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THE EMERGENCE OF CHINA: A VIEW FROM CENTRAL AMERICA

Manuel R. Agosin
Pablo Rodas Martini and
Neantro Saavedra-Rivano

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PREFACE

Regional Operations Department 2 (RE2) is pleased to make available to the interested public this study of the impact of the emergence of China on Central American economies, with special emphasis on Guatemala and Honduras.

China's opening to international trade and to direct investment, combined with the spectacular growth of its economy, is one of the most remarkable developments in the latter part of the twentieth century. All indications are that this growth, as an open market economy is being consolidated, is going to continue for some time, and that China will continue to pursue its long-term economic potential at a rapid pace.

The issue of the China's impact is generally approached from the standpoint of threats hovering over the economies of Central America (and of others in Region 2, such as Mexico and the Dominican Republic), without noting that the rapid growth and great openness of the Chinese economy also present new potentialities that the countries of the region could turn to their own advantage.

This study presents analyses and recommendations for enhancing the competitive advantages already developed by Central American countries, particularly in the apparel and textiles sector, and others envisioned as possible, vis-à-vis the challenges that they face from the strong competitiveness of Chinese industries. But it also considers how to take advantage of the new opportunities offered by the Chinese market for exports of the region's goods and tourist services, and also the policies needed to begin to attract direct investment from that country.

This study was prepared by Manuel R. Agosin (Regional Economic Advisor of Regional Operations Department 2), Pablo Rodas Martini (Director, Regional Program for Central America in the World Economy of the XXI Century, Guatemala City) and Neantro Saavedra-Rivano (Professor of Economics at the University of Tsukuba, Japan). Julián Caballero provided research assistance. Miriam Pérez-Fuentes was responsible for the physical production of the study. The study was prepared for the Regional Integration and Programs Department (INT) project entitled *The Emergence of China: Opportunities and Challenges for Latin America and the Caribbean* and was financed jointly by INT and RE2.

Miguel E. Martínez
Manager
Regional Operations Department II
Central American Isthmus, Mexico, Haiti and Dominican Republic

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Introduction and Executive summary

This study represents a first effort to address the issue of the potential impacts on Central America of the huge export-led growth that China has been experiencing for over two decades which is probably going to continue well into the foreseeable future. For the immediate future, China's impact on Central America appears to be complex, particularly in the apparel industry, which has been one of the most dynamic sectors in the region since the late 1980s.

Although some reference is made to the region as a whole (the five countries of the Central American Common Market: Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua), and occasionally to individual countries, the study is centered on Guatemala and Honduras as case studies.

Section I describes Central America's economic relations with East Asia. For Central America, Asia is still a relatively minor trading partner. Noteworthy, however, are Korean investment in *maquiladora* apparel manufacturing plants and the penetration of manufactured goods from Japan, Taiwan, Korea, and increasingly from China, among the imports of the countries of the region. Central American countries have diplomatic relations with all the countries mentioned except China. Taiwan has received diplomatic recognition from all Central American countries, in exchange for which it offers significant grant aid. Ties with Taiwan, despite their weakness on the private sector side, have prevented the development of more intense economic relations with China.

Section II discusses the characteristics of the emergence of China and presents it in a long-term historic perspective. China is rapidly undergoing a triple transformation: from a centrally planned to a market economy, from a rural economy to a world manufacturing power, and from a closed to an extraordinarily open economy. All this is taking place in the midst of a rate of growth that is the highest in the world today. Combined with the vast size of its economy, these transformations suggest that China's emergence is likely to lead to a complete reorganization of the global economy and to have a profound impact on all the countries of the world.

Section III deals with China's challenge to Central America. Thus far, Central America is exporting virtually nothing to China, although it has indeed become a growing market for a range of Chinese manufactures, thereby lowering costs for customers (both companies and consumers). Nonetheless, China's strong growth is harming Central America through sharp price hikes of a significant set of raw materials that the region has to import (especially oil).

But the main challenge is coming from competition with Chinese producers in the US apparel market. With China's entry into the World Trade Organization (WTO) in 2001 and the removal of the Agreement on Apparel and Textiles in 2005, China's impact on Central America in the short term is seen as threatening, because the quotas that used to impede the entry of Chinese apparel into the United States are going to be dismantled and the advantages once granted to the countries of the region by the Caribbean Basin Trade

Promotion Act (CBTPA) of 2000 may no longer be sufficient to counteract China's strong competitive advantage with these goods. Approval of the Free Trade Agreement between the United States and Central America (CAFTA) is essential in order for the region to be able to stand up to this competition.

Section IV sketches some interesting features of the Chinese growth process that could ultimately become very attractive to the countries of Central America. One of these features is the rapid growth in China's consumer imports. Central America has a potential export capacity in fresh and processed foods, but obstacles both objective (transport costs, technological backwardness) and subjective (mutual ignorance) are conspiring to prevent these possibilities from coming to fruition. A second feature is the growing internationalization of Chinese companies, which are very rapidly investing overseas. It would not be too rash to hope that they would also become interested in investing in Central America in order to take advantage of proximity to the United States, and potentially, CAFTA. Finally, outbound tourism is a fast growing industry in China, but Central American countries have not yet begun to exploit its potential.

Section V presents some suggestions for achieving greater economic rapprochement with China. A central issue is that the challenges that China poses to the region are inevitably going to occur and in the immediate future, whereas the advantages that the region can draw from the new reality of China in the world economy, which are all long-range, will take place only if the region's government leaders are visionary enough to understand the process and to respond to it creatively.

I. Central America's Economic Relations with East Asia

The economic relations of the countries of Central America are essentially with the United States and among themselves within the regional integration framework. Europe and South America are substantially less relevant to Central America. The importance of Asian countries is in a very distant third place.

Central America has not formulated its own specific policies toward Asian countries. The advances made thus far with Asian countries are due to the initiative of the latter, not to any deliberate design on the part of Central American countries. The uncertain nature of its own policies toward Asia is surely due to the distance, but it is also greatly accentuated by the disparity of cultures.

Despite this difficulty in communicating with Asia, it is remarkable that there are relationships with various countries on various fronts. There is modest trade with Japan, Taiwan, and South Korea. Japan and Taiwan contribute significant development aid to Central America. Taiwan and particularly South Korea have considerable investments in the region in the *maquiladora* sector. Chinese, and more recently Korean immigrants have settled in Central American countries.

Relations with mainland China are much more tenuous. Aside from the immigrant population that arrived in the twentieth century and imports from that country since the 1990s to the present, there have been virtually no economic or political relationships. The region has not been significant to China, nor has it shown much interest in China. The extent of knowledge of one another is still very limited on both sides.

To this must be added a political variable that even further complicates any rapprochement with China. Only 26 countries in the world recognize Taiwan, and seven of them are Central American countries (including Belize and Panama). Taiwan contributes considerable development aid in Central America, and hence the countries of the region are very grateful to it. This close diplomatic relationship, however, stands in the way of any accentuation of relationships that the governments or private sectors of the region might undertake with China.

A. Statistics of the Relationship with East Asia

Trade

Asia is not a significant destination for the region's exports. Table 1 breaks down the exports of Guatemala and Honduras by continent. In 2002 only 9.1 percent of Guatemala's exports went to Asia and in 2003 they fell to 6.7 percent. For Honduras the figures are even lower: it exported 1.5 percent in 2002 and 1.1 percent in 2003.[1] Exports to Asia are only higher than exports to Africa and Oceania, continents whose economic

[1] These figures underestimate Asia's importance, because *maquiladora* production, sent almost solely to the United States, is recorded as value added in the exporting country, which is approximately 35 percent of the gross value exported.

weight is substantially less in world trade than that of Asia. Of all the countries in Asia, only Korea and Japan receive significant amounts of exports from Guatemala and Honduras (around $10 million). Exports to Taiwan are insignificant.

Table 1
Destination of Exports from Guatemala and Honduras

	Guatemala				Honduras [a]			
	2002		2003		2002		2003	
	Millions US$	%	Millions US$	%	Millions US$	%	Millions US$	%
Americas	2,041.8	82.9	2,226.5	84.5	999.8	75.7	1,013.9	76.1
Europe	175.4	7.1	216.8	8.2	279.1	21.1	289.5	21.7
Asia	223.7	9.1	175.7	6.7	20.2	1.5	15.1	1.1
Africa	18.2	0.7	13.3	0.5	..	..	..	..
Oceania	0.8	0.0	0.6	0.0	..	..	..	..
Other	1.7	0.1	1.8	0.1	22.1	1.7	14.0	1.1
Total	2,461.6	100.0	2,634.7	100.0	1,321.2	100.0	1,332.5	100.0

Sources: SIECA and Central Bank of Honduras.
[a] For Honduras, Asia refers solely to Japan. Honduran exports to Africa and Oceania are included in the "Other" category.

Import figures are quite similar to those of exports, with low levels of imports from Asia (see Table 2). Again, these low levels are striking because commercially, many goods from China, Taiwan, Hong Kong, and other Asia countries can be bought in Central American cities. This underestimation of imports could be attributed to two reasons: contraband or incorrect registration of Asian goods. With regard to the latter, it is known that many Asian products are purchased indirectly through international markets, such as the Colon Free Zone in Panama, and they could be registered as Panamanian products or goods from other countries when in fact they are really Asian.

Tourism

Guatemala and Honduras have a strong potential for tourism, but they have not yet managed to develop it to the same extent as Costa Rica. Among its attractions Guatemala has the colonial city of Antigua Guatemala, Lake Atitlan and the Mayan ruins of Tikal. The main attractions in Honduras are the Bay Islands of Roatán and the Mayan ruins of Copán.

Tourism policies, like trade policies, are focused on the North American and European markets. They pay almost no attention to Asian countries, even though these countries, especially Japan, are major importers of tourist services. Tourism entering Guatemala and Honduras largely replicates the pattern of foreign trade. Of over 880,000 tourists entering Guatemala in 2003, only 2.6 percent came from Asia. In Honduras in 2002, only 1.2 percent of the 550,000 foreign tourists were of Asian origin.

Table 2
Guatemala and Honduras: Origin of Main Imports

	Guatemala				Honduras [a]			
	2002		2003		2002		2003	
	Millions of US$	%	Millions of US$	%	Millions of US$	%	Millions of US$	%
Americas	4,986.4	79.1	5,393.6	80.2	2,551.4	85.6	2,675.8	81.7
Europe	739.0	11.7	697.8	10.4	189.9	6.4	275.9	8.4
Asia	545.3	8.6	589.1	8.8	97.6	3.3	114.0	3.5
Africa	2.7	0.0	1.9	0.0	..	..	..	..
Oceania	27.3	0.4	25.7	0.4	..	..	..	..
Other	3.3	0.1	13.4	0.2	142.1	4.8	209.9	6.4
Total	6,304.1	100.0	6,721.5	100.0	2,981.0	100.0	3,275.6	100.0

Sources: SIECA and Central Bank of Honduras.
[a] For Honduras Asia refers solely to Japan. Honduran imports from Africa and Oceania are included in the "Other" category.

Foreign investment

Guatemala and Honduras have not been major recipients of foreign direct investment (FDI). Although the available figures are not very reliable they do indicate sufficiently that among all Asian countries only South Korea has made direct investments in Guatemala and Honduras, and they are entirely in textiles and apparel. By contrast with the large Japanese investment in Mexico to take advantage of the North American Free Trade Agreement (NAFTA), there is practically none in Central America.

International Development Aid

Guatemala and Honduras have been significant recipients of international aid in Latin America. Aid has come to Guatemala in support of the return to democracy in the 1980s and subsequently of the peace agreements in the 1990s. Aid has come to Honduras more because of its per capita income level, which makes it a low-income country and a beneficiary of the Highly Indebted Poor Countries (HIPC) Initiative.

Table 3 presents the international aid that Guatemala and Honduras have received from Japan and South Korea in relation to the total. Japan clearly plays a major role in aid to these countries. South Korea's share, on the other hand, is minimal. The disparity between the two countries in terms of aid is striking, because in FDI the situation is reversed.

Table 3
Net official development aid to Guatemala and Honduras
(in millions of dollars)

	Guatemala		Honduras	
Country	**2001**	**2002**	**2001**	**2002**
Japan	45.7	29.4	76.3	94.9
South Korea	0.2	0.3	0.1	0.1
United States	63.6	64.7	201.3	97.3
Total	226.6	248.7	679.2	434.9

Source: OECD, DAC.

The Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) does not give equivalent figures for Taiwan, but its contribution to the region is known to be very significant. In addition to the bilateral contributions, Taiwan is also a member of the Central American Bank of Economic Integration (BCIE – *Banco Centroamericano de Integración Económica*) and it sends many donations to integration bodies such as the General Secretariat of the Central American Integration System (SG SICA – *Sistema de Integración de Centroamérica*) and the Secretariat for Central American Economic Integration (SIECA – *Secretaría para la Integración Económica de Centroamérica*).

