European Community Research Institute

CENTRAL AMERICAN INTEGRATION

Report for the Commission of the European Community
Central American Integration

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Joaquin Roy
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This publication is the final summary of a study (composed of 13 appendices, to be published at a later date) sponsored by the Commission of the European Community. Its content is the sole responsibility of the authors, and it is independent of the attitudes, perceptions, or opinions of the Commission.
INTRODUCTION

The five republics of Central America have dreamed of integration ever since the collapse of the Central American Federation in 1838. Many schemes were launched in the following century to integrate the area; all ended in failure, and some ended in war. (See Appendix 13.) Despite the rhetoric of union, the countries remained isolated from each other with virtually no trade and investment links. Transport between the countries of the isthmus was extremely difficult by land and time-consuming by sea.

With the launch of the Central American Common Market (CACM/MCCA — throughout this report MCCA is used, referring to the Spanish, Mercado Común Centroamericano.) in 1960, it seemed that the old dream of integration might finally be realized. Intraregional trade grew rapidly, reaching over 25 percent of total trade by the end of the decade. A new class of entrepreneurs was formed in the emerging industrial sector who regarded the region and not the nation as the relevant market. In line with the increase in intraregional trade, the transport links began to improve; among members of both private and public sectors, air travel facilitated the communications required to sustain the integration scheme.

The withdrawal of Honduras from the MCCA at the end of 1970, following the war with El Salvador, was the first indication of mortality in the integration process. Trade between El Salvador and Honduras was blocked for ten years, and communications in the region were made more difficult. Intraregional trade continued to grow throughout the decade, but the integration process had lost its dynamism. Extraregional trade grew faster than intraregional trade as countries in the region responded to the improvement in the net barter terms of trade by once again focusing on traditional primary product exports. Any hope of expanding extraregional exports of non-traditional products was blocked by the protectionist nature of the MCCA, which opposed exports of such products outside the region.

Reconstruction of the Nicaraguan economy after the fall of Somoza in 1979 at first sparked intraregional trade, and the value surpassed $1,000 million in 1980 for the first time. However, the advent of the debt crisis, the measures taken to suppress imports, and the rise in non-tariff barriers on intraregional trade undermined the MCCA in the next five years. Indeed, the collapse of intraregional trade was spectacular, with the value falling to $470 million in 1986. A modest recovery in the second half of the decade was not sufficient to restore the 1980 level of trade, and as late as 1991 the proportion of intraregional trade in total trade was still less than 15 percent.

Our study (See Appendix 1.) makes clear that fluctuation in three variables had a particularly strong impact on the value of intraregional imports in the 1980s: gross domestic product (GDP) per capita in constant prices, the real exchange rate, and the proportion of intraregional trade passing through the regional clearing house, i.e. Cámara de Compensación (CC). Thus, the fall in GDP per capita throughout Central America at the beginning of the 1980s reduced the demand for imports from all sources (including the rest of Central America). At the same time, the need to bring about a rapid adjustment of the external sector forced the republics to devalue the real exchange rate, which made imports more expensive. Finally, the collapse of the CC, which had been used until the beginning of the 1980s to finance virtually all intraregional trade, had a strong negative impact on the demand for intraregional imports.

This report is based upon supporting materials contained in 13 separate appendices, to be published at a later date, a listing of which is contained at the end of this document. In the text of this report, reference is made to those appendices, but footnotes have not been used in order to reduce the report's complexity.
As the level of real GDP per capita begins to recover in the 1990s and as countries move toward exchange rates that are much more stable in real terms, it is to be expected that the level of intraregional trade—irrespective of other changes with regard to integration—will increase. The efforts to revive the CC so far have not met with success. (See Appendix 9.) Yet our data analysis shows that the modest recovery in intraregional imports after 1986 took place despite the collapse of the CC. The private sector was able to increase the volume and value of intraregional trade by making use of soft (local) currencies, hard (dollar) currencies, and even barter. Thus, what matters for the level of intraregional trade is not so much the existence of a regional clearing house, however desirable, as the existence of a functioning payments system.

In the 1960s and 1970s, the CC in effect was the payments system, but the situation has become much more complicated in the last decade. Furthermore, in the last few months the desperate shortage of foreign exchange has been turned into an excess. Neither the central banks nor the private sector wish to burden themselves with a payments system which is perceived as inflexible and bureaucratic. Yet it is difficult to believe that the excess of dollars is likely to be permanent, and we believe it is sensible to preserve the CC as part of a multifaceted payments system whose role can be expanded if difficulties in access to foreign exchange should arise in the future.

The collapse of intraregional trade after 1980 was associated with the adoption of stabilization and adjustment programs that obliged each republic to expand exports and reduce imports in an effort to generate the foreign exchange resources needed to service the public external debt. A new model of development began to take shape, emphasizing the need for promotion of non-traditional exports and restoring extraregional exports as the engine of growth. In this export-led growth model, there was at first no room for regional integration. The MCCA was seen as an obstacle because of the anti-export bias implied by high levels of tariff protection. Indeed, the MCCA was seen as having promoted those (capital-intensive) sectors in which Central America had a comparative disadvantage rather than those (labor-intensive) sectors in which its competitive advantage was expected to be found in international trade.

The export-led growth model has not been without its successes. Costa Rica in particular has been very successful in increasing non-traditional exports to the rest of the world, and Guatemala also has experienced a significant expansion in the last few years. Yet the model has been unable to overcome numerous weaknesses inherited from the past. The distribution of income remains very unequal, the new exports have done little to strengthen the industrial sector in the region, and the links with the rest of the economy are often fragile. Some products have enjoyed subsidies from generous tax concessions that have provoked retaliation by importing countries. The fiscal cost of these subsidies has imposed a serious burden on the public sector which must either raise revenue through additional taxes levied on the non-export sector or use deficit financing with potentially inflationary consequences.

These problems in the export-led growth model have been compounded by the growing recognition in Central America that the region can only derive certain advantages from the international trading system if it operates as a bloc. Whether in negotiations on a free trade agreement with the United States or in negotiations with the European Community over the access of bananas after 1992, it has become clear to many in Central America that a renewed attempt at integration is no longer a luxury but has become a necessity.

The renewed interest in integration therefore arises from a number of different factors, but all participants share the view that a new integration scheme must be made compatible with the promotion of exports to the rest of the world. Regional integration does not mean a return to the old MCCA with its high levels of protection
and restrictions on certain forms of trade. The new regional integration scheme is seen as complementing the new emphasis on non-traditional exports to the rest of the world and as providing the institutional basis for Central America's participation in the international trading system.

Many obstacles have prevented the adoption of a new regional integration scheme. The need for draconian stabilization programs, subject to conditions imposed by international financial agencies, has encouraged unilateral measures by countries that have often undermined moves toward closer integration. For many years there was no consensus among the governments of the region on economic policies. The existence of civil war in several countries militated against policies designed to break down the barriers between countries.

By the beginning of the 1990s, however, many of these problems had been overcome. Stabilization programs were reducing inflation to manageable levels, leading to greater stability in exchange rates. The 1990 election in Nicaragua completed the political shift in the region toward governments that share much the same attitude toward the private sector, the role of the market, and the need for some form of export-led growth. An integration scheme complementing the emphasis on non-traditional exports began to find favor. By helping to lower costs of production, regional integration was seen as an important instrument in the struggle for international competitiveness on the basis of agro-industrial exports. Such a reduction in costs was incompatible with the old integration scheme with its high tariffs, so that the new scheme was seen to require the lowering of tariffs on imports from the rest of the world and the elimination of all barriers on trade within the region.

The Antigua meeting of Central American presidents in 1990 showed progress toward regional integration, and this was taken further by the meeting the following year in San Salvador. A new regional integration scheme, the Central American Economic Community (CEC), was created in these two presidential meetings. Targets were set for tariff reductions and the creation of a new common external tariff. Agricultural trade, restricted under the MCCA, was to be liberalized. There was even talk of free movement of factors of production, and steps were taken toward reducing trade barriers with other countries.

Can the CEC succeed where the MCCA failed? This is not a simple question; one needs to remember the long series of failed previous attempts at integration in Central America. Political will in favor of integration is not sufficient. Indeed, we have identified in our research a number of weaknesses in the new integration scheme that need to be addressed urgently. There are also many illusions held by Central Americans regarding the alleged benefits to be obtained from integration. The most serious illusion is that a regional bloc needs to be formed in order to gain speedy access to the markets of North America (i.e., the North American Free Trade Area, NAFTA). We do not believe that this will happen (See Appendices 11 and 12.), and we therefore do not consider that this is an appropriate basis on which to launch a new integration scheme.

In the following sections of this report, we explore the key issues which are relevant to the new integration scheme. We examine the attitudes of Central Americans themselves toward regional integration, and we note the differences to be found between countries and between different pressure groups in each country. These subtle differences, often disguised by the rhetoric in favor of integration, are important in determining the final outcome of the CEC. We look at the implications of a model of growth that does not involve integration and quantify the costs associated with non-integration.

We then turn to the three areas of economic activity (agriculture, industry, and services) and explore the implications of the new CEC. Next we examine the question of factor mobility.
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(including free movement of labor). We consider the payments system for intraregional trade before turning to the coordination and harmonization of economic policies implied by the CEC. We examine the international dimension of the regional integration scheme and consider the possible links of Central America with other countries and regions. We provide a critical examination of the regional institutional framework before offering our conclusions.

REGIONAL ATTITUDES

In Central America there exists a consensus that regional integration is not only desirable but necessary and inevitable if the Central American countries are to respond to the challenges presented by the regional and world situation. This is based on the opinions both of the elite and of the general citizenry. (See Appendices 2 and 3.)

