT
(% growth rates)

	Subregion	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1998	4.6	3.9	4.0	4.2	8.8	7.0
1999	n.a	-5.6	n.a	-7.1	1.0	4.6
1991-94	7.1	7.4	9.4	11.8	0.5	-10.3
1995-98	6.4	2.8	8.0	7.1	8.9	6.1

Source: IDB, Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit

Performance of the agricultural sector

Table 4 shows the performance of the agricultural sector. This was substantially affected by low international prices for products such as coffee and bananas and by the devastating effects of Hurricane Mitch, which had varying effects on the productive capacity of the countries of the subregion.

In Honduras, agricultural GDP fell by 8.7% in 1999, above the 7% decline of 1998. El Salvador recorded a fall of almost 2% in 1998, although agricultural GDP recovered in 1999. This was not the case in Guatemala, where agricultural production expanded by barely 2.2% in 1999. Nicaragua had lower growth in the agricultural sector in 1998, but this recovered in 1999. The fall in Costa Rica's agricultural growth stemmed not from Hurricane Mitch (since its direct effects on the sector were relatively minor), but from the fall in prices for its main export products to international markets.

TABLE 4
CENTRAL AMERICA: PERFORMANCE OF THE AGRICULTURAL SECTOR
(% growth rates)

	Subregion	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1997	2.9	8.3	0.5	-0.1	2.9	5.6
1998	2.3	5.3	-1.9	3.5	-7.0	3.5
1999	1.7	3.5	3.7	2.2	-8.7	4.8
Average 91-95	2.7	3.7	1.8	3.0	2.2	2.4
Average 96-99	2.8	2.5	1.6	2.9	0.2	5.7

Source: IDB, Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit.

The negative effects on agriculture clearly had a more severe impact in those countries that are more dependent on the sector, such as Guatemala, Honduras and Nicaragua. This was not the case in Costa Rica and El Salvador, where the relative share of agriculture in total GDP fell throughout the 1990s and now stands at under 15%. It is worth noting that, as a subregional trend, the relative size of the agricultural sector fell in the 1990s in all Central American countries except Nicaragua.

Performance of the manufacturing sector

Table 5 shows the performance of the Central American industrial manufacturing sector, which expanded by 6% in the 1997-98 period and by 9.1% in 1999. The 21.2% growth of Costa Rica's manufacturing sector largely accounts for this increase. In 1999, all countries of the subregion except Costa Rica and Nicaragua recorded lower industrial growth rates than in 1998. Growth in El Salvador's industrial sector, which has been one of the most dynamic in the subregion, slowed significantly from 7.5% in 1997-1998 to 3.4% in 1999. Honduran industry expanded by 4% in 1999, half the growth posted the previous year, while industrial growth in Guatemala slowed from 5.9% in 1997 to 4.1% in 1999.

TABLE 5

CENTRAL AMERICA: PERFORMANCE OF THE INDUSTRIAL SECTOR

(% growth rates)

	Subregion	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1997	6.2	5.5	7.5	5.9	5.5	5.7
1998	6.9	7.9	7.3	5.2	8.1	4.8
1999	9.1	21.2	3.4	4.1	4.0	12.6
Average 90-94	3.8	4.8	4.6	3.5	2.8	0.6
Average 95-99	5.6	6.6	5.4	4.6	5.0	6.8

Source: IDB, Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit.

Costa Rica and El Salvador have the subregion's largest industrial sectors, and Guatemala and Honduras the smallest. It is important to note that growth in small and medium industrial firms declined in all the economies. In Costa Rica, growth in industries not associated with free zones and *maquiladoras* is slowing down, while there was a fall in the output of firms manufacturing for the domestic market (CEPAL [1999]). Of a total of 9,803 industrial companies in the subregion,[5] 61.2% are small firms (5 to 19 employees). Microenterprises (1 to 4 employees) account for 49.6% of all Costa Rican firms, 32.3% of those in El Salvador and 95% of those in Nicaragua.

Price Stability and Fiscal Pressure

As regards subregional macroeconomic stability, inflation in all five CACM countries fell in 1999 relative to the previous year, and the subregional average (6.1%) dropped to its lowest level in the 1990s[6] (Table 6). Lower inflation evidences greater monetary discipline in each country. Although not explicitly coordinated by a subregional body, nor by agreements between countries, such discipline is necessary for strengthening trade and investment. A similar pattern of convergence emerges from a comparison of the average inflation rates in the 1992-1994 and 1995-1999 periods.

---

[5] See *www.cicr.com,* Central American industrial companies by size.

[6] Costa Rica, which has a relatively restrictive policy, met its targets. In El Salvador, prices remained almost static and inflation was even negative in February, June and November 1999. The fall in Guatemalan inflation sprang partly from a reduction in electricity tariffs. In Honduras prices fell because of foreign donations and stability in the price of fuels. Nicaragua recorded the sharpest fall in the subregion (eleven percentage points below the 1998 rate).

Despite this apparent stability, significant macroeconomic imbalances persist. Costa Rica, Honduras and Nicaragua face difficulties in reducing their fiscal deficits, which stem from high-spending policies in the past (financed by foreign or domestic debt). The interest on these debts is a heavy burden that hampers cuts in public spending. Thus far, El Salvador and Guatemala have not faced significant fiscal problems, but to comply with the commitments of their peace agreements they must make further efforts to improve tax collection, make the allocation of public spending more efficient, and increase the tax take.

TABLE 6

CENTRAL AMERICA: INFLATION RATE

(percentages)

	Subregion	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1998	8.7	11.6	2.5	7.0	13.7	18.5
1999	6.1	10.1	0.5	4.9	11.6	7.2
Average 92-94	13.2	15.0	13.5	10.9	13.7	16.2
Average 95-99	10.8	15.1	5.5	8.1	19.8	11.3

Source: IDB, Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit.

Table 7 shows that Guatemala's tax take (a key element in balancing public finances) has increased since 1994, reaching 11% of GDP in 1999. El Salvador's has remained stable at 12%. Costa Rica's and Honduras's tax take was also stable in the 1990s at around 17%, while at almost 25% Nicaragua recorded the highest rate in recent years. On the fiscal side, the countries have focused their tax policy more on improving collection than on levying new taxes.

It is important to note that this indicator is highly dependant on the level of tax collection and the quality of GDP estimates in each country. The relatively high rates in Costa Rica, Honduras and Nicaragua[7] spring more from an underestimate of GDP than from heavy taxes on transactions in the domestic economy. El Salvador and Guatemala have the lowest tax collection rates in GDP terms, largely because of the relatively large size of their informal economies.

TABLE 7

CENTRAL AMERICA: TAX REVENUE

(percentages/GDP)

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1998	16.8	12.6	10.4	18.8	26.2
1999	n.a.	n.a.	11.0	n.d.	25.1
Average 90-94	15.1	10.8	9.0	16.8	30.6
Average 95-98	16.6	12.8	9.6	17.6	23.4

Source: IDB, Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit.

As regards the size of the fiscal deficit relative to GDP, Table 8 shows that in all the countries of the subregion the deficit was higher in 1999 than in 1998. Not since 1992 had El Salvador and Guatemala recorded a deficit above 2.2% of GDP, while in Costa Rica and Honduras the figure was volatile because of elections and the lack of a clear fiscal restructuring process. Nicaragua's deficit levels are significantly

7 The new GDP estimate, which is on average 27% higher than the previous one, reduces the tax take to 13%.

different from those of the previous decade. However, since much public spending is being financed by foreign assistance, the deficit figures are not solely a consequence of greater fiscal discipline.

TABLE 8

CENTRAL AMERICA: FISCAL DEFICIT

(percentages/GDP)

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1998	-3.3	-1.9	-2.2	-3.6	-1.8
1999	-3.9	-2.4	-2.8	-5.0	-4.5
Average 91-94	-3.4	-2.1	-0.3	-7.0	-1.1
Average 95-99	-4.2	-1.6	-1.3	-3.9	-1.9

Source: IDB, Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit.

Box B illustrates the countries' efforts to improve tax collection and the constraints posed by the growing need for fiscal spending. All the countries are seeking to improve tax collection through legislation and controls against evasion. However, tariff reduction continues to undermine public finances in view of the the relative importance of taxes on foreign trade in the total. Countries like El Salvador and Guatemala have even pledged part of the revenue from the sale of state companies to supplement their fiscal commitments.

The financing of fiscal imbalances in Central America is no easy task, since foreign indebtedness imposes significant constraints. The countries' tax structures are also quite regressive: in 1999, indirect taxes accounted for an average of 72% of total tax revenue.

The countries are also excessively dependent on foreign trade taxes.[8] In 1999 these accounted for 42% of the tax revenue of Costa Rica's central government[9], and 29.5% of Nicaragua's. In El Salvador and Guatemala the share of foreign trade taxes in total tax collection fell by almost half between 1994 and 1999. In Guatemala it declined from 23.4% to 13.7%, and in El Salvador it fell from 19.4% to 10.7%.

The high share of foreign trade taxes in the revenue of some Central American governments impedes tariff liberalization. The latter is thus conditioned by the scale of the public deficits, and requires both improved tax collection and the reform of tax and customs procedures. The countries of the subregion, however, are not developing alternative sources of public sector financing, despite the imminent decline in revenue prompted by the elimination of tariffs at the multilateral level and the signing of free trade agreements.

Nicaragua has the highest level of central government spending as a share of GDP: an average of 30% in the 1995-1998 period and 37% in 1999. Next come Costa Rica and Honduras, with an average of 21% in the first period mentioned. El Salvador averages 14.5% and Guatemala, with 10.6%, has the lowest level of central government spending as a share of output. The rates in Costa Rica and Nicaragua adversely affect domestic interest rates and the chances of private sector access to market financing. In the other countries the public sector's limited participation negatively influences the likelihood of future growth, because of low social (education and health) and physical infrastructure investment.

---

8 If the Central American countries had foregone revenue from foreign trade taxes in 1996, the public sector deficit would have increased by 54% in Costa Rica, 367% in El Salvador, 206% in Guatemala, and 83% in Nicaragua (Regional Programming Document (RP-CA), IDB).

9 According to SIECA this share rose significantly between 1996 and 1997, from 16.3% to 44.7%.

The governments of the subregion face significant fiscal constraints, not only in terms of revenue but also in their ability to manage spending. The scale of current spending (used for the operation of the state apparatus) leaves few resources for public investment, which is clearly a distinguishing and dynamic element of growth. In Costa Rica current spending accounts for 91% of total spending, in El Salvador it represents 80%, and in the other countries it stands at between 66% and 77%. This is not encouraging given the need to strengthen the health, education, and judicial systems, quite apart from the great need for infrastructure spending.

A substantial portion of public spending in every country of the subregion is used for payroll and for purchasing operational supplies. In 1990-1994 such spending accounted for over half of their budgets with the exception of Costa Rica, where the share was a third of the total. Efforts to reduce the size of the state have led to a general decline in these proportions. In 1990-1998, the share in Nicaragua fell from 82% to 34%, in El Salvador from 61% to 50%, in Guatemala from 56% to 33%, and in Honduras from 52% to 45%.

Another significant obstacle to a reduction of spending consists of interest payments on the public debt. In 1998 Costa Rica allocated a significant share of its tax revenue (21%) to that end, followed by Honduras and Nicaragua with 15%. At around 9%, El Salvador and Guatemala recorded the lowest levels.

BOX B

CENTRAL AMERICA: MAIN FISCAL DEVELOPMENTS, 1999

Country	Relevant Issues
Costa Rica	Costa Rica had an economically stable year. It adopted a conservative fiscal policy and a very restrictive monetary policy with increasing interest rates. Credit was under control, as was the size of the fiscal deficit, at around 4%. This led to a fall in domestic demand and inflation compared to 1998. The slowdown in domestic demand hit revenue from consumption and income taxes, which respectively fell by around 12% and 29%, while customs taxes (45% of total tax revenue) increased by only 6%, lower than the 27% rise in 1998. Domestic debt continues to be the main problem facing the country's public finances. Although domestic debt was swapped with foreign debt in 1998, interest payments continue to be very high, accounting for more than 30% of fiscal revenue. As of December 1999 the debt represented 37.1% of GDP and the foreign debt 26.9% of GDP.
El Salvador	Fiscal policy has sought to broaden the tax base and reduce tax evasion (VAT and income tax laws were reformed in September 1999). In order to reduce domestic debt, the government also placed US$ 150 million worth of government bonds in the international financial market. This will mostly be used to finance the fiscal deficit with foreign resources. Through the stock market, the government sold shares of the *Administradora Nacional de Telecomunicaciones* for US$ 33 million and announced a credit line for the agricultural sector worth US$ 4.6 million.
Guatemala	The Guatemalan central government deficit of 2.8% of GDP in 1999 stemmed mainly from a sharp increase in government spending, principally on public investment for basic infrastructure reconstruction and an expansion of social projects, which increased by 70%. The fiscal authorities are making a significant effort to improve tax collection, and a Fiscal Pact Preparatory Commission has been created. The international telephone service was privatized, and shares were sold in electricity distribution companies.
Honduras	Honduras financed most of its fiscal deficit (around 5% of GDP) with foreign resources, and public investment was used to repair the damage caused by Hurricane Mitch. Despite the hurricane's devastating effects, progress was made on privatization and on reducing tariffs. Tax revenue reached 18.5% of GDP, despite the fact that import tariffs for finished goods fell from 19% to 18% and the marginal rate for income tax dropped from 30% to 25%.
Nicaragua	The Tax Justice Law was reformed in March 1999 to improve tax collection and control tax evasion. Income and company taxes fell from 30% to 25%. A US$ 210 million agreement for infrastructure reconstruction was signed with the IMF for a second year.

Current transfers and subsidy payments from governments to specific social sectors (such as universities and firms[10]) are a significant constraint when, for fiscal reasons, attempts are being made to change the spending structure. In 1998 these payments represented 17%-22% of current spending in all countries of the subregion except Costa Rica (38%). It is worth noting that in the 1990s the relative importance of current transfers increased in all the countries, making fiscal management more rigid.

Irrespective of the size of the resulting fiscal deficit, the public sector in general and the central government in particular are obliged to finance it with resources from either domestic or foreign debt. Governments often resort to cutting infrastructure investment or underfunding social expenditure, such as on education and health. This jeopardizes medium- and long-term growth, and affects the lower socio-economic groups.

Central America therefore needs alternative mechanisms for state investment in infrastructure projects that improve the competitiveness required by the subregion's productive sectors.

The Central American countries have used domestic and foreign debt to finance recurrent fiscal imbalances. Throughout the 1990s, Costa Rica and Guatemala used a large share of their domestic resources to finance their fiscal deficits. In contrast, El Salvador relied more on foreign funds to finance its fiscal needs, and not until 1998 did it use domestic resources equivalent to 2.1% of GDP in order to finance its 1.9% deficit and to make external amortization payments equivalent to 0.2%. Honduras also relies more heavily on foreign resources to finance its deficit. Nicaragua is the only country to use domestic and foreign resources equally, with only slight year-on-year variations.

Because of fiscal imbalances, Costa Rica and Nicaragua have a domestic debt/GDP ratio that is significantly higher than that of the other Central American countries. As Table 9 shows, Guatemala averaged 13% and Honduras 7% between 1995 and 1999. The problem is particularly serious for Costa Rica, where the ratio was equivalent to almost half of GDP in 1997, and servicing this debt accounts for a large part of its budget. Nicaragua also has a serious debt problem, while Honduras belongs to the group of highly indebted countries.

TABLE 9

CENTRAL AMERICA: DOMESTIC DEBT IN RELATION TO GDP

(percentages)

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1995	42.3	14.6	7.1	9.1	18.2
1996	45.1	13.5	6.0	7.4	25.5
1997	47.8	12.0	5.4	7.2	131.6
1998	37.4	11.3	5.2	5.5	121.8
1999[1/]	43.4	12.4	5.8	4.3	n.d.

1/ Preliminary data.

Source: Central American Monetary Council.

[10] Until very recently the Costa Rican and Nicaraguan export sectors received direct state subsidies for exports to third markets.

To maintain fiscal balance in a subregion with growing infrastructural, educational, health and security needs (and fundamental constraints on increasing government revenue), there is a need to devise policies to make state spending more efficient and profitable, and to increase private investment.

Performance of the External Sector and Exchange Rate Policy

As to the external sector, the subregion as a whole had a current account deficit of US$ 2.69 billion in 1999, which was more than offset by capital inflows of US$ 3.587 billion. As Table 10 shows, this led to a net balance of payments that improved the subregion's net international reserves by US$ 897 million. However, analysis of the situation in each country reveals some significant differences. Although Guatemala's current account deficit fell as a result of an economic slowdown, its reserves fell by around US$ 125 million. El Salvador completely financed its largest current account deficit and ended the year with US$ 100 million more in reserves. The same occurred in Honduras and Nicaragua, where capital inflows (mostly donations and remittances from citizens abroad) also more than offset their largest current account deficits and boosted their reserves by US$ 150 million and US$ 300 million, respectively. Costa Rica's current account deficit was similar to that of 1998. It financed it with capital inflows of US$ 970 million, boosting its reserves by US$ 480 million.

TABLE 10

CENTRAL AMERICA: BALANCE OF PAYMENTS TRENDS, 1998-1999

(US$ millions)

	Subregion	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
Current Account						
1998 (p)	-2,134.5	-460.3	-84.4	-1,031.8	-66.8	-491.2
1999 (p)	-2,690.2	-490.0	-255.5	-884.7	-505.0	-555.0
Variation	-555.7	-29.7	-171.1	147.1	-438.2	-63.8
Balance of Payments						
1998 (p)	1,137.5	87.6	552.5	242.6	214.5	40.3
1999 (p)	896.9	480.0	100.0	-125.4	150.0	292.3
Variation	-240.6	392.4	-452.5	-368.0	-64.5	252.0

Source: IDB, Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit.

Analysis of the current account in 1999 shows that the subregion posted deficits in goods trade[11] except Costa Rica, which enjoyed a surplus for the first time in recent years. As regards the subregion's services balance (including tourism), only Honduras and Nicaragua had slight deficits. The subregion's balance of earnings was clearly negative. Costa Rica was a notable case, with outflows of US$ 1.5 billion. This consisted mostly of payments for foreign-owned factors (royalties, bonuses, and the repatriation of profits).