B. Bilateral Relationship with Japan, South Korea, and Taiwan

Although Central America's relationship with China will certainly take its own course, an examination of how the region has related to other Asian countries can no doubt offer some clues for understanding what China's interest in Central America might be and what obstacles the region would have to overcome if it wishes to have closer ties with China. Here we focus on the bilateral relations of Central America's three most important Asian partners (Japan, Korea, and Taiwan) with Guatemala and Honduras.

Japan

The oldest relationships of Guatemala and Honduras are with Japan. Japan began diplomatic relations with Guatemala in 1935 and with Honduras in 1932. Those relations were of course interrupted during World War II, when the Central American countries were allied with the United States. However, trade is practically restricted to exporting coffee to Japan and importing vehicles. Central America has not succeeded in tapping Japan's high per capita income, nor do the Japanese seem to be very interested in exporting to Central America, with the exception of vehicles.

One area in which Japan has in fact shown ongoing interest – although thus far it has not made significant expenditures – is in all government initiatives for large physical investments. The Japanese government and Japanese companies have demonstrated great interest in airport, port, and highway concessions, and will no doubt be involved in their subsequent implementation. This is further corroborated by their obvious interest in the infrastructure projects of the Puebla-Panama Plan. Should closer economic ties be forged

with China in the future, some of these same sectors could be very attractive to its companies. Moreover, like Japan, China could become a significant provider of aid to the countries of the Central American region.

South Korea

Korea began relations with Guatemala and Honduras in 1962. Initially, the relationship did not have much impact. It was only in the early 1990s, with the opportunities that opened up for developing *maquiladora* industries in Central America, that Korean investors began to come to the region.

Today there is greater commercial exchange, such as in the purchase of vehicles and other Korean industrial products, and the export of sugar from Guatemala to Korea. However, the relationship with Korea revolves essentially around one sector: textiles and apparel. Korean investors first came to Guatemala and Honduras attracted by the chance to take advantage of unexploited export quotas to the United States (and later by the preferential access granted to the region by the CBTPA), by geographical proximity to the US, and by the vast supply of unskilled labor in Central America (with the exception of Costa Rica), the resource most needed for producing apparel.

The Guatemalan Apparel and Textiles Industry Commission [*Comisión de la Industria de Vestuario y Textiles de Guatemala*] (VESTEX) estimates that the 151 Korean companies represent around 66 percent of the companies in the sector. The Honduran *Maquiladora* Manufacturers Association [*Asociación de Maquiladores de Honduras*] estimates that 30 companies in the sector are of Korean origin. They represent 15 percent of the number of companies in the sector. What Korean investors will decide to do when the Textiles and Apparel Agreement in 2005 expires is uncertain, that is, it is not known whether they will continue with their investments in the region or whether they will take their investments back to Asia, and particularly to China.

Taiwan

Taiwan established diplomatic relations with Guatemala in 1960 and with Honduras in 1965. In one respect Taiwan's relationship with Guatemala and Honduras is similar to that with Japan: little trade, little investment, but considerable international aid. Japanese aid is part of an overall policy of aid for development, but Taiwan sends its aid to bolster its diplomatic relations with Central America,

Taiwanese aid takes place on two levels: directly to countries and to the regional institutions of economic integration. Bilaterally, Taiwan supports economic development projects and makes donations to ministries, as does Japan, but it also maintains a policy of cultivating close relationships with the different administrations in power, as well as with members of congress, military officials, business leaders and even the press.

Regionally, Taiwan has positioned itself as the main donor to the regional integration agencies. The SIECA building was made possible by Taiwanese aid, many projects of SG SICA and other integration bodies are being aided by Taiwan, and it is also a member of, and major contributor to, the BCIE.

The latest new development on the part of Taiwan for strengthening diplomatic relationships with countries friendly to it is signing free trade agreements (FTAs). By so doing, Taiwan would hope to correct what has been its main weakness vis-à-vis Central America: the difficulty in establishing trade and investment relationships.

Clearly for Central America the challenge is how it can achieve closer relations with China in a context in which diplomatic recognition impacts Taiwan. There are two possible scenarios. The first would be the continuation of the status quo: do nothing and continue to ignore China. If would be regrettable if Central America were to take this path, because it would only have to struggle with economic challenges from China without being able to benefit from the opportunities. The second would be to achieve an economic opening to China without breaking diplomatic relations with Taiwan. This would be the more desirable scenario, although there is no way to know how realistic it is. But it is certainly worth trying.

II. The Emergence of China

The process of the emergence of China reveals three main characteristics. First, it is taking place in association with profound changes in the country's economic structure. Second, it has a historic significance that is relevant to the positions of the main actors participating in it. And finally, the emergence of China is destined to have a profound impact on the world economy, particularly by changing the relationships of economic power between regions. As we will see below, these characteristics are relevant in particular for understanding the evolution of the relationship between China and the countries of Central America.

A. Structural Changes

As the World Bank (1997) notes, China is undergoing two transitions at the same time, from a centrally planned economy to a market economy, and from a basically rural economy to an industrialized economy. We could add another transformation that is very important for the purposes of this study: the transition from a closed to an extraordinarily open economy. As is described in greater detail in Section IV, in 1980 at the dawn of its historic transformation, China was importing only 8 percent of its GDP, practically none of which was consumer goods. Today, China is one of the most open economies in the world with an import rate of over 30 percent, thereby making its economy substantially more open that that of the United States or Japan. In Europe only the smallest countries in the European Union have higher import rates. This already extraordinary confluence is compounded by the speed with which these transitions are taking place and the enormous size of a country with 1.3 billion inhabitants.

Agricultural production, which represented 35 percent of GDP in 1970, has fallen to less than 15 percent in 2003. At the same time, the portion of the population in urban areas has risen from 17.4 percent in 1970 to 36.7 percent in 2001.[2] China's urban growth has been spectacular in the past thirty years, and it is spreading from the coastal regions into the interior of the country. Not only are large metropolises like Shanghai, Beijing and Guangzhou flourishing, but new cities are appearing, and urban centers are growing at all levels. This process is continuing very rapidly, and indeed, urban growth is expected to be one of the main driving factors for growth in the medium run.

The drop in agricultural production has not been more rapid, especially in the period up to the mid-1980s, because of economic reforms implemented in the agricultural sector. These reforms entailed granting greater responsibility to farmers and reducing the role of collective farms. At the same time, the development of rural enterprises was encouraged, and these enterprises have gone on to play an important role in the growth of production and of the country's exports. These enterprises practically did not exist before 1980, but in 1999 they contributed 30 percent to GDP and 48 percent to China's exports.

The development of rural enterprises is only one of the transformations that China has undergone since 1978 which are bringing the country ever closer to the status of a market

[2] World Bank, *World Development Indicators*.

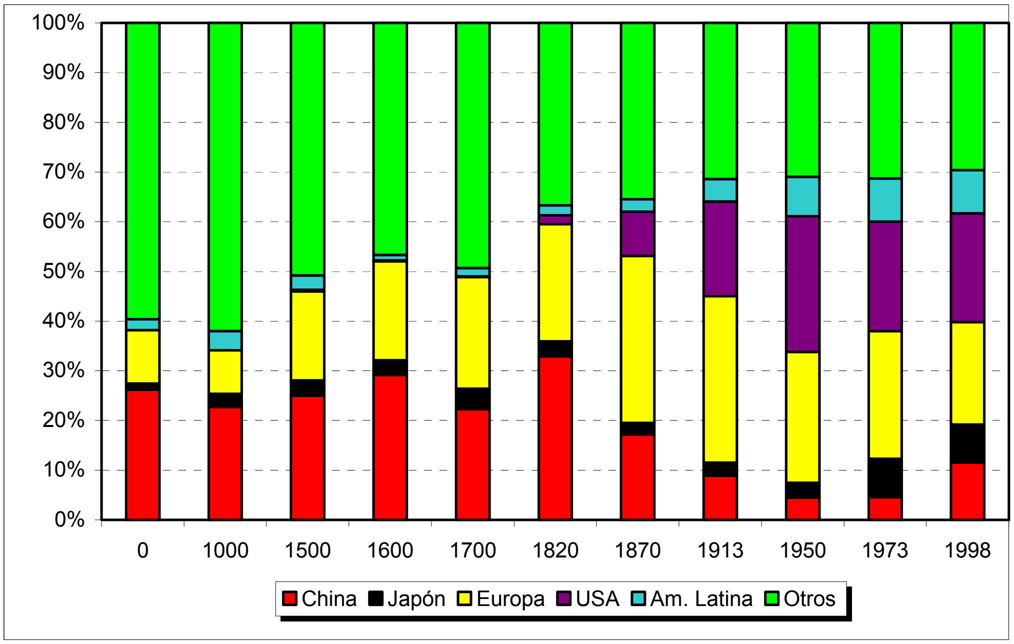
economy. Other reforms were the creation of Special Economic Zones, the opening to foreign capital, the liberalization of foreign trade, and the increasing autonomy granted to state-owned enterprises. With regard to the latter, there have been several noteworthy developments. These enterprises now have an autonomous and corporate structure which has allowed them to open up to private and even foreign capital. The stock market, in particular, which before 1990 did not exist, by the end of 2000 listed 1088 companies on the Shanghai and Shenzhen exchanges with a capitalization of over 50 percent of GDP.[3] More than a third of the shares were held by private (Chinese and foreign) investors. Foreign investment is also present in joint ventures with Chinese state-owned enterprises and also in companies with complete foreign share control (WFOEs or wholly foreign-owned enterprises). The growth of foreign investment in China can be clearly illustrated by the fact that the amount of this capital rose from US$ 6.3 billion in 1980 to US$ 447.9 billion in 2002. This last sum is equal to 36.2 percent of China's GDP.

B. Historic Significance

It is well known that China has a glorious past and that long ago it was the most advanced nation on the planet. The economic historian Angus Maddison (2001), who has devoted great efforts to quantifying the growth of the world economy and income distribution among nations throughout our era, estimates that until approximately 1600 China was the richest country in the world. Figure 1 shows developments in China's share and that of selected other countries or regions in the world economy over the past two thousand years. These numbers make it clear that for most of this long period China was the most prosperous country in the world, and that its becoming an "underdeveloped" country is a phenomenon of the past 150 years. In historic terms the recent emergence of China could be interpreted as a correction of the trend toward decline observable especially in the 1850-1950 period, from the beginning of the decades of the Qing dynasty to Mao Zedong's rise to power. In the light of this historic evidence, predictions of the sustained growth of the Chinese economy and its conversion to the largest economy in the world take on greater likelihood.

[3] See Wang et al. (2004).

Figure 1
Share in the World Economy by Selected Countries, 0-1998
(percentage of world GDP, measured in purchasing parity power)



Source: Maddison (2001).

Examining the issue in its historic context further, it may be noted that this is not the first instance in recorded history of an "emergence" of China. According to historian Wang Gungwu (2004), three other periods of emergence may be documented in the past. The first is associated with the Qin (221 to 206 BCE) and Han (206 BCE to 220 CE) dynasties, and it corresponds to the establishment of the first great Chinese empire and the development of its main institutions which were to last for centuries. The name of the country comes from Qin, and the Han are the majority ethnic group. The second period is associated with two more dynasties, the Sui (581-618) and the Tang (618-907). It reached its greatest splendor in the eighth century. This was a period of great expansion of trade and development of the arts, and was characterized by an opening to the outside world. Finally, the third period is associated with the last two dynasties of the Chinese empire, the Ming (1368-1644) and the Qing (1644-1911), and it reached its zenith between the fifteenth and the eighteenth centuries. It was during the Ming dynasty, however, that China entered a period of introspection and isolation in reaction to the upheavals experienced after the Mongol invasion and during the period of the Yüan dynasty (1206-1368) established by the Mongols. Some historians believe that it was the adoption of these policies that over time brought the Chinese empire to its decline and eventual collapse in the early twentieth century.

Insofar as awareness of history exists in China—and all indications are that it does—one may imagine the confidence and security underpinning the current process, and its actors and leaders. It is not just the great size of the country, which obviously allows for

spectacular projections, but also knowing what it was possible to achieve, more than once, in the not so distant past.

C. Worldwide impact

A fundamental difference between the current process of the emergence of China and the earlier periods noted has to do with its relationship with the rest of the world. Past processes of emergence took place within a setting in which the developments were basically internal to China. It is also true that the impact that they had on the rest of the world in those days was limited, and circumscribed to its geographical setting, primarily Korea, Japan, and Vietnam. Today the situation is quite different. There is no question that while China's awakening has internal motivations, the process of emergence is greatly fueled by factors outside the country, namely influx of capital and technology, and the appetite of international markets for products made in China. China is a great beneficiary of the globalization of the economy, which has made possible the consolidation of its process of economic development. Moreover, the vastness of the country and expectations for a continued emergence will continue to impact all regions of the world regions and all sectors of economic activity.