This integration, however, is perceived differently by the different countries and groups that form Central America. For some, those with the most pronounced international orientation, the objective of regional integration is to achieve complete integration, like that which is expected to be accomplished with NAFTA and the rest of the world. For these sectors, without NAFTA, regional integration lacks real significance and scope, and it will be insufficient to respond to the new economic and trade situation in the world.

For others it is more a question of reaccommodation that would enable the previous integration scheme to respond little by little to the wider integration challenges to which the economies are subjected. The indiscriminate opening of traditionally protected markets is seen as a menace to the survival of certain enterprises, especially industrial enterprises, which would be in no condition to compete against stronger and more dynamic commercial adversaries. For these sectors the entrance into NAFTA is a mirage.

Despite possible resistance from one or another employers’ group, the predominant trend favors integration. At most, the speed and the extent of some of the required changes are questioned. However, under present conditions, which favor the integration of the five countries for better access to the world market, the possibilities are greater of achieving a new consensus in favor of integration, even with those groups which, like the industrialists, have shown greater resistance to a commercial opening and to structural change.

One limitation, however, is the very weak regional negotiating capacity in the field of foreign trade, a weakness that should be improved immediately so as to enable the formation of teams that are sufficiently trained, informed, and flexible to carry out negotiations with NAFTA, Mexico, and other countries and regions. This also includes the private sector, which feels deeply the urgency of training programs in the field of economic, financial, and commercial negotiations referring to integration.

There is a notable lack of internal cohesion among the majority of the region’s governments, subject to different pressures, which forces them to make constant concessions to popular demand and introduces unexpected shifts in their economic integration policies. These end up seriously affecting the clarity of the rules of the game that characterize the process. To this there is added the truly serious strategic lack of definition of the simultaneous levels of integration with which the countries are dealing (Central America, Panama, NAFTA, Mexico, Venezuela, Colombia, Chile, the Caribbean Community [CARICOM], and so on), their real significance, and the priorities that should guide the process, both as a whole as well as with each one of its parts.

The lack of definition is reflected in the gap between presidential declarations and the general integrationist rhetoric throughout the region and the weakness in implementing the integration programs; in the interministerial conflicts that place the governments in, if not contradictory, at best incoherent and erratic positions; and the institu-
tional improvisation that obscures clear definitions of the objectives and methods for achieving integration and the lack of a realistic design of the functions that such institutions should fulfill.

Nevertheless, there are grounds for optimism for integration in Central America. The population in Central America strongly supports pursuing the integration of the region. A public opinion survey of nearly 4,200 respondents conducted in each of the six countries (only Belize was excluded) found that 86 percent of them believed that their governments ought to work hard to achieve Central American integration. As Figure 1 shows, this opinion was felt most strongly in El Salvador and Nicaragua and was common throughout the region with the exception of Panama. In Panama, the majority still favored working toward integration, but two-fifths of the population expressed reservations. This finding lends support to the view that, at least at the moment, support for the integration movement is strongest within the five Central American countries that formed part of the now defunct Central American Common Market, a group of countries that have historical ties dating back to the colonial period. Panama has been traditionally excluded from that historically defined unit.

![Government should work hard to achieve C. A. integration](image)

**Figure 1**

Although there is widespread support for economic integration, opinions of the populations are more divided on the issue of political integration. As was the case at the onset of the movement toward the creation of a European Economic Community in the early 1950s, support seems greatest for focusing the integration movement on economic concerns rather than moving beyond them to deal with political issues that might affect national sovereignty. Hence, when the public was asked if they agreed with the notion of converting Central America into a single country, support was lower in each country than it was for economic integration. More important, perhaps, is that in marked contrast to the uniformly positive opinions found throughout the region (with the exception of Panama), political integration is opposed by large majorities in both Costa Rica and Panama, as is shown in Figure 2.
Policy makers need to be aware of these sentiments and not move too rapidly in the direction of regional political integration, especially when such moves might appear as threatening to the sovereignty of the members of the Central American community. A case in point is the Central American Parliament (PARLACEN), which, although functioning at the present time, does not have the full participation of all of the countries of the region. If full participation in the PARLACEN is established by either regional or extraregional actors (national or international) as a precondition for further progress in regional economic integration, then serious negative consequences are likely to be the net result.

**Figure 2**

**COSTS OF NON-INTEGRATION**

Some in the region prefer an economic model where integration is irrelevant, that is to say, based on the individual effort of each country to enter the world market with new products. The simulations carried out using a macroeconomic model for the region (See Appendix 4.) demonstrate that the Central American countries will incur a high cost in terms of growth of income if they base economic recovery exclusively on the growth of non-traditional exports.

The diverse exports in the region have different impacts on income because, when one is dealing with intraregional exports, there is a saving of hard currency that can be used on extraregional imports to finance investment; with an increase in investment the multiplier effect on income is increased and so too is its rate of growth.

We have compared two extreme hypothetical situations, growth without integration and growth with integration. In the former, intraregional exports would not grow, while non-traditional exports would increase by 15 percent annually. In the latter, intraregional exports would grow by 15 percent annually, while non-traditional exports would stagnate. In order to isolate the impact of a change in each variable, in both cases it is assumed that traditional exports
have zero growth. The results point to important differences in growth favoring the first scenario: in Guatemala a model without integration would produce a rate of growth of income of 5 percent annually, while with integration the increase would be of 16 percent. In El Salvador the growth is one of 4 percent and 18 percent, respectively. Costa Rica produced results along the same lines, albeit of a smaller magnitude, with figures of 6 percent and 9 percent, respectively.

In Nicaragua and Honduras the situation is different: in Nicaragua a model without integration produces a growth of income very similar to that of a model with integration, while in Honduras the rate of growth of income is considerably higher without integration. These results might lead one to conclude that for Nicaragua and Honduras the efforts at integration do not provide substantive benefits or could even bring about costs in the form of a reduction in the rate of economic growth.

One must, however, take into account in the first place that in both countries, and especially in Honduras, the key variable for growth is the export of traditional agricultural products, which represent a very large proportion of total exports, while the share of intraregional exports in the base year of the model is almost zero.

Second, the simulations are based on parameters derived from the 1970s and 1980s in the manufacturing sector. Integration in the 1990s assumes potentialities for both countries derived from the incentive to export agricultural and agroindustrial products. As we will show, for these opportunities to translate effectively into net benefits, especially for Honduras, immediate measures will be required that could provide the country with a more competitive starting point, measures that could include devaluation or a reduction in costs through an adequate technology transfer.

Our study also shows that, for the region as a whole, a model without integration implies a loss of per capita income. In the scenario without integration (see Table 1) Central American per capita income in 1995 will be US$ 1,146, while in the scenario with integration regional per capita income would in the same year reach US$ 1,734. Therefore, in regional terms the cost of not integrating would be a reduction in Central American per capita income of approximately 34 percent. (For the details of the model and the analytic results, see Appendix 4.)

<table>
<thead>
<tr>
<th></th>
<th>Income with integration</th>
<th>Income without integration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costa Rica</td>
<td>7923</td>
<td>6318</td>
</tr>
<tr>
<td>El Salvador</td>
<td>12350</td>
<td>4362</td>
</tr>
<tr>
<td>Honduras</td>
<td>3577</td>
<td>8790</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>4686</td>
<td>5004</td>
</tr>
<tr>
<td>Guatemala</td>
<td>25138</td>
<td>10995</td>
</tr>
<tr>
<td><strong>Central America</strong></td>
<td><strong>53674</strong></td>
<td><strong>35469</strong></td>
</tr>
<tr>
<td><strong>Per capita income</strong></td>
<td><strong>1734</strong></td>
<td><strong>1146</strong></td>
</tr>
</tbody>
</table>

Note: Based on a population estimate of 30.95 million.
A problem tied to growth is the distribution of income and the magnitude of poverty. Although available data suffer from serious limitations, the concentration of income among the 5 percent of the population with the highest incomes is obvious. (See Appendix 4.) This stratum concentrates, in all the countries, between 21 and 26 percent of income, with the exception of Costa Rica, where the figure is 15 percent. Furthermore, during the 1980s a process of income concentration has also become evident in Costa Rica among this higher stratum. The proportion of the population living in poverty increased between 1980 and 1985 from 71 to 83 percent in Guatemala, from 68 to 87 percent in El Salvador, from 68 to 79 percent in Honduras, from 62 to 69 percent in Nicaragua, and from 25 to 28 percent in Costa Rica. Out of a regional population of 23 million in 1985, 17 million were in a state of poverty, among which were 12 million in extreme poverty.

In the initiatives present in the region to build an integration scheme under new international conditions, the problem of reducing poverty is rarely mentioned as one of the priority objectives in the context of regional cooperation. It should be stressed that the new integration scheme does not by itself guarantee that the economic process will favorably change the distribution of income or reduce the absolute levels of poverty.

AGRICULTURE

When the MCCA was first established, trade in manufactured goods was rapidly liberalized. Trade in agricultural goods, however, remained subject to numerous restrictions so that the expansion of intraregional trade after 1960 was almost entirely confined to industrial products.

The July 1991 meeting of the five Central American presidents in San Salvador showed a particular interest in the liberalization of trade in agricultural products within the region. Since intraregional trade has been hindered by the existence of non-tariff barriers, domestic demand for many agricultural products is met mainly by domestic supply. In the crucial area of basic grains (maize, rice, beans and sorghum), which account for such a high proportion of total agricultural employment and total agricultural output, the trade links at the regional level are very weak. Domestic production accounts for over 90 percent of domestic demand in all five countries, and the figure is close to 100 percent in Guatemala and Honduras. Imports of basic grains from the MCCA accounted for only 0.2 percent of total regional production of those products in the 1985-87 period and imports from MCCA represented only 6.3 percent of imports from the rest of the world.