Current transfers received by the Central American countries enabled them to balance their weak current accounts. In El Salvador these transfers amounted to US$ 1.6 billion in 1999, including remittances by

[11] According to SIECA's 1999 *Informe Económico Subregional*, the trade deficit rose in 1999 because of the combined effect of lower export volumes and the decline in international prices (coffee, bananas, sugar). This cost the subregion around US$ 700 million, in addition to the US$ 485 million in extra import spending prompted by higher oil prices.

Salvadoreans abroad (US$ 1.1 billion). Guatemala, Honduras and Nicaragua received substantial foreign assistance and transfers in the 1990s; donations rose sharply in 1997-1999. These three countries received US$ 5.1 billion in transfers, compared to US$ 3.17 billion in 1994-1996.

An examination of the financial and capital account reveals several interesting points. The first concerns the increase in capital transfers to Guatemala, Honduras and Nicaragua in 1999. Another important issue is the volume of foreign direct investment, which totaled US$ 2.379 billion in 1998; El Salvador and Guatemala accounted for 65% of the total following the privatization of a number of state companies, such as ANTEL. Costa Rica (US$ 584 million) and Nicaragua (US$ 300 million) accounted for most investment flows in 1999. As to other investment, Guatemala and Nicaragua have the highest external indebtedness and these were joined by Honduras in 1999.

BOX C

CENTRAL AMERICA: MAIN FEATURES OF THE EXTERNAL SECTOR, 1999

Country	Relevant Issues
Costa Rica	Exports and foreign investment are the engines of growth in the Costa Rican economy. The country has the highest rate of per capita exports (US$ 1,830) in Latin America and, because of exports by the INTEL Corporation, posted its first trade surplus. However, because of its dependence on the INTEL Corporation and on foreign companies operating under the free zones regime, the external sector is highly vulnerable. There was a significant increase in foreign capital inflows (63%), partly because of bond issues in the international market and foreign direct investment. A slowdown in inflation and a higher supply of foreign currency in the exchange market limited the depreciation of the exchange rate to 11% in 1999.
El Salvador	The slower dynamism of the Salvadorean external sector was mainly the result of slow export growth, including in *maquiladoras*, which was unable to offset the increase in imports. This led to a deterioration of the trade balance. Foreign direct investment, particularly a US$ 250 million investment in thermal energy generating plants, had a significant effect on the management of monetary reserves.
Guatemala	Guatemala's external sector reflects an economy in recession, in which exports and imports are falling, the trade deficit is increasing, international monetary reserves are declining, and the exchange rate is weakening. There was a fall in the export of non-traditional goods in 1999, especially to the subregional market. Imports of consumer goods, raw materials and capital goods also declined because of a fall in domestic demand and a higher exchange rate. There was also a slowdown in the dynamism of the *maquiladora* sector.
Honduras	In 1999 the external sector was characterized by a severe and absolute fall in the value of exports and the need to increase imports. This led to a significant widening of the current account deficit, which was financed by foreign resources. Honduras's trade balance with the subregion deteriorated because of a faster increase in imports.
Nicaragua	The decline in international prices and the cost of fuels led to a current account deficit. Donations, current and capital transfers and foreign credit are enabling Nicaragua to sustain its weak external situation.

As regards exchange rate management, Guatemala and Honduras have adopted a free exchange rate regime, stabilizing the currency through active Central Bank intervention. In Costa Rica and Nicaragua the Central Bank uses a crawling peg system. El Salvador[12] recently introduced partial dollarization,

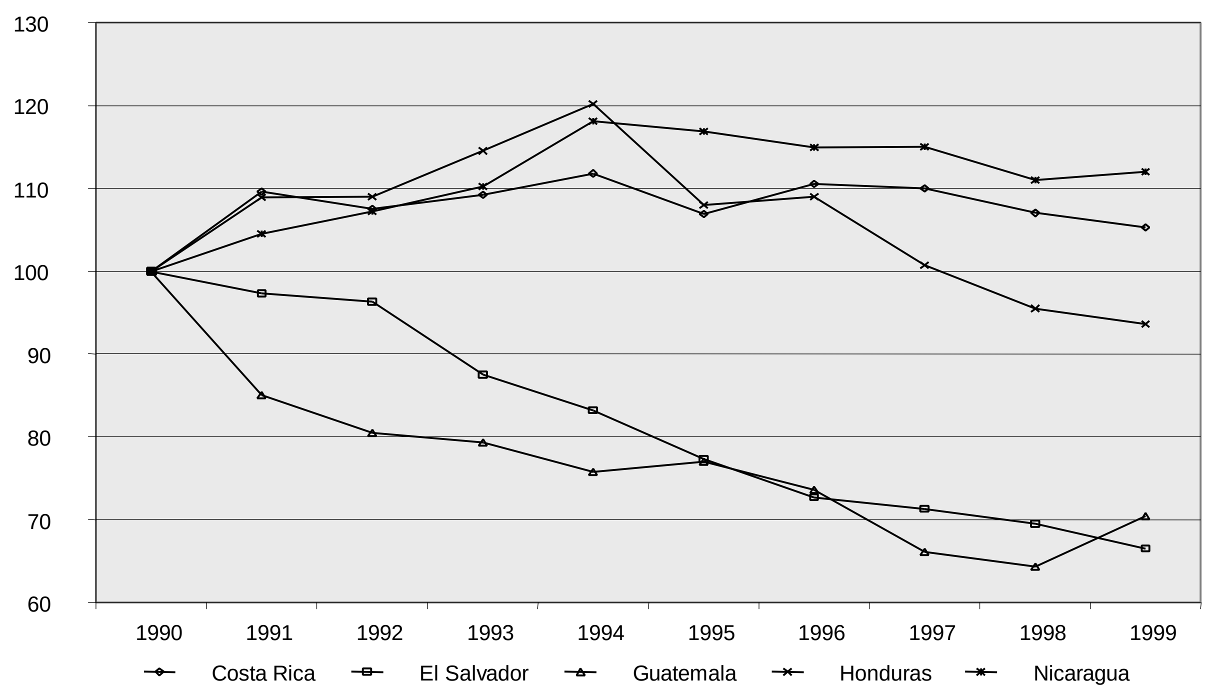
[12] Through the Monetary Integration Law, on 2 January 2001 El Salvador legalized the free circulation of the US dollar at parity with the Salvadorean colón in order to promote the voluntary and gradual dollarization of the economy in the short term.

whereby both the US dollar and the Salvadorean colón circulate. Box C outlines the main features of Central America's external sector in 1999.

The subregion has undergone significant exchange rate lag. In El Salvador the sustained influx of family remittances enabled the country to maintain a fixed exchange rate and accumulate international reserves, which led to an appreciation of the real exchange rate. In Guatemala and Honduras exchange rate stability has been more affected by the balance of payments, intra- or extra-subregional capital flows, and the expectations of a devaluation. These countries have experienced significant exchange rate fluctuations, forcing the Central Banks to intervene and thus undermining the management of their domestic monetary policies. Active intervention in Costa Rica's curency market has prevented a sharp depreciation of its real exchange rate. As Figure 1 shows, Nicaragua's exchange rate has depreciated significantly.

FIGURE 1

CENTRAL AMERICA: EVOLUTION OF THE REAL EXCHANGE RATE, 1990 = 100



Monetary Policy, Financial Markets and Interest Rates

Table 11 shows that the Central American countries followed clearly restrictive monetary policies in 1999. There was even a fall in net domestic credit in Costa Rica, Guatemala and Honduras, which is congruent with controlled inflation rates and low output.

TABLE 11
GROWTH OF DOMESTIC CREDIT
(percentages)

	Subregional Average	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1995	6.7	-6.0	25.9	26.5	-1.1	-11.7
1996	6.0	34.6	14.6	4.8	0.9	-25.0
1997	18.0	15.8	17.0	12.3	35.0	9.7
1998	9.6	23.0	0.5	0.8	20.1	3.6
1999	-2.3	-7.1	7.3	-7.7	-9.0	5.3

Source: Central American Monetary Council.

BOX D
CENTRAL AMERICA: MAIN ISSUES OF MONETARY AND FINANCIAL POLICY, 1999

Country	Relevant Issues
Costa Rica	Costa Rica limited its credit capacity in 1998 in order to dampen domestic demand, which had an impact on national output and imports. This policy was pursued until the first half of 1999. There was an increase in the use of open market operations as a mechanism to absorb liquidity, and gradual increases in the reserve requirements of new intermediaries and financial instruments. As of October 1999 the compulsory reserve rate was cut by one percentage point every six months in order to reduce it from 15% to 10% (local currency). There was a slowdown in the expansion of credit to the private sector after the ceiling on annual growth was increased from 26% to 30%, while growth in public sector credit fell to 27.1%. There was therefore a decline in domestic credit. Financial policy was characterized by three significant elements: the Financial Groups Regulation (control of offshore operations and of other financial transactions), the minimal amount of capital needed by private banks, and new rules on the bank ratings system.
El Salvador	Monetary policy was restrictive and sought to reduce excess liquidity in the money markets through open market operations, and especially by gradually eliminating reserves. The Central Bank opened credit lines to resolve the credit problems of commercial and financial banks. A number of mechanisms to supervise the financial system were introduced, such as the Bank Law, which increased banks' minimum capital to US$ 11.4 million. Banks were also banned from assuming risks worth more than 25% of their assets with a single individual or company, which have to be classified according to risk.
Guatemala	Guatemala adopted an expansionary monetary policy until July 1999. However, the intervention of the Central Bank through open market operations and reserve increases led to interest rate hikes. An emergency program was applied to financial institutions with liquidity problems. Banks' minimum capital was also increased and measures introduced to protect small savers' deposits.
Honduras	Honduras did not modify its compulsory reserve (12%). Domestic credit fell because of limits on resources to fund government spending. However, the availability of credit to the private sector was not affected, increasing by almost 14% between January and September 1999. It is worth noting that there were no significant movements in domestic interest rates, which remained at the high level prevailing since the end of 1998. On financial matters, Honduras introduced limits on banks' short-term foreign debt and increased the minimum capital for financial institutions.
Nicaragua	In 1999, Nicaraguan monetary policy sought to reduce the Central Bank's net domestic assets, in line with reserve targets and the fall in inflation. However, problems caused by Hurricane Mitch led to a reduction in the compulsory reserve in order to provide additional financing during the first phase of economic recovery. The Central Bank subsequently adopted a neutral position in its open market operations. Credit to the private sector also quickly increased.

Given the fall in banking reserves (Costa Rica and El Salvador) and the control of domestic liquidity as a means of maintaining inflation targets, the subregion’s Central Banks adopted a highly active role in controlling liquidity through open market operations. All countries also made efforts to increase the capital requirements and limits of banking and financial institutions, and to introduce measures to protect small savers (see Box D).

In 1999, real active interest rates rose by about 5 percentage points (to 16%) in all countries of the subregion except Nicaragua, where they increased by 9.5 additional points (to 25%) (Table 12). Passive rates also rose, from 5.2% in Guatemala to 14.7% in Nicaragua. It is important to note that interest rates were not negative in real terms, as they had been in Guatemala and Honduras in previous years. This reflects the relative progress made on financial deepening in the Central American markets.

TABLE 12

REAL INTEREST RATES, 1999

(percentages)

	Subregional Average	Guatemala	El Salvador	Honduras	Nicaragua	Costa Rica
Active	17.9	15.1	16.3	16.7	24.9	16.3
Passive	9.9	5.2	11.8	6.9	14.7	10.9
Margin	8.0	9.9	4.5	9.8	10.2	5.4

Source: Central American Monetary Council.

Costa Rica and El Salvador (which have the relatively most developed financial markets in the subregion) had the lowest (around 5% in 1999) real gross margins (defined as the difference between net active and passive inflation rates). This indicates greater efficiency compared to the other countries, which had gross margins of around 10%. It is worth noting that, in contrast to the other countries, Nicaragua's margin increased significantly during the period under study, from 5.9% in 1996 to 10.2% in 1999.

Finally, as to the relative size of the financial market, the Central American economies have strengthened their financial systems to varying degrees, as measured by the share of the broad money supply (M2) in relation to GDP (Table 13). This indicator shows that Guatemala has the smallest financial sector in the subregion, equivalent to some 35% of GDP. Those of El Salvador, Honduras and Costa Rica account for between 42% and 46.8%, and El Salvador has the largest. The Nicaraguan case should be examined with care in light of the aforementioned problems of measuring its GDP, although it is clear that the country's financial sector has grown, as shown by the data for the 1995-1999 period.

TABLE 13

CENTRAL AMERICA: RELATIVE SIZE OF THE FINANCIAL MARKET, 1999

(percentages)

	Subregional Average	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
M1/GDP	11.2	11.3	9.1	10.9	13.4	11.4
M2 / GDP	44.9	42.0	46.9	24.8	45.8	64.7

Source: Central American Monetary Council.

Main Economic Convergences and Asymmetries

The economic strategies of the five Central American countries feature similar positions on opening up, deregulation, privatization, attracting investment, and greater competitiveness. There are, however, differences in the speed and scope of the changes because of the peculiarities and domestic macroeconomic policies of each country. As shown below, this shapes the main indicators of economic performance.

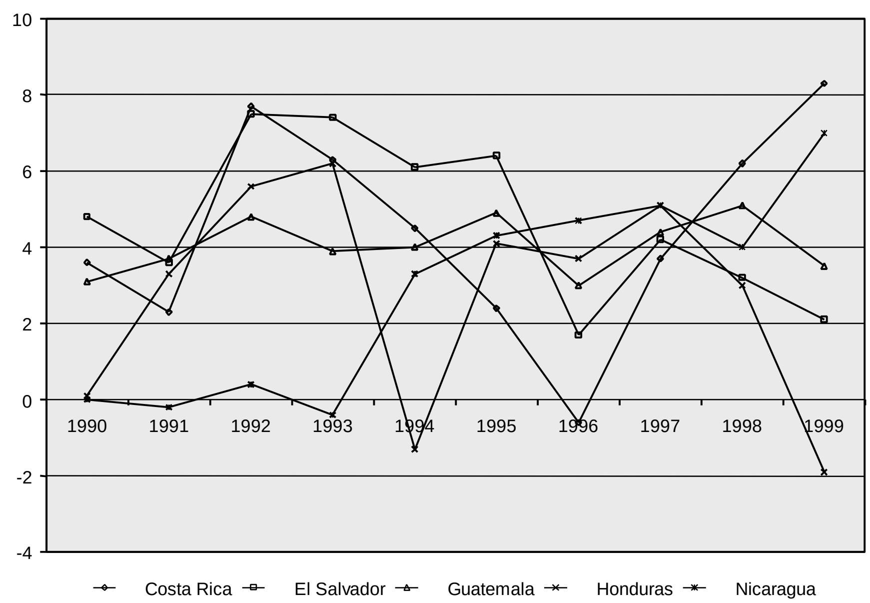
Dynamism of output

Despite differences in size and in their level of economic development, the subregion's economies are susceptible to external developments because of the greater dynamism of intra- and extra-subregional trade and the relative similarities of their economic structures. Figure 2 shows that there are years in which they performed poorly (like 1996) and others when performance was satisfactory (like 1992). In 1999 the Mayan Triangle countries (El Salvador, Guatemala and Honduras) performed less well than in the previous year, in contrast to Nicaragua or, if the free zones are taken into account, to Costa Rica.

FIGURE 2

CENTRAL AMERICA: ECONOMIC DYNAMISM

(real annual GDP growth rate)



Source: IDB, Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit.

The analysis of real growth rates in the countries of the subregion, based on statistical methods,[13] does not show a clear upward trend since the average rates are highly volatile (between 2% and 6%).

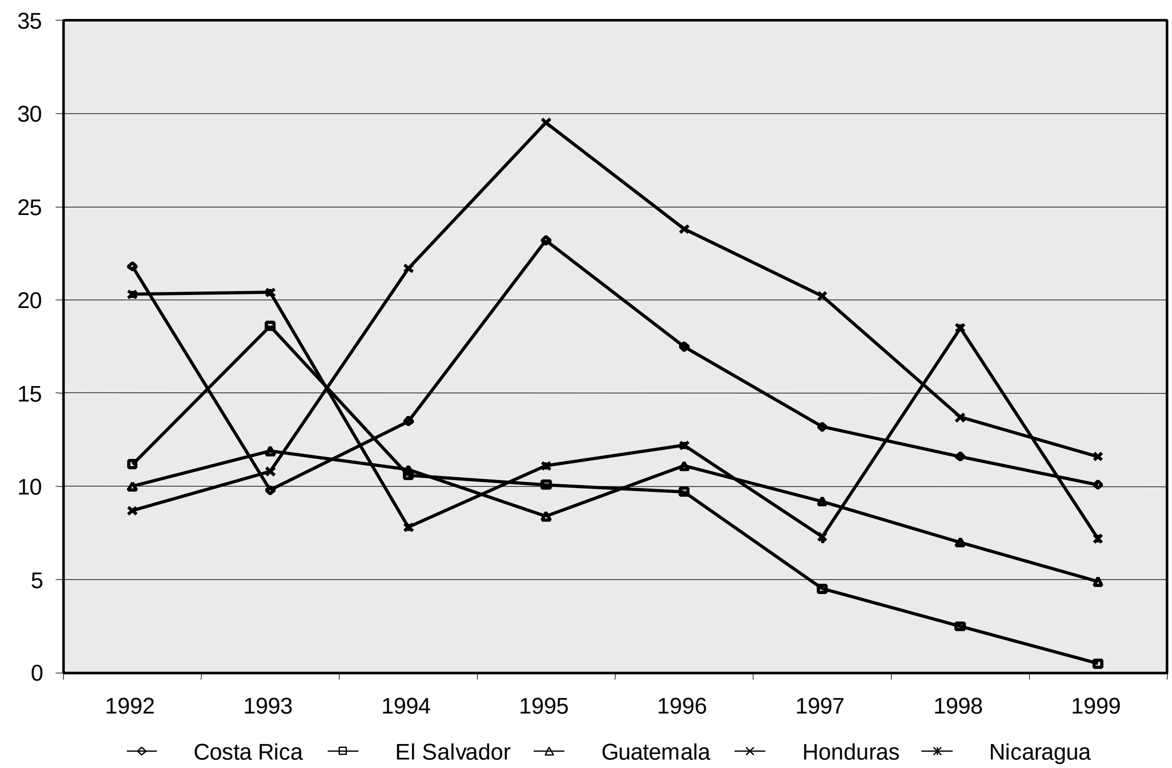
Price stability

As Figure 3 shows, all the countries of the subregion made continued efforts to control domestic prices throughout the 1990s. Interest rates, however, varied widely. Inflation in Costa Rica and Honduras was around 10% in 1999, and both countries found it difficult to lower the rate. Guatemala had inflation of 5% while, by contrast, El Salvador's consumer price index fell by 1%. Despite these differences, the trend in all the Central American economies was toward single-digit inflation, in contrast to the levels of the 1980s and early-1990s. This sends a very positive signal to domestic and international investors.