Nowhere is this effect so evident as in East Asia. Almost imperceptibly, China is becoming the main economic partner, or one of the main partners, of all countries in the region. For Japan, China is now the second most important destination for its exports after the United States, but China is the more dynamic market. Furthermore, since 2002 China has surpassed the United States as principal source of Japanese imports. For East Asian countries, it is also clear that China is almost always the most dynamic or one of the most dynamic trading partners. As may be seen in Table 4 this trend has accelerated in recent years and China has also become the main trading partner of countries like South Korea and Taiwan.

Table 4
Countries of East Asia: Main Changes of Export Destinations, 1985-2001

	Increasing export markets, by relative importance				**Greatest reduction of share in market**	
	Greatest share in market		**Second greatest share in market**			
Exporter	Importer	Change (%)	Importer	Change (%)	Importer	Change (%)
Brunei	Korea	13.7	China	12.4	Singapore	-11.4
Cambodia	Thailand	6.8	Hong Kong	6.5	Vietnam	-23.1
China	Korea	10.4	Taiwan	4.6	Singapore	-15.3
Hong Kong	Malaysia	5.9	Singapore	5.9	China	-26.9
Indonesia	Malaysia	6.0	China	5.8	Korea	-8.1
Korea	China	42.0	Taiwan	4.7	Hong Kong	-25.2
Laos PDR	Thailand	33.5	Vietnam	31.3	China	-53.8
Malaysia	China	10.4	Hong Kong	8.3	Singapore	-11.6
Mongolia	China	46.2	Korea	1.0	Vietnam	-47.4
Philippines	Taiwan	12.4	China	4.2	Malaysia	-9.0
Singapore	China	8.3	Vietnam	5.1	Malaysia	-10.1
Taiwan	China	43.8	Vietnam	3.0	Hong Kong	-31.5
Thailand	China	6.0	Indonesia	3.8	Malaysia	-10.0
Vietnam	China	23.2	Taiwan	9.6	Hong Kong	-48.7

Source: Direction of Trade (IMF), cited by Ng and Yeats (2003).

Trade ties between China and East Asia should keep growing closer by virtue of the network of relationships (production chains) created by the investments of Japanese, Korean, and Taiwanese companies. For its part China is actively encouraging this trend by encouraging economic liberalization agreements with ASEAN (Association of Southeast Asian Nations), in addition to being part of the process of the integration of East Asia, which besides China, includes the ten member countries of ASEAN, Japan, and South Korea (ASEAN + 3). With regard to negotiations with ASEAN, a Framework Agreement was signed setting 2010 as a target for completing a FTA between China and ASEAN.

Without doubt one of the factors having the greatest impact on the Chinese process is its recent entry in late 2001 into the WTO. The Accession Protocol signed by China at that time commits the country to carry out a broad set of reforms in its regulatory apparatus in order to assure the principles of non-discrimination between Chinese and foreign companies, eventually eliminate non-tariff obstacles to international trade, eliminate export subsidies, increase the transparency of its legislation, and establish the ability of foreign companies to appeal to it, and so forth.

Much has been written about the consequences of China's entry into the WTO, both on China itself and on its trading partners.[4] An important point is that as part of the conditions for accession to the WTO, China agreed to not be regarded as a "market economy" for a fifteen-year period, during which time it will be vulnerable to discriminatory treatment in anti-dumping cases. Some observers think China was hasty in its negotiations with the United States in 1991 when it accepted this condition. Recently China has engaged in a diplomatic offensive to be recognized as a market economy by the European Union and other trading partners.

Despite uncertainties regarding these effects, China's accession to the WTO has contributed to the image of a rapidly modernizing country being integrated into the world economy. In particular, foreign investment in China keeps growing. In 2001-2002, almost US$100 billion entered China, in comparison with US$174 billion going to the United States. Indeed, in 2003 China was the largest recipient of FDI in the world, receiving US$ 54 billion, as compared with only US$30 billion that entered the United States (UNCTAD, 2003; UNCTAD, 2004).

In sum, we can say that the emergence of China is a phenomenon of profound significance which is taking place very quickly and in a vast country that has the potential to redefine the future of international economic relations, and which will ultimately affect all economic actors and all countries one way or another. Like globalization, this is a process that should not be ignored and one that brings with it both challenges and opportunities. The challenges are not negotiable, but the opportunities are there for those who make the effort to understand the process.

[4] See, for example, the recent special issue of the *World Bank Economic Review* (2004), and also World Bank (2003).

III. China's Challenge to Central America

Thus far the impact of China's emergence on Central America has been modest, given the low levels of mutual trade. Chinese competition in apparel for the US market has now been felt and it will become more acutely felt with the dismantling of textile quotas in the WTO at the beginning of 2005. This does not mean that Central America lack major competitive advantages in this sector. The apparel industry is consolidating its transformation, which in the future could attract investment, even Chinese investment. However, it is virtually a certainty that the immediate impact of the dismantling of the Agreement on Textiles and Apparel will be the loss of many jobs in Honduras and Guatemala, and elsewhere in the region.

A. Central America's Economic Relations with China

Central America's economic and financial relations with China are at a very early stage. In terms of direct investment, we are aware of only two joint ventures with the Kattán Group in San Pedro Sula to produce apparel for export and of two investments in the IPZ (Industrial Processing Zone) Comayagua, all of them in Honduras. No Chinese investments in Guatemala are recorded.

Levels of exports from Central American countries to China are insignificant, with the exception of some high technology (computer chips) from Costa Rica. In fact, there are practically no exports from Guatemala and Honduras to China (Table 5). That does not mean of course that there is no potential for increasing exports to China. We think that the potential is great, and we will return to that issue in the next section.

Table 5
Central America: Exports to China and Total Exports, 1994 and 2002
(Exports in millions of dollars; percentage shares)

Countries	Exports 1994		Exports 2002		China share in total exports	
	To China	Totals	To China	Totals	1994	2002
Costa Rica	0.28	2,090.4	33.4	4,902.4	0.01	0.68
El Salvador	0.09	817.5	1.1	1,237.0	0.01	0.09
Guatemala	0.00	1,497.4	0.1	2,227.5	0.00	0.00
Honduras	--	613.9	1.4	1,338.8	0.00	0.10
Nicaragua	0.03	348.2	1.2	633.5	0.01	0.03
CACM	0.40	5,367.5	36.1	10,339.8	0.01	0.35

Source: Comtrade, compiled by the United Nations Statistics Department.

Central America's main exports are listed in Table 6. The eight most important categories of exports in 2002 represented over 90 percent of total exports from the CACM to China. Guatemala was not involved in any of these exports and Honduras appears in the list only starting with the fourth category, with exports of less than a

million dollars each. Despite the small size of these exports, it is nonetheless interesting to note that the main ones are dominated by rather sophisticated intermediate and capital goods exported almost entirely by Costa Rica, the most technologically advanced country in the region. The categories in which one would expect Central America to have a comparative advantage (such as foodstuffs) are barely beginning to appear in Central American exports to China.

Table 6
Eight Main Export Categories from the CACM to China, 2002
(millions of dollars)

Item	Guatemala	Honduras	CACM
Equipment and electrical machinery	--	--	19.03
Office supplies	--	--	8.22
Mechanical measurement and control instruments	--	0.00	1.74
Scrap and wastes	--	0.36	1.35
Food preparations (misc.)	--	--	1.07
(Fresh or frozen) fish	--	--	0.70
Radio or TV reception equipment	--	0.00	0.69
Harvests, except for grains	--	0.69	0.69
Total eight main exports	--	1.05	33.49

Source: Comtrade, compiled by the United Nations Statistics Department.

The situation with regard to imports is quite different. In the past decade, China has been rapidly gaining ground in the Central American market (Table 7). Imports from China are extraordinarily diversified, ranging from some that are technologically very sophisticated (machinery and electric tools) to those in which Central America has been developing competitiveness in its export markets (apparel), to others that are unskilled-labor-intensive, like footwear and toys (Table 8). In some products, imports from China already represent a significant percentage of total imports. As may be noted in Table 8, in 24 categories imports from China represent 10 percent or more of total imports and in 10 of the categories over 20 percent.

Table 7
Central America: Imports from China and Total Imports, 1994 and 2002
(Imports in millions of dollars; percentage shares)

Countries	Imports 1994		Imports 2002		China share in total imports.	
	China	Totals	China	Totals	1994	2002
Costa Rica	20.8	3,018.8	121.2	6,894.3	0.69	1.76
El Salvador	4.1	2,647.2	202.7	6,074.5	0.15	3.34
Guatemala	6.8	1,334.6	19.0	3,033.0	0.51	0.63
Honduras	0.9	852.5	38.6	1,766.2	0.10	2.19
Nicaragua	12.4	2,261.8	70.4	3,896.0	0.55	1.81
CACM	45.0	10,114.9	451.9	21,663.9	0.44	2.09

Source: Comtrade, complied by the United Nations Statistics Department.

Table 8
Main imports from China to CACM, 1994 and 2002
(imports in dollars; percentage shares)

Product	Imports from China		Share in total imports	
	1994	2002	1994	2002
Pottery	0.7	9.0	8	49
Footwear	1.3	52.2	2	32
Wool and animal hides	0.0	0.0	0	29
Luggage	0.4	9.8	4	28
Toys	4.6	31.4	8	26
Petroleum products	1.2	10.3	7	24
Cotton cloth, knit	2.1	10.6	5	23
Motorcycles, bicycles	2.1	16.4	4	23
Wood wastes	0.0	0.2	0	21
Explosives, fireworks	0.1	1.3	3	20
Watches	0.1	3.1	2	18
Radio receivers	0.4	11.7	1	17
Hats	0.2	3.5	2	16
Women's apparel, knitwear	0.1	13.9	1	16
Radio, TV recorders	0.5	4.8	3	16
Misc. non-ferrous metals	0.0	0.0	2	15
Lamps	0.5	5.9	3	15
Misc. manuf. articles	1.1	11.2	3	14
Office machines	0.3	4.6	1	13
Cutlery	0.7	3.7	4	12
Men's apparel, knitwear	0.2	11.7	1	12
Inorganic mineral salts	0.1	13.9	0	12
Ferro alloys	0.1	0.4	7	12
Artificial cloth, knitwear	0.6	8.0	1	10
Apparel nec.	0.3	7.0	1	10

Source: Comtrade, compiled by the United Nations Statistics Department

The benefits for consumers and producers entailed in the increase of imports from China are obvious. Chinese products are not only cheaper than those with which they compete, but they are regarded as high quality goods.[5] Apparel manufactures say they are using Chinese cloth to a significant extent (as is evident in Table 9). Farmers would likewise seem to be increasingly using machinery and supplies from China.

One aspect of the Chinese presence in Central America has been the growing competition to which some local producers are subject. In fact, in 2004 a major group of producers of manufactures for the local market asked the government of Honduras to impose tariff surcharges on Chinese imports, but their request has not met with success.

[5] This is something we heard repeatedly in our interviews with business people and analysts.

One indirect adverse aspect of China's strong growth in recent years has been higher prices for the raw materials that Central America imports. The region produces no oil and is lacking in almost all minerals and in other agricultural products such as soy, the prices for which have risen sharply, largely because of the growth of the Chinese economy and the fact that China has become one of the most important importers of these products in the world. These hikes in the prices of imports have contributed to the deterioration of the terms of trade and rising inflationary pressures.

B. The Most Important Challenge: Apparel Exports

However, the greatest challenge Central America faces in relation to the emergence of China as one of the main participants in world trade comes from the strong competitiveness of Chinese producers in products on which the region has based its growth during the past fifteen years. The sector most affected is going to be apparel manufacture. Indeed eight plants have closed in Honduras so far in 2004. Something similar is happening in El Salvador where apparel exports began to decline in mid-2003, a trend that has continued to the present. In Guatemala, 24 companies had shut down between January and September 2004, out of a total of 231 in the cluster. However, another 24 had been set up in the same period. It is almost a certainty that the Chinese challenge is going to become more acute as of January 1, 2005, with the dismantling of the quotas in the WTO Agreement on Textiles and Apparel, which reserved quotas for Central American countries in their main market (that of the United States) and also limited Chinese exports to that market.

At the very least, there is going to be a contraction in exports to the United States. VESTEX, the association of *maquiladora* operators in Guatemala, projects that exports will decline by between 20 and 30 percent. Honduras also expects exports to contract.

As may be seen in Table 9, China's share in apparel imports into the United States has been rising throughout the current decade. The value of US total imports in these categories fell during the 2001 recession, and recovered somewhat in 2002, and then reached a new historic record in 2003. Chinese exports of apparel grew in absolute terms throughout the 1990s, but were sharply restricted by quotas, and hence their share of total US imports declined. Furthermore, when NAFTA took effect in 1994, Mexico began to enjoy free trade in apparel with the United States (with restrictions on the rules of origin), and it took advantage of the preferences granted to strongly increase its exports and to become the number one supplier to the United States. Since China's entry into the WTO at the end of 2001, China's exports to the United States have increased dramatically, dislodging Mexico from its position as number one supplier. Mexico is the country that has been most affected by the rapid rise of exports from China. The CACM countries have managed to hold onto their share of the US market.