According to the current timetable, intraregional trade liberalization in agricultural products should be a reality by the end of December 1992. This process will mainly affect a group of twelve so-called “basic agricultural products”—maize, rice, sorghum, soya, beans, pasteurized and powdered milk, live cattle, beef, chicken, pork, poultry (especially live chickens) and eggs. This move towards the liberalization of agricultural trade is welcome, but it is a matter of some concern that many products have so far been excluded from the process. Some of these excluded products (e.g., cotton) are an important element in the costs of production of manufactured goods (e.g., textiles). If firms in Central America are to reduce costs of production so as to be able to compete efficiently in the world market, regional integration needs to embrace all commodities used as inputs.

The liberalization of trade in agricultural products implies that domestic producers within Central America must not only compete with each other, but also with imports from the rest of the world. In an effort to provide some degree of protection to local farmers, liberalization of trade will, in general, make use of a system of import price bands subject to variable tariffs designed to
keep prices within a certain range. The tariffs have been set so as to provide Central American farmers some protection from competition from abroad, while the liberalization of trade will force farmers to compete within the region. Thus, not all farmers can expect to benefit from the new arrangements. By implication, some countries will become net importers and others, net exporters.

Our study of the implications of free trade in agriculture has been limited to basic grains since these are the most important commodities subject to liberalization. The expected changes in trade in basic grains within the region have been carried out through a simulation model (see Appendix 5). Its main goal has been to determine for each basic grain and each country the changes in production and consumption to be expected as a result of free trade, that is, to see if the country becomes a net exporter or importer of basic grains after trade liberalization.

The existence of non-tariff barriers to intraregional trade in basic grains causes price differences among Central American countries. Many of these differences will vanish after trade in basic grains is attained; for the purposes of this work, it can be assumed that only one price will prevail. Those countries with marginal production costs less than the new price will become net exporters, gaining in domestic production and losing in domestic consumption. By contrast, those with marginal costs higher than the new price will be net importers, having production losses and consumption gains. If the basic agricultural product is not subject to the import price band system, those gains and losses will depend on the level of the new price. However, in those products subject to price bands, gains and losses will be determined by the maximum and minimum levels of the regional band.

The simulations were carried out by product and by country. The full results are presented in Appendix 5. The most realistic simulation assumes that the price after liberalization is the same as the median price (precio mediano) before liberalization; this simulation implies that all countries are net exporters of at least one product. (See Table 2.) In the case of maize, the net exporters are Guatemala and Nicaragua, with the largest production gain accruing to the former (a reflection of both its pre-trade liberalization low price and its initial volume of production); in the case of beans, the net exporters are Costa Rica and Honduras; in the case of rice, the net exporters are Costa Rica and Nicaragua; and in the case of sorghum, the net exporters are Costa Rica and El Salvador.

### Table 2

<table>
<thead>
<tr>
<th>Country</th>
<th>Maize</th>
<th>Beans</th>
<th>Rice</th>
<th>Sorghum</th>
<th>Basic Grains (Total)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costa Rica</td>
<td>No change</td>
<td>Net exporter</td>
<td>Net exporter</td>
<td>Net exporter</td>
<td>Net exporter</td>
</tr>
<tr>
<td>El Salvador</td>
<td>Net importer</td>
<td>Net importer</td>
<td>Net importer</td>
<td>Net importer</td>
<td>Net exporter</td>
</tr>
<tr>
<td>Guatemala</td>
<td>Net exporter</td>
<td>Net importer</td>
<td>No change</td>
<td>Net importer</td>
<td>Net exporter</td>
</tr>
<tr>
<td>Honduras</td>
<td>Net importer</td>
<td>Net exporter</td>
<td>Net importer</td>
<td>No change</td>
<td>Net importer</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>Net exporter</td>
<td>No change</td>
<td>Net exporter</td>
<td>Net importer</td>
<td>Net importer</td>
</tr>
<tr>
<td>Central America</td>
<td>Net exporter</td>
<td>Net importer</td>
<td>Net exporter</td>
<td>Net importer</td>
<td>Net exporter</td>
</tr>
</tbody>
</table>
Although all countries under this simulation are net exporters of at least one product, the same is not true of net imports. As Table 2 shows, Costa Rica is either a net exporter or has no change in all products—a reflection of its relative price levels in basic grains before trade liberalization. All other countries import at least one product after trade barriers are removed: maize, beans, and rice in the case of El Salvador; beans and sorghum in the case of Guatemala; maize and rice in the case of Honduras; sorghum in the case of Nicaragua.

The simulations show surprising results, particularly those related to Costa Rica, Nicaragua and Honduras. Despite Costa Rican misgivings with regard to intraregional trade liberalization in agricultural products, the simulations indicate that Costa Rica could obtain important benefits as a net exporter. The results for Nicaragua and Honduras are more worrying, since these countries are the least developed in the region and are expected to have comparative advantage in agricultural products. Yet in our simulations these two countries appear to be mainly net importers of basic grains as a result of starting with prices that are higher than the regional average.

Countries that become net importers of basic grains enjoy a consumption gain as a result of lower prices for consumers. Thus, consumers in Honduras and Nicaragua could expect to reap benefits from free trade in basic grains. However, the imports of basic grains must be purchased and under the CEC no country is expected to run structural (i.e., permanent) deficits with the rest of the region. Thus, countries that become net importers of basic grains need to increase their regional exports.

As imports of basic grains increase, marginal domestic suppliers are forced to abandon production and the resources (land, labor and capital) need to be switched to the production of other goods. In the case of a country that has a comparative advantage in industrial products, it is expected that the released resources are devoted to additional industrial production so that additional regional imports of agricultural goods are paid for with additional regional exports of industrial goods. However, neither Honduras nor Nicaragua are expected to have a comparative advantage in industrial goods.

The problem for Nicaragua is not as serious as for Honduras. The reason is that, in our simulation, the net imports of basic grains into Nicaragua are due entirely to sorghum. Nicaragua has net exports of maize and rice under this simulation and no change in beans. (See Table 2.) Thus, under the prices assumed in our simulation, the problem Nicaragua faces is very specific; it must reduce costs of production in sorghum through a transfer of technology, an increase in yields and a decrease in inefficiency.

If the import price bands lead to lower prices than we have assumed in our simulation, then both Nicaragua and Honduras face a serious problem. Indeed, Honduras faces a serious problem in any case since even under our simulation it is a net importer of maize and rice.

There are three possible solutions to the problem. The first is that Honduras and Nicaragua lower costs of production in basic grains production (particularly sorghum in Nicaragua and maize in Honduras). This could be done through a transfer of technology and the application on a nation-wide basis of the Green Revolution in order to increase yields. This is unlikely to be a simple matter and assumes that other countries in the region do not adopt cost-reducing measures. The second is to assume that Honduras and Nicaragua are able to compensate for net imports of basic grains through an increase in net exports of other agricultural commodities. The third is that Honduras and Nicaragua devalue their currencies so that they cease to be uncompetitive in basic grains.

Price comparisons among the five Central American countries suggest that, even at current exchange rates, Honduras and Nicaragua may be able to export some agricultural products other than basic grains, but their price advantage in
these products is modest and unlikely to be sufficient. There is a further problem in that the price advantage sometimes arises in products (e.g., Nicaraguan cotton) which are not expected to be subject to trade liberalization in the region. Thus, it is difficult to escape the conclusion that the balanced growth of intraregional trade in Central America requires a realignment of exchange rates so that Honduras and Nicaragua can exercise their comparative advantage in agricultural products. Even this change, however, is unlikely to be sufficient to maintain comparative advantage in basic grains in the long-run in these two countries. An increase in farm-level efficiency through the transfer of technology and the application of improved farming techniques is absolutely essential. Since this is not a simple matter, it is of some importance to establish through further research how such an improvement could be achieved.

The need to improve agricultural efficiency in the weaker countries cannot be overemphasized. The problems of the MCCG began with the withdrawal of Honduras as a result of its failure to establish balanced trade with its Central American partners. The new integration scheme, by including agriculture, provides the possibility of a fairer distribution of net benefits among the member countries. This presupposes, however, that each country is able to establish its comparative advantage in intraregional trade. If Honduras and Nicaragua fail to become significant net exporters of agricultural products to the rest of Central America, either as a result of high costs of production or because of the limited nature of agricultural trade liberalization, the implications for the future of the CEC are grave.

In a process of intraregional trade liberalization, there will inevitably be gains and losses in terms of domestic production and consumption. However, it is important to determine who would lose in terms of production (the smaller farmers or the larger ones?) and in terms of consumption (the lower-income groups?). Depending on the level at which the price band is established, the different combinations of gains and losses in production and consumption would be different as well as their political implications, particularly if they affect the smaller farmers and the poorer social groups.

It is very difficult to determine a priori the gainers and losers from trade liberalization in agriculture. It used to be true that small farmers specialized in basic grains, and most basic grains were produced by small farmers. While it is still in general true that small farmers specialize in basic grains, it is no longer true in all countries that basic grains output is dominated by small farmers. Large farmers have started to produce maize, rice and sorghum and this is one of the reasons why costs of production have fallen in countries such as Costa Rica and Guatemala. In Honduras and Nicaragua, however, there is less evidence that basic grains have attracted large-scale farmers with new technology and mechanized investments, which is a possible explanation for their loss of price competitiveness.