FIGURE 3

CENTRAL AMERICA: INFLATION LEVELS

(percentages)



Source: IDB, Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit.

---

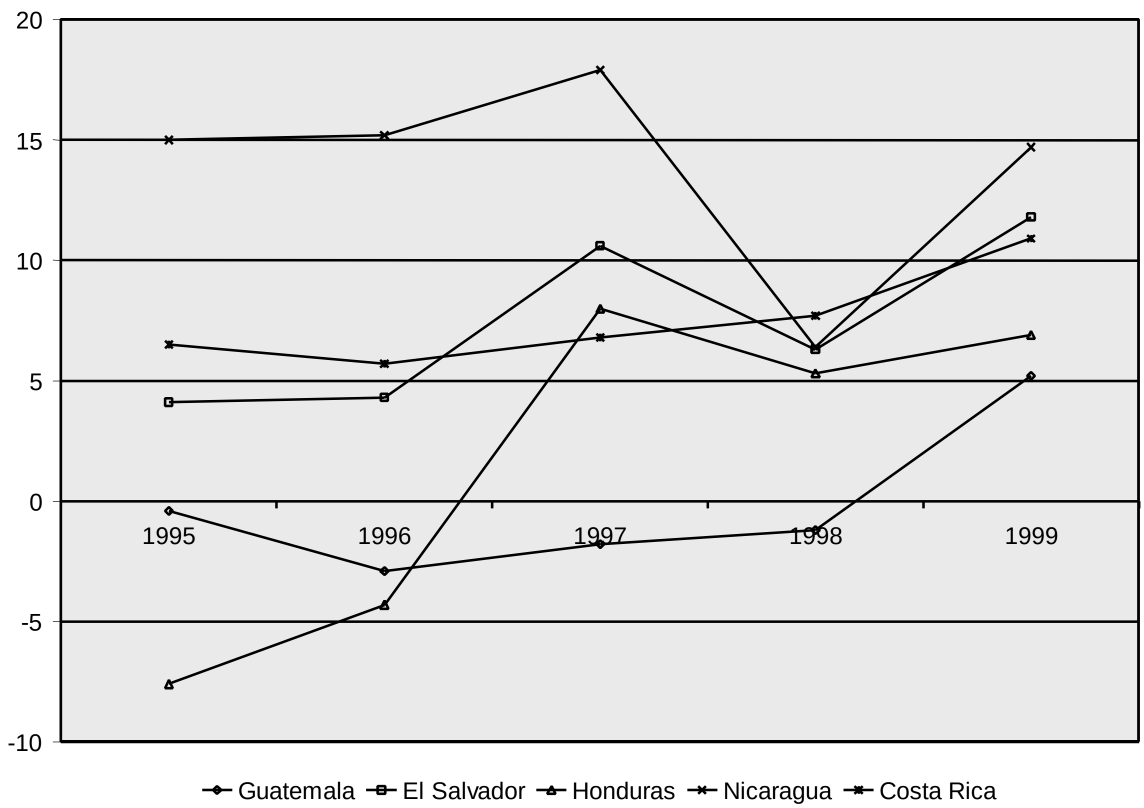
[13] Based on the Regional Programming Document (RP-CA), Vol II, IDB.

The statistical analysis again shows a trend towards lower average inflation rates[14] and lower standard deviation – that is, a clear tendency towards convergence. There were slight reversals, illustrated by significant increases in Costa Rica and Honduras (1995) and, more recently, in Nicaragua (1998).

Interest rates

Real rates are calculated using the nominal rates less the average inflation rate. The statistical analysis shows a tendency toward positive real interest rates, which were negative for much of the 1980s and early-1990s. This stems from efforts to deepen the subregion's financial markets and make them more transparent (Figure 4).

FIGURE 4
CENTRAL AMERICA: REAL PASSIVE INTEREST RATES
(percentages)



Source: IDB, Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit.

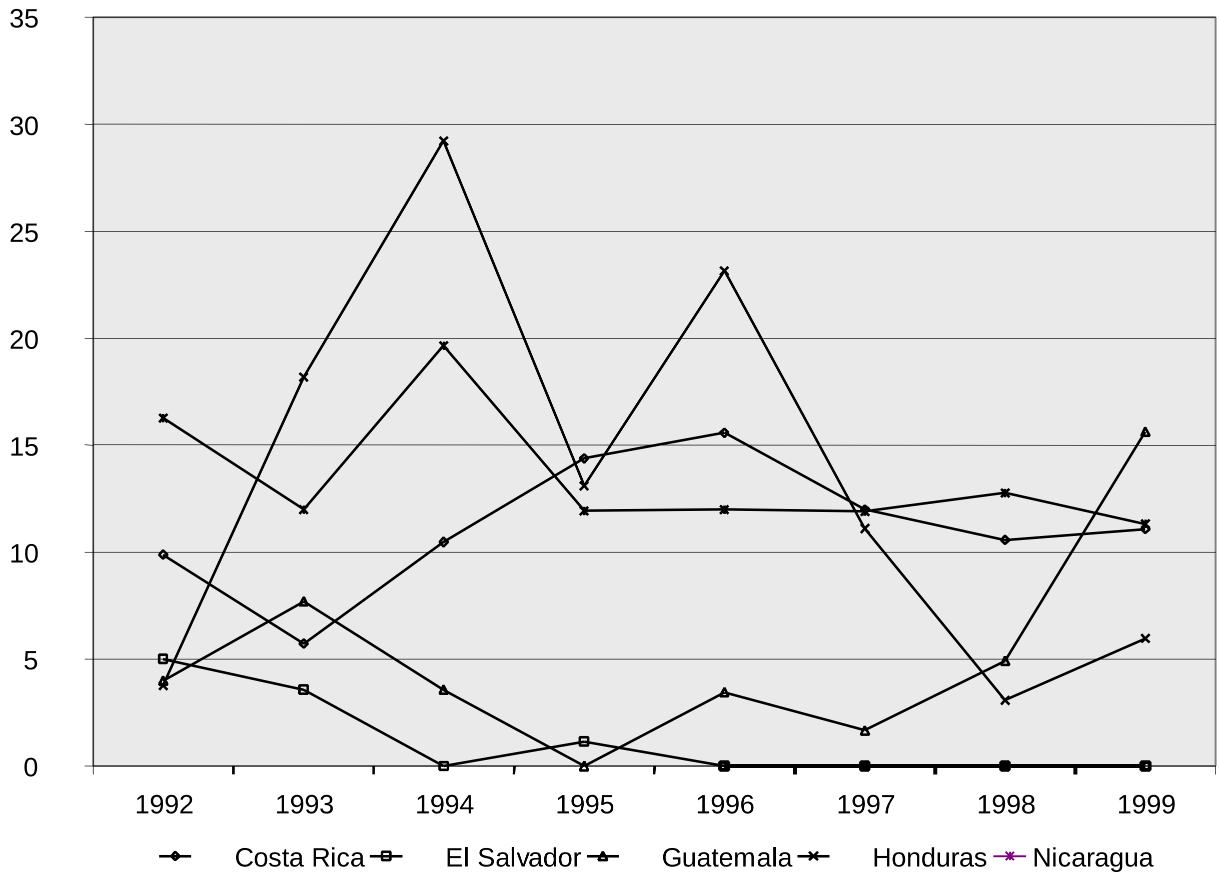
---

[14] The nominal GDP in dollars in each year was used to calculate the averages.

Exchange rate

The statistical analysis reveals a trend toward a lessening of annual average exchange rate depreciation in the Central American countries, and of the rate of standard deviation. There were slight reversals in Honduras in 1994 and 1995, but the trend toward greater convergence is clear (see Figure 5)

FIGURE 5
CENTRAL AMERICA: EXCHANGE RATE



Source: IDB, Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit.

This trend toward greater convergence and lower annual variation in the exchange rate is also linked to adjustment processes. The latter have given rise to lower inflation and, in general, to the use of more transparent exchange rate systems that are less influenced by intervention in the currency markets; their currency prices are therefore much more credible. El Salvador is the only country to have maintained exchange rate parity through the use of remittances from abroad, with a consequent overvaluation[15] of the currency.

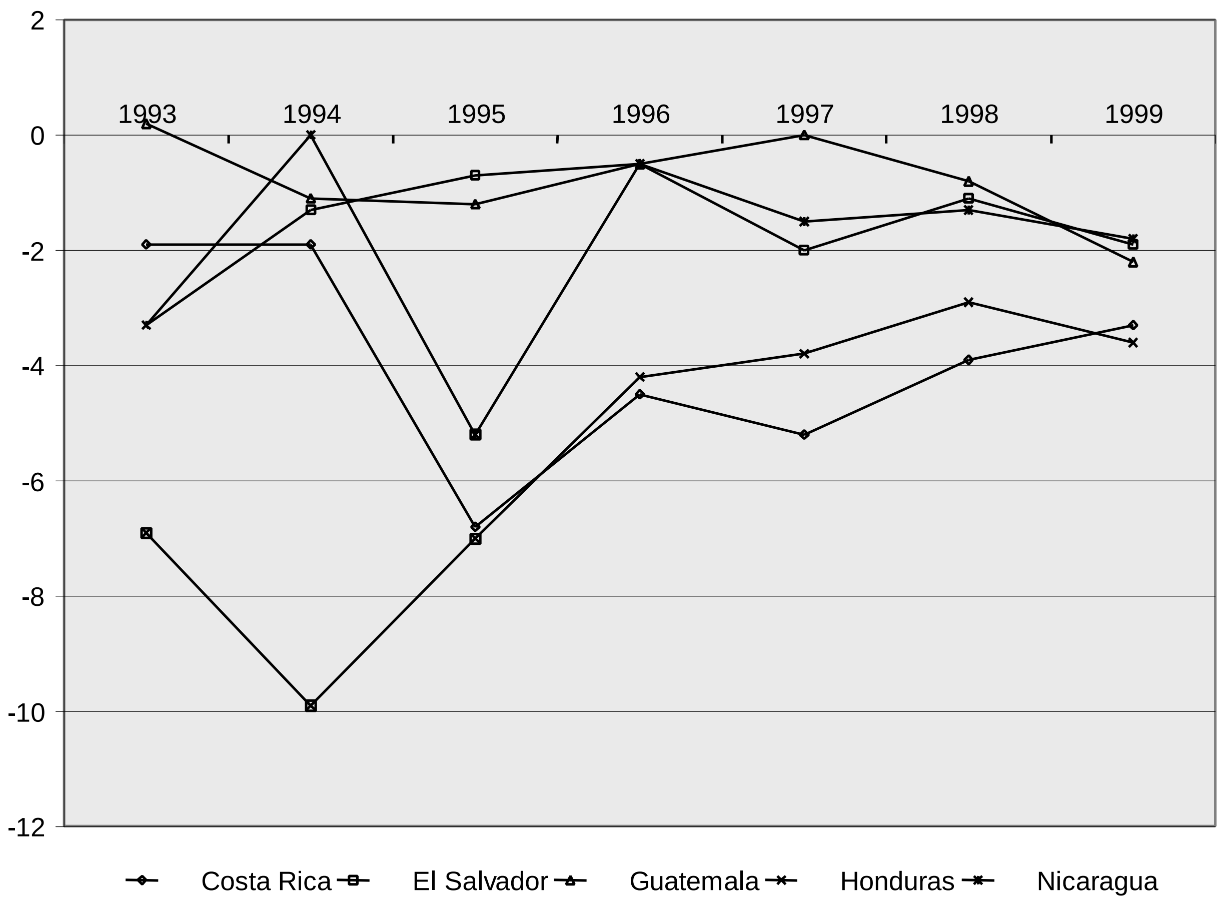
---

[15] The issue of the overvaluation of El Salvador's currency is controversial. It could be argued that the exchange rate is at equilibrium from the balance of payments viewpoint, which includes capital movements and remittances. However, this situation should be re-examined in light of the reforms implemented by the Salvadorean government as of January 2001.

Fiscal balance

Figure 6 shows that there is no clear trend toward lower fiscal deficits in the subregion, but it does reveal a decline in their dispersion. It also demonstrates some convergence between countries in the direction of the deficit. In some years, such as 1994, the subregion in general (except Honduras), had low deficits, in contrast to the situation in 1996. This is because of the countries' tax structures, which are highly dependent on foreign trade performance.

FIGURE 6
CENTRAL AMERICA: FISCAL DEFICIT
(% of GDP)



Source: IDB, Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit.

Other significant convergence variables

Another inidcator of economic convergence is the ratio of total public debt to GDP. The average ratio is falling and its standard deviation is fluctuating between 18% and 22%, with no clear trend. This is because El Salvador and Guatemala have cut the ratio by around 50% since the start of the 1990s, while in Costa Rica it has increased and Honduras it has been erratic.

Neither is there a clear trend toward convergence in the value of foreign trade relative to GDP, but it is evident that all the countries are opening up, albeit at diferent speeds. The trade agreements that they are negotiating, including the FTAA, are likely to lead to greater convergence in this sphere by spurring more openness in the region as a whole.

In conclusion, the subregion's business environment improved in the 1990s. Some significant risk factors persist, but the evidence suggests that the countries of the isthmus are carrying out reforms and consolidating stability, although at varying rates. Evidence of this is the significant growth of both foreign direct investment and subregional investment, in response to the opportunities offered by trade and by greater private sector participation in the economy. Nevertheless, the subregion still faces enormous challenges in attracting the major investment its needs for infrastructure and human development.

CHAPTER III. ANALYSIS OF TRADE FLOWS IN THE SUBREGION

The 1990s saw the start of subregional economic reactivation and the revitalization of the Central American integration process, the result of increasing political stability and of the economic reforms that all the countries began in the late-1980s in order to secure the subregion's greater insertion in the world economy.

Trade liberalization, accompanied by better market access and fiscal incentives, triggered the recovery and diversification of the Central American Common Market's (CACM)[16] trade flows with the rest of the world. Trade recovered not only with non-traditional markets but also within the subregion. As an important complement to the small domestic markets of each country, the subregional market also underwent substantial reactivation.

In the 1990s, all countries reduced and standardized their external tariffs with a view to adopting a common external tariff (0% -15%). They began to dismantle their protection schemes and to move toward a more complete free trade area, including even agricultural products. Despite some setbacks in tariff reduction policy and continued protection for certain (mainly agricultural) goods, current levels of protection are substantially lower than those of a decade ago.

Great efforts have also been made to boost exports, although the most positive developments relate to extra-subregional trade (simplified bureaucratic procedures for export formalities). Steps remain to be taken to remove the obstacles to intra-subregional trade, especially as regards subregional norms and facilitating procedures at the borders.

Scale and Direction of Trade

Total Central American trade (exports and imports) has grown. Trade practically tripled over the decade, increasing from US$ 10.448 billion in 1990 to US$ 31.719 billion in 1999. Intra-subregional trade was also dynamic, growing 2.8 times in the same period and totaling US$ 4.828 billion in 1999.

Despite this, in the last three years trade growth has declined in all countries (see Table 14) for various reasons: Hurricane Mitch destroyed crops and affected external sales of coffee, bananas and other agricultural products; international prices have fallen for some export products that are very important for the Central American countries, especially coffee and bananas.

[16] What is known as the Common Market in Central America is really a free trade area that has a common external tariff on most products, with some agricultural exceptions.

TABLE 14
CENTRAL AMERICA: GLOBAL TRADE FLOWS

Growth Rates

	Subregion	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1996-1997	17.2	14.6	23.2	16.0	14.6	20.6
1997-1998	14.9	26.9	3.9	15.3	14.2	-5.6
1998-1999	3.2	9.9	2.4	-7.9	1.0	10.5

Source: IDB, Division of Integration, Trade and Hemispheric Issues, on the basis of IMF data.