Table 9
Share of China, Mexico, and Central America in Imports of Apparel into the United States, 1990-2003
(percentage share, total imports in billions of dollars)

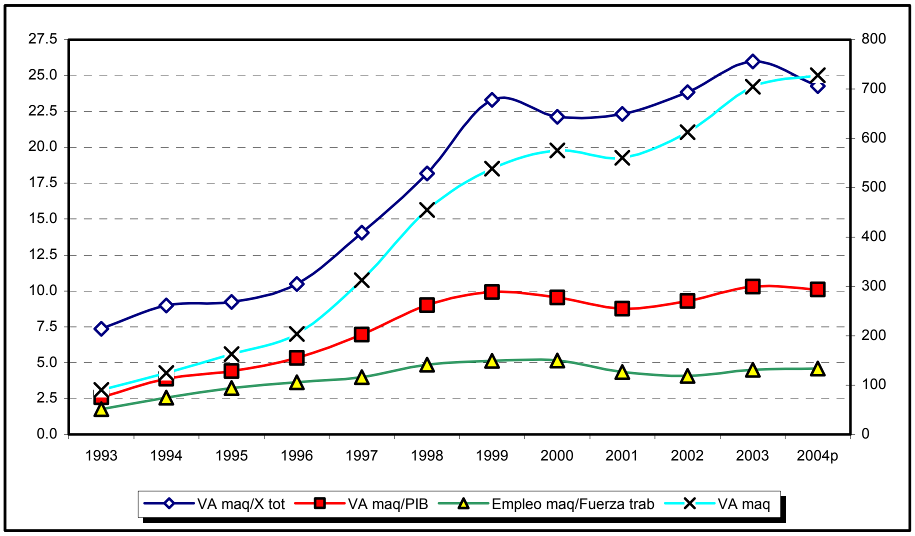
Exporting countries	1990	1993	1995	2000	2001	2002	2003
China	14.5	18.1	13.9	11.6	12.1	13.7	16.1
Mexico	3.2	4.6	7.8	14.1	13.3	12.5	10.8
CACM	3.1	6.0	7.8	10.3	10.7	10.7	10.1
Honduras	0.5	1.5	2.4	3.7	3.8	3.8	3.6
Guatemala	0.8	1.7	1.8	2.3	2.5	2.6	2.5
World (US$ billons)	25.5	33.8	40.2	66.5	65.9	67.3	72.8

Source: IDB calculations, based on USITC data.

This sector is crucially important for Central America. In Honduras, apparel manufacture for export to the United States has been one of the most dynamic export sectors since the late 1980s (Figure 2). Not only has value added on apparel exports increased, but so has their importance in exports and in GDP grown dramatically up to 2000. After that year they fell, and then recovered in 2003 and 2004. Currently, the value added in apparel *maquiladora* plants represents over a quarter of exports of goods and services and over 10 percent of GDP. Likewise, the *maquiladora* industry employs 130,000 workers, which represents 4.5 percent of the labor force, somewhat lower than the 5 percent recorded in 2000. The importance of the *maquiladora* industry can likewise be noted in the wages: they are much higher than those in the rest of the economy and even than per capita gross product. In Honduras, the annual wage plus benefits stands at US$4,232, as compared with a GDP per capita of no higher than US$800.[6] These figures for employment and wages are indicative of the strong economic and social impact of this sector.

[6] It is widely acknowledged that the GDP of Honduras is very much underestimated (perhaps by as much as 40 to 70 percent) by the official national accounts.

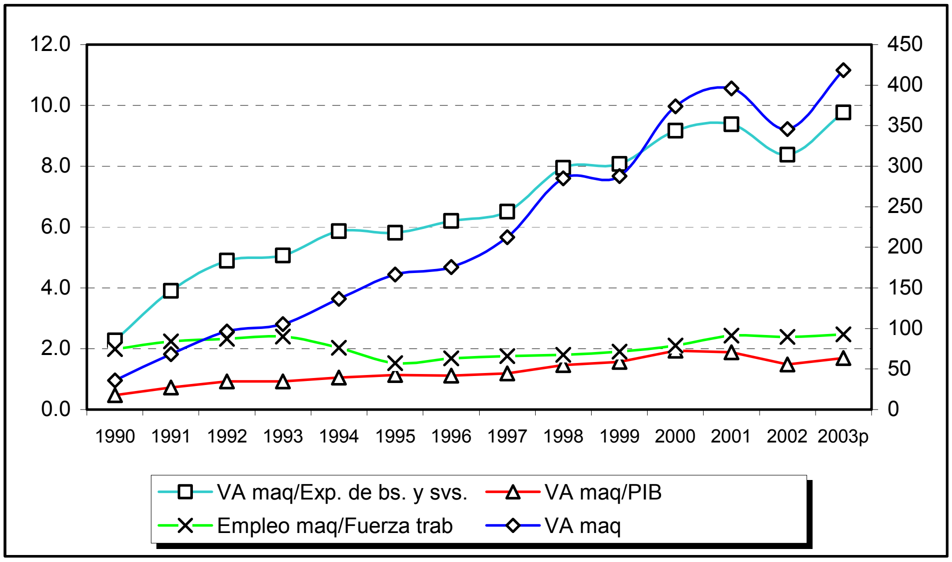
Figure 2
Honduras: Importance of the *Maquiladora* in Exports, GDP and Employment, 1993-2004
(Value added in millions of US$ (right axis), relative figures in % (left axis))



Source: IDB calculations, based on figures from the Central Bank of Honduras and from the Honduran *Maquiladora* Manufacturers Association.

In Guatemala available information indicates that the value added in the *maquiladora* sector is far less, and is barely half of the figures recorded for Honduras (see Figure 3). Growth of those exports and of their ratios to total exports and to GDP have followed a pattern very similar to that of Honduras, reaching their highest level in 2000-2001, dropping in 2002 and subsequently recovering. As a proportion of total labor force, *maquiladora* employment is considerably less in Guatemala (less than 2 percent) than in Honduras. Nor has there been the same tendency to rise as in Honduras. Average annual pay plus benefits is around US$ 2,907, with a per capita GDP of somewhat over US$ 2,000.

Figure 3
Guatemala: Importance of the *Maquiladora* in Exports, GDP and Employment, 1990-2003
(Value added in millions of US$ (right axis), relative figures in % (left axis))



Source: IDB calculations based on figures from the Central Bank of Guatemala and Vestex.

When it began, the *maquiladora* industry consisted of operations of sewing pieces of cloth and inputs from the United States ("shared production" systems). The finished product was exported to the United States under Section 807 of the United States Tariff Code, which allowed paying duties only on the value added outside the country. This segment of the industry is now in decline and will probably be the one most impacted by the end of textile quotas in the WTO, because it is the segment that uses unskilled labor most intensively and that is precisely where China has its greatest competitive advantages. The *maquiladora* industry has been evolving as a result of business strategies in the region seeking to take advantage of the benefits of the 2000 CBTPA (known as the "NAFTA-parity" law), which allows the use (with restrictions of origin and limitations on certain products, most of them based on knitted fabrics) of cloth from the region, provided sewing thread from the United States is still used in preparing it.

In addition, apparel manufacturers have anticipated the end of quotas in the US market. Thus, production from "cut, make and trim (CMT)"[7] and "full package" operations have become increasingly important. In the full-package modality, the producer receives from the buyer detailed specifications for the apparel and a budget. The Central American producer accepts responsibility for purchasing or producing the components and for coordinating all stages of the production process, In many cases, the producers are now producing their own cloth. This has encouraged vertical integration, in which the producer makes the cloth, cuts it, does the sewing, and delivers the final product to the buyer. The Honduran *Maquiladora* Manufacturers Association estimates that full-

[7] These go beyond the conventional *maquiladora* operation, because they involve cutting the cloth, finishing it, sewing, and adding accessories.

package operations represent 65 percent of *maquiladora* production. Vestex, its Guatemalan equivalent, estimates that in Guatemala the full-package share is also 65 percent of total exports.

This is evidence of the verticalization that has been taking place in the apparel and textiles industry, observable in both national producers and foreign firms operating in the industry.[8] The only essential input which is produced in very small amounts in the region and that is largely imported from United States is sewing thread.[9] In other words, conventional *maquiladora* operations (sewing pieces and parts supplied by the sales companies in the United States) until now depended on trade preferences for such activities (payment of duties only on the value added outside the United States and the intricate system of quotas of the Agreement on Textiles and Apparel). This model has already become outmoded, partly as a result of the broader preferences of the CBTPA. When CAFTA goes into effect, granting even more significant preferences to the CACM countries, it is very likely that the *maquiladora* will cease to be economically viable and will be replaced by a much more integrated model of industry.[10] Chinese competition, based on full-package export (which also has design capabilities and the beginnings of its own brands) is hastening the transformation of Central American industry.

Thus the move toward full package in Central America has contributed to the emergence of textile and apparel manufacture clusters. In some cases, apparel producers that have shifted toward full-package produce cloth for other companies specializing in apparel. Producers of buttons, zippers, and other accessories have likewise emerged.

Although the beginnings of a trend toward the emergence of a regional cluster can be detected, for now, the clusters in the industry are primarily national, and are more developed in Guatemala, Honduras, and El Salvador than in Nicaragua, a country still specializing in the traditional *maquiladora*, or in Costa Rica, where apparel exports have become less important in relative terms. Honduran cloth manufacturing companies are beginning to export to other countries in the region. However, the existence of inefficient custom houses within the CACM and of high transportation costs between the member countries due to a poor highway infrastructure are major barriers to establishing a regional cluster.

[8] Several of the latter have their own distribution channels in the United States.
[9] This happens because the CBTPA rules of origin force Central American producers to import US sewing thread. This is going to be relaxed under CAFTA, but only by allowing the use of sewing thread from the region. There will also be tariff quotas for apparel manufactured with cloth or sewing thread from outside the region.
[10] For a detailed analysis, see ECLAC (2004).

Strengthening the cluster regionally is vital in order to be able to confront Chinese competition successfully, because in almost all the sectors comprising it there are significant economies of scale and scope. China has successfully formed a fully integrated textile and apparel cluster, with production of apparel, cloth, sewing thread, all kinds of accessories, and even machinery, which it exports to other producing countries, including those in Central America. This grants China a great advantage. In fact Chinese lower costs in producing apparel are probably due more to the existence in China of an integrated cluster than to low wages, because many production processes in the (fabric production) cluster are ceasing to be labor-intensive and are becoming predominantly capital-intensive using computerized technology.

China's competitiveness in this industry does not mean that producing apparel for export is going to disappear in Central America. Producers in the region have major competitive strengths, which governments should help to consolidate. Proximity to their main market is unquestionably an important advantage. Being two-hours away by air from the main cities in the southern United States means that United States buyers and investors are physically close to the production centers in the region, thereby allowing them better quality control and a more fluid relationship with suppliers. Moreover, Central American producers can deliver an order in the United States approximately eight days after receiving it,[11] while delivery periods for Chinese companies are necessarily longer. This advantage is very important for responding quickly to changes in consumer preferences and to demands that must be met in a short period of time (so-called "*quick response*"). Also in order to minimize the costs of keeping inventories, distributors are forcing suppliers toward a "just-in-time" model of production. This reinforces the advantages of geographical proximity.

If CAFTA, which is already approved by negotiators from the six signatory countries,[12] becomes a reality, exports from Central America will be tariff-free, while those from China would not be. Of course, exports from Central America will have to comply with rules of origin that are still quite complex and will certainly add to costs if regional producers want to take advantage of tariff preferences.

The rules of origin are set forth in Table 10. The fundamental requirement is that of using cloth and sewing thread from the region or the United States in manufacturing apparel. Neither cloth nor sewing thread from the United States is internationally competitive and whether thread manufactured in Central America will eventually be so remains to be seen.

[11] Maritime transport between Puerto Cortés, in Honduras, and the main ports on the Gulf of Mexico or Miami is just two days.
[12] The Dominican Republic recently joined the Treaty.