If this broad description is accurate, it means that small farmers have become the marginal producers and large farmers have become more profitable producers. As production falls in any given country as a result of a price fall, the burden of adjustment will fall most heavily on the small farmer. As production increases as a result of a price increase, marginal producers will become more profitable and the new marginal production could come either from large or small farms. It is more likely, however, to be associated with small farms. Thus, we expect the small farm sector to suffer in countries where basic grains production contracts, while the small farm sector may benefit (although it is not certain) in countries where basic grains production expands.

The consumption gains and losses will be fundamentally determined by the import price bands. Consumption losses will be concentrated in the countries with the highest production gains, since it is these countries which, by definition, have experienced the sharpest increase in
price. Under our simulation (See Appendix 5.), this means that consumption losses are carried by Costa Rica, El Salvador and Guatemala, with the biggest losses carried by Costa Rica and Guatemala.

The proportion of real disposable income spent on basic grains tends to vary inversely with the level of real income per capita. Thus, basic grains consumption is proportionately more important in Guatemala than Costa Rica. Furthermore, Costa Rica has a social and economic system capable of absorbing the expected increase in basic grains prices. The Guatemalan case presents greater concern since the social and economic system is far more fragile. Nevertheless, even in Guatemala, the anticipated rise in basic grains prices is not very large. The increase in maize prices, for example, is unlikely to exceed 10 percent under realistic assumptions about the import price bands.

INDUSTRY

Trade in manufactured goods formed the basis of the old Central American Common Market. Virtually all intraregional trade in the three decades after 1960 consisted of trade in industrial products as a result of the removal of tariffs on manufactured goods and the application of a high common external tariff on imports from the rest of the world.

Intraregional trade in manufactured goods under the CEC is also expected to be of great importance, although it will not dominate trade flows to the same extent as a result of the (partial) liberalization of trade in agricultural goods. A CEC plan agrees to the imposition of a common external tariff by the beginning of 1993, to apply to all imports from outside the region while intraregional trade is to be freed from all restrictions. The aim is progressively to eliminate non-tariff barriers, such as selective consumption taxes, which currently impede intraregional trade.

Therefore, it might seem as if there is a parallel between the formation of the MCCA in 1960 and the formation of the CEC in 1992. The circumstances are in fact very different. The MCCA began its life with the imposition of a common external tariff which raised average tariff levels; at the same time, the absence of a significant industrial base meant that the MCCA was bound to be net trade diverting, i.e., imports from the rest of the world were replaced by more expensive imports from partner countries as domestic industrial production became established. By contrast, the CEC is being launched with a common external tariff which will lower tariffs on average; at the same time, each country has established high-cost local industry so that the CEC is expected to be net trade creating, i.e., high-cost domestic production will be replaced with cheaper imports from partner countries.

There are many uncertainties as to how the CEC will work in the 1990s. One thing that seems certain, however, is that the allocation of regional manufacturing resources will change between sectors and among countries. The common external tariff to be introduced at the beginning of 1993 is very different from its predecessor, and almost all the changes have been approved with a tariff range from 5 to 20 percent; indeed, disputes have been reduced to a handful of "sensitive" products (e.g., textiles) for which some manufacturers are asking a longer period to phase in the reductions.

The reduction in the maximum tariff to 20 percent is likely to have a major impact on Central American industry. If this reduction is not accompanied by real exchange rate depreciation and/or reductions in costs, many firms in the manufacturing sectors will be unable to compete. On the other hand, other firms face relatively little competition from imports as a result of their initial cost advantages which are unlikely to be eroded by tariff cuts. Thus, a first step in our analysis of industry was to examine sectoral balance sheets that record supply and demand in terms of domestic production, trade with Central America, and trade with the rest of the world. (See Appendix 6.)
Unfortunately, such balance sheets are not prepared by any of the regional institutions in Central America. Furthermore, the production data (based on the U.N. Standard International Industrial Classification) are quite different from the trade data (based on NAUCA II [Uniform Central American Tariff Nomenclature]) so that comparisons between production, imports, and exports at the sectoral level can only be done by using a "bridge" which allocates each entry in the trade statistics to a specific industrial sector.

Despite the problems involved, we considered the need for sectoral balance sheets for each country to be so important that it was worth making the necessary effort. Using an unpublished bridge provided by the Banco Central de Costa Rica, all imports and exports in the regional trade statistics were allocated to an industrial sector and disaggregated between Central America and the rest of the world.

We believe that this is the first time such an exercise has been carried out for the five Central American countries. Yet it is absolutely essential if the impact of trade liberalization on regional integration is to be assessed properly. It follows that a high priority in future statistical work in the region is the preparation of trade data on an industrial as well as a commodity basis. This need not be expensive and should clearly be the responsibility of SIECA (Secretariat for Central American Economic Integration).

A summary of the balance sheets is given in Table 3 for the whole of the manufacturing sector, and the results are very revealing. It can be seen that roughly one-third of total manufacturing supply is provided by imports from the rest of the world—a high figure by Latin American standards. By contrast, the importance of regional imports (i.e., imports from other Central American countries) is very small; it varies from a "high" of 5.8 percent in the case of El Salvador to a low of 1.9 percent for Honduras. A similar conclusion is reached when we examine the proportion of domestic production sold in the regional market (i.e., exported to other Central American countries). The highest proportion is found in Guatemala (8.8 percent) and the lowest in Honduras and Nicaragua (1.1 percent). The role of intraregional trade in manufactured goods is therefore very limited.

<table>
<thead>
<tr>
<th>Country</th>
<th>Imports from ROW as % of total supply (%)</th>
<th>Imports from MCCA as % of total supply (%)</th>
<th>Exports to MCCA as % of production (%)</th>
<th>Exports to ROW as % of production (%)</th>
<th>Value of net exports to MCCA (US $ millions)</th>
<th>Value of net exports to ROW (US $ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costa Rica</td>
<td>31.7</td>
<td>2.8</td>
<td>4.4</td>
<td>13.6</td>
<td>+1.5</td>
<td>-870.3</td>
</tr>
<tr>
<td>El Salvador</td>
<td>27.9</td>
<td>5.8</td>
<td>6.5</td>
<td>5.6</td>
<td>-41.5</td>
<td>-667.2</td>
</tr>
<tr>
<td>Guatemala</td>
<td>34.7</td>
<td>3.6</td>
<td>8.8</td>
<td>8.9</td>
<td>+67.2</td>
<td>-1075.8</td>
</tr>
<tr>
<td>Honduras</td>
<td>29.3</td>
<td>1.9</td>
<td>1.1</td>
<td>8.9</td>
<td>-30.7</td>
<td>-620.5</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>36.5</td>
<td>2.0</td>
<td>1.1</td>
<td>4.9</td>
<td>-25.9</td>
<td>-696.4</td>
</tr>
</tbody>
</table>

Note: ROW = Rest of World
The summary statistics demonstrate the relative lack of importance of regional trade for Central American manufacturing. The importance of regional trade, however, varies from sector to sector. In order to assess the impact of future trade flows following trade liberalization and consolidation of the new regional integration scheme, it is necessary to examine the importance of the regional market and world market on a sectoral basis for each country in the base year. The results are summarized in Table 4, which demonstrates that there is an almost inverse relationship between the importance of a sector in production and its importance in intraregional exports. Thus, the food, beverages, and tobacco sectors, which represent between 42 to 56 percent of total industrial production, account for only a small fraction of total intraregional exports. By contrast, the share of the chemicals industry in total intraregional trade is far greater than its share of total industrial production in all five countries. This reveals a serious structural weakness in intraregional commerce.

The significance of this imbalance can be demonstrated very easily. The sectors in which intraregional trade is seriously underrepresented are food, beverages and tobacco, wood and furniture, paper, printing and publishing, and non-metal mineral products. In every case, intraregional exports account for less than 10 percent of regional production. In our simulations (See Appendix 6.), we assume that intraregional exports rise to (a) 10 percent and (b) 20 percent of regional production as a result of the abolition of various barriers. In the first case, total intraregional exports would rise by nearly 100 percent and intraregional trade would reach 26.8 percent of total exports. In the second case, the transformation is even more spectacular. Intraregional exports would rise by over 200 percent and intraregional trade would reach 43.3 percent—nearly half of all exports.

The target of 20 percent may be considered too ambitious, but the target of 10 percent is very modest. It is not unreasonable to expect 10 percent of regional production to enter into regional trade; indeed, anything less suggests that countries are not reaping the advantages that regional competition can be expected to bring. Thus, the removal of barriers which currently impede intraregional trade in these underrepresented sectors should be regarded as a priority.

Our analysis of each sector (See Appendix 6.) suggests that the barriers are complex and differ from sector to sector so that their removal is not a simple task. Yet it is quite clear that a major problem is created by non-tariff barriers. These include restrictions imposed by multinationals on their subsidiaries in Central America, restrictive agreements between manufacturers and distributors in each country, and customs delays. The new regional integration scheme has not yet given sufficient emphasis to the removal of these non-tariff barriers. Yet, without such emphasis, Central America will never be properly integrated.

The new effort at regional integration is marked not only by the attempt to re impose a common external tariff, but also by the general reduction in tariffs on imports from the rest of the world. From the beginning of 1993, almost no firm can expect to receive nominal tariff protection greater than 20 percent and many firms will receive less. This is bound to affect not only the allocation of resources at the level of production but also the intraregional trade flows.