TABLE 15
CENTRAL AMERICA: INDEX OF OPENING FOR TOTAL TRADE, 1990-1998

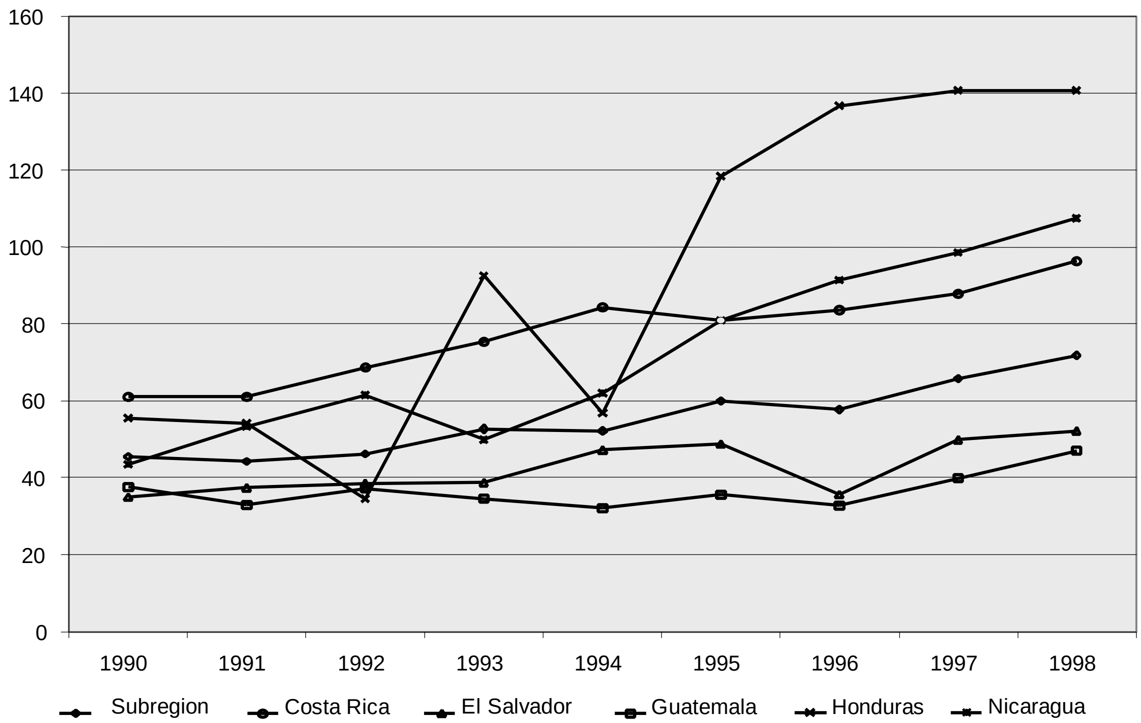
Percentages

Year	Subregion	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1990	45.4	61.0	35.0	37.7	55.5	43.3
1991	44.2	61.0	37.5	32.9	54.1	53.2
1992	46.2	68.6	38.5	37.2	34.6	61.5
1993	52.7	75.3	38.8	34.6	92.4	49.9
1994	52.1	84.3	47.2	32.0	56.8	61.9
1995	59.9	81.0	48.7	35.7	118.4	80.9
1996	57.8	83.6	35.6	32.8	136.7	91.5
1997	65.7	87.9	49.9	39.8	140.8	98.5
1998	71.7	96.3	52.2	47.0	140.8	107.5

Source: IDB, Division of Integration, Trade and Hemispheric Issues, on the basis of IMF data.

Table 15 shows the index of opening as the ratio of imports plus exports to gross domestic product, both for the subregion and for each of the countries. It is clear that the relative scale of trade is important in Central America, the subregional average being 71.7% in 1998. For Honduras and Nicaragua, the subregion's smallest economies in output terms, the magnitude of external trade exceeds the value of GDP, as shown by indicators that surpass 100%. In 1998 Costa Rican trade was at a similar level to its GDP, and in 1999 surpassed 100%. El Salvador and Guatemala are the subregion's most closed economies; their external trade is equivalent to about half of their GDP and they have very significant intra-subregional trade flows. Figure 7 shows the progress of Central American trade liberalization during the 1990s; the trends were rising as a result of the process of opening up.

FIGURE 7
INDEX OF OPENING, 1990-1999



Source: IDB, Division of Integration, Trade and Hemispheric Issues, on the basis of IMF data.

The index of opening for Central American trade flows (that is, intra-subregional exports and imports in relation to the GDP of each country and of the subregion as a whole) also increased substantially, growing from 5.4% in 1990 to 8.6% in 1998 (see Table 16).

TABLE 16
CENTRAL AMERICA: INDEX OF OPENING FOR INTRA-SUBREGIONAL TRADE, 1990-1998
Percentages

Year	Subregion	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1990	5.4	4.9	7.2	5.5	3.2	5.2
1991	6.1	5.8	8.0	5.1	3.2	12.0
1992	7.1	6.8	9.4	6.1	3.0	14.6
1993	7.1	6.0	9.2	5.7	6.5	13.4
1994	7.3	6.3	9.1	5.9	5.7	16.0
1995	7.6	6.5	8.8	5.8	8.0	19.1
1996	7.9	6.9	9.2	5.2	10.6	21.6
1997	8.1	7.3	9.2	5.6	10.5	22.7
1998	8.6	7.8	9.8	6.0	10.6	24.7

Source: IDB, Division of Integration, Trade and Hemispheric Issues, on the basis of IMF data.

It should be noted that despite the different growth rates for trade between the Central American countries, for all of them intra-subregional trade became more important during the 1990s. Honduras and Nicaragua most increased their intra-subregional commerce. Despite this, the lower ratio of intra-subregional trade to GDP, relative to that evident in trade with the rest of the world, suggests a need for further efforts to facilitate trade within the subregion. Such efforts would invigorate intra-subregional trade flows and foster the growth of the small and medium companies that dominate Central American commerce.

The subregion's trade balance

The productive structures of the Central American countries have been highly dependent on imports of inputs and raw materials, most of which come from extra-subregional countries, and until recently their exports have been highly concentrated in a few traditional products whose main market is the United States.

Table 17 shows the trade deficits of the Central American countries during the 1990s. The deficits grew in all cases except Costa Rica, which in 1999 posted a surplus for the first time in its goods trade – the result of the INTEL Corporation's contribution to exports.

TABLE 17
CENTRAL AMERICA: TRADE BALANCE BY COUNTRY, 1990-1999
(US$ millions)

Year	Subregion	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1990	-1,574	-443	-666	-217	-12	-238
1991	-1,839	-200	-704	-443	-72	-420
1992	-3,042	-338	-963	-1,044	-151	-548
1993	-3,328	-649	-1,034	-1,021	-231	-392
1994	-3,454	-624	-1,155	-997	-258	-420
1995	-3,199	-322	-1,524	-875	-111	-367
1996	-2,644	-249	-1,243	-643	-133	-376
1997	-3,355	-234	-1,107	-1,152	-199	-662
1998	-4,279	-244	-1,267	-1,717	-247	-805
1999	-4,099	723	-1,401	-1,480	-833	-1,109

Source: IDB, Division of Integration, Trade and Hemispheric Issues, on the basis of IMF data.

Export Performance

In 1999 the subregion as a whole exported goods worth US$ 13.81 billion, 4.4% more than the previous year, including sales effected through free zones, temporary admission, or *maquila* operations. This growth is somewhat unsatisfactory in comparison to the rates of 1997 (15.9%) and 1998 (13%), or even to the subregional average between 1990 and 1994 (10.2%) and that between 1995 and 1999 (6.3%) (see Table 18).

TABLE 18
CENTRAL AMERICA: TRENDS IN TOTAL GOODS EXPORTS

	Subregion	**Costa Rica**	**El Salvador** 1/	**Guatemala**	**Honduras** 2/	**Nicaragua**
			US$ millions			
1998	13,230	5,547	2,451	2,562	2,091	579
1999a	13,810	6,593	2,457	2,410	1,820	530
			Growth Rates			
1998	13.0	27.5	1.5	7.2	13.6	-18.3
1999a	4.4	18.9	0.2	-5.9	-13.0	-8.5
1990-94	10.2	42.7	26.8	2.4	2.4	0.6
1995-99	6.3	23.3	6.1	0.7	2.0	0.0
			Percentage Structure			
1990	100.0	30.5	14.5	27.3	20.2	7.5
1995	100.0	37.5	17.9	23.2	15.7	5.7
1999a	100.0	47.7	17.8	17.5	13.2	3.8

1/ Includes goods for processing since 1995; 2/ Includes goods for processing since 1993; a: average.

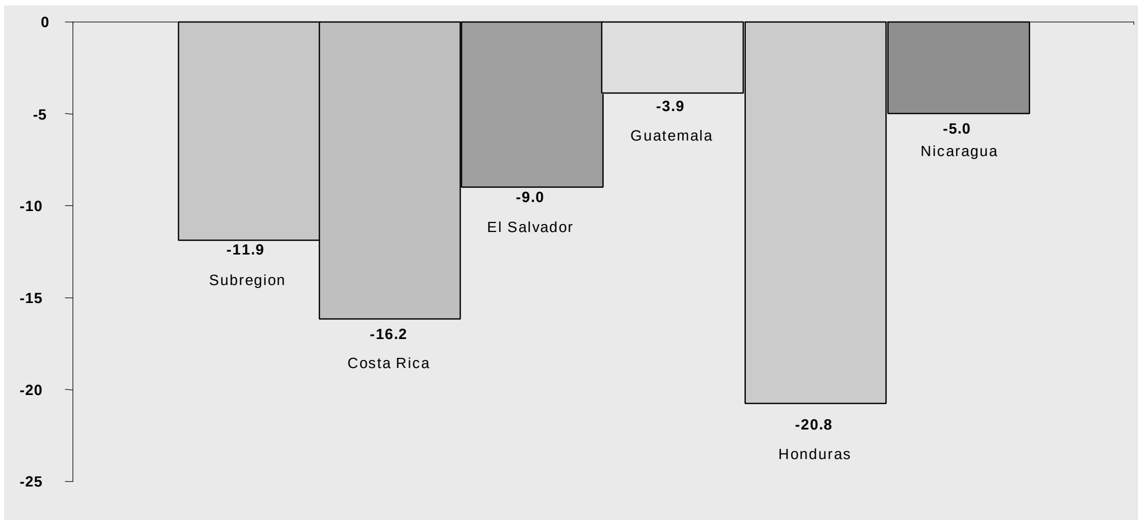
Source: IDB, Statistics and Quantitative Analysis Unit

Analysis of the performance of exports that do not come from free zones or *maquiladoras* reveals a more critical picture. According to the Secretariat for Central American Economic Integration (SIECA [1999]), the subregion's exports fell by 11.9% between 1998 and 1999, as shown in Figure 8. The growth rate in Costa Rica, which has the greatest export dynamism in the subregion, fell from a positive 18.9% to a negative 16.2%. El Salvador posted no growth in that year and recorded a negative 9%. The Honduran case is even more serious: as a result of Hurricane Mitch, global export values fell by 13% and, excluding exports from free zone companies and *maquiladoras*, the value of exports fell by 20.8% in 1999 relative to 1998.

In the 1990s there were significant changes in the Central American countries' share of the subregion's exports (see Table 18). In 1990, exports from Costa Rica and Guatemala were at a very similar level and accounted for about 60% of Central America's total extra-subregional sales; Honduras accounted for 20% of exports. By 1999 almost half of the subregion's exports came from Costa Rica. El Salvador and Guatemala shared second place with about 18% each; and Honduras barely accounted 13.2% of Central American exports. Nicaragua remained the smallest economy: its share of Central American exports fell from 7.5% to 3.8% during the decade.

FIGURE 8
CENTRAL AMERICA: GROWTH OF EXPORTS, EXCLUDING FREE ZONE AND *MAQUILA*

Percentages



Source: *Informe Económico Regional 1999,* SIECA.

An examination of CACM exports by destination reveals the importance of extra-subregional sales, which account on average for 78.8% of the subregional total. Figure 9 shows that extra-subregional sales account for 88.2% of Costa Rica's total exports and 55.9% of El Salvador's.[17] The United States is the main trade partner, with about 40% of the subregion's total sales in 1998. The European Union took about 19% of Central America's exports that year, and the subregion itself was the third main market, taking 20.4%.

During the 1990s the subregion's dependence on the United States increased markedly, the result of the benefits that the latter grants to Central America.[18] The Caribbean Basin Initiative (CBI) and *maquila* arrangements[19] have spurred product diversification, since the relative significance of highly traditional products such as bananas, coffee, sugar, cocoa and minerals has diminished. There has been a substantial increase in light manufactures and new agricultural products, as shown in Table 19. Despite these developments, traditional products are still significant in the subregion's export structure, accounting for about 65% of the total.[20]

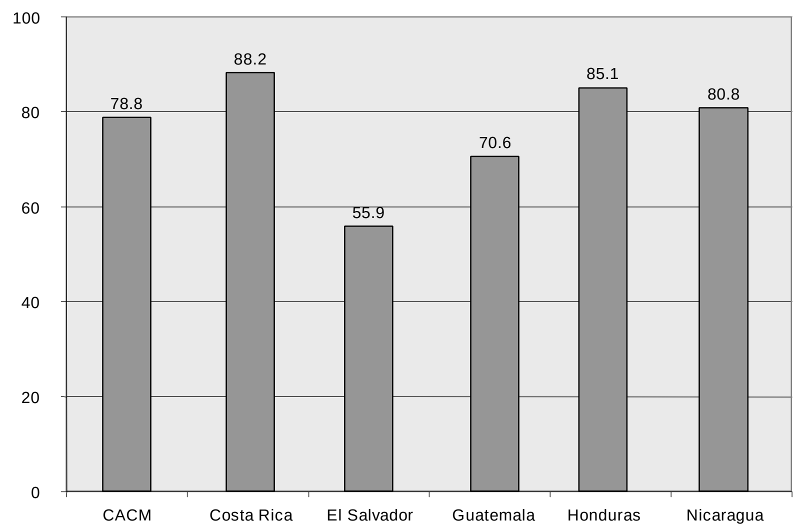
[17] The growing importance of exports of manufactured products protected by special customs and fiscal regimes (*maquila* and free zones) is changing Central America's export profile. According to some estimates, exports under these regimes in El Salvador and Honduras respectively accounted for 70% and 80% of their total exports to the United States in 1997. In Costa Rica and Guatemala they represented 50%, and in Nicaragua, 31%.

[18] Most exports to the US market enter under the Generalized System of Preferences or the Caribbean Basin Initiative, whereby Central American exports are granted tariff exemptions.

[19] Under this scheme the *maquiladora* companies can import US cloth and assemble finished products. On entering the US market they pay only the tariffs corresponding to the value added generated abroad. There are various forms of the scheme, especially as regards the granting of quotas. When the cloth is made and cut in the United States, the quotas are much higher than for exports of textile products made with fabric not made in the United States. The scheme is also known as Program 807.

[20] Costa Rica did attain a substantial diversification of its export structure in the 1990s; the share of traditional products fell from 65% to 35%.

FIGURE 9
CENTRAL AMERICA: EXPORTS TO THE REST OF THE WORLD
Percentages



Source: Secretariat for Economic Integration, SIECA.

TABLE 19
CENTRAL AMERICA: TEN MAIN EXPORT PRODUCTS, 1998
US$ millions

Product	Value	Percentage
Gold coffee	1,512.5	13.4
Bananas	961.4	8.5
Machine parts	550.9	4.9
Sugar	466.2	4.1
Electronic microstructures	409.5	3.6
Roasted coffee	395.4	3.5
Cotton pants	147.1	1.3
Medicines	135.9	1.2
Tropical pineapples	121.7	1.1
Shrimp	117.1	1.0
Subtotal	4,817.7	42.7

Source: Secretariat for Central American Economic Integration, SIECA.

Despite the tariff preferences granted by the United States, Central American products face a considerable disadvantage compared to those from other trading blocs. According to the ECLAC,[21] the duties levied on the import value amounted to 5.1% for Central America, 1.2% for CARICOM, and 0.6% for Latin

[21] Taken from the Regional Programming Document, RP-CA Vol II.

America as a whole. Hence the need to revise the scope of US trade policy toward the CACM, and hence also the search for NAFTA parity.[22]

Textiles and clothing is one of the most important categories for Central America in its trade with the United States. In 1997 El Salvador and Honduras posted growth of 37% and 45%, respectively, in their exports to the US market. Average subregional growth was 31.3%, stimulated by the *maquila* program for US textile products assembled abroad. The inclusion of such goods in the negotiations for NAFTA parity has been fundamental in offsetting the subregion's disadvantage relative to Mexico, and in offering investors greater juridical security to establish a presence in Central America.

The measures providing trade benefits to the CBI countries, the result of the 2000 Trade and Development Act approved by the US Congress, are very important in that they stipulate that practically all the products imported from the beneficiary countries (which meet certain origin requirements) will be exempt from tariffs on entering the US market. With some exceptions, therefore, all imports from the subregion will be admitted to the United States duty-free. These measures include exceptions to the duty-free treatment granted in previous acts, specifically those on textiles and clothing, leather products and by-products, canned tuna, oil and by-products, and certain timepieces.

Conditions of access for Central American products in the European Union (EU) under its Generalized System of Preferences (GSP) do not differ greatly from those granted by the United States. Hence the relatively modest performance of exports to Europe stems from geographical proximity, which makes the United States a more attractive market. The EU has extended to Central America the benefits of the special GSP that the Andean countries have enjoyed since late-1998; these entail tariff exemptions and preferences for industrial exports. Nevertheless, export dynamism toward the EU still shows no sign of quickening. Bananas remain one of CACM's main exports to the EU, but market access for bananas has not improved.

This trend poses significant challenges for the CACM countries in terms of market diversification and dependence on a limited range of products. Despite the export promotion strategies pursued by all countries to boost sales to third markets, these have not led to such a broad diversification of the export basket as Costa Rica has generally attained.

Intra-subregional exports

Because of the special circumstances in Central America during the 1980s, and given the small size of the Central American market in comparison to the opportunities offered by the world market, it is unsurprising that national policies to promote and attract investment, and the incentives granted, center on the opportunities offered by the extra-subregional market rather than on the subregional market.

The CACM has great potential, however, since most trade is between bordering countries and hence there is room for more intra-Central American commerce. Facilitating such trade would support the efficient substitution of imports from abroad, as well as strengthen the export and management capacity of many small and medium companies that currently produce solely for the domestic markets of each country. Despite the fact that the subregion's national markets are viewed as very small, Central America as a whole has almost 35 million inhabitants. This is hardly negligible, as evidenced by Mexico's interest in negotiating trade agreements with all the CACM countries.

[22] The Central American governments deployed an entire lobby in the US House and Senate to secure parity with the benefits of the North American Free Trade Agreement (NAFTA) between the United States, Canada and Mexico in the area of tariffs on textile exports. Mexico can export such products duty-free to the US market, while they were excluded from the Caribbean Basin Initiative and the Generalized System of Preferences (GSP). At the time of writing, the House and Senate had approved NAFTA parity.

Between 1990 and 1994, intra-subregional exports grew by 15%, above the 12.6% rate of the second part of the decade, revealing a loss of dynamism in the latter period. In the period 1994-1998 subregional exports grew by 11.0% and exports to the rest of the world by 14.7%. This indicates significant constraints on the capacity of the subregional market to absorb higher levels of trade, the need to remove barriers to the trade in Central American goods, and the absence of incentives that foster greater intra-subregional commerce.