Table 10
Comparison of CBTPA and CAFTA Benefits by Rules of Origin of the Process

	Product	Origin of process					CBTPA	CAFTA
		Assembly	Cutting	Cloth	Sewing thread	Yarn	% MFN tariff	% MFN tariff
1	Garments (Chap. 61-63)	CACM	Outside CAFTA				100%	0 or 50% with tariff quota 100% outside quota
2	Garments (Chap. 61-63)	CACM	EE.UU.	Outside CAFTA			100% on value added	0% [1]
3	Garments (Chap. 61-63)	CACM	EE.UU.	EE.UU.	Outside CAFTA		100% on value added	0% [1]
4	Garments (Chap. 61-63)	CACM	EE.UU.	EE.UU.	EE.UU.	Outside CAFTA	0%	0% [1]
5	Garments (Chap. 61, 63, and 62, except note)	CACM	CAFTA	CAFTA	CAFTA	Outside CAFTA	0% if the cloth and thread are from the US.	0% [1]
6	Garments Selected (See note)	CACM	CAFTA	Outside CAFTA			0% if the cloth and thread are from the US.	0%
7	Fabrics and cloth (Chap 50-60)	Change of tariff heading (REO)					N.A.	0%

Source: IDB, based on draft of treaty.

Note: Boxer shorts, pajamas, nightwear, brassieres, women's dresses (cotton, synthetic or artificial fibers).

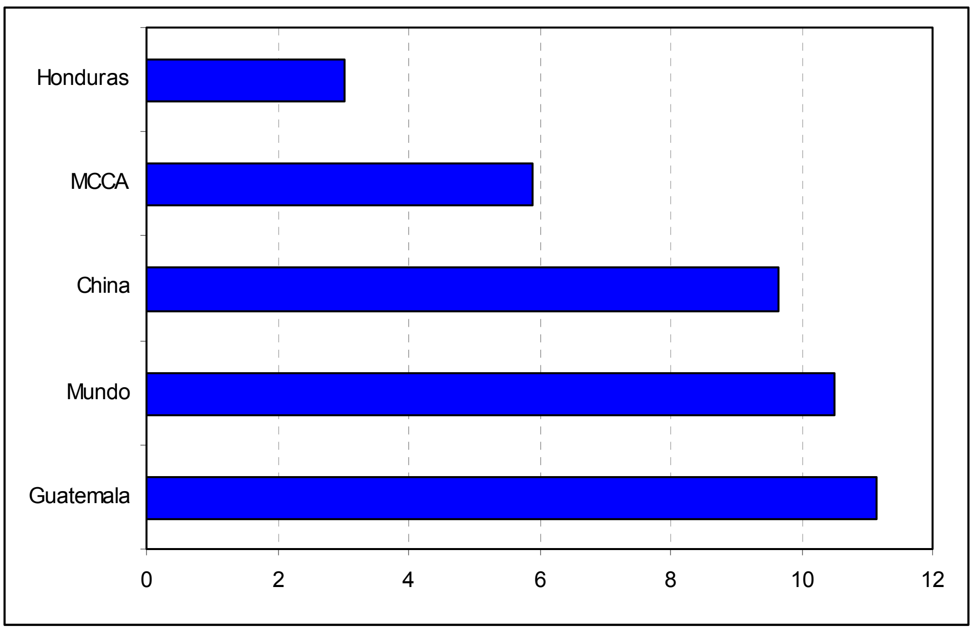
Thus when CAFTA is approved (and retroactively to January 1, 2004), apparel from Central America will enter the US market duty-free provided it is made with regional cloth (from any of the signatory countries), which must be manufactured starting with thread from the region. A *de minimis* rule was agreed upon whereby up to 10 percent by weight of the components may be not from the signatory countries without affecting the rule of origin. Accumulation of origin with Mexico and Canada is granted in apparel except for knitwear. Finally, each country has received a tariff quota for exporting apparel made with cloth or thread of any origin.

As complex as the rules of origin in the textiles and apparel industry are, there is no question that approval of CAFTA would give Central America a significant advantage in its main export market. In fact, producers in the region consider CAFTA to be essential for them to be competitive in the US market. Moreover, CAFTA will encourage the production of fabric and perhaps thread in the region. In these areas, China is very competitive and if certain pitfalls of a political nature are overcome, that Chinese companies may be expected to show interest in investing in Central America. We return to this issue in the next section.

CAFTA would help mitigate China's cost advantage over Central America in apparel manufacture. However, many believe that the tariff preference granted by CAFTA would not be sufficient to eliminate the difference in production costs of goods with large runs. While in 2002 China was facing customs duties for its apparel exports to the United

States averaging 10 percent, Central American exports were being levied a tariff averaging 6 percent (see Figure 4).[13] Yet there are estimates that average tariff equivalent of the quotas that China confronts is around 40 percent (Kathuria, Martin and Bhardwaj, 2001). Hence, the current tariff on Chinese exports to the United States is redundant. When the quotas are eliminated, the average actual tariff will fall from 40 to 10 percent, and this 10 percent would be the tariff preference that Central America's exports would have. Moreover, a surcharge on costs resulting from the rules of origin (let us say, 5 percent) has to be taken into account, and Central America's preference over China would accordingly drop to more or less 5 percent.

Figure 4
Average Tariff for Exports of Apparel to the United States, World, China, Guatemala and Honduras, 2003
(percentage of value of exports)



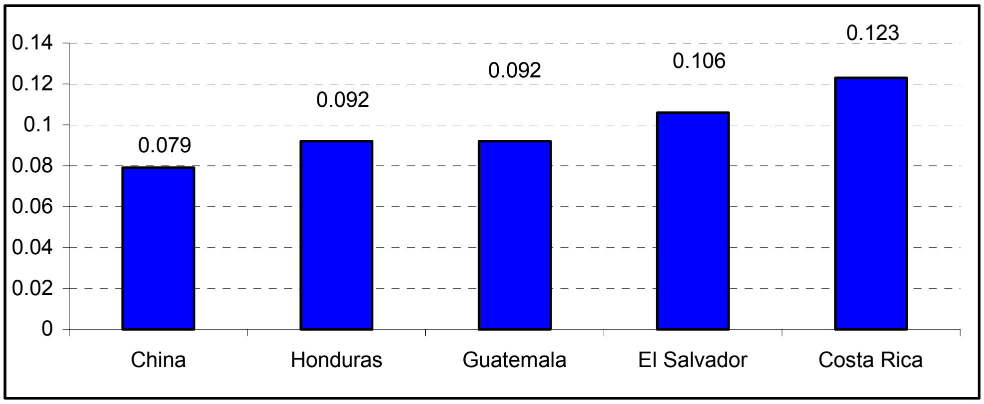
Source: IDB calculations, based on USITO.

The cost differences are probably higher. China's labor costs are approximately 15 percent lower than those of Honduras and Guatemala (Figure 5) and its electricity costs 50 to 60 percent what it costs in Honduras and Guatemala, respectively (Figure 6). In addition, it must be kept in mind that Chinese and thread are cheaper than their counterparts in the United States and that the countries of the region are obliged to use thread from the region (thus far produced only in the United States) if they want to take advantage of the trade preferences offered to them by CAFTA. While production of Central American thread may eventually become competitive, it will take time to reach

[13] It is interesting to observe that the average tariff applied to imports from Guatemala is slightly higher than that imposed on total imports. That means that Guatemala is not taking advantage of the preferences granted to it by CBTPA, perhaps for failure to comply with the rules of origin. Guatemalan exports might also be more concentrated on goods with high tariffs than total exports into the United States.

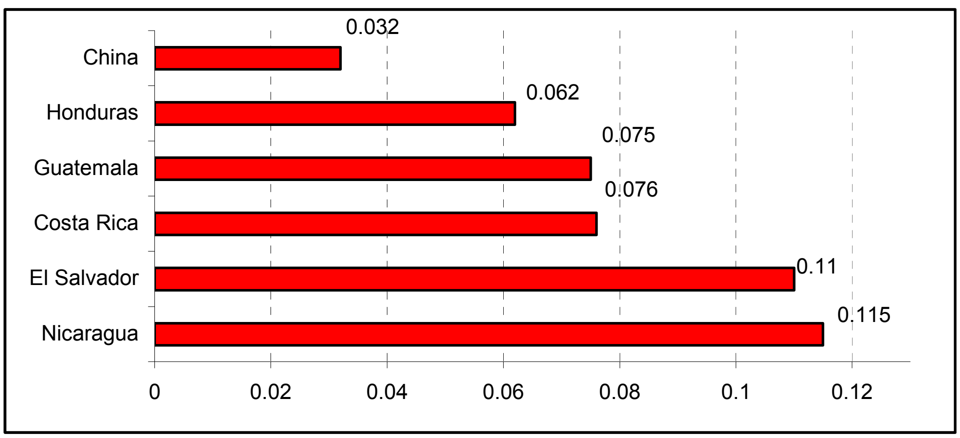
production levels adequate for costs to approach those of China, because there are economies of scale and of course a learning curve for any new activity.

Figure 5
Central America: Labor Costs in Apparel Industry, 2001
(dollars per minute of production)



Source: INCAE (2003). p. 17.

Figure 6
Central America and China: Costs of Electricity, 2001
(dollars per kw./hour)



Source: ECLAC (2004). p. 56.

If, however, apparel exports from China succeed in displacing enough Central American production, this process will never even get started. Of course, these negative factors must be counterbalanced with other more positive ones having to do with the comparative advantages of certain types of apparel production in Central America. Production of goods in these categories could increase, but over a longer time period, because expanding them is going to require new investments.

Unfortunately, long-term development policies in Central America have been limited to supporting garment-making processes typical of the *maquiladora*, which are inexorably being replaced by other types of increasingly integrated production. Hence a change of emphasis in policies for developing production is absolutely necessary. Fortunately, business people in the region began to move toward the full-package model, and there are even plans to produce sewing thread in the region. An aggressive policy to promote foreign investment in the undeveloped aspects of the cluster could be very positive for Central America's competitiveness in this complex of industries.

Apparel exports from Central America are facing other problems. First, there are high transportation costs, stemming fundamentally from the low productivity of ports and delays in getting goods across borders. The most advanced port in Central America is Puerto Cortés on the north coast of Honduras. But even the capacity of Puerto Cortés could be insufficient for handling sharp increases of exports to the United States. Puerto Cortés currently has five docks but only two fixed cranes and one mobile crane. The other ports in the region are not sufficiently technologically advanced to move cargo quickly and cheaply.

Additionally, within Honduras the road infrastructure is of good quality and the production centers are located at reasonable distances from the ports. For example, Puerto Quetzal and Santo Tomás of Castilla are 111 and 295 kilometers, respectively, from Guatemala City (INCAE, 2003, p. 19). Puerto Cortés is only 60 kilometers from San Pedro Sula and the production centers in Honduras are located along the corridor running from San Pedro Sula to Puerto Cortés, which is served by the best highway in Honduras. However, the road network is considerably poorer for sending production to the ports of a neighboring country. Thus, for example, Salvadoran and Nicaraguan exports heading toward the east coast of the United States and US ports in the Gulf of Mexico go out from Puerto Cortés.

Likewise delays at customhouses between countries impose unnecessary costs. Customs officials in the area have still not managed to synchronize their schedules and coordinate their paperwork or transit of goods. Corruption at customhouses also represents an additional cost.

Central American producers complain of the high costs of maritime transport along routes from Central America to the main ports of entry into the United States (New Orleans, Mobile and Miami). Apparently, geographical proximity would not give Central America an advantage over China, because the unit freight costs would be very similar for shipments from China to the west coast of the United States as from Central America to ports in the Gulf of Mexico. There is a perception that the problem is caused by the oligopolistic power being exercised by shipping conferences operating the routes between Central America and the United States. Without ruling out that idea, high transportation costs could also be due to the relatively low volume of the shipments, in comparison to those made by China. It is well known that economies of scale in maritime transport are very strong. According to ECLAC (2004, p. 93), the ships that ply the route between

Asia and the United States are much larger and carry much more cargo than those between Honduras and the United States.[14]

If this last interpretation is correct, then to the extent that the volume of export to the United States increases and the tonnage of ships making the journey increases, unit transport costs should decline. That means that in technical terms there are two equilibriums. Central America-United States trade tends to stay at its current levels because transport costs are high. However, if steps were taken to coordinate actions aimed at increasing the volume of trade transport costs would drop, thereby validating the competitiveness of larger volumes of exports.

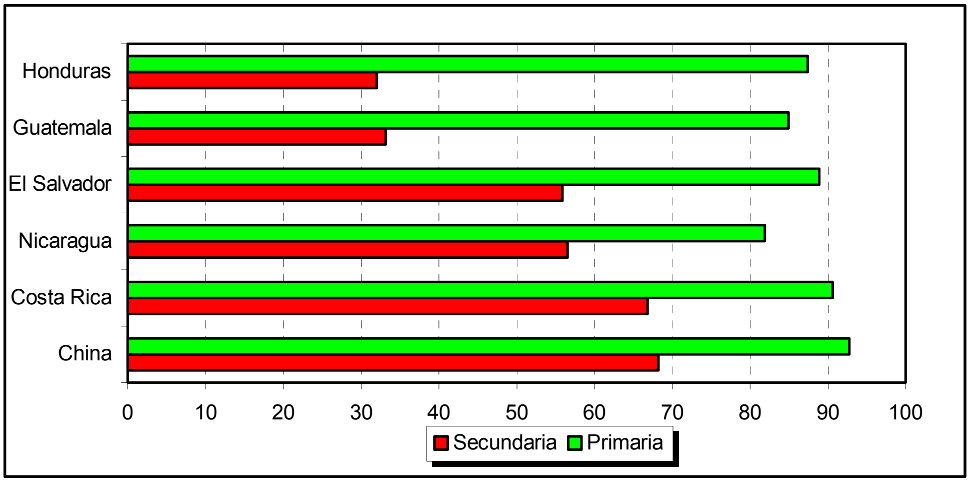
Financing exports and the purchase of capital goods is certainly another major difficulty, especially for medium sized-companies that do not have access to international financing. Full-package production requires working capital and fixed investments much higher than those of the conventional *maquiladora*. Besides the fact that interest rates in the region (except in El Salvador) are much higher than international rates, there is practically no financing for investment in Central America. This has kept companies from moving from the *maquiladora* to more sophisticated models.