The impact of tariff reductions will vary from sector to sector. One of the most important determinants is the proportion of total supply obtained from the rest of the world. In those sectors where the proportion is small, it is safe to assume that tariff reductions will have only limited impact. This conclusion is reinforced if the sector has positive net exports to the rest of the world. Food, beverages and tobacco, clothing and footwear, leather goods, wood products and furniture are in this position. Although tariff reductions will force them to lower prices on sales in the domestic market, most firms will be
Table 4
Central America: Sectoral Contribution to Domestic Output and Intraregional Exports, 1987

<table>
<thead>
<tr>
<th></th>
<th>Costa Rica</th>
<th>El Salvador</th>
<th>Guatemala</th>
<th>Honduras</th>
<th>Nicaragua</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Domestic output (%)</td>
<td>MCCA exports (%)</td>
<td>Domestic output (%)</td>
<td>MCCA exports (%)</td>
<td>Domestic output (%)</td>
</tr>
<tr>
<td>Food, drink &amp; tobacco</td>
<td>42.1</td>
<td>13.2</td>
<td>52.8</td>
<td>8.2</td>
<td>51.5</td>
</tr>
<tr>
<td>Textiles &amp; leather prod.</td>
<td>6.5</td>
<td>10.6</td>
<td>12.1</td>
<td>20.7</td>
<td>10.7</td>
</tr>
<tr>
<td>Wood prod.</td>
<td>4.5</td>
<td>2.2</td>
<td>2.5</td>
<td>0.3</td>
<td>2.0</td>
</tr>
<tr>
<td>Paper &amp; printing</td>
<td>7.9</td>
<td>3.9</td>
<td>3.2</td>
<td>16.7</td>
<td>3.8</td>
</tr>
<tr>
<td>Chemicals, plastics, etc.</td>
<td>24.7</td>
<td>35.3</td>
<td>16.5</td>
<td>30.2</td>
<td>20.9</td>
</tr>
<tr>
<td>Non-metal mineral prod.</td>
<td>3.9</td>
<td>5.9</td>
<td>3.7</td>
<td>0.5</td>
<td>4.7</td>
</tr>
<tr>
<td>Basic metal prod.</td>
<td>0.0</td>
<td>12.3</td>
<td>3.1</td>
<td>11.3</td>
<td>1.8</td>
</tr>
<tr>
<td>Metal prod.</td>
<td>10.0</td>
<td>13.0</td>
<td>4.0</td>
<td>10.2</td>
<td>3.7</td>
</tr>
<tr>
<td>Other manuf.</td>
<td>0.3</td>
<td>3.4</td>
<td>2.2</td>
<td>1.9</td>
<td>0.8</td>
</tr>
<tr>
<td>TOTALS</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

able to adjust since the cost of their inputs will be lowered as a result of tariff reductions on their inputs. This group of sectors is therefore well placed to take advantage of trade liberalization and may be able to increase production and exports to the rest of the world. Many of these sectors, however, are underrepresented in intraregional trade, so it cannot be assumed that intraregional exports will increase significantly. There will only be a big increase if the non-tariff barriers referred to above are eliminated.

There is a second group of sectors in which imports from the rest of the world account for a large proportion of total supply, but at the same time exports to the rest of the world are also important. Textiles is in this category for most countries, and rubber products occupy this position in Costa Rica. Tariff reductions in these sectors are expected to reinforce the tendency toward intraregional trade. Those firms producing only for the regional market are expected to face problems as a result of a fall in tariff protection; those firms already selling in the world market without the benefit of tariff protection are expected to increase production and exports as a result of the decline in their costs. In the case of textiles, there is no reason to assume that this process of increased intraindustry trade will not affect intraregional and extraregional trade equally. Intraregional trade is already important in textiles and likely to become more so after trade liberalization and external tariff reductions. Non-tariff barriers do not appear to be a serious problem in this sector.

The third group of sectors includes all the remainder in which imports from the rest of the world are very important and net exports to the rest of the world are negative. These sectors are
paper, printing and publishing, chemical and plastic products, petroleum derivatives, non-
metal mineral products, basic metal industries, metal products and miscellaneous manufactured
products. With the exception of Costa Rica, rubber products are also in this category. Tariff
reductions are likely to pose serious problems for all these sectors with the exception of petroleum
derivatives, where non-tariff barriers will con-
tinue to be important.

Although imports from the rest of the world are expected to increase in these sectors, imports
from Central America can rise or fall. The coun-
tries most likely to gain, however, are those with revealed comparative advantage in the relevant
sectors. If we measure revealed comparative
advantage by net exports at the regional level,
our research shows that in the nine sectors Costa
Rica has revealed comparative advantage in five,
Guatemala in four, El Salvador in three, Nicara-
gua in two, and Honduras in one. However,
Costa Rica and Guatemala have revealed com-
parative advantage in all the sectors which are
most important in terms of intraregional trade.
Thus, the well-known problem of the distribution
of the benefits from intraregional trade, which
contributed to the withdrawal of Honduras from
MCCA in 1970, is likely to reassert itself after
trade liberalization if no additional steps are
taken.

Those additional steps should by now be
clear. The key to intraregional trade is to be
found in removing those non-tariff barriers which
currently impede intraregional exports in the
sectors that account for a high proportion of total
domestic production. The removal of these
barriers would not only encourage a rapid
growth in intraregional trade but also would
allow the weaker industrial countries (Honduras
and Nicaragua) to participate fully. Honduras' revealed comparative advantage, for example, at
the regional level in manufactured goods is
found in clothing and footwear, leather goods
and wood products—none of which figure
prominently in intraregional trade and all of
which appear subject to non-tariff barriers. This
conclusion would be strengthened if either
Honduras or Nicaragua were to build an inte-
grated pulp and paper industry based on forest
products or an integrated chemical complex
vertically integrated with various forest products
such as resins.

TRADE IN SERVICES

Development in the services sector is key to
integration in the 1990s. (See Appendix 7.)
Although the principal objective of integration
has been and will continue to be the enlarge-
ment of trade in products, trade in services plays
a complementary role of the greatest importance.
If in the medium to long term the CEC repre-
sents the joint effort of the five countries for a
new and more efficient insertion of their econo-
 mies into the world market, then regional coop-
eration constitutes a mechanism which will
permit the reduction of costs in order to com-
pete successfully. This cooperation is essential for
those services indispensable to production and
trade and which represent for many enterprises
approximately 30 to 40 percent of the costs of
production.

The consequences of the innumerable
problems that the region faced during the 1980s
(economic crisis, natural disasters, violent con-
licts, and so on) are evident in the deterioration
suffered by the physical infrastructure which had
been built in the 1960s and 1970s. It is therefore
important that the immediate efforts at recon-
struction of the integration scheme be directed
toward lifting obstacles to trade (facilitation of
transport and customs procedures, homogeniza-
tion of documents) and toward reconstruction
and rehabilitation of the existing infrastructure.
Despite this, the accords in this field and in other
areas related to services have led to the forma-
tion of countless ad hoc organs and bodies to
deal with specific sub-sectorial problems. This
dispersion of efforts is reflected in a significant
lack of homogeneous regional statistics and in
the absence of an institutional framework that
could provide coherence and strategic meaning
to actions in the field of services, in accord with
the key role that each sector plays in the new
integration scheme.

The construction of this institutional frame-
work is the key to seeing that the criterion of
regionality is translated into practical terms in the
area’s modernization initiatives. An integrated
and efficient network of air, rail, and highway
transport, of related infrastructure and services,
and of electrical and telecommunications connec-
tions would avoid costly duplication and take
advantage of economies of scale. The sizeable
investments that this modernization requires
suggest external financing negotiated jointly, as a
complement to investment in the region. At the
national level, some countries require greater
investments, to reduce the differences in the
initial conditions of their infrastructure, in order
to improve their competitive position within the
region. This is the case, for example, with im-
provement of rural roads so farmers will be able
to take advantage of the liberalization of trade in
agricultural products.

Along with the services directly linked to trade
we have identified other areas with a potential
impact on the region. Tourism is a sector that could
have favorable effects in terms of balance of
payments and could serve as a stimulus to related
sectors such as transportation. The establishment
of regional routes focusing on archeological and
ecological attractions has great potential.

Another area that has potential in the 1990s is
marketing services. One of the obstacles that the
development of the non-traditional products sector
faces is the woeful lack of marketing expertise. The
non-traditional products that the Central American
countries export are similar; regional marketing
enterprises that could guarantee levels of quality,
quantity, and regularity of supply could be estab-
lished to improve the conditions of access to the
major external markets.

As the process of constituting the CEC
advances to ever more complicated areas of
integration, including the coordination of national
policies and the free movement of capital and
labor, the topic of intraregional liberalization of
services will have to be included on the negotiat-
ing agenda. Without it, the new integration
scheme will not be able to take advantage of
opportunities that arise.

FACTOR MOBILITY

Integration schemes vary in the extent to
which the movement of goods, services and
factors of production is liberalized. A free trade
area allows free movement of goods (not neces-
sarily services) subject to different national
external tariffs and restrictions on the movement
of labor and capital. A customs union is the same
as a free trade area except that there is a com-
mon external tariff. A common market, however,
permits unrestricted movement of labor and
capital among the member states in addition to
free movement of goods and services subject to a
common external tariff.

The new integration scheme in Central
America is committed to a common market.

Indeed, the expression “Comunidad Económica
Centroamericana” implies an integration scheme
similar to that which will operate in Europe after
1992 with free movement of labor and capital
and the harmonization of many economic poli-
cies. This integration scheme corresponds closely
to the vision advanced by private sector organi-
izations that believe that Central America can only
become fully integrated into the world economy
if it liberalizes the regional market in goods,
services and factors of production.