Table 20 shows that the share of subregional exports in total exports (excluding sales from free zones and *maquiladoras*) stood at 21.2% between 1994 and 1998. Throughout that period, the share of intra-subregional exports in total sales was about 44% for El Salvador, 30% for Guatemala, a little less than 20% for Nicaragua, 15% for Honduras and 11.8% for Costa Rica. The share increased in El Salvador and Nicaragua and fell in Costa Rica from 1997, coinciding with substantial growth in sales from free zones.

TABLE 20

CENTRAL AMERICA: RELATIVE IMPORTANCE OF INTRA-SUBREGIONAL EXPORTS

Percentages / total trade

	Total	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1994	22.6	12.7	41.8	31.6	14.5	23.9
1995	21.7	12.9	42.5	28.8	14.8	16.3
1996	20.7	12.1	44.4	28.5	15.6	15.3
1997 (P)	21.1	11.5	42.6	29.2	14.7	18.2
1998 (P)	19.8	9.6	49.0	29.0	14.8	22.2
1999 (E)	18.4	9.6	25.1	32.0	19.4	28.9
1994-1998	21.2	11.8	44.1	29.4	14.9	19.2

(P) Preliminary, (E) Estimates.

Source: Secretariat for Central American Economic Integration, SIECA.

El Salvador and Guatemala are the source of most intra-subregional exports, accounting for 60% of the total in 1999. The shares are evidently influenced by the size of the countries, and hence it is more appropriate to calculate the regional orientation coefficient (the coefficient of each country's importance in intra-subregional exports and its importance in total exports). This indicator also shows that El Salvador and Guatemala are the countries whose external trade is relatively more concentrated in Central America, while Costa Rica and Honduras are more geared toward third markets.[23]

As regards the composition of Central American trade, intra-subregional exports are much more diversified (in terms of the number of products) than those sold to the rest of the world. Exports within the subregion are predominantly products of the foodstuffs industry and manufactures, the result of previous import substitution policies. Grouping the manufacturing sectors of the SITC (chemical products, manufactured goods classified by material, machinery and transport equipment, and miscellaneous manufactured articles), these account for almost 70% of total intra-subregional sales. This is in contrast to total exports, some 65% of which consist of unprocessed products.

[23] Taken from the Regional Programming Document, RP-CA Vol II.

Despite these circumstances, exports of processed foodstuffs are increasing and are gaining relative share in total intra-subregional trade. This is the result of these products' inclusion in the free trade area and, more recently, of food needs spurred by Hurricane Mitch's destruction of crops.

As shown by trends in exports to the OECD countries,[24] Central America is now more competitive internationally, since the relative weight of the most dynamic sectors (where demand is growing in the import market) has increased in all countries. All CACM countries now produce more sophisticated exports; Costa Rica has experienced the greatest increase in the sophistication index,[25] although compared to more developed countries the size of the gap at the international level remains considerable.

Costa Rica has the most clearly defined policies for promoting exports and attracting FDI, and it seems logical to relate that circumstance to its relatively better position in the last two indicators mentioned. This might justify the granting of fiscal and customs advantages to export companies in the other countries of the subregion.[26] Attracting investment, however, is also related to the quality of the business climate and the availability of resources; the quality of human capital is decisive.[27] These are the factors that will have the greatest influence on competitiveness in the future.

Import Performance

As Table 21 shows, subregional imports totaled US$ 17.909 billion in 1999, barely 2.3% more than in 1998. This growth rate was congruent with the lower growth of imports in the second half of the 1990s (5.1%). It contrasts with the 16.4% growth of the period 1990-1994 and reflects less dynamism in the subregional economy, at least among the relatively bigger economies. Guatemalan imports, which grew by 20.8% in 1998, contracted by 9.1% in 1999, a significant indicator of recession. Costa Rica, whose imports grew by a substantial 26.3% in 1998, increased by just 1.3% in 1999, reflecting the constraints on growth in that part of the productive sector that is unrelated to free zones. El Salvador's imports grew at a lower annual rate than the previous year, but increased by 3.8% in 1999. Honduras and Nicaragua, the economies most affected by the effects of Hurricane Mitch, have seen import growth of 13.5% and 18.4% respectively – the result of their need to meet their food requirements and of an upswing in imports of inputs for reconstruction.

---

[24] Taken from the Regional Programming Document, RP-CA Vol II.

[25] Calculated as the mean position of the country's exports within a basket of goods previously classified according to their degree of technological sophistication and innovation, according to the Regional Programming Document, RP-CA Vol II, Chapter 5.

[26] Despite the commitments assumed by the Central American countries as members of the WTO, with regard to the elimination of fiscal incentives (subsidies) for exports there is room to offer incentives that the countries of the subregion view as mechanisms for continuous export promotion. Clearly, such incentives should be compatible with the fiscal capacity of each country. The issue of free zones, which are so important for the countries of the subregion, should be analyzed in light of the commitment assumed in the WTO to eliminate the tax exemption incentives as of 2003 (except for countries with a per capita income below US$ 1,000 – Honduras and Nicaragua). The lack of clarity in this field is currently causing uncertainty for potential investors.

[27] Investment in human capital is fundamental, especially in education, health and flexible university training.

TABLE 21

CENTRAL AMERICA: TRENDS IN IMPORTS BY COUNTRY, 1990-1999

Year	Subregion	Costa Rica	El Salvador [1]	Guatemala	Honduras [2]	Nicaragua
			US$ millions			
1998	17,509	5,791	3,718	4,279	2,338	1,384
1999a	17,909	5,870	3,858	3,890	2,653	1,639
			Growth Rates			
1998	16.3	26.3	5.6	20.8	14.7	0.9
1999a	2.3	1.4	3.8	-9.1	13.5	18.4
1990-94	16.4	27.3	19.9	17.1	7.7	3.9
1995-99	5.1	7.7	1.6	2.5	12.7	19.4
			Percentage Structure			
1990	100.0	29.9	21.8	23.8	15.1	9.5
1999a	100.0	32.8	21.5	21.7	14.8	9.2

[1] Includes goods for processing since 1995; [2] includes goods for processing since 1993; a: average

Source: IDB, Statistics and Quantitative Analysis Unit.

According to SIECA data, in 1999 Costa Rica's and El Salvador's[28] imports fell by 0.5% and 5.3% respectively. This strengthens the argument that the sectors linked to local or intra-subregional trade (especially small and medium companies) are those with the greatest constraints on and potential for increasing their output and trade.

Unlike the subregion's exports, Central American imports changed little in the 1990s in terms of their composition by country. Costa Rica accounts for about 33% of total subregional imports, El Salvador and Guatemala share another 43% almost equally, and the rest are divided between Honduras (15%) and Nicaragua (9%). There have been no significant changes in the composition of imports. Manufactures represent about 73% of the subregional total,[29] and the share does not vary between countries since they have quite similar productive structures that are dependent on machinery and transport equipment (28.7%), manufactures (26.1%) and chemical products (17.5%).

The decline in external protection has undoubtedly played a decisive role in the subregion's import trends, as has greater public and private investment. Higher levels of investment spurred by economic reactivation, as well as tariff reduction (which has mainly affected capital and intermediate goods in recent years), are the main reasons for import growth. The value of imports tripled between 1990 and 1999, increasing from US$ 6 billion to almost US$ 18 billion.

The greatest growth in Central American imports in the period 1996-1999 was connected to the need for intermediate and capital goods. In El Salvador and Honduras these are related to the dynamism of

[28] Costa Rica and El Salvador are the only countries that distinguish between imports from *maquiladoras* and free zones, on the one hand, and other imports on the other.

[29] Taken from the Regional Programming Document, RP-CA Vol II, Chapter 5, based on INTAL data for 1996.

the *maquiladora* industry and to investment in infrastructure; in Costa Rica, they are associated with the increase in free zone production. Consumer goods imports were also important for the increase in Central America's purchases, since the countries have a relatively small industrial base and have cut tariffs in response to higher demand. Hurricane Mitch also heightened the need for extra-subregional imports of consumer goods.

As a result of the foregoing, the CACM's trade deficit has grown substantially in recent years and seems to be a structural feature. The general tendency is to maintain a surplus in agriculture and a deficit in manufactures, especially machinery and transport equipment. The latter sector has made the biggest contribution to the increase in the trade deficit. Imports largely reflect significant physical capital investment in Central America, which stimulates and partly facilitates the diversification and growth of exports, especially in the *maquila* sector and light manufactures. Intra-subregional imports have been a very stable share of total imports (about 13% in the period 1994-1999), as shown in Table 22.

TABLE 22

IMPORTS FROM CENTRAL AMERICA / TOTAL IMPORTS (%)

	Total	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1994	12.5	7.6	17.7	11.0	11.2	22.3
1995	12.4	7.3	17.2	8.9	14.3	22.6
1996	12.1	6.3	18.9	7.7	15.1	24.2
1997(P)	12.9	6.6	19.5	10.7	14.3	22.6
1998(P)	13.0	5.0	19.3	13.1	16.4	27.3
1999(E)	12.7	4.9	15.6	11.7	18.9	29.8
1994-1999	12.6	6.3	18.0	10.5	15.0	24.8

(P) Preliminary; (E) Estimates.

Source: Secretariat for Central American Economic Integration.

As regards the intra-subregional trade balance, El Salvador, Honduras and Nicaragua are in deficit, their purchases exceeding exports. Honduras and Nicaragua have had a growing trade imbalance with the subregion, especially as of 1997, as a result of the effects of Hurricane Mitch. This triggered both significant export contraction and a need for greater imports for the purposes of supply and reconstruction. Costa Rica and Guatemala, given their relative size, are Central America's main net suppliers, although Costa Rica's subregional trade is small relative to its total trade (Table 23).

TABLE 23

CENTRAL AMERICA: INTRA-SUBREGIONAL TRADE BALANCE

(US$ millions)

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1994	55	-56	183	-24	-106
1995	114	-64	263	-70	-145
1996	161	-51	335	-91	-159
1997 (P)	150	0	272	-136	-210
1998 (P)	202	17	141	-194	-296
1999	293	-18	273	-266	-321

(P): preliminary

Source: Secretariat for Central American Economic Integration, SIECA.

Some Final Remarks on Regional Flows

Despite the CACM's long history, which dates from the early-1960s, and notwithstanding the efforts made in the wake of pacification, its dynamism has been weakened by its own internal limitations. A prominent feature in that context is the weakness of the CACM's institutional and regulatory framework, which has been unable to prevent the application of various unilateral, non-tariff measures[30] that hamper free trade and that are used to protect domestic markets. Political activities have also affected regional trade, such as the 35% tariff that Nicaragua imposed on imports from Honduras in response to the latter's approval of a treaty with Colombia on the demarcation of borders.

Central America is the natural market for a series of small companies, mainly manufacturers that were specifically created for that market. Hence the subregional area should not be disregarded as a market for CACM exports, especially between bordering countries, where there is evidence of much greater relative trade intensity.[31] This is the case of Costa Rica with Nicaragua and Panama, or El Salvador and Guatemala.

The sharp recovery of Central American trade in the 1990s largely reflects an increase in extra-subregional exports rather than an increase in intra-subregional commerce. A viable strategy for the subregion is therefore to harmonize measures to stimulate intra-subregional trade without curbing the extra-subregional trends, as a mechanism to create new commerce without diverting trade.

30 Costa Rica's Foreign Trade Ministry estimates that 90% of the trade disputes to which it attends arise in the country's trade with Central America, and of these more than the half concern agricultural trade.

31 The trade intensity index measures the importance of trade between two partners in light of each one's importance in world trade (RP-CA, Vol II, Chapter 5).

CHAPTER IV. INVESTMENT FLOWS IN THE SUBREGION

Since the 1993 signing of the Protocol to the General Treaty on Central American Economic Integration, known as the Guatemala Protocol,[32] sub-regional integration has been marked by modest progress, both in the official government sphere and among Central American business organizations. The concrete efforts evident in this area have in fact been undertaken by the subregion's private sector, and have taken the form of intra-subregional investment.

As mentioned earlier, the subregional integration process has been conceived in terms of successive phases, starting with the establishment of a Central American free trade area, moving on to the deepening of external trade relations, the establishment of a Central American customs union and the free movement of factors of production and, finally culminating in the monetary and financial integration of Central America. In practice, however, the process has advanced little if the agreements reached are compared with their level of implementation.

As regards Central American business organizations, despite the presence and activities of subregional organizations such as the Central American Federation of Chambers of Commerce (*Federación de Cámaras de Comercio Centroamericana*, FECAMCO), the Central American Federation of Chambers of Industry (*Federación de Cámaras de Industrias de Centroamérica*, FECAICA) and the Central American Federation of Chambers of Exporters (*Federación de Cámaras de Exportadores de Centroamérica*, FECAEXCA), these are not particularly vigorous in promoting and facilitating business activities between the countries.

The transformation of existing subregional institutions, both public and private, is an important requirement of deeper subregional economic integration. Central American companies with investments in three or more countries argue that the main factors promoting greater economic integration are speedy and uniform processes for establishing companies; an effective Central American registry of trademarks and patents; the harmonization of labor legislation; a registry of sanitary norms for medical and food products; business organizations with a subregional approach; the elimination of trade barriers and of protection to national industries; a subregional monetary policy and the harmonization of financial legislation; a capital market with a subregional vision; uniform fiscal regimes, incentives and investment promotion policies; and improvements at border post services to facilitate transport.

These factors constitute a necessary condition for improving the subregional business climate. The latter, in turn, is a key determinant of the capacity to attract new intra-subregional and foreign direct investment. Foreign investors not only view the subregion's countries as important locations from which to export to international markets; they also consider supplying the subregional market. An expanded internal market thus raises the interest of both extra-subregional and Central American investors.

[32] According to the conceptual commitment assumed in the Guatemala Protocol, the member states are to achieve a Central American Economic Union in a voluntary, gradual, complementary and progressive way. Progress in this field should respond to the needs of the countries in the subregion. The Protocol's main objective was to complete the five different stages of the economic integration process: the Central American free trade area; external trade relations; the Central American customs union; the free movement of factors of production; and Central American monetary and financial integration.

Investment Flows within the Subregion

Investment in the CACM countries by Central American firms increased during the 1990s, and although the contribution of this output of goods and services is not fully reflected in the subregional trade statistics, its importance is growing.

Investment by Central American firms in the other countries of the area reveals an upward and currently strengthening trend, which evidences the maturity of the subregional integration process. It also shows greater investor awareness of the opportunities afforded by a market of almost 35 million people, in which the complementarity of subregional demands reinforces the trend towards specialization among business groups established in the market. Table 24 illustrates some of the main investments by Central American companies in the subregion.

TABLE 24

CENTRAL AMERICA: MAIN INTRA-SUBREGIONAL INVESTMENTS BY COUNTRY OF ORIGIN

Sector	Activity	Group or Company	Recipient country
	Costa Rica		
Industrial	Construction materials	Grupo Durman Esquivel	CA and Mexico
Trade	Wholesale trade	Supermercados Más x Menos	Honduras, Nicaragua
Services	Written press	Grupo La Nación	Guatemala
	El Salvador		
Services	Airlines	Grupo Taca	Central America
Services	Financial	Grupo Cuzcatlán	Costa Rica El Salvador Guatemala
Services	Financial	Agrícola Comercial	Guatemala
Services	Hotels	Intercontinental Camino Real	Costa Rica Honduras
Construction	Property	Grupo Poma	Central America
Trade	Department stores	Almacenes Simán	Guatemala
	Guatemala		
Farming	Poultry	Grupo Gutiérrez	El Salvador, Honduras
Farming	Sugar industry	Ingenios Guatemaltecos	Costa Rica, Honduras Nicaragua
Trade	Supermarkets	Grupo Paiz	El Salvador, Honduras
Industrial	Fizzy drinks	Grupo Mariposa	Honduras, Nicaragua
Services	Hotels	Hoteles Princess	El Salvador, Honduras, Nicaragua
Services	Fast food	Pollo Campero	Central America
Trade	Goods vehicles	Camiones Hino	Honduras
	Honduras		
Industrial	Brewing industry	Cervecería Hondureña	Nicaragua
Trade	Supermarkets	Despensa Don Juan	El Salvador
Housing	Property	Inversiones Sogeval	Guatemala
Industrial	Non-alcoholic beverages sector	Grupo Facusse	El Salvador, Guatemala
	Nicaragua		
Services	Financial	Grupo Pellas	Central America
Services	Financial	Grupo Pacific	Central America
Services	Financial	Grupo Fogel	Guatemala

Source: Drawn up on the basis of Document RP-CA. Vol. II.

Most investment by Central American businesses in the subregion has gone to the following sectors: trade (supermarkets, household supply stores, sale of parts), industry (food, beverages, construction materials), the services sector (airlines, hotels, restaurants), and the financial sector (banks, financial investments). Progress has been more limited in the agricultural sector because of food safety considerations and the protectionist interests of local groups.

Guatemalan businesses have shown the greatest dynamism in investing in the rest of Central America. Their investments are mostly in the commercial and industrial sectors. In the poultry area, and adopting a vertical integration approach, Grupo Gutiérrez has invested in El Salvador and Honduras. In the sugar sector, the Ingenios Guatemaltecos group has invested in Costa Rica, Honduras and Nicaragua. Supermarket operations have also grown in the subregion; Guatemala's Grupo Paiz has invested in El Salvador and Honduras. Grupo Mariposa's investment in the soda sector are directed at Honduras and Nicaragua. The Princess hotel chain now operates from Guatemala to Nicaragua, and Pollo Campero restaurants have been set up all over Central America. As to sales of goods vehicles, Guatemalan investors have set up the distribution of Hino trucks in Honduras.

Salvadorean investors have also invested actively abroad. Some of the best known are: Grupo Taca in the airline sector; the Cuzcatlán and Agrícola Comercial Groups in the financial sector; the Intercontinental Camino Real Hotels in Costa Rica and Honduras; Grupo Poma's investment in the development of commercial centers and housing; and the penetration of Guatemala's commercial sector by Multi-Mart, Almacenes Simán and Gentrac (see Table 24).