It has already been said that the costs of electricity, an essential input for producing textiles and apparel, are higher in Central America than in China. Moreover, in Central America supply is more unreliable and outages are common. Some major Honduran apparel producers have had to install their own electric generator plants, which is not very efficient. Along these same lines, the high costs of international telecommunications remain a significant problem, especially in Honduras and Costa Rica, where telephone service is still in the hands of state companies (Hondutel, in Honduras and ICE [*Instituto Costarricense of Electricidad*] in Costa Rica). This latter company has a monopoly on distribution of electricity and telephone service).

Low education levels of labor present additional problems for competitiveness. While there are differences between China and Central America in terms of rates of enrollment in primary education, they are not very pronounced. The situation is quite different in secondary education. Whereas in 2000 in China the gross enrollment rate in secondary education was 65 percent of that age group, the rates for Guatemala and Honduras were no more than half of that rate (Figure 7). The rapid adoption of "full package" in Honduras and Guatemala has increased the need to have qualified workers at every level (plant, mid-management, and executives). The next step will be to pass to the design stage, at which point the demands for trained staff will be even greater.

[14] Ships used in runs between Asia and the United States have a capacity of 6,600 TEU (twenty equivalent units), while those going from Honduras to the United States are only 900 TEU.

Figure 7
China and Central America: Enrollment Rates in Primary and Secondary School, 2001[a]
(enrolled as percentage of their age group)



Source: World Bank. World Development Indicators.

[a] Net rate for primary, gross rate for secondary education. Figures for China are for 2000. The figure for secondary education in Honduras is for 1996, the last one available.

Some progress has been made in setting up institutes for higher education in textiles and apparel. Recently in Honduras the University of Textiles and Apparel [*Universidad de Textiles y Confecciones*] was set up in San Pedro Sula. The main objectives of this university are training of higher-level staff for industry, training technicians, and help for design. Likewise, in 1993 a Apparel Manufacture Technical Institute [*Instituto Tecnológico de la Confección*] was set up in El Salvador, and offers courses for mid-level management in the industry. However, these efforts must be regarded as incipient when compared with the design and management capability of Chinese producers. There are reports that in certain lines such as brassieres, Chinese producers are now moving into the stage of designing their own products. As the regional cluster becomes firmly established, it will become more feasible to finance a shared effort in the area of education.

The problem of the lack of training and higher education for the textile and apparel industry is not solely one of lack of supply. The modest levels of Central American industry do not allow for schools in the area to attain a sufficient size to operate profitably. For example, the Universidad del Valle in Guatemala established a program for engineering in textiles and apparel, but it had to close it for lack of sufficient demand to make the program viable.

In conclusion, the apparel industry is facing major challenges, partly because of Chinese competition and partly because the traditional *maquiladora* has ceased to be attractive to Central American companies operating in the industry and to their customers (the large sales chains). The sector most impacted will be that devoted exclusively to apparel. Chinese competition may deal a mortal blow to this subsector of the industry. Some observers estimate that *maquiladora* exports will drop by 20 percent in Guatemala and Honduras. This is a hefty percentage of what is left of the traditional *maquiladora* industry.

At the same time, the full-package production sector which makes apparel starting with the cloth (not from already cut pieces) whether domestic or imported from Asia, could continue growing. These sectors of the market are apparently still competitive and they have important advantages of being located in Central America, especially proximity to the designers and buyers. Indeed, it is not difficult to imagine that these sectors could keep attracting foreign (including Chinese) investment. However, the negative effect on the *maquiladora* industry is going to be immediate and movement toward a more advanced industry will take time and will have to tackle the problems already mentioned.

What is needed is a comprehensive policy toward the sector to support the emergence of producers of components and accessories. Better financing, the road network, the operation of customhouses within the region, energy supply, and prices are some of the things that need to be coordinated to make the sector more competitive in Central America.

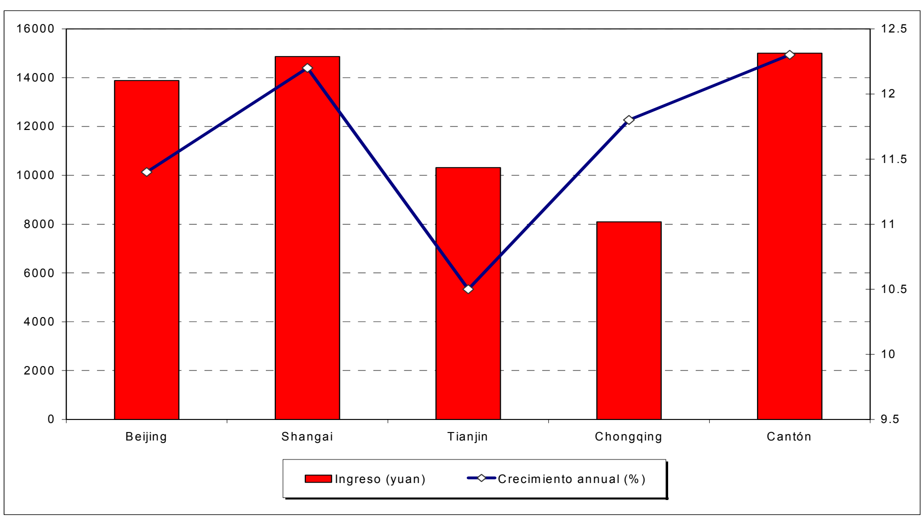
IV. New Opportunities

As has been noted, the emergence of China presents opportunities as well as dangers. These opportunities lie in potential exports to China (probably in agroindustrial goods), capturing growing flows of the new Chinese tourism, and attracting FDI from China.

A. New Consumption Patterns

The sustained growth of the Chinese economy during the past 25 years has led to a gradual rise of personal incomes, and more recently, to profound changes in patterns of consumption in the large metropolitan areas. According to the Shanghai Municipal Statistics Bureau,[15] average disposable personal income of people living in that city of over 16 million inhabitants rose from around RMB 8,000 in 1997 to over RMB 14,600 in 2003. Assuming an exchange rate of RMB 1.8 per U.S. dollar in terms of purchasing power parity (PPP),[16] this translates into somewhat more than US$ 8,100 a year per person, or to a disposable income of US$ 24,300 for a family of three persons. Shanghai is not an isolated case; in fact it occupies second place among a group of five large metropolitan cities, according to Figure 8 which gives amounts in renminbi. In more aggregated terms, it is also good to bear in mind that household consumption grew at an average annual rate of 7.2 percent in the two decades between 1978-97 and remained at 6.7 percent in the 1998-2002 period (Lin, 2004).

Figure 8
Disposable per Capita Income in Principal Metropolitan Cities of China. 2003



Source: Beijing Review (2004).

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[15] See *Beijing Review* (2004).

[16] This amount is consistent with the estimate of a per capita income of US$ 5,000 PPP in 2003 (CIA, *The World Factbook*) and official estimates of US$ 1,090 for per capita income in current dollars for this same year. A similar sum is obtained if one uses alternatively the implicit calculations for 2002, in the most recent *Human Development Report* (UNDP, 2004).

The upward trend in personal incomes has been accompanied by two other relevant phenomena. On the one hand, as is known, Chinese economic growth has been accompanied by a notable worsening in income inequality, particularly between the rural and urban populations (see World Bank. 2003). On the other hand, as was already mentioned in Section II, the pace of China's urbanization has increased very rapidly. It is clear that this phenomenon will eventually have a moderating effect on the deterioration of income inequality as the country becomes predominantly urban. It should not be forgotten that over 60 percent of the population lives in rural areas.

Without doubt, income inequality is undesirable, and it will have to be gradually lessened for China's development to be sustainable over the long run. However, it is also hard not to recognize that this inequality, combined with the huge size of China's largest cities and the rapid growth of median personal incomes, have made possible the appearance of a significant mass of consumers with a great deal of purchasing power. It is this mass which is having a powerful role in changing consumption habits in China, particularly with its profound impact on imports of goods and services. At the upper end of this group, a demand for luxury goods can now be identified, as is obvious to the casual observer in the opening of stores of companies like Armani, Prada or Louis Vuitton in Beijing and Shanghai. According to a recent article in *The Economist* (2004), this market is estimated at 10-13 million people. Other estimates (*Peoples Daily,* 2004) indicate that in 2003 this market had a volume of around two billion dollars.

Some important characteristics of the group previously identified as high purchasing power consumers may be identified. The attractiveness of products of a foreign origin is one of them, and it has been skillfully exploited by some international chains. McDonald's, for example, has around 600 outlets in China, and Kentucky Fried Chicken (KFC) over a thousand restaurants. A second characteristic, related to the first, is brand loyalty, especially to foreign brands. According to Victor Yuan, president of the consulting company Horizon Research Group, the consumption decisions of 51 percent of consumers are guided by loyalty to foreign brands, while only 2 percent of them are loyal to local brands (the other 47 percent is not brand loyal in its decisions).[17] Finally, the trail-blazing role played by younger segments in defining new consumption habits and trends should be noted. This fact is related to the special attention paid by parents to their heirs within the context of China's one child per family policy, which has led to calling these young people the "little emperors."

Going beyond the demand in large cities, it is worth noting that China, especially in view of its huge size, has become an extraordinarily open economy. Imports as a percentage of its GDP have risen from less than 8 percent in 1980 to around 32 percent in 2003 (World Bank, *World Development Indicators*). Among these imports, the demand for consumer goods is growing rapidly. The United States in particular has been quite successful in penetrating this market. According to the US Department of Agriculture (USDA, 2004), exports of consumer goods to China rose at an annual rate of 30 percent between 1998 and 2003, when it reached US$ 439 million (see Table 11). This opening to imports has been accompanied by a continual lowering of tariffs, as may be seen in Table 12.

[17] Presentation to the Denver China Forum, University of Denver, Colorado, whose theme was "Taking the Pulse of the Chinese Economy: Challenges and Opportunities," May 8, 2003.

Table 11
Exports of Agricultural Consumer Products from the United States to China, 1998-2003
(thousands of dollars)

	1998	1999	2000	2001	2002	2003
Other products	19,313	18,334	34,583	58,354	41,975	135,645
Chicken and poultry	28,889	42,093	35,994	29,575	42,621	72,272
Processed fruits and veget.	9,337	15,883	25,734	34,134	43,328	59,498
Red meat F/C/F	15,278	15,192	22,099	40,532	45,805	46,867
Dairy products	13,908	17,748	22,302	40,267	32,135	38,869
Fresh fruit	11,333	1,866	23,147	29,059	24,280	33,335
French fries, etc.	8,549	14,020	20,425	18,208	15,305	17,811
Seeds	2 ,337	3,702	8,895	10,164	18,554	15,080
Pet foods	490	977	1,454	3,390	5,822	6,540
Fruit and vegetable juice	1,490	1,734	1,223	2,451	5,347	4,248
Wine and beer	2,404	3,826	1,420	2,697	3,260	2,828
Breakfast cereal	508	323	661	861	1,459	2,085
Fresh vegetables	3,735	3,657	5,080	3,005	788	1,662
Red mean P/P	2,918	1,125	863	783	200	1,240
Eggs	139	340	266	1,118	523	870
Baby food	1,029	1,358	1,129	1,025	1,462	598

Source: US Department of Agriculture (1994).

Table 12
Average import duties
(percentage of cif value of imports)

	All products		Primary products		Manufactures	
Year	**Unweighted**	**Weighted**	**Unweighted**	**Weighted**	**Unweighted**	**Weighted**
1992	42.9	40.6	36.2	22.3	44.9	46.5
1993	39.9	38.4	33.3	20.9	41.8	44.0
1994	36.3	35.5	32.1	19.6	37.6	40.6
1996	23.6	22.6	25.4	20.0	23.1	23.2
1997	17.6	18.2	17.9	20.0	17.5	17.8
1998	17.5	18.7	17.9	20.0	17.4	18.5
1999	17.2	14.2	21.8	21.8	16.8	13.4
2000	17.0	14.1	22.4	19.5	16.6	13.3
2001	16.6	12.0	21.6	17.7	16.2	13.0
After WTO entry	9.8	6.8	13.2	3.6	9.5	6.9

Source: Bhattasali et al (2004).