The commitment to full factor mobility is
long-run, and there are no immediate plans to
implement measures which would allow, for
example, unskilled workers in one country to
move to neighboring republics. This reluctance to adopt a strict calendar is in strong contrast to the timetable which is being applied to the creation of a common external tariff, and it can be explained by the hesitation of some governments in the region to embrace a scheme which could generate strong political resistance.

If the economic arguments in favor of full factor mobility were overwhelming, these political constraints on the adoption of full factor mobility could be seen as a regrettable, if inevitable, obstacle in the path of liberalization. However, the economic arguments in favor of full factor mobility are very complex, and the issues have not as yet been properly debated in Central America. Our own research (See Appendix 8.) is devoted to a fuller understanding of the economic issues raised by removing all restrictions on factor movements.

In making the case for full factor mobility, it is usually assumed that wage rates and rates of return on capital are unequal before factor mobility is permitted. This is almost certainly a correct assumption in the case of wage rates. In the case of capital, however, it is more difficult to assume unequal rates of return. Even if the partner countries are forbidden from investing in each other's economies, it does not follow that investment by third countries (direct foreign investment) is forbidden. Furthermore, restrictions on labor are always more severe than restrictions on capital. Capital can be transferred electronically in a fraction of a second, while labor migration is a costly and time-consuming exercise. Thus, we need to consider the case in which labor is immobile and wage rates are different, while capital is partially mobile and real rates of return on capital are equal. We believe that this corresponds more closely to the Central American reality.

Assume there are two countries (A and B) and that country A has lower wage rates. Labor will now move from A to B, driving up wage rates in country A and lowering them in country B. This will raise costs in A and lower the real rate of return on capital. Meanwhile, in country B labor costs have been lowered and the rate of return on capital has also increased. Capital will now flow from A to B—the reverse of what happened before—until the rate of return is again equalized. Labor in B is now worse off, capital in B is better off, labor in A is better off, capital in A is worse off, and the factors which move are better off. The impact on social welfare is now very complicated; there is the real danger that the benefits will be very unequally distributed between the two countries. If the outmigration of labor leads to almost no improvements in wage rates, country A will almost certainly be worse off. If the outmigration of labor from A leads to a sharp fall in wage rates in B, then country B may well be worse off.

There is an additional problem which needs to be considered in this case. Country A has lost both labor and capital. Even if the social welfare of those who remain has improved, the country has lost resources and is now economically smaller. This will reduce the chances of exploiting economies of scale, will raise the unit costs of activities with large fixed costs, and so on. If we think of the two countries as two regions of the same country, it is clear that the danger of a vicious circle is not imaginary. In such cases, although factor mobility may equalize rates of return, one region is drained of resources and becomes "depressed"; the other region attracts both labor and capital and becomes "overdeveloped".

The case for full labor mobility, therefore, is not strong. It is favored by the private sector organizations representing employers, but the decision should be based on the needs of workers and employers—not only employers. Furthermore, employer organizations perhaps do not pay sufficient attention to the "depressed region" problem. Central America is small enough for us to think of each nation as one region of a single country. Full labor mobility would increase the chances that no employer ever had to worry about labor shortages, but it would imply capital movements in the same direction as labor as rates of return began to change with the fall
(rise) in labor costs. These movements could lead to boom regions and depressed regions. This is, after all, what has happened in countries such as Mexico, Canada, and the United States.

The capital markets in Central America are very different from the labor markets. Capital for investment purposes is already mobile within the region, bringing real rates of return on capital toward equality. There is a shortage of domestic savings in each country so that gross investment must be financed in part by foreign savings (i.e., deficits in the current account of the balance of payments). There is an organized financial sector, represented by a central bank and a number of commercial banks, which offers very different nominal and real rates of interest on deposits between countries. All countries except Nicaragua now have a market for financial securities (stock exchange), but it is very small and financial securities of one country cannot be traded on the stock exchange of another. There are restrictions on currency convertibility between Central American currencies and tax rates on dividends and profits are very different in the five countries.

Investment capital (direct foreign investment) is already partially mobile between countries. Every republic has real assets owned by nationals of other republics (including land). The welfare gains from this kind of mobility are considerable, and steps should be taken to increase it. This can be done by moving toward currency convertibility, easing the repatriation of profits, and avoiding double taxation. Such measures not only encourage the mobility of capital within Central America but also discourage capital flight by making the post-tax real rate of return on capital in the region more attractive.

Financial capital is not mobile. If restrictions were lifted, financial capital would tend to move toward the country offering the highest real rate of interest. This will increase savings in the receiving country. It will decrease savings in the sending country unless interest rates are free to move upwards. Thus, the mobility of financial capital requires the lifting of interest rate ceilings and other such restrictions on the operations of financial intermediaries.

If the sending country is free to increase its real rates of interests, then it is quite possible that the total regional volume of savings will increase. This is the big difference between capital and labor mobility. Under capital mobility, both the allocative efficiency of capital and its total volume may increase. Under labor mobility, the gain is only one of allocative efficiency.

If the total volume of savings is to increase, however, the range of financial instruments and the extent of financial intermediation will have to change. At present, savers are offered far too little choice. There are virtually no futures or forward markets in Central America either for currencies or for commodities. The range of securities traded on the stock exchange of each country is tiny. Neither new nor existing private sector firms use the stock market for raising additional capital. Privatized firms are not usually traded on the stock market; even when they are, nationals of other Central American countries cannot purchase the shares.

Greater mobility of financial capital is inseparable, therefore, from the need for greater choice in financial instruments. If the target is to increase regional savings, then increasing the range of instruments is probably more important than increasing financial capital mobility. Yet mobility can help if the range of instruments has been broadened. New companies need to be able to raise capital throughout Central America — not just in the country where the firm is registered. The sale of state-owned assets to the private sector (privatization) is likely to be more successful if the assets are sold throughout Central America. Stocks and shares are likely to become a much less speculative activity if they are traded in all the exchanges of the region.

Our research has demonstrated that the question of factor mobility is complicated and deserves much more discussion than it has at present received. We see the apparent willing-
ness of some governments and organizations in the region to promote factor mobility without a clear understanding of all the implications as a potential danger since it encourages the signing of treaties whose terms will not in the final analysis be respected. Central America cannot afford to take such risks with its new integration process.

SYSTEM OF PAYMENTS

In the past, the experience of the MCCA demonstrated that the expansion of intraregional commerce should be accompanied by mechanisms that would facilitate payments and that would permit rational use of the scarce convertible currency available to the countries of the region. When examining the variables that contributed positively to the growth of intraregional trade, even in the period of crisis that characterized the 1980s, the "system of payments" factor is shown to have played a key role as a determinant of trade. It also became evident that the deterioration of the system of compensation, or its virtual disappearance, contributed substantially to the collapse of trade flows. (See Appendix 9.)

During the 1970s and the first half of the 1980s, the regional clearing house played the key role. In the second half of the 1980s, with the clearing house's virtual closing due to the accumulation of debit balances among the countries, other payment mechanisms were utilized such as barter, the use of dollars, and to a lesser extent the use of national currencies. We consider, however, that these mechanisms, although they helped maintain trade flows, do not constitute a permanent solution for guaranteeing the growth of intraregional commerce in the context of a shortage of hard currency.

The efforts at reactivating intraregional trade in the 1990s have coincided with the search for a payments system adequate to the conditions of the new integration scheme. This search has had wide political support both within the countries and from the international community. Toward the end of 1990, with the financial support of the EEC, the Central American Payments System (SCP) was established. This system consists of a multilateral compensation of balances, which includes the granting of automatic loans by the central banks and which is complemented by an Export Support Fund to cover the imported component of regional production and a compensation fund for granting special loans to a country with temporary difficulties in its balance of payments. In addition, the EEC established a special support fund for the exports of Honduras and Nicaragua as the countries with the lowest relative development. In order to gain access to EEC financing, all the Central American countries committed themselves to implementing a program of dismantling obstacles to regional trade. The system was designed taking into consideration the complex set of factors which should affect the payments system of an integration scheme.

The SCP was implemented at a time, however, when special conditions in the countries and an institutional vacuum at the regional level had particularly adverse effects. Concurrent to the functioning of the SCP, the countries continued making payments through private agreements between the businessmen of the region by means that they considered convenient and that were translated in practice into the generalized use of dollars. This simultaneity of systems favored a relatively low, but growing, utilization of the compensation mechanism. The process of liberalizing the exchange markets has led the central banks to reduce their presence there. The low utilization of the compensation mechanism, the slowness and contradictions with which Central America complied with the requirements of lifting obstacles to trade, and the low profile of the central banks created conditions such that, by the middle of 1991, the participating bodies in the SCP decided to continue it, but without the granting of automatic loans. Despite these developments, the new integration scheme will need in the future, as it did in the past, a payments
system. The free convertibility of regional currencies does not yet exist, and the problem of scarcity of hard currency is still latent despite appearances to the contrary.

At the moment the Central American countries are in a situation of unprecedented liquidity because of family remittances, speculative movements of capital as a result of low interest rates in the United States, and other movements of currency that some allege derive from drug trafficking operations. These circumstances have brought about a "euphoria of dollars" which obscures the likelihood of future scarcity of hard currency. As a result, insufficient attention is being paid to the payments system as a necessary step to the free convertibility of the region's currencies.

It is obvious that none of the factors generating liquidity have a permanent character, so that the new integration scheme, as it increases the flow of intraregional transactions, will require a rational scheme of compensation of payments that would generate savings of hard currency. The continuation and strengthening of the SCP is still an essential element in reactivating inter-
changes in the isthmus based on stability and predictability. Nevertheless, the payments system in general should include not only the SCP as a compensation mechanism but other payments alternatives as well that would be acceptable to regional businessmen.