Honduran businesses have been relatively less vigorous in investing in Central American countries. One of the few well-known examples of Honduran investment in the subregion is in the brewery sector, where La Constancia (El Salvador), Cervecería Centroamericana (Guatemala) and Cervecería Hondureña (Honduras) participate. These three companies bought Industrial Cervecera S.A., a Nicaraguan consortium producing La Toña and Victoria beer. Other investments by Honduran companies outside their own country include: La Despensa de Don Juan in El Salvador, investment in Grupo Sogeval in Guatemala's housing sector, and the significant participation of Grupo Facusse in the non-alcoholic beverages sector (fresh juices).

In the financial sector, Nicaraguan businesses have become leaders in credit cards and off-shore banking, with Grupo Pellas (BAC and CREDOMATIC), Grupo Pacific and, in investment banking, with Grupo Lafisse. Another area where Nicaraguan investors are leaders is through Grupo Fogel, with investment in Guatemala and Nicaragua and an important share of the subregional market for commercial refrigeration systems.

Costa Rican businesses' reticence to invest in the rest of Central America has been dissipating in recent years. Investment such as that by Grupo Durman Esquivel in construction materials, and by Grupo La Nación in the Guatemalan newspapers Siglo XXI and Al Día, are examples of the changing attitude of Costa Rican businesses. In the commercial sector, the supermarket chain Más x Menos has expanded into Honduras and Nicaragua.

There are no official registers of the amount invested by Mexican businesses in Central America, but some examples illustrate the trend: investment in Costa Rica's financial sector by Bancrecer; investment in the food sector by Bimbo in El Salvador, Maseca in Costa Rica and Guatemala, and Sabritas in Guatemala; ICA's presence in the construction sector throughout Central America; Elektra's aggressive penetration of the Central American commercial sector; the participation of Telmex in Guatemalan telecommunications; and even growing participation in the media (television) and entertainment (cinema) sector. The significant participation of Mexicans in Central American associations of foreign exchange houses is another sign of commercial interest.

Foreign Direct Investment (FDI) in the Subregion

Recent years have seen a growing awareness in Central America of the benefits of foreign direct investment as a key element in the economic growth of recipient countries. Among the positive effects generated by such investment, in addition to the growth of the capital stock (the construction and installation of facilities; new and more technologically advanced equipment), is its contribution to the insertion of the national economies in international markets through export growth, innovation and technological development.

FDI in Central America grew markedly in the 1990s, Costa Rica being the main recipient (see Table 25). In 1990, FDI inflows stood at US$ 257 million, of which 63% went to Costa Rica. The rest was divided almost equally between El Salvador and Guatemala.

In the period 1990-1998, FDI inflows into the subregion amounted to US$ 6.5 billion. Of this, 46% went to Costa Rica, 21% to Guatemala, 15% to El Salvador and the remaining 18% to Honduras and Nicaragua in almost equal proportions. Of these resources, about 37% were secured in 1998 from the sale of state enterprises in El Salvador and Guatemala, and from investment in tourism and free zones in Costa Rica. Of the US$ 4.1 billion entering the subregion in the period 1990-1997, some 60% was invested in Costa Rica, which became Central America's main recipient of FDI. Multinationals like Laboratorios Abott, Procter & Gamble and Phillip Morris have transferred their operational management centers to Costa Rica, complementing the investment by INTEL in plant and equipment.

TABLE 25

NET INFLOWS OF FOREIGN DIRECT INVESTMENT, 1990-1998

Excludes financial centers (US$ million)

	CACM	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1990	257	163	2	48	44	n.a.
1991	347	178	25	91	52	1
1992	398	226	15	94	48	15
1993	472	247	16	143	27	39
1994	461	298	23	65	35	40
1995	634	396	38	75	50	75
1996	687	427	-5	77	91	97
1997	862	483	0	84	122	173
1998	2,372	559	872	673	84	184
Accumulated	6,490	2,977	986	1,350	553	624
Percentage	100.0	45.9	15.2	20.8	8.5	9.6

Source: ECLAC, Information Center of the Unit on Investment and Corporate Strategies of the Division of Production, Productivity and Management.

This growth of FDI in Central America during the 1990s springs from a combination of factors, chief among them a higher degree of economic, political and institutional stability throughout the subregion; FDI promotion policies, which by using special fiscal or customs regimes have been able to attract foreign investment; and the privatization of electricity and telecommunications companies in El Salvador and Guatemala.

As regards foreign groups' acquisition of local businesses in Central America, flows have been quite modest, totaling US$ 58 million. As Table 26 shows, most acquisitions of local businesses in 1997 were in Nicaragua, at a total of US$ 32 million. Next came Guatemala, with US$ 14 million, followed by El Salvador with US$ 12 million. There are no data on the acquisition of local businesses by foreigners in Costa Rica and Honduras.

TABLE 26

INFLOWS OF CAPITAL FOR THE ACQUISITION OF BUSINESSES BY FOREIGN INVESTORS, 1997

US$ million

	Acquisitions (1)	Net FDI inflows (2)	Net inflows as % FDI (3) = (1) / (2)
Central America	58	825	7.0
Costa Rica	n.a.	446	n.a.
El Salvador	12	n.a.	n.a.
Guatemala	14	84	16.7
Honduras	n.a.	122	n.a.
Nicaragua	32	173	18.5

Source: ECLAC, Information Center of the Unit on Investment and Corporate Strategies of the Division of Production, Productivity and Management.

These flows are modest, but FDI has a clear influence on the establishment of foreign-owned businesses in Central America, and on the merger and acquisition of existing local businesses. Of the total FDI received by Guatemala and Nicaragua in 1997, mergers and acquisitions purchases accounted for just 16.7% and 18.5%, respectively.

The Business Climate and Incentives to Foreign Direct Investment (FDI) in Central America

It is important to distinguish between the inherent characteristics offered by a country to foreign investors, which relate to its business climate, and the fiscal and credit measures conceded by countries to firms, which are more clearly identified as actual incentives to FDI.

According to research undertaken by the World Bank's Foreign Investment Advisory Service (FIAS) in 1999, the main factors influencing the decision to invest in a country are related more to its political stability, infrastructure, education and governability than to traditional incentives[33], which rank sixth.

As to the subregion's inherent conditions, it is clear that all countries face the challenge of improving their infrastructure. This includes energy generation, electricity interconnections, telecommunications, port and airport facilities, as well as issues of a more regional nature such as the Central American logistical corridor, given that none of the countries has an efficient system of land (rail) transport. There are also fundamental demands for education and human resource training, and for further progress in strengthening the stability of political systems and governability.

---

[33] See Convenio Procomer - CINDE [1999].

FDI is very sensitive to the issue of the juridical security of investment. Hence the need for both specific investment laws and for compliance with them. Costa Rica is the only country of the subregion that does not have specific statutes regulating foreign investment, but the national treatment and constitutional respect it affords to such capital have obviated this limitation. Foreign investors are also sensitive to the subject of expropriation, especially the reasons that the state might have to expropriate assets and the chances of reasonable compensation. There appears to be little disagreement in the subregion as to the justification for compensation for reasons of clear public and social interest, but there are problems in respecting the established norms. Because of difficulties over criteria and cadastral registers, significant disputes have arisen about the mechanisms for determining the fair price of goods subject to compensation. Costa Rica and El Salvador are the countries that have shown the greatest respect[34] for compensation. Hence it is unsurprising that foreign investors resort to extra-subregional mechanisms in cases of non-compliance with contracts and to resolve conflicts, since often local agencies do not guarantee prompt and full justice.

It is important for foreign investors whether there are capital controls and whether they can convert their profits into foreign exchange and repatriate them. It should be noted in this respect that there are no capital controls in the subregion, that the foreign exchange market is accessible, and that there are no restrictions on the repatriation of profits (with the exception of Nicaragua, where repatriation is not allowed until three years after the investment).

Another relevant issue for FDI concerns the reserved sectors from which foreign investment is excluded. In the countries of the Maya Triangle, there are limitations on private investment in border and coastal territories. Honduras imposes restrictions on foreign investment in trade and in the services of small and medium companies. El Salvador places size limits on agricultural property; El Salvador and Nicaragua in the fisheries sector; and Costa Rica and Guatemala in the field of insurance. The remaining restrictions on FDI are in Costa Rica: electricity generation and distribution; mineral deposits; railways; docks and airports; the import, refinement and distribution of hydrocarbons; liquor production; and water and sewerage system services.

As regards fiscal incentives for businesses that set themselves up in the subregion’s free zones and industrial parks (Table 27), the exemptions are very similar and differ only as regards some time limits and types of taxes. However, there is exemption from most taxes, particularly income, sales, selective consumption, asset, capital and municipal taxes. El Salvador’s regulations are relevant in two respects: the first concerns the timeframe for the exemption, which is granted for the period in which the business is operational; the second concerns the company’s prospects of internationalizing or nationalizing its production up to 100%, with the sole restriction of paying the corresponding taxes. With respect to this latter point, Costa Rica allows internationalization of a certain share, 25% and 50% respectively, for goods and services, while Nicaragua allows the internationalization of a certain share of textile production. In Costa Rica the period of exemption varies depending on whether the free zone is located in a high-growth or a depressed region and (as an employment incentive) there is a rebate of 10% of the payroll, which falls by 2% a year and disappears after five years. Nicaragua has a certificate of tax benefits and Costa Rica is studying the possibility of a new generation of incentives to replace those that expired in September 1999.

As shown above, and in line with the motives underlying a company’s decision to establish itself in a country, it does not appear to be the case that FDI is flowing to any particular country of the subregion solely because of its fiscal exemptions, since the levels of incentives are very similar in all the countries.

---

[34] This is not a problem of the treatment of foreign investors relative to national investors, since there are many cases in the subregion that also affect the latter.

TABLE 27
CENTRAL AMERICA: FISCAL INCENTIVES
Free Zones

Tax levels and incentives				
Costa Rica	**El Salvador**	**Guatemala**	**Honduras**	**Nicaragua**
Income: 30%	Income: 25%	Income: 25%	Income: 30%	Income: 25%
13% sales	VAT: 12%	VAT: 10%	VAT: 13% Municipal 0.015 %, on gross sales.	Gross sales: 1% in Managua. 1% annually on the property value of assets.
Exemption 100% for 8 years, 50% 4 years (12 and 6 years, rural), income, consumption, sales, municipal. Private cars. Rebate 10% payroll, is reduced by 2% a year. 10 years capital and net assets. Reinvestment, 75% income, 4 years. May sell 25% in local market and 50% if services.	Free zones with 100% exemption (income, tariffs, VAT, municipal, assets and capital) For the period in which the business is operating in the country. Sales to local market are subject to taxes.	Free zones with exemption of 100% on income, VAT and tariffs.	Free zones, industrial zones, temporary import regimes, 100% tax exemption.	Free zone with 100% exemption of income (15 years), tariffs, capital, establishment, transfer, assets, sales, selective, municipal. Repatriation 100% on registered capital. Textiles industry may sell part of production in internal market. Tax benefit certificates.

CHAPTER V. ACCESS CONDITIONS AND OTHER ASPECTS OF THE CENTRAL AMERICAN COMMON MARKET

The general legal framework of subregional integration laid down by the Protocol of Guatemala in 1993 entailed the definition and formal start of a new subregional economic agenda. The Protocol's main aim was to complete the different stages of the economic integration process, which were divided into five sections: the Central American free trade area; external trade relations; the Central American customs union; the free movement of the factors of production; and Central American monetary and financial integration.

The recent efforts at greater subregional integration suggest more political will on the part of governments to consolidate the free trade area, to undertake the reforms necessary to deepen it, and to ensure the operation of a customs union. The free trade area, however, requires further coordination to resolve a series of issues that hinder the free movement of goods in the subregion. In that regard, the countries have not reached agreement on some of their positions, which leads to a certain reluctance to forego their national interests for the sake of greater subregional trade integration.

Despite this, they have made individual efforts to establish trade relations with third countries, for which purpose they have granted concessions that they were unwilling to make within the CACM. Their greater willingness to conduct trade negotiations with third countries is evident in the 1995 free trade accord between Costa Rica and Mexico, and that of 1998 between Nicaragua and Mexico. El Salvador, Guatemala and Honduras completed negotiations and signed a free trade agreement with Mexico in 1999. Later, all the countries of the subregion jointly signed free trade accords with Chile and the Dominican Republic. In the latter two cases, the Central American countries adopted a joint subregional position but each negotiated bilaterally on the more controversial issues, such as market access and rules of origin.

The foregoing reveals significant differences in the countries' perceptions of the benefits accruing from deeper integration, given that intra-subregional trade varies between countries in both scale and direction. However, the fact that there are trade agreements between the countries of the subregion and some extra-subregional partners makes the management of the accords a delicate matter in the framework of the subregional integration agreements. It poses a practical need for joint efforts to standardize many of the stipulations established. Specifically, the three agreements that Mexico signed with countries in the subregion include peculiar provisions in each case, in areas such as exclusions, quotas, and the speed of and schedules for tariff reduction. Even in the FTA between Mexico and the countries of the Northern Triangle there are different stipulations on quotas and limits on access to the Central American countries, specifically in agricultural products.

The Prevailing Legislation in the Central American Common Market

The legislation in force in Central America conforms to a period when matters such as intellectual property, customs or the classification and codification of goods were addressed subregionally. The countries now prefer to negotiate much more general framework disciplines that both satisfy the principles of integration and are properly adapted to the technical regulation required at the national level. Hence the countries continuously but superficially reiterate their political commitment to the subregion, when in truth the technical instruments reveal different, more autonomous and more pragmatic circumstances that give them flexibility and maneuvering room in view of the international trade agenda.

As regards the deepening of the free trade area in the subregion, it is important to note that there are two kinds of regulations: some related to the free trade area, which are concerned with the Central American disciplines that regulate intra-subregional commerce; and others related to the common trade policy, which consist of common regulations for certain technical aspects of trade relations both within the subregion and beyond.[35] It is striking that the Central American countries have negotiated disciplines in many trade issues with third countries but not within Central America. This exceptionally important task cannot be delayed if the subregional free trade area is to be completed.

Common regulations govern certain aspects of the subregion's trade relations with the rest of the world in areas such as industrial property, customs and customs valuation, unfair trade, safeguards, and the codification and classification of goods. However, the Central American countries have not still made concrete commitments to harmonize their customs or trade legislation, with a view to conducting joint negotiations with third countries (especially in the areas of market access and rules of origin) and to harmonizing other basic economic policies for the purposes of greater trade development in the subregion.

The Priority of the Integration Process from the Countries' Perspective

The idea of deepening integration has not been abandoned, but all the signs are that the current priority is to consolidate intra-subregional free trade and then progress toward other stages of integration once conditions are right. The subregion requires a stable regime upon which the five countries agree, since their differing and sometimes contrary national perceptions of how to do things block progress. The absence of leadership on the part of a country or a group of countries interested in deepening integration has cultivated a system that accommodates the different needs of each of the members and thus impedes agreements on basic matters.

Currently there is no consistent and shared vision of a common project at the subregional level. The joint negotiation of free trade agreements with the Dominican Republic, Chile and Panama should not prompt the conclusion the subregion acted as a monolithic bloc. Each of those negotiating processes had a joint component but, as mentioned earlier, market access and rules of origin issues (essential aspects of trade) were subject to bilateral agreements or discussions, revealing the low level of internal cohesion in the subregion.

Exclusions in Subregional Trade

The vast bulk of intra-subregional imports are subject to a tariff of 0%. This took many years to secure, and it is an important achievement of Central American integration. In the agricultural sector, however, liberalization is pending in some sensitive tariff lines that account for a significant share of potential intra-subregional trade. Difficulties in this sector mainly concern compliance with rules of origin.[36]

[35] Some elements can be distinguished here, such as the regulation on safeguard measures applicable solely outside the subregion. In other words, it is a Central American framework regulation for the imposition of safeguard measures against imports from non-Central American countries.
[36] In the case of Costa Rica, about 90% of the trade disputes concern trade with Central America. Of that total, some 50% concern agricultural products. It should be noted that agricultural trade does not amount to half of Costa Rica's trade with the subregion, and thus it can easily be argued that a significant number of these disputes are related to agricultural products.

Notwithstanding this, the Central American countries should continue their efforts to include those products in subregional trade. The exclusions common to the five countries are in just two products, unroasted coffee and cane sugar. As for wheat flour, roasted coffee, ethylic alcohol, petroleum by-products and distilled alcoholic beverages, the Central American countries have negotiated bilateral restrictions.[37]

The Common External Tariff

The common external tariff is one of the subregion's main problems, since it has been impossible to maintain discipline on the stability of harmonized tariff levels for goods. Factors that seriously hinder attainment of a common external tariff include the use of safeguards; the application of the supply clause; the impact of protectionist or fiscal pressures; the drive to hasten unilateral tariff reduction in some countries; others' participation in sectoral, multilateral, zero for zero tariff reduction schemes (such as the WTO Agreement on Information Technology); and the multilateral "tariffication" of non-tariff measures affecting agricultural trade, which led to very different levels in each country.

Subregional commitments to agree jointly on tariff reduction were effective, and tariff ceilings and floors were subject to agreements on progressive tariff reduction in line with the schedules negotiated by the five countries. This does not mean, however, that Central America has a common external tariff, since the negotiations occurred at different times and it was even necessary to allow tariffs above 100% to effect "tariffication."

The absence of a strong juridical regime has added to the instability of the agreements on tariff matters, a situation exemplified by Nicaragua's recent and unilateral imposition of higher tariffs on Honduran imports for reasons unrelated to trade.

Another factor that undermines the common external tariff concerns the effect of free trade negotiations that the countries are conducting with third parties, either singly or in regional subgroups. Mexico has signed three trade agreements with the subregion, each with dissimilar terms on exclusions, tariff treatment and tariff reduction. In the negotiations with Chile and the Dominican Republic, each country negotiated their exceptions bilaterally. In this framework of trade negotiations, the existence of a common external tariff between the countries is not a basic requirement, which weakens their interest in the matter.