B. The Case of Coffee

How promote coffee consumption in a tea-drinking country? That was the challenge posed to the public relations company Hill & Knowlton by the International Coffee Organization in 1997. Familiar with the new trends emerging in the Chinese consumer market, Hill & Knowlton decided to "convert the act of drinking coffee into a modern and stylish life-style" and for four straight years (1998-2001) it organized Coffee Festivals in Shanghai, where promoting this product was combined with fashion shows.[18] Actually, coffee was not so unknown in China, having been introduced by a French missionary in 1887 in Yunnan province. The Chinese government made an unsuccessful attempt to develop coffee production in this region in the mid-1960s. A new attempt was made in 1988, in conjunction with the United Nations Development Program and with the participation of Nestlé. Consumption of instant coffee has been developing since that time, primarily with the involvement of Nestlé and Maxwell House. In any case, coffee consumption in China is still in its infancy, according to the International Coffee Organization. In 2002 China imported approximately 19,600 tons of coffee, which amounts to 15.3 grams per inhabitant. This represents an increase of 13 grams per inhabitant in 1991.[19]

The recent challenge is that of introducing consumers to high quality coffees. There are at least three reasons for being optimistic about this challenge. The first, already mentioned, comes from the natural inclination of Chinese consumers to adopt western consumption habits when they are suitably presented. The second reason is that coffee culture flourished in the Shanghai of the 1930s. Finally, some light may be shed by noting the example of Japan, another great traditional consumer of tea. Starting from a negligible level of consumption in the 1960s, it has risen to where it is now the third largest coffee consumer in the world (around 3.5 kilos per person a year). South Korea is another interesting example of a country that has recently become interested in consuming coffee and whose per capita consumption is around 1.8 kilos per person a year (data from the International Coffee Organization).

The Chinese market potential for high quality coffee has not gone unnoticed by some major actors in this sector. Example one: the Seattle company Starbucks has now set up around a hundred of its cafes in China (not counting Hong Kong), primarily in Beijing and Shanghai. Example two: recently, in early 2004, the president of Café Britt in Costa Rica visited China for the first time. The reason was the purchase by a Chinese entrepreneur of a container of his company's coffee in order to introduce it to the Beijing public. The Café Britt executive was enthusiastic over the potential offered by this hitherto unknown market, which could also serve for offering other company products, such as chocolates. The news article reporting this story on the company's web site is revealing of how little knowledge there is in Central American countries of the potential and the characteristics of the Chinese market.[20] In our interviews with executives in

[18] See Hill & Knowlton (2004).
[19] International Coffee Organization. Other information in this paragraph comes from Dharmananda (2003).
[20] See http://www.cafebritt.com/newsletter/2004/06/president.htm

Guatemala we could observe an even greater unawareness of this market.[21] Example three: according to BBC news,[22] the Council of Coffee Exporters of Brazil intends to carry out a campaign to promote its product in China. The approach proposed is to distribute free samples using Brazil's coffee reserves.

C. Tourism from China

Although tourist flows from China to the rest of the world are relatively recent, this is an area where events are moving swiftly. Until 1982 it was practically impossible for an ordinary Chinese citizen to travel outside the country, not only because of the economic obstacles connected with the low incomes at that time, but because the Chinese government imposed strict controls on such movements. Starting that year it became possible to travel to Hong Kong and Macao, although still under a quota system. In 1988 it became possible to travel outside the country for family reunions. Thailand was the first destination approved for such a trip, and Malaysia and Singapore were added in 1990 and the Philippines in 1992. Restrictions on access to foreign exchange meant that for these visits to be approved it had to be shown that the travel expenses were being paid by relatives in those countries. It was only in July 1997 that a system was established for regulating trips outside the country paid for by Chinese citizens themselves. The main element is this system is the granting of ADS (*Approved Destination Status*) to a growing number of countries by the government of China. In principle a country requests an ADS from China, and it is granted as a result of negotiations starting with this request. The ADS allows groups of Chinese tourists generally from the metropolitan areas of Beijing, Shanghai, and Guangzhou to travel to the country in question. Australia and South Korea were the first countries to receive this status (1999), followed by Japan in 2000 and by Vietnam, Cambodia, Myanmar, and Brunei in 2001. China's entry into the WTO at the end of 2001 led to various modifications in its system for administering outbound tourism, all having the effect of liberalizing the system. The main changes are the elimination of the quota system for trips to Hong Kong (as of December 2001), the elimination of letters of invitation that Chinese citizens used to have to show in order to request a passport (2002), and starting in 2004, simplification of the issuance of passports for Chinese citizens who live in large and medium-sized cities.

By May 2002 a total of 19 countries or areas had received an ADS, most of them in Asia. Since then the most important change has been the signing of a tourism agreement between China and the European Union in February of 2004. This agreement includes the ratification of the Memorandum of Understanding on ADS that had been initiated in October 2003, and also measures applicable to Chinese tourists who exceed the period of their legal stay in Europe. This is the largest ADS thus far granted by China and it includes the signatory countries of the Schengen Convention on free movement of persons.[23] Other important new developments in this field are the ADSs granted to Brazil in May of 2004 (during President Lula's official visit to China), to Argentina in June (during President Kirchner's official visit to China), and to Mexico in August. These

[21] Interview with members of the Board of Directors of ANACAFE, Guatemala City, August 4 , 2004.
[22] BBC News Online, "Brazil coffee barons target China," (http://news.bbc.co.uk/2/hi/business/3754325.stm)
[23] See http://Europe.eu.int/comm/external_relations/china/intro/ip04_196.htm

are significant because they are the first countries with this status in the Americas, and particularly in Latin America.[24]

With the formalization of the system of travel outside the country and its subsequent liberalization, the number of Chinese travelers outside the country has increased exponentially. As Table 13 shows, the number of travelers has increased from 3.7 million in 1993 to over 12 million in 2001. The World Tourism Organization has estimated that in 2020 the number of Chinese traveling outside the country will reach 100 million people, making China number four in the world, with 6.4 percent of international tourism (Table 14).

Table 13
Trend of Outbound Tourism from China, 1993-2001

Year	Visitors (1,000)	Change (%)
1993	3,740	--
1994	3,734	-0.2
1995	4,520	21.1
1996	5,061	12.0
1997	5,324	5.2
1998	8,426	58.3
1999	9,232	9.6
2000	10,472	13.4
2001	12,133	15.9

Source: World Tourism Organization (2003)

Table 14
Main Countries of Origin of Tourism to China, 1995 and 2020

Base year (millions)		Estimate (millions)	Average Annual Growth (%)	Share (%)	
	1995	2020	1995-2020	1995	2020
1. Germany	75	153	2.9	13.3	9.8
2. Japan	23	142	7.5	4.1	9.1
3. United States	63	123	2.7	11.1	7.9
4. China	5	100	12.8	0.9	6.4
5. United Kingdom	42	95	3.3	7.4	6.1
6. France	21	55	3.9	3.7	3.5
7. Holland	22	46	3.0	3.8	2.9
8. Italy	16	35	3.1	2.9	2.3
9. Canada	19	31	2.0	3.4	2.0
10. Russian Federation	12	31	4.0	2.1	1.0
Total (1-10)	**298**	**809**	**4.1**	**52.7**	**51.8**

Source: World Tourism Organization (2003)

[24] See
http://news.morningstar.com/news/DJ/M08/D19/200408191457DOWJONESDJONLINE000564.html,
http://www.china.org.cn/english/2004/Jun/99789.htm and
http://www.sinomedia.net/eurobiz/v200407/briefs0407.html

It is these estimates that explain the interest many countries have in establishing tourist agreements with China. In 2002, for example, there were approximately 650,000 Chinese tourists in Europe and twice as many European tourists in China. With the signing of the treaty between China and the European Union, the latter can expect that in the near future a balance will be established between these flows. In the case of Mexico, which draws eight percent of its GDP from tourism, the opening to China has an irresistible potential. Mexico has also just signed a commercial aviation agreement with China, which will allow direct commercial flights between the two countries to begin. Brazil should also begin flights between São Paulo and Beijing in the next few months. From the perspective of Central America, establishing an air link between Mexico and China is possibly the most interesting news, because it would facilitate movement of Chinese tourists toward their countries. Of course, in order to realize this potential, Central American countries would have to negotiate arranging an ADS with China. This also brings up again the issue of the complex triangular relationship between Central America, China, and Taiwan.

D. Flows of direct investment from China

As is well known, China is one of the main destinations of FDI. Less known is the fact that direct investment from China is growing rapidly to both developing and developed countries. Chinese investment is not limited to securing raw materials for its industry but also extends to the manufacturing sector. A recent technical report from UNCTAD (2003) addresses this topic. By 2002 Chinese companies had accumulated around US$ 35 billion in assets (based on balance of payments Figures). Chinese companies are engaged in a wide range of sectors and operate in all regions of the world, including Latin America. Table 15 indicates the distribution by countries of where Chinese FDI is going overseas, including three in Latin America (Brazil, Mexico, and Peru).

Table 15
Approved Direct Investment from China in 30 Principal Destination Countries. 1979-2002
(value in millions of US$)

Country	1999		2000		2001		2002		1979-2002	
	Nº	Sum	Nº	Sum	Nº	Sum	Nº	Sum	Cumulative number of projects	Cumulative value of investment
Total	220	590.6	243	551.0	232	707.5	350	982.7	6.960	9,340.0
Hong Kong	24	24.5	15	17.5	26	200.7	40	355.6	2.025	4,074.3
United States	21	81.1	15	23.1	19	53.7	41	151.5	703	834.5
Canada	1	0.1	8	31.7	4	3.5	4	1.2	144	436.0
Australia	3	1.7	13	10.2	6	10.1	15	48.6	215	431.0
Thailand	3	2.0	6	3.3	9	121.3	5	3.9	234	214.7
Russia	12	3.8	14	13.9	12	12.4	27	35.5	482	206.6
Peru	1	75.7	1	0.001	2	3.1	..	..	20	201.2
Macao	3	0.2	4	0.5	6	2.4	2	2.0	229	183.7
Mexico	2	97.0	1	19.8	1	0.2	1	2.0	45	167.4
Zambia	4	6.7	3	11.6	3	4.3	1	0.3	18	134.4
Cambodia	13	32.8	7	17.2	7	34.9	3	5.1	61	125.0
Brazil	1	0.5	3	21.1	4	31.8	8	9.3	67	119.7
South Africa	14	12.8	17	31.5	2	12.4	3	1.7	98	119.3
Korea	1	0.1	5	4.2	2	0.8	7	83.4	62	107.8
Vietnam	2	6.6	17	17.6	12	26.8	20	27.2	73	85.0
Japan	1	0.5	2	0.3	6	1.7	11	18.2	236	82.1
Singapore	6	2.9	6	1.0	3	0.4	6	2.1	172	71.7
Myanmar	1	6.6	7	32.9	3	1.8	5	15.8	38	66.1
Indonesia	0	19.0	1	8.0	2	0.6	6	3.7	59	65.0
Mali	1	1.2	1	28.7	..	..	..	..	5	58.1
Mongolia	15	40.3	12	5.4	7	4.5	7	3.4	69	56.6
Germany	1	0.3	1	1.6	3	3.5	6	2.8	150	51.5
New Zealand	..	..	..	..	2	0.9	2	0.9	26	48.7
Egypt	5	3.8	3	9.7	2	1.4	3	16.3	27	48.5
Oman	..	..	..	..	..	..	1	17.5	70	47.2
Papua New Guinea	..	..	1	0.9	..	..	..	..	20	44.7
Nigeria	2	1.6	1	2.6	8	6.4	9	11.4	49	44.3
Tanzania	3	16.3	1	1.0	..	..	2	0.4	19	41.3
Kazakhstan	7	17.2	5	7.7	1	0.3	3	26.9	51	39.6
Laos PDR	1	2.0	2	24.4	1	1.2	2	61	18	36.6

Source: Ministry of Trade of China, cited in CNUCED (2003).

With the exception of a few investments in the textile industry in Honduras, there are no instances of direct investment from China in Central America. Clearly without diplomatic relations and guarantees for direct investment, there are not likely to be any. However, the very factors that should assure the survival of at least some sectors of the textile and apparel industry, also constitute reasons why Chinese capital might be attracted. For example, Central America's proximity to North American markets, which allows a quick response to the demands of consumers whose preferences are continually

changing, will be of interest to Chinese investors and would lend itself to cooperative projects between Chinese and Central American companies. The creation of these "export platforms" could also take place in other sectors of the manufacturing industry, such as the electrical, electronics, and auto parts industries.[25]

[25] In Honduras, the production of electric harnesses for cars and wooden dashboards for luxury cars are two rapidly growing industries.