In addition, the existence of compensation or other forms of covering transactions does not solve all the problems related to a payments system linked to the development of an integration process that will necessarily require institutional participation with a regional perspective. One such problem is the funds for covering temporary balance of payments problems that could be granted conditional to compliance with the commitments of integration. Another concern the provisions of funds for attending to the special needs of countries of lower relative development, as the scheme begins to generate net benefits for all the participating countries. In any case, the essential element that could have an impact on the reactivation of trade is not merely the revitalization of the regional clearing house, but a payments system adapted to the new circumstances.

HARMONIZATION OF ECONOMIC POLICIES

The long-term perspective in favor of building the CEC has led to the perception among certain sectors in the region that total harmonization of economic policies must be achieved or the scheme will fail. From this point of view, the scope of harmonization should be quite deep, concerning both the areas that should be subject to regional coordination and the depth of the commitments.

From our perspective, total harmonization is not only unnecessary but could lead to countries' choosing to abandon the scheme in an effort to defend their level of control over the instruments of economic policy. Although the economic need for coordination of some policies is obvious, and the efforts in this direction inevitable, the harmonization and coordination process is complex and implies accepting a reduction in the national control of policy instruments. This could imply undesirable effects for some countries, but in the weaker countries the absence of coordination could be necessary to spur development in certain fields.

The integration project over the long term already implies policy coordination, but the priority areas and the required degree of coordination must be identified. With the purpose of identifying the degree of harmonization of economic policies that the new integration scheme requires, we have examined the essential elements. (See Appendix 10.)

The initial degree of interdependence among the countries that are integrating pushes them to look for coordination of economic policies. If the initial level of interdependence
and complementarity is high, the countries will tend "naturally" to coordinate their policies to avoid the consequences of factors that destabilize the conditions of access to markets. These difficulties are overcome with greater ease if the initial degree of interdependence is high, as the experience of various integration processes has shown.

The degree of interdependence among countries and regions may be measured by the openness of the economies, i.e., the relation between the sum of exports and imports and gross domestic production. The initially high degree of interdependence among the countries of the European Economic Community (EEC), and its subsequent growth until it surpassed extraregional interdependence, explains in large part the progress the EEC has achieved in coordinating key policies. In contrast, in the case of the countries of the Latin American Free Trade Association, the level of interdependence has been and continues to be extremely low and is much smaller than extraregional openness.

In the case of the countries of the MCCA, the initial level of intraregional openness is similar to that of the EEC but is greatly surpassed by extraregional openness. In contrast as well to what happened in the EEC, the tendency has been to maintain this difference; after the reduction in intraregional trade in the 1980s, the interdependence within the MCCA has been reduced from 15 to 5 percent, while the extraregional openness has stayed at around 45 percent. This means that the starting point for integration in the 1990s will not spontaneously generate policy coordination; this coordination will only be achieved if the magnitude of the political commitment leads to the adoption of harmonization measures.

An element that has facilitated policy harmonization in the 1990s is the stabilization and adjustment programs that have been implemented in the different Central American countries with the purpose of liberalizing their economies and reducing their external and internal macroeconomic imbalances. These programs have generated some policy coordination, at least in terms of achieving common objectives. Even with the differences in implementation from country to country, these programs represent the same logic and meaning for economic policy, implying the same diagnosis and the application of similar instruments, leading to a greater homogeneity among the countries of the region.

Although these programs have provided more stability, they do not translate into a permanent solution to the need for policy coordination. There exist areas where the regional cooperation effort cannot be replaced by other, more indirect means. The priority tasks for coordination are in trade policy, where the fulfillment of the commitment to establish a common external tariff by the end of 1992 is indispensable.

In order for the common external tariff to exist in practice and for trade policy to be coherent, the surcharges that still exist on imports must be abolished, and the problem of taxes on consumption and other non-tariff barriers must be tackled. In certain cases, such as the surcharges, there already exist commitments to eliminate them in a defined period; but there persist a series of non-tariff barriers whose treatment has still not been incorporated into the commitments of the new integration scheme.

Moreover, by the end of the 1980s, all the countries had abandoned the system of fixed exchange rates, replacing it with a variable exchange rate as an active instrument of export promotion. This opens a field of coordination which necessarily must be dealt with in the integration of the 1990s and for which there is no previous regional experience. What must first be avoided is explosive fluctuations of exchange rates that would discourage the fulfillment of commercial agreements.

As for monetary and fiscal policy, which includes highly sensitive topics within the countries such as the taxation question, the only requirement is that this be coherent with exchange policy in favor of a real, competitive, and
stable exchange rate. In these areas and in others related to stimulating investment, the countries may maintain differences that would permit them to attract investment, especially those countries that are relatively less developed. In any case, it should be kept in mind that the factors susceptible to harmonization should be incorporated onto the negotiating agenda as the integration process proceeds. It is important that these harmonizing measures be taken ex ante in those areas which most affect interchanges. The practice of ex post defensive measures should be avoided when a country feels affected by the political decisions of another member of the scheme.

At the sectorial level, policy coordination gradually will need to include the different sectors insofar as they are incorporated in the process of trade liberalization. This is the case of the agricultural sector, where the liberalization of the exchange of products leads to the adoption of a common agricultural policy when policies toward this sector are harmonized. In the medium term, with regional cooperation in services, the region will require solving, in a coordinated fashion, the problems related to the prices of public services, the role of state monopolies, and so forth.

Finally, not all the areas require the most advanced level of harmonization. This can be achieved in phases starting from the basic form, which consists of the interchange of information, toward more complex levels such as the search for congruence in long-term objectives, harmonization proper, and policy coordination in the short term.

INSTITUTIONAL PROBLEMS OF THE NEW INTEGRATION

The institutional problem of integration has been treated in a chaotic and disorderly manner without a truly coherent and rational frame of reference. Instead of strategies of institutional development, there seem to have existed not only varied, but dissimilar, spontaneous political initiatives: from the creation of PARLACEN to the new version of ODECA (Organization of Central American States), through the appearance of commissions, subcommissions, secretariats, executive committees, and so on. Each of these threatens to barricade itself in bureaucratic preserves encapsulated in its own and sectorial interests.

Attempts are being made to revitalize old organizations such as ODECA, ignoring the history of that organization and its negative image in many sectors. Many institutions have been created because of some transitory need and should have been abolished when that need was met. Instead, these organizations have become permanent and have been searching to invent a role for themselves. Unfortunately, because the staffs of these organizations have political ties to national political decision makers, it has become especially difficult to eliminate them or even reduce their size.

Today it is especially important and urgent to revitalize the integration secretariat into a truly modern, efficient organization. If, as is advisable, it were possible to transform today’s SIECA, it could play this role, although for that it would have to restructure and be provided with the necessary means and personnel to do so. It is in this type of new entity, directly linked to real developments in regional cooperation and which the economic integration process urgently needs for its development, that the greatest efforts should be centered and not in the PARLACEN or the ODECA. The Parliament, besides being accompanied by political tensions and problems in its formation, does not carry out truly specific functions in the integration scheme. One of the few functions which the constituent treaty assigned to it was that of designating the higher functionaries of the Community; however, with the Accords of Tegucigalpa which revived ODECA, the function of designating the secretary general of the entity, that is, the highest functionary of the Community, was transferred, as Article 25 of the Protocol of the ODECA Charter requires, to the meeting of presidents.

A rationalization of this institutional universe,
based on a realistic analysis of the role that each entity plays in the integration process, is a priority task for institutional development. It is not a secondary or subordinate question, but a decisive one for the future of the new integration scheme. The absence of useful and functional institutions will become an insurmountable obstacle if it is not treated with the attention and strictness it deserves. One of the most appropriate mechanisms for treating this question in general seems to be the adoption of a policy that would specifically reorientate external support only to those entities that have a functional, practical, and useful purpose.

This rationalization should not follow models foreign to Central American reality or ideological considerations. Rather it should flow naturally from the state of development reached by intraregional relations. We are referring not to a useless exercise in social and institutional engineering but to clear planning to assist the development of the integration process without inappropriate political pressures. Such pressures could deepen nationalism and provoke resentments that ultimately block integration. Channeling resources specifically to these entities and supplying them with the necessary means to fulfill their mission would contribute a material, social, and cultural base indispensable to achieving further solid growth in the process of institutional development in the region.

For this reason it appears that an important dose of realism, careful rationalization in the distribution of resources, prudence in relations with all actors involved in the process, and historical patience — particularly on those issues that affect sovereignty — seem to be key elements for a positive and effective attitude in the solution of institutional problems in the new Central American integration.

INTERNATIONAL DIMENSION

Initially the projected Central American Economic Community was affected by the search by some Central American countries (Costa Rica, Honduras, and, more recently, El Salvador) for bilateral accords with the United States and Mexico, in the hope of entering NAFTA. However, very recently this has begun to change — if not with the speed that the importance of the question requires — because of the announcement by U.S. officials that difficulties exist in providing Central American access to NAFTA. (See Appendix 12.) The illusory initial attitude of a quick arrangement with the United States has had the negative effect of weakening regional integration policies in favor of what turned out to be only a remote possibility. However, this change in the expectations of Central American integration with North America has had positive effects on the future of Central American integration by introducing a more realistic appreciation of the difficulties the region must overcome in its negotiation with North America and by elevating the significance of short- and long-term regional cooperation in the Central American political and business leadership.

In effect, the euphoria of the prospects of entering NAFTA, which had marked the first moments of the adoption of the Central American Economic Action Plan, has been followed by a new attitude, which is less optimistic and more realistic. The negotiation between North America and Central America will be much slower and more difficult than that going on between the United States and Canada with Mexico.