Finally, the idea of negotiating a hemispheric integration scheme has also induced some Central American countries to think in terms that are not necessarily conducive to the deepening of integration, given the effort required and the short period for which such integration would operate. With the exception of El Salvador and Guatemala, the countries of the subregion have opted for now to negotiate individually in the Free Trade Area of the Americas (FTAA). There is no collective belief that the balance of costs and benefits in a joint negotiation is positive; the same has happened in multilateral WTO negotiations.

[37] In the case of wheat flour, Guatemala negotiated bilateral exclusions with each of the Central American countries, and El Salvador did so with Honduras and Nicaragua. With respect to roasted coffee, Costa Rica negotiated with the whole subregion, Guatemala with Honduras and Nicaragua, Honduras with Nicaragua and El Salvador, and the latter with Nicaragua. For ethylic alcohol, Costa Rica agreed on the bilateral exclusion with each country, and El Salvador did so with Guatemala, Honduras and Nicaragua. For petroleum by-products and alcoholic drinks, Honduras has bilateral agreements with the rest of Central America.

In conclusion, Central America does not appear to have the necessary conditions to secure a standardization of the common external tariff in the medium term. A favorable environment to pursue such a goal must await the end of the tariff reduction processes agreed upon in the various trade agreements that the Central American countries have signed with external trade partners.

Subregional Commitments on Tariffs

From 1995 onward the countries assumed subregional commitments to standardize their external tariffs with a view to moving toward the establishment of a common external tariff. The tariff reduction commitments are outlined in the following table:

TABLE 28
CENTRAL AMERICA: STATUS OF THE COMMON TARIFF

Category of goods	Tariff level
Raw materials, intermediate goods and capital goods produced outside the subregion	0% a/
Raw materials produced in the subregion	5%
Intermediate goods and capital goods produced in the subregion	10%
Finished products	15%

a/ 1% while the Third Protocol of the Central American Tariff and Customs Agreement enters into force.

Source: Secretariat for Central American Economic Integration, SIECA.

As regards capital goods and raw materials, El Salvador, Guatemala and Nicaragua apply a tariff of 0%, while Honduras is implementing a tariff reduction schedule. As to the rates for the tariff "ceiling" and intermediate goods, all countries have applied tariff reduction schedules. In 1995 these commitments covered 95% of the import tariff lines; special regimes were negotiated for the other 5% of unharmonized lines.

Notwithstanding the commitment assumed by the Central American countries in 1995, in the second half of the 1990s there was a substantial deterioration in the common external tariff. Nicaragua unilaterally cut its tariff faster than the other countries, which distorted the agreed external tariff. However, Nicaragua then increased the tariff, raising its common external tariff to levels of about 60%. Another factor that significantly undermines the prospects of securing a common external tariff concerns the Temporary Protection Tariff (*Arancel Temporal de Protección,* ATP). This involves temporary concessions granted to Nicaragua for reasons related purely to immediate economic conditions, authorizing the country to levy duties on goods from Central America that have already been liberalized. These are included in the Protocol of Guatemala, and are therefore hard to eliminate. Application of the ATP increased the tariff from 5% to 15%, which is a clear disadvantage for Central American goods.

The Pending Agenda on Tariff Matters

Still pending are subregional negotiations on agricultural goods, specifically sugar (except cane sugar), basic grains, milk and its by-products, beer, wines and other fiscal goods (automobiles, tobacco and other sumptuary goods), as well as the standardization of tariffs on products whose different domestic taxes were subject to "tariffication". Hence there is substantial tariff dispersion at the subregional level.

Also pending is the negotiation of tariffs imposed via application of the safeguard clause, in line with article 26 of the Central American agreement on tariffs and customs. This measure, characterized as a safeguard, allows the countries to alter tariffs unilaterally and then report that they have done so. This nullifies the measure's original initial purpose and has become a legal mechanism to which the countries can resort in order to modify their tariffs. Table 29 shows the number of tariff positions maintained by the Central American countries under the safeguard mechanism.

TABLE29
CENTRAL AMERICA: NUMBER OF TARIFF POSITIONS PER COUNTRY

Country	Tariff positions
Costa Rica	80
El Salvador	78
Guatemala	50
Honduras	23
Nicaragua	11

Finally, another tariff issue to be negotiated at the Central American level concerns Nicaragua and the Tax and Trade Justice Law. Using the safeguard clause, Nicaragua was able to increase the tariffs on Central American raw materials and products.

Tariff Classification System

The Central American countries jointly adopted the Agreement on the Harmonized System for Classifying and Codifying Goods at the start of the 1990s. In 1996 they jointly reformed the agreement but the reforms were implemented nationally on different dates. Previously, when the need arose in Central America to revise a common instrument, the revision was undertaken jointly. Now, however, there is a greater tendency to modify trade policy instruments nationally, thereby unraveling the Central American legal instrument. The few common instruments still extant no longer tend to rest on highly detailed regulations with common procedures and governing bodies, but are rather based on very general framework agreements that offer wide room for national autonomy.

Rules of Origin

The CACM's limitations as a customs union arose because, when the rules of origin regime was being defined at the start of the 1990s, the rules on a number of significant products were not negotiated. There is nevertheless an annex in which the issue of origin is dealt with at the level of tariff lines and, although there are some disputes about the treatment of certain products (such as edible oil, largely related to particularities of production) the matter is not a significant obstacle in the subregion. The main problem in this area is institutional and relates to compliance with the rules, since the latter prompt the triangulation of products and cause a series of difficulties for Central American companies.

There are no major difficulties with the Central American regulations on rules of origin, which are mostly based on the North American Free Trade Agreement (NAFTA) but with less restrictive and simpler rules. This framework was used to fix the rules of origin in the agreements that the Central American countries negotiated with the Dominican Republic in 1998 and with Chile in 1999.

Sanitary and Phytosanitary Regulations

The subregion suffers from a considerable weakness in the area of sanitary and phytosanitary regulation. The rules are little developed, despite the fact that the issue was subject to a firm multilateral regulation to which the countries have necessarily sought to adhere. This is a matter of enormous importance in the subregion. It demands the establishment of technical groups with the capacity to resolve the sanitary and phytosanitary problems evident at border posts, and thereby help facilitate intra-subregional trade flows. The subregion's agriculture ministries, however, face significant constraints and there has been no real interest in resolving the problem. Such regulations often act as a technical barrier to agricultural trade.

Mitigation of the difficulties in this area requires a subregional approach grounded in multilateral disciplines and the formation of discussion mechanisms with a willingness to solve the attendant problems. The establishment of institutional frameworks for drawing up subregional norms and guidelines in this field is fundamental, although its demands greater levels of preparation and institutional development than is attainable through a process geared to the medium term.

The Main Technical Barriers to Trade

Trade between the Central American countries is marked by very slow procedures in customs and at border posts,[38] mainly the result of technical obstacles to trade. Despite commitments to apply multilateral and bilateral obligations in agreements with third countries, the basic technical disciplines that regulate problems associated with the creation of possible technical obstacles to intra-subregional trade are barely approved within the subregion. The Central American countries have national structures for standardization, technical regulation, metrology and assessment, with no proper subregional coordination. The only subregional institution in this area, the Central American Institute for Research and Industrial Technology (ICAITI) recently closed.

The subregion's problem lies in its institutional capacity to manage subregional processes for drawing up or harmonizing technical norms and regulations. Multilateral disciplines, however, should serve as a framework for the creation of basic institutions wherein intra-subregional trade disputes can be discussed and resolved. They should also provide a basis for the establishment of public, private or mixed bodies in the fields of metrology, laboratories and other entities for accreditation and inspection, quality audits and others, that offer specialized technical services at the subregional level.

Unfair Trade and Safeguards

Central America adopted a Regulation on Unfair Trade Practices and Safeguard Measures in 1993. It was revised in 1995 to make it more compatible with the obligations assumed in the Uruguay Round. The issue of safeguard measures was dealt with separately and is subject to a different regulation. Both the Regulation on Unfair Trade Practices (dumping and subsidies) and that on Safeguard Measures had a subregional focus, but neither of them goes further than the general guidelines established in the

[38] The Customs Modernization Project developed by CLACDS-INCAE determined that, taking into account delays at border posts, cargo moves through Central America at an average speed of 12 kilometers an hour.

multilateral agreements that were approved in the Uruguay Round. Hence there is a substantial legal void as regards procedures.

The countries have also established specialized units responsible for the technical research required by the agreements. These operate nationally, since the measures are not applied jointly in Central American integration. It should be noted that it is not possible to apply safeguard measures intra-subregionally (since the tariffs in the free trade area for goods are already consolidated) but countervailing duties and antidumping measures that conform to the disciplines of the respective regulation can be imposed.

Subregional Dispute Settlement Mechanisms

Central America lacks a real judicial arrangement for dispute settlement. Its official bodies operate only at the level of Directors, Vice-ministers and Ministers, who necessarily seek consensus-based solutions. Not all the countries are members of the Central American Court of Justice, and in any case a traditional Court is not the most appropriate means of settling trade disputes.

Central America negotiated a regulation on alternative methods for resolving conflicts, which are traditionally referred to mandatory arbitration, mediation and good offices, among others. Nevertheless, approval of such options has been hindered by legal problems and by the national and institutional sensibilities that arise when the complementary role of these mechanisms (in contrast to the ordinary mechanisms of a subregional Court) is insufficiently defined. This constraint should be resolved speedily, in order to spur greater dynamism in intra-subregional trade by offering more juridical security to the conditions of market access and trade treatment guaranteed by the agreements and treaties.

Intellectual Property

Central America has had an agreement governing industrial property for over two decades, specifically in areas such as brands and trademarks. However, issues such as intellectual property, royalties and related rights, patents and others are subject only to national laws marked by significant legal voids. There are still no subregional instruments, despite the fact that the adoption of the WTO Agreement on Aspects of Trade-Related Intellectual Property Rights required the revision of subregional and national legislation before 2000.

The Central American countries have been working on the matter, but the discussions have been difficult. It is likely that, given the urgent need to comply with the commitments assumed, they will adopt an approach similar to that for customs valuation, whereby the multilateral mechanism obviates subregional regulations and the countries need only implement the agreement nationally through their respective legislatures.

Customs Valuation

For many years the countries of Central America have applied the Brussels valuation system. However, they must move toward implementation of the 1994 GATT Customs Valuation Code, in effect since 2000, since Costa Rica and Honduras pledged to adopt it in January of that year, El Salvador in May, Guatemala in July and Nicaragua in September. The latter two countries have nevertheless sought a delay in the system's entry into force.

Adoption of the framework Multilateral Code prompted the idea that it is unnecessary to implement a subregional instrument on the matter and that the countries should simply establish regulations for the Code somewhat imprecisely at the national level, since they prefer the kind of flexibility that subregional regulations have not normally afforded. Hence each country can move at its own pace and there is a guarantee that all the regulations are WTO-compatible, which obviates the difficulties that might arise at the subregional level in this area.

Customs Procedures

Customs procedures at the subregional level are based on the Central American Uniform Customs Code (CAUCA) and its regulation (RECAUCA), which have been revised to adapt them to the greater demands of international trade. The new versions of the Code remain to be approved by the parliaments of three of the five countries. In should be noted in this regard that the countries have changed their approach to subregional regulation. Originally, the rules in this field consisted of detailed codes and regulations that covered almost all customs operations; the new versions involve framework agreements that offer the countries greater flexibility to regulate the conception and operation of customs facilities. This again highlights the tendency to favor a national approach and to make subregional concessions only when conditions are right.

Treatment of Trade in Services and Investment

As regards trade in services and investment, progress has been much greater in the extra-subregional sphere than intra-subregionally, which limits the deepening of this component of subregional integration to a series of special considerations. In that context it seems that, apart from some purely symbolic initiatives, there is little short-term hope that the Central American countries will secure real deepening by assuming greater commitments to open up among themselves.

Negotiation of a Central American free trade area in services also demands attention to a series of prior commitments that the countries have assumed, as well as the strategic requirements of the future FTAA project. By concluding free trade agreements, the Central American countries have made commitments to Mexico, the Dominican Republic and Chile, and any new concession that the countries of the isthmus want to grant to each other will automatically be extended to those other countries by virtue of the most favored nation principle. This imposes a significant constraint on any subregional initiative connected to services, since there are drastic differences in the benefits that Central America would want to grant to Mexico in comparison to the Dominican Republic. The only exception in the field of services concerns the exclusions classified in the agreements, as is the case of financial services between Mexico and Costa Rica.

With respect to investment, everything suggests that establishment of a harmonized Central American framework should stem from a consolidated list that is subject to some commitments to end the restrictions and sectoral limits applied by the various countries. They could then proceed jointly, in the context of the FTAA and the WTO, to the possible opening up of sectors subject to legal restrictions. Only by negotiating concessions in the multilateral framework will the elimination of obstacles to investment be politically “sellable” in each of the countries.

Bilateral Agreements

In their negotiations with and commitments to third parties, the Central American countries have acted either jointly (as with Chile, the Dominican Republic and, more recently, Panama), in groups (the case of the accord between Mexico and the Northern Triangle – El Salvador, Guatemala and Honduras) or bilaterally (Mexico has negotiated agreements with Costa Rica and Nicaragua). There has been a gradual shift of approach in talks between Mexico and the countries of the subregion, which began with the 1991 Declaration of Tuxtla Gutiérrez, toward more flexible national positions. The change was accentuated in the joint negotiations with the Dominican Republic. The shift is also evident in the talks with Chile and

Panama, which involved an express agreement that negotiations on market access and rules of origin (two fundamental aspects of a trade accord), would be conducted individually and that the outcomes would not be coordinated with the other countries. In that context, the joint component comprises the launch of the negotiations, the timetable of meetings, the legislative element of the treaty subject to quite standardized international disciplines, and the signing of the final agreements. Although the countries project an image of joint action in the negotiations, unity is minimal because of their intention of negotiating individually.

Costa Rica and Nicaragua ratified free trade agreements with Mexico in 1995 and 1998, respectively. The Northern Triangle completed negotiations with Mexico in June 2000, and only the congressional ratification of Honduras is pending. Mexico now has trade agreements with the whole subregion, suggesting a need to harmonize and facilitate their application. It is unsurprising that the Central American and Mexican presidents have signed a political agreement[39] on the pursuit of convergence between these accords, although there have been no technical discussions of the matter.

With respect to the Andean Community, the Northern Triangle has decided to start trade talks at the initiative of Colombia, although neither Costa Rica nor Nicaragua currently participate. The failure of negotiations between Central America, Colombia and Venezuela in 1991 and 1995, and the tone of the first contacts between the countries, suggest that a future agreement could center on a substantial widening of the preferences agreed upon in the partial scope accords already concluded, and which remain in effect. Unlike the previous agreements, the new accord could include two-way obligations – that is, applicable to both groups of countries.

Canada-Costa Rica negotiations are advanced and an accord could be signed in the first half of 2001. El Salvador, Guatemala, Honduras and Nicaragua have also begun discussions with Canada on future joint negotiations.

With Chile, the five Central American countries completed the joint negotiation of the uniform regulations pending from the agreement of October 1999, with a view to the FTA's entry into force in 2000. Market access issues and rules of origin were (partially) dealt with bilaterally between the countries, and all the bilateral annexes have been completed except those for El Salvador and Honduras. Costa Rica ratified the accord in December 2000, and ratification by Chile is expected in early 2001.

Central American negotiations with the Dominican Republic ended successfully in 1998, and the issue of the exclusion of products negotiated bilaterally remains pending. All the Central American legislatures except Honduras have ratified the accord. The Dominican Republic has faced problems in securing congressional ratification because of the agreement's fiscal implications, although Dominican business circles expect approval in the first half of 2001.

The Central American countries have also begun negotiations for a free trade agreement with Panama. The initiative is recent but talks have already been held between technical groups and at the Vice-Ministerial level, and the agreement is expected to be signed during 2001.

With regard to the United States, Central America negotiated[40] a project to widen the benefits granted to the countries of the subregion within the Caribbean Basin Initiative (CBI).

There is a commercial rapprochement between the subregion and the Republic of China–Taiwan, although with greater emphasis on investment. Costa Rica has also shown some interest in starting free trade talks with Trinidad and Tobago, but as yet there is no timetable for technical negotiations.

---

[39] Joint Declaration of the Fourth Summit of Heads of State and of Government of the member countries of the Tuxtla dialogue and coordination mechanism, August 2000.

[40] At the time of writing, the project had been approved by the US House and Senate

Multilateral Agreements

The Central American countries have no single perception that their participation as a bloc in global or hemispheric trade fora might increase their bargaining power. They have preferred to build alliances with other commercial centers and the five countries have often been in opposite camps. The fundamental problem is of a divergence of interests that constrains the prospects of collective action. Their perceptions and needs differ, and all the signs are that they are reluctant to forego national positions for the sake of an alliance with the others, suggesting not a lack of organizational capacity but of political will.

In a significant shift, however, El Salvador, Guatemala, Honduras and Nicaragua recently agreed to coordinate their positions in the FTAA negotiations.

Tariff Income and the Free Movement of Non-Central American Goods

Central America has neither a common account for tariff collection, nor a mechanism to facilitate the free intra-subregional movement of goods from outside the subregion once they have been admitted. The countries thus saw a need to negotiating an intra-subregional rules of origin regime in 1994, which shows their willingness to move gradually toward a free trade area rather than to a customs union. Fixing harmonized levels in tariff policies is a good attempt at coordination that helps obviate a substantial number of problems; it is also a good strategy for tariff reduction. However, much remains to be done if the subregion is to establish a customs union.

Some Progress on the Creation of a Customs Union

In some cases, the lack of progress at the subregional level has prompted partial integration initiatives. Such is the case of El Salvador, Guatemala, Honduras and Nicaragua, which have agreed on the free movement of people by means of a common migration document, CA-4. El Salvador and Guatemala agreed to form a real customs union by 1 January 2001, with a common external tariff, joint tariff collection, and the free movement of goods and people. The two countries have also agreed to negotiate jointly in the FTAA and the WTO, and have undertaken a series of joint customs integration projects. If successful, this initiative could serve as an example and could have a significant demonstration effect on the rest of the subregion. However, although El Salvador and Guatemala are closely linked and integrated in terms of trade and investment, they alone do not seem to offer the kind of leadership that can induce the deepening of integration in the rest of the subregion.