V. Conclusions and Recommendations

A. Summary of Findings

The preceding analysis leads us to reach the following conclusions:

China's Presence in the World

The emergence of China is one of the most prominent contemporary developments and it helps define the international scene. This process, which began with the economic reforms of 1978, is far from having run its course, and it can be said that China's rapid growth should continue for the foreseeable future. Given the country's size, the impact of China's emergence is felt practically everywhere in the world and in all sectors of economic activity. This impact is likely to become even greater as the Chinese economy looms ever larger in the world. China's increasing integration into the world economy, reflected in particular in its recent accession into the WTO, and the forces of globalization will contribute to this trend.

Relations between Central America and China

This relationship is very limited and little developed in all aspects, whether economic, political, or cultural. This situation is explained partially by the distance between the two regions, China's scarce interest thus far in Central America, and the strong and lasting ties that Central America has had and still has, primarily with the United States and Mexico, but also with Europe and the rest of Latin America.

There is yet another powerful factor that helps explain the lag in the development of relations between China and the countries of Central America, as compared, for example, with relations between China and countries in South America. This factor is Taiwan, whose diplomatic success in cultivating relations with the countries of Central America, backed by its economic aid programs, has constituted an obvious obstacle to the development of normal relations with China. It may legitimately be asked whether the benefits of economic aid from Taiwan compensate for the potential losses that could be attributed to not having an economic relationship with China. In any case, an obvious consequence of the lack of normal relations with China is that there is little knowledge of the country, its economy and its culture in Central America. This lack of knowledge leads to a paucity of ideas and initiatives about how to take advantage of the economic potential offered by the growth of China.

The Impact of China on Central America

The primary effect of China on Central America is experienced by the textile and apparel export sector, which has to face competition from Chinese products in its main market, the United States. This effect will be felt more sharply starting in 2005 with the expiration of the Agreement on Textiles and Apparel and the quota regime associated with that Agreement. As has been stated in Section III, China's impact on this sector of

the economies of Guatemala and Honduras is real and is based on a set of advantages possessed by China: low cost of factors of production, particularly energy and labor, and vertical integration of production. Although the case of the textile and apparel industry is by far the most important, other sectors such as furniture production, will also be affected.

Opportunities Offered by China

A rapidly growing economy like that of China presents challenges to all its competitors. On the other hand, rising incomes imply increased imports, and in China that growth has been extraordinary. As shown in Section IV, demand for consumer goods, particularly agricultural products, has increased significantly. The amounts are relatively small, but the trend points toward interesting and conceivably great opportunities for potential exporters. This report dealt in some detail with the case of coffee, which is particularly important for both countries (Guatemala and Honduras), and its potential is unquestionably important. There are no doubt possibilities for other final consumer goods of agricultural origin as well.

Additionally, Guatemala and Honduras have a rich tourist potential, as do other countries in Central America. The demand for tourist services from China is already strong, and its growth projections are well documented internationally. The Chinese authorities are gradually but decidedly liberalizing the international movement of Chinese citizens and in particular they have signed many agreements to facilitate travel by Chinese tourists, even in the Americas (Argentina, Brazil, and Mexico). The obvious attractive prospects opened by the convergence of Central America's tourism potential and the demand for tourism services from China are impeded by the absence of diplomatic relations between China and the countries of the region. That has been a recurring theme throughout this study.

Finally, a third route for exploring opportunities is the identification of possible direct investments by China in Honduras and Guatemala. There have already been some isolated cases of investments in the apparel sector in Honduras and it is easy to imagine that in the future Chinese companies would be interested in investing in the region to take advantage of its geographical advantages vis-à-vis North American markets, which will be accentuated once CAFTA is approved. Chinese investments could unleash a process of whereby the competitiveness between the two regions would partially level off, and that would obviously be beneficial to Central America. Once more, normalizing political relations between China and the countries of the region seems to be an indispensable condition for Chinese investment on any significant scale.

B. Recommendations

On the basis of these findings, this study identifies some areas of action and offers some specific proposals on which the Inter-American Development Bank can work together with governments to fill in the gaps noted above, meet the challenges posed, and take advantage of existing opportunities.

Improve the Competitiveness of Central American Export Sectors

Only two proposals are made here and they are not so much about specific policies as a change of focus. Central America must rethink the role of the state in a context of integration into the world economy as central development model. Of course we are not advocating the use of subsidies, because they are fiscally expensive in a situation in which the countries are not in a position to undertake expenses of this kind and because they are not what the region needs. The role of the state should be that of coordinating private decisions which must be made jointly and without which the private sector will not make the investments needed to strengthen the emerging clusters.[26]

Proposal 1. The countries of Central America must shift from a system of supporting activities in Free Trade Zones – which, by design have few links to the rest of the regional economy and are based on their competitiveness in low labor costs – to a model of production that is much more integrated nationally and regionally. This is particularly important in the textiles and apparel industry, where productivity is increasingly based on economies of scope and of scale. To be able to compete with China successfully in this industry, the countries of the region must strengthen the thread/textiles/apparel/accessories cluster, and take advantage of proximity to the United States and the advantages of CAFTA. Policies to foster industry must explicitly make provision for this need. Strengthening the CACM, lowering intraregional transaction and transport costs, and improving ports is essential for the emergence of a powerful regional cluster. Foreign investment policies should put emphasis on attracting those companies with state-of-the-art technologies and that are competitive in specific sectors of the cluster (for example, textiles and sewing thread) in which the region is weak. Chinese companies could possibly be very interested in such investments.

Proposal 2. Be very alert to emerging competitive advantages. The countries of the region show evidence that they are beginning to diversity their manufacturing exports. In Honduras, for example, an auto parts production cluster is in formation, specifically making electrical harnesses and wooden dashboards for luxury cars. The state should support the diversification of export manufacturing production by coordinating the actions of the private sector. This will be helpful for becoming less dependent on apparel exports. These sectors could also be of interest for Chinese investment, particularly after approval of CAFTA. China is rapidly becoming internationally competitive in the automotive industry.

Increase Knowledge about China in Central America

The proposals in this area of action seek to remedy the situation of ignorance of China in Central America, a task that is prior to any other.

[26] Hausmann and Rodrik (2003) argue in favor of grants to entrepreneurs with new ideas that can help expand the range of comparative advantages; in their words, subsidies to pay a portion of the fixed costs of "self-discovery." These arguments are fascinating but treatment of them is beyond the scope of this study.

Proposal 3. The countries of the region, perhaps jointly through their regional bodies for economic cooperation and integration, could develop an ongoing cycle of forums on the Asian, and especially the Chinese, economy, to be held throughout the five countries of Central America. The lecturers could be Chinese experts or North American or South American experts on the Chinese economy. The same expert could make a tour giving the same speech in the five countries of Central America. That would not take more than a week and would surely include press interviews and meetings with high government officials. This approach could also be combined with holding one or two-day workshops with the participation of various experts aimed at academia, the private sector, and government officials. The workshops would have a lesser scope than the forums, but they would have the advantage of enabling a smaller but more knowledgeable audience to delve further into the issues considered.

Proposal 4. Likewise, the countries of the region and their subregional bodies could encourage publicizing successful stories of economic relations with Asia in general and with China in particular. In Central America, for example, there is little information about progress made by Mexico and South America in exporting to China; all the emphasis in the region is focused on the threats to apparel exports, but it does not go any further. Nor is there much information on the fact that China is an exporter of capital to other countries, let alone that Chinese tourists are now beginning to visit other countries. This proposal would have to be carried out through writing and/or talks by business people who have paved the way in exporting to the Chinese market or by academics who have been following this process.

Proposal 5. Complementing the previous proposal, which would be more focused on the private side, it would also be important to publicize in Central America innovative policies or steps that other Latin American governments – e.g., Chile, Argentina, Mexico, and Brazil – might be pursuing to increase their exports to China and attracting investment from that country. In this instance the presentations could be made by government officials or business people from those countries.

Proposal 6. With the aim of systematizing activities emerging from the foregoing proposals, research into the Chinese economy could be encouraged. Instruments such as LAEBA (Latin American/Caribbean and Asian/Pacific Economics and Business Association, an initiative of the IDB and the Asian Development Bank) could be used for that purpose.

Proposal 7. The countries of the region, perhaps with help from China, could promote the formation of a grant fund, the purpose of which could be to foster visits by government officials, business people, journalists, and academics from Central America to China. This has been a common practice of governments like those of Japan and Taiwan, and has made it possible to experience directly the success of emerging economies. Impressions created in visits of this kind tend to have more impact and last longer than any cycle of conferences or distributing publications. Obviously on the Chinese side it would entail organizing a set of talks and visits to selected places for a ten-or fifteen-day period.

Strengthen the Relationship between Central America and China

Proposal 8. Central American governments are not willing to break diplomatic relations with Taiwan in order to establish them with China, nor would it be the intention of this study to suggest it. However, that does not mean that Central American countries should not try to establish trade relations with China. Central American countries should become aware of the tremendous potential that China represents, and hence they should seek to open trade offices in China – to achieve economies of scale, consideration could be given initially to setting up one office for the five countries– and inviting the government of China to open trade offices in the Central American countries. To accentuate economic ties it is crucial that the countries have at least a trade representation to facilitate operations between the private sectors and to handle getting visas and other permits that may be required.

Proposal 9. There are many possible ways for countries that do not have diplomatic relations to be related commercially. There can be bilateral chambers of commence, bilateral committees for promoting investment or various economic activities, working groups within international organizations in which these countries participate (such as the WTO and perhaps eventually the IDB itself). It is interesting to note that Taiwan and China, for example, normally rotate places within many organizations of this kind.

Proposal 10. The countries could encourage the creation of academic ties between Central American countries and China, particularly agreements on academic, scientific, and technological exchange between research institutes and between universities in both areas. The structure already existing between these countries and Taiwan, on the one hand, and between Taiwan and China, on the other hand, could be utilized, giving Taiwan the role of link between both parties. Again LAEBA could be a good instrument for facilitating this type of link.

Proposal 11. The countries of the region should envision an eventual incorporation of Central America into APEC. Initially, the emphasis could be placed on having the delegates from the five countries attend selected APEC forums as observers, but subsequently they would have to be brought in as full members of this initiative. Membership in APEC automatically makes countries aware of the importance of the Chinese market, because it is the main trading partner of this region. Other Latin American countries such as Mexico, Peru, and Chile are fully incorporated into this initiative, but the Central American countries have shown surprisingly little interest in it, even though they are also geographically part of the Pacific Rim.

Study the Prospects for the Apparel and Textile Sector in Greater Depth

Proposal 12. There is a need for a study in the United States to determine the possible patterns of behavior of the main buyers of textiles and apparel in that country. Perhaps the IDB could sponsor such a study. At the moment, very speculative scenarios are circulating in Central America, ranging from a very severe impact to no impact. The assessments are nothing but perceptions of how North American companies would react

to the end of quotas. To go beyond this comparison of perceptions, it would be important to do a study that would survey the main North American importers as soon as possible. This study would make it possible to have a more solid foundation for forecasting what will happen starting in 2005.

Take Advantage of the Opportunities Offered by China

Proposal 13. With the sponsorship of international and regional institutions, studies could be commissioned to analyze the logistical limitations for exporting to China and identify limitations that could exist in Central American countries to allowing Chinese investment in the region. Exporting to China would seem to be an excessively arduous undertaking because of the long distances (despite which importing takes place), lack of knowledge of the customs situation in that country, and the lack of trade contacts with it. A few studies could clarify the situation for Central American governments and exporters on possible routes, transportation cost, customs requirements, and main centers of trade. These studies should later be broadly circulated on the Internet and presented to the trade organizations of the five countries of the region.

Proposal 14. Section IV of this study constitutes an initial contribution for identifying sectors that could have an export potential to Asia in general and China in particular, or sectors that could draw direct foreign investment from those countries. However, this study needs to be expanded. Central America's export menu has to be compared with China's import menu. This exercise would have to be done for the agroindustry sector, which is where Central America would have the greatest potential. The results of such studies would have to be broadly publicized in the region, particularly to business people and their organizations.

Proposal 15. It is proposed that pilot plans be set up for training human resources for developing export capacities of the sectors identified in Proposal 12. One example of the application of this proposal is the tourism industry. In this case, training programs involve being aware of the profile of the Chinese tourist and also workable use of the Chinese language for preparing (or overseeing the preparation of) promotional materials aimed at that market.

These are some specific proposals for addressing the issues noted in this study. As previously stated, the growth of the Chinese presence and its impact on Central America is inevitable. Even though this presence brings with it challenges and opportunities, there is a fundamental asymmetry between these two propositions. The challenges and their generally negative effects would occur no matter what, albeit possibly moderated by mitigating actions. The opportunities, on the other hand, exist only potentially and taking advantage of them will require the taking up of positions that are active and well informed. This set of proposals seeks to correct this fundamental asymmetry.

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