With respect to the multilateral integration of the WTO, the Central American countries have displayed considerable differences as regards the coordination of their positions, as evidenced by the divergent interests made evident in the banana dispute. Not until the WTO's Third Ministerial Conference in Seattle did Central America adopt a joint position on the banana issue for the first time.

Central America's participation in the FTAA has been somewhat ambiguous. The countries agree that they will not conduct joint negotiations, at least for the moment, but the process of hemispheric negotiation already entails prior meetings to discuss coordination between national delegations. Although there is no single Central American position, the nature of the hemispheric negotiations fosters such coordination or prior discussion. It is worth noting that two Central American countries chair FTAA negotiating groups: Costa Rica chairs the Dispute Settlement Group, and Guatemala does so in the Consultative Group on Smaller Economies.

CHAPTER VI. OTHER RELEVANT ISSUES FOR CENTRAL AMERICAN INTEGRATION

Attracting Investment

The redefinition of general investment policy is an issue that demands particular attention, especially because of the challenges it entails for improving the Central American business climate. The latter, ultimately, determines direct investment inflows. General investment policy forms part of the countries' national economic reform programs, but there is much to be done in this field as regards conditions of competitiveness and the juridical security offered to foreign investors.

The subregional orientation of investment policy should be based on more technologically advanced activities, and not necessarily on promoting low-cost manpower schemes. In this connection, countries like Costa Rica have undertaken programs to attract investment with transnational companies such as the INTEL Corporation. Other factors favoring a redefinition of policies to attract investment are the implementation of legal commitments in the WTO to dismantle investment subsidies and other support measures. This imperils the future of the free zones, an incentives scheme that is widely used in the subregion.

The Customs Issue

One of the basic and most costly constraints on commerce is customs administration and its inability to function as a facilitator of trade. Although all the Central American countries have been modernizing their customs systems, they have not done so with the necessary depth and speed. It should nevertheless be noted that, as in all transformation process, the improvement of customs management requires major investment in buildings, in the electronic interconnection of all the subregion's customs (especially at border posts), in the professionalization of personnel, and in the adoption of simple and harmonized procedures that facilitate goods traffic. None of this is easy, especially in a context of subregional integration. The realization of these objectives is a goal embodied in the subregional regulations of CAUCA III, but only El Salvador and Guatemala have shown a political interest in formalizing their binational customs union.

Progress on customs matters requires the participation of the Central American countries in the World Customs Organization (WCO); adoption of the principles of the WTO agreement on valuation; the training of technical teams in valuation, rules of origin and tariff classification; and espousal of the UN-EDIFACT standard of information exchange.

As regards completion of the free trade area, the regulatory factors to which the countries of the subregion should pay particular attention concern investment, services, government procurement, technical norms and regulations, conformity assessment procedures, metrology, sanitary and phytosanitary measures, intellectual property, and customs reform and modernization (including proper implementation of modern disciplines on customs valuation).

Liberalization of the Services Market

Financial regulations differ in each Central American country. Capital markets are small and strictly local. There is a need to modernize and harmonize regulatory frameworks, and for each country to tackle the institutional challenges of coordination between regulators and monetary policies. The training of professionals in the oversight institutions is central to the goals of integrating and harmonizing banking rules. As a result of these deficiencies, the lack of formal market integration imposes high transaction costs on subregional operators.

Particularly relevant issues for the subregion in this regard include the development and harmonization of capital markets, so as to establish subregional standards for compensation and payment transactions, as well as for the supervision of banking and securities markets.

The issue of finance, as part of services trade, is part of the WTO negotiations and as such entails the definition of national negotiating positions.

Transport Infrastructure in the Subregion

It has often been pointed out that one of the subregion's main problems is road infrastructure. The existing network does not adequately meet the needs of subregional trade, and the answer seems to lie in the Regional Highways Network to aid the intra- and extra-subregional movement of people and goods. The Central American Logistical Corridor was devised for this purpose. It was conceived as a means of developing the subregion's road and port infrastructure, as well as an impulse to the integration of Central America and the consolidation of its role as a strategic link between the Americas (Declaration of Tuxtla, 25 August 2000). The Corridor has four subcomponents: i) the Natural Road Corridor (Pacific Corridor), about 1,700 kilometers long, connecting Tecún Umán in Mexico with Paso Canoas al Sur on the border with Panama; in Panama it connects with the port complexes in Colón and Ealboa; ii) the Pan-American Road Corridor (Alternative A), about 1,400 kilometers of various stretches of the Pan-American Highway or CA 1, not included in the previous corridor, which links the capital cities of Guatemala, El Salvador, Nicaragua and Costa Rica; iii) the Atlantic Road Corridor (Alternative E), about 1,400 kilometers of road connecting extensive areas of Central America on the Atlantic coast, linking San Pedro Sula and Tegucigalpa in Honduras with the rest of the Network; and iv) various connections of around 1,100 kilometers to link the other corridors, or to connect them with sea ports, capital cities and specific economic centers.

The foregoing is a significant challenge for the subregion, since practically all trade within the CACM is transported by truck.

The Central American Logistical Corridor's development and logistical services program also involves the modernization of customs and border posts by means of virtual customs, the use of telematics for electronic information exchange, the development and operation of inland cargo terminals, and the establishment of companies to provide logistical services in the subregion. From the legislative and regulatory viewpoint, the program mainly requires the harmonization of frameworks, technical norms and standards, and institutional arrangements. The Central American countries have also made a commitment to deregulation so as to eliminate the current limits and obstacles on cargo handling, and to open transport to market competition.

Particularly striking is that only Costa Rica and Guatemala have slowly developed road concessions, which suggests an absence of an adequate legal and regulatory framework to attract private capital to this sector.

Another vital issue in the subregion is port infrastructure and the need to offer some port activities to concessionaires. Despite the marked absence of formal regulation, there is no framework for promoting subregional cabotage so as to allow a partial reduction in cargo traffic on the main roads.

With regard to air transport, the regulation of air safety and the provision of control and air navigation services are the two foremost challenges in the subregion. There is no common policy for air transport, neither within the subregion nor from and to it, but bilateral agreements are being pursued in line with the processes of opening.

Energy Infrastructure

In this field, the most interesting issue is the consolidation of reforms and the regulations for the privatization of the electricity industry. This requires a regulatory culture among the general public, in the responsible bodies and in governments, and all this in a competitive environment that is conducive to the formulation and approval at the national level of anti-monopoly laws and consumer protection legislation. The Declaration of Tuxtla calls for the electrical interconnection of the Central American countries.

As to natural gas, it is important to attract private investment for the construction of a gas pipeline, and to define the regulatory framework for introducing and marketing the energy. The subregional importance of this project is evident in the Economic Complementarity Agreement between Mexico and Guatemala on the trade in and transport of natural gas. This is the first stage of the project and lays down the legal, regulatory and tax foundations that will give confidence to investors interested in it. El Salvador will join this agreement.

With respect to rural energy, the absence of alternative options and the rural population’s limited access to electricity suggest an urgent need to expand the coverage of the network by establishing small, isolated electrical systems. This entails adapting the existing legal frameworks and assessing private projects to use natural resources (hydroelectric, geothermal, wind power, etc.) and cogeneration, since rural telecommunications have been neglected because of the high costs of the network and the potential users’ low payment capacity.

The Subregional Approach to Infrastructure Services

Given the constraints on infrastructure and the scale of the challenge it poses to Central America, development of a subregional vision that stresses infrastructure services would foster a joint working program between the public and privates sector in the context of an improved subregional business climate. This is an area in which use can be made of the experiences and structure of the Program of Competitiveness and Sustainable Development, which is supported by the Central American governments, the Central American Bank for Economic Integration (BCIE) and the Central American Institute of Business Administration (INCAE). The private sector should be involved in this, given its interests as a supplier and user of services. Joint work in this field could make a positive contribution to resolving the problems of Central American infrastructure services.

The Labor Issue

The free movement of productive factors is a delicate issue among Central American governments, especially between Costa Rica and Nicaragua, given the significant migration to Costa Rica of Nicaraguans working in agriculture and industry.

SIECA, the executive agency of the Labor Modernization Program, concentrates on the operation of the labor market by adapting the prevailing legislation, as well as on the functioning of the institutions that formulate and apply policy in this field. The pending tasks for the subregion include mechanisms to facilitate agreements between the social actors of reform, strengthening the Labor Ministries or Secretariats through a labor information system, and harmonizing the application of labor standards.

Human Resource Training

At the subregional level this issue poses a substantial challenge given the lack of norms and standards for assessing knowledge and teaching quality, and for identifying and measuring minimum basic skills for each level. In this field the subregion is resistant to the movement of human and technological resources from one country to another.

The Central American countries need to reform their training systems. These have basically been the responsibility of national institutions that have been unable to satisfy private sector demands. They should strengthen the state's role in overseeing and regulating training, and should foster and expand the capacity of the private sector to offer subregional training in the interests of a more efficient and harmonious development of human resources. These deficiencies highlight the lack of subregional accreditation systems and the absence of training programs in devising teaching strategies.

The Scope of Integration and the Institutional System

There is a need to strengthen the organizational structure, human resources, budget and legal framework of the subregion's institutional system. Progress in this area, however, is subordinated to political consensus-building among the authorities of the Central American countries. The attainment of consensus in this matter is connected to the difficulties of defining the scope and future of integration.

Pending the countries' willingness to strengthen the institutions further, there is a need to continue to support the subregional bodies both in terms of defining the financial, organizational and political dimensions of the institutional structure, and of its capacity to devise and implement subregional cooperation projects.

As to integration's institutional design, the Central American Bank for Economic Integration (BCIE), the General Secretariat for Central America Economic Integration (SIECA), and the General Secretariat of the Central American Integration System (SG-SICA) are the most relevant bodies.

One of the main challenges facing Central America in developing its institutions is to modify the BCIE's institutional and financial operations so that it can access international financial markets and thereby secure cheaper resources. There is also a need to strengthen the Bank's financial and administrative capacity, so as to enable it to obtain an investment rating from risk assessment agencies.

The SG-SICA plays a key role in developing Central American integration programs. On a range of issues that are relevant from the integration perspective, including social and environmental matters, the SG-SICA is the executive agency or coordinates implementation. Hence the need to strengthen the Secretariat's capacity to draw up subregional strategies and projects, as well as to monitor their implementation.

Support for Trade Negotiations

The need to strengthen the multilateral trading system and open regionalism, and to intensify economic relations between the regions of the world under equitable conditions, is another challenge. So too is the urgent need to hold a new WTO round of global and integral trade talks that covers all sectors that leads to a real reduction of tariff and non-tariff barriers to goods and services.

In this connection, the negotiations for the Free Trade Area of the Americas (FTAA) are committed to the progressive elimination of barriers to trade and investment.

The approach to trade in the subregion underscores the need to strengthen the ministries and agencies concerned with external trade and investment in both the public and private sectors, by means of impact studies and by reinforcing their capacity to formulate national negotiating positions.

A contentious issue in international trade concerns export and investment incentives. The elimination of some of the benefits of the free zones (as part of the WTO commitments), as well as the exclusion of free zones from many trade negotiations, thwart the Central American economies since such schemes are part of the countries' export strategies.

Information Technology

In this area SIECA has developed and set up the first Intranet in subregional institutions. Additionally, the Central American Network of Information and Technical Support to Trade has been developed and efforts are under way to update it, especially as regards maintenance services and the training of the personnel responsible for using it in each of the subregion's Ministries of Economy and External Trade.

Also under way is an Information Gathering System for the FTAA's Hemispheric Database on Market Access; the Integrated Database of the World Trade Organization (WTO); and the special database on the trade of the Latin American countries developed by the Institute for the Integration of Latin America and the Caribbean (IDB-INTAL). The broad and specialized content of these initiatives aims to serve trade negotiations.

The Information Technologies System for Central American Economic Integration and Trade Negotiations, based on trade systems, tariffs and documentary databases, provides SIECA data to sectors of civil society.

Levels of Coordination in Economic Policy

This analysis of convergence in Central America would not be complete without reference to the lack of explicit macroeconomic policy coordination between the countries. There is, however, awareness of the benefits arising from information exchange and cooperation, and hence a Regional Technical Support Group has been created. This, in conjunction with SIECA, prepares proposals on the harmonization of fiscal policies. The Central American Monetary Council (CMCA) is entrusted with the "coordination, harmonization or unification of the countries' monetary and financial policies ..." (CACM, 1997). There seems to have been little progress on either of these two fronts in terms of explicit coordination, but the CMCA acts as an important catalyst of information.

Mechanisms for Environmental Management

In the absence of subregional regulations on the environment, the countries face the challenge of establishing the bases for strengthening institutional mechanisms, harmonizing the regulatory and legal frameworks for managing them and, via international agreements, attaining the coordination between national and subregional organizations that has been lacking thus far.

In terms of subregional integration and productive competitiveness, environmental problems are central to the business sector's negotiations in the WTO framework, and to its efforts to secure trade agreements. The problem in this field concerns the lack of harmonized regulatory frameworks on issues such as dangerous substances and waste; the management of resources in transborder basins; quality norms and standards that affect the main tradable products; agreements on environmental information and disaster prevention; policies and laws on the use and exploitation of marine coastal resources and on product certification.

Given the subregion's great vulnerability to natural disasters, environmental monitoring is particularly important for the purposes of establishing early warning systems. Hence the significance of initiatives such as a regional georeferenced information system and the Central American Plan for Water Resources.

In the area of production there is a need to institute a system of certification, accreditation, audits and subregional environmental incentives to promote the application of ISO 14000 norms. The business sector could thus face the environmental challenges that might arise in the WTO trade negotiations or in other commercial accords.

Other relevant environmental issues in the subregion concern the reduction of greenhouse gas emissions and carbon fixing. The goals in this area are enshrined in the Framework Agreement on Climatic Change and the Kyoto Protocol.

The management of shared hydrographic basins is another matter of particular significance at the subregional level. The countries have identified the border basins that will later require a more specific assessment. These include: the Lempa River (Guatemala, Honduras and El Salvador); the Coco River (Honduras and Nicaragua); the San Juan River (Nicaragua and Costa Rica); the Chixoy River in Guatemala; El Cajón in Honduras; and the basins in the north-central region of Nicaragua. These offer a solid basis for embarking on the management of subregional basins.

Central America is unequipped with key elements for the environmental management of marine coastal resources. There is a lack of institutions, laws, norms and information. However, initiatives such as the establishment of a marine corridor could be considered for priority areas like the coral reefs of Guatemala, Belize, Honduras, and Nicaragua. This would be a parallel and complementary area to the Mesoamerican Biological Corridor. Also salient in this context are the feeding and nesting areas for marine turtles in Costa Rica and Nicaragua.

Another strategic area of subregional deficiency requiring due attention is the conservation and sustainable use of biodiversity. There is a need for a joint approach to the factors that cause a loss of biological diversity.

The Importance of Small and Medium Companies in the Subregion

Given the importance of small and medium companies in Central America,[41] attention to them should be priority if the development opportunities afforded by integration are to be exploited. This is undoubtedly a serious challenge for the Central American economies. Globalization confronts small and medium companies with international competition, and their survival depends more on their external than their local competitiveness. Hence the need for new productivity and performance standards in critical areas such as quality and service management, as well as international environmental requirements.

[41] According to estimates based on national census data national and FEDEPRICAP surveys, published in "Compilación de estadísticas de Pymes en 18 países de América Latina y el Caribe", second report of the IDB project ATN/EA-5846-RG, June 1999, in Central America there are more than 215,000 small and medium enterprises (SMEs) employing over 1,500,000 people. SMEs account, on average, for 94% of the businesses and 66% of the jobs in the Central American countries.

BIBLIOGRAPHY

BALLESTERO, F. AND RODRÍGUEZ, E. "Centroamérica hacia un área económica armonizada". Integración & Comercio. N° 1, Year 1. Buenos Aires : BID-INTAL, January-April 1997.

CENTRAL AMERICAN MONETARY COUNCIL. Information on economic series, 1995-99.

_______________. *Informe Económico Regional 1999*. March 2000.

CENTRO LATINOAMERICANO DE COMPETITIVIDAD Y DESARROLLO SOSTENIBLE (CLACDS). *Proyecto de Modernización Aduanera.* Instituto Centroamericano de Administración de Empresas (INCAE), 1999.

COMISIÓN ECONÓMICA PARA AMÉRICA LATINA (CEPAL). *Balance Preliminar de las Economías de América Latina y el Caribe*. 1999.

_______________. Information Centre of the Unit on Investment and Corporate Strategies of the Division of Production, Productivity and Management. Information on economic series, 1998.

CONVENIO PROCOMER – CINDE. *Benchmarking de Incentivos a la Inversión Extranjera Directa, Costa Rica y sus Principales competidores*. Costa Rica, 1999.

FEDERACIÓN DE CÁMARAS Y ASOCIACIONES DE INDUSTRIALES DE CENTROAMÉRICA (FECAICA). "Centroamérica, Indicadores Industriales 1990-98, October 1999.

HARVARD INSTITUTE FOR INTERNATIONAL DEVELOPMENT. *The Central America Competitiveness Report*. 1998.

_______________. Information on economic indicators, 1998.

INTER-AMERICAN DEVELOPMENT BANK (IDB), Department of Integration and Regional Programs, Statistics and Quantitative Analysis Unit. Information on economic series, 1991-99.

_____________. Department of Integration and Regional Programs - Regional Operations Department 3. "Central America, Regional Programming Document (RP-CA)", Vols. I and II, September 2000.

_____________. Division of Integration, Trade and Hemispheric Issues, Information on convergence indicators based on data from the International Monetary Fund (IMF), 1991-99.

SECRETARÍA PERMANENTE DEL TRATADO DE INTEGRACIÓN ECONÓMICA CENTROAMERICANA (SIECA). Informe Económico de la Región, 1999.

WORLD BANK. *Foreign Investment Advisory Service* (FIAS). 1999.