The signals coming out of Washington have finally begun to be understood in the region, although as has been noted, not with the speed and clarity they should have been. Illusions still persist of rapid agreements, based on considerations foreign to those properly economic and commercial, and which every day have less weight in decision making in the United States. This is having the positive effect of producing a revaluation of the new integration as the most
effective and realistic path for the Central American countries for improving their competitiveness and access to the world market.

Another important actor at the regional level is Mexico, whose relations with Central America have more of a political and strategic character, and only secondarily one of economic and commercial interest. (See Table 5.) The opposite seems to be true for Central America, which furthermore erroneously sees in its relationship with Mexico a bridge for its products destined for North America, underestimating the controls established for the place of origin of products. Counting on a commercial ally within NAFTA, although of lesser importance, is also a Central American consideration in its negotiations with Mexico.

Negotiations with Mexico for a free trade agreement are not an obstacle for the new regional integration and are in fact an important stimulus. In that sense, the Mexican perspective, which considers the Central American isthmus as its southern frontier and which should therefore be free from any foreign interference, instability and violence that might open the possibility of interventionist military actions, favors the positive influence of Mexico for the development of the new Central American integration. This does not mean that relations with Mexico are free from difficulties and tensions, particularly in trade matters. It simply means that politically the international environment, and particularly Mexico, are contributing favorably to the new integration project.

As for Venezuela and Colombia, these countries appear as minor partners in the effort at economic and commercial opening which Mexico and Central America are carrying out. Even though their contribution is not negligible, it is limited; it favors the new integration process, in that both countries are interested politically and commercially in the region as a stable, integrated, and democratically consolidated area.

Even though Panama has been participating in the presidential summits, and despite its positive governmental pronouncements in favor of integration with Central America, in reality it does not seem possible that it could solve its diverse difficulties which hinder its full participation in the new integration. It could nonetheless, play a significant role as a partner close to the region, supplying services in exchange for Central American products, in a mutually beneficial relationship.

More difficult is integration with Belize, whose small size and limited trade relations with the region (See Table 5.) indicate increased integration at a very slow pace and over the very long term, without prejudice to specific bilateral interests that could develop between that country and neighboring Guatemala.

Chile, for its part, is a distant expression of interest for the region. Central America wishes to facilitate its relations with that country, so as to eliminate obstacles and eventually win it as an ally, along with Mexico, to make up the future free trade zone of North America.

CARICOM is only relevant in the distant future. For now, however, it is a competitor in some markets and a partner difficult to include in the very different socioeconomic agenda that Central America has.

All this tends to strengthen the idea that the step to a new integration of the Central American countries confronts international conditions that are favorable to the future development of the region and perhaps its eventual insertion in NAFTA and in the world market.
Table 5
Central America: Exports to and Imports from Different Countries/Regions as Percentage of Total Exports/Imports, 1990

<table>
<thead>
<tr>
<th></th>
<th>Costa Rica</th>
<th>El Salvador</th>
<th>Guatemala</th>
<th>Honduras</th>
<th>Nicaragua</th>
<th>Central America</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Exports (%)</td>
<td>Imports (%)</td>
<td>Exports (%)</td>
<td>Imports (%)</td>
<td>Exports (%)</td>
<td>Imports (%)</td>
</tr>
<tr>
<td>U.S.A.</td>
<td>37.7</td>
<td>38.6</td>
<td>33.1</td>
<td>42.6</td>
<td>38.7</td>
<td>39.5</td>
</tr>
<tr>
<td>Mexico</td>
<td>0.2¹</td>
<td>6.0¹</td>
<td>0.8</td>
<td>7.7</td>
<td>3.1</td>
<td>6.7</td>
</tr>
<tr>
<td>Venezuela</td>
<td>0.8¹</td>
<td>7.4¹</td>
<td>0.0</td>
<td>6.3</td>
<td>0.0</td>
<td>7.2</td>
</tr>
<tr>
<td>Colombia</td>
<td>0.4¹</td>
<td>1.6¹</td>
<td>0.0</td>
<td>0.6</td>
<td>0.3</td>
<td>0.7</td>
</tr>
<tr>
<td>Panama</td>
<td>2.9¹</td>
<td>1.8¹</td>
<td>1.5</td>
<td>0.6</td>
<td>2.4</td>
<td>0.7</td>
</tr>
<tr>
<td>CARICOM</td>
<td>0.8¹</td>
<td>0.4¹</td>
<td>0.3¹</td>
<td>0.0¹</td>
<td>1.2¹</td>
<td>0.3¹</td>
</tr>
<tr>
<td>Belize</td>
<td>0.1¹</td>
<td>0.0¹</td>
<td>0.2¹</td>
<td>0.0¹</td>
<td>0.1¹</td>
<td>0.0¹</td>
</tr>
</tbody>
</table>

¹1988 ²1989

CONCLUSIONS

Our research has examined regional integration in Central America from a variety of perspectives—economic, political and institutional. In the final analysis, however, regional integration is a mechanism to help a group of nations to achieve a variety of shared goals. In Central America it is clear that the theoretical case in favor of regional integration rests on two principal arguments. First, it is expected to contribute towards the movement in favor of peace and democracy in the political sphere; second, regional integration is seen as an instrument for increasing economic efficiency and permitting Central America to compete more effectively in the world market.

We believe that these theoretical arguments are soundly based. Although it is true that part of the problem of political instability in the past arose from national conflicts, the integration of countries and the need to coordinate policies over a wide range of issues can still help to reduce tensions among nations and create better social and economic conditions so that the political arguments in favor of Central American integration are strong. Although regional integration in Central America in the past was subordinate to a model that emphasized import-substituting industrialization, it is possible to design an integration scheme which is consistent with export-led growth and the promotion of non-traditional exports. Such an integration scheme, however, must put much greater emphasis on supply-side measures designed to reduce costs of production and less emphasis on demand-side measures intended to build a protected regional market. This is the fundamental difference between the old and the new integration schemes in Central America.

The theoretical case is important, but in itself it provides no guarantee that a successful
integration scheme can in fact be implemented. Our investigations have demonstrated many of the pitfalls and problems which have been, and will be, faced by the effort to construct the CEC. Yet it is important to remember that the circumstances under which the new integration scheme is being launched are relatively favorable. Public attitudes toward economic integration are generally very positive both among the five republics of the region and among the principal pressure groups in each country. Although our work has revealed differences in attitudes toward political integration on the part of the principal actors, there is a broad consensus—for the first time in many years—in favor of a renewed attempt at economic integration. Similarly, since its low point in 1986, intraregional trade has been steadily increasing and contacts among Central Americans at all levels have never been greater.

These are all solid achievements and provide an excellent basis for launching the CEC. It is clear, however, that the new integration scheme already faces a series of problems which need to be addressed as a matter of urgency. Our research also has suggested other areas where problems are likely to arise in the future.

First, the theoretical case in favor of economic integration rests strongly on the ability of the new scheme to lower costs of production and to allow firms to compete more efficiently in the world market. A large part of these costs consists of purchases of raw materials, processed products and services. In each of these areas the design of the CEC is deficient. The scheme to liberalize agricultural trade, for example, is very partial; and there are no plans to include many products which represent an important component of the total costs of agro-industrial firms. The liberalization of trade in manufactured products has not paid sufficient attention to the numerous non-tariff barriers which restrain intraregional trade. The process of liberalizing trade in services has barely begun. In all three cases the data base needed to guide policy and to inform decisions is very deficient.

Second, all integration schemes imply some degree of policy coordination among the member countries. The stronger the degree of integration, the greater the need for coordination and even harmonization of policies. This coordination becomes more difficult as the size of the integration scheme increases. We have therefore developed in our research (See Appendix 11.) the concept of concentric circles in which the inner circle consists of the core members of the group (the five republics of Central America) followed by a series of outer circles to embrace Mexico, Panama, Colombia, Venezuela, the United States, and so on. The relationship between the inner and outer circles, i.e., between Central America and other countries, implies a series of negotiations in which Central America has at present very little experience. It is a matter of urgency that programs are developed to provide assistance to Central America in international negotiations. This is an area where the European Community can provide considerable help.

Third, an integration scheme requires the adoption of a regional institutional framework with the capacity to promote and implement policies at the regional level. At present in Central America there is a serious gap in the regional institutional framework. We view with some concern the proliferation of new institutions intended to fill the vacuum, which run the risk of creating a regional “spoils system” — a response that is all the more likely in the context of the current trend toward reduction of the size in the national state. The political support for integration, referred to above, has encouraged an uncritical approach to the building of institutions which threatens to leave the region without an appropriate framework for promoting new ideas and implementing decisions. What is needed is the consolidation of a smaller number of regional institutions with the resources and the flexibility necessary to provide real support to the integration process.

Fourth, there is an imbalance between rhetoric and reality with regard to integration in many parts of the region. The goodwill in favor
of integration has encouraged many actors rhetorically to favor whatever measures appear to further the integration process. If some of these measures were actually adopted, however, resistance would be considerable and the whole integration process could be put at risk. In this report we have used the example of full labor mobility to illustrate this problem, but there are many other examples which we could have chosen.

Fifth, we have noted in our investigations many illusions surrounding the integration process. The CEC is still seen by some as an effective way of gaining entry to the U.S. market through membership in NAFTA. Others believe that a regional agreement with Mexico, or even Chile, will provide de facto entry for Central American products to the United States. Still others cling to the illusion that a regional integration scheme embracing CARICOM or Belize could provide access to the market of the European Community. We do not believe that these are good arguments for forming an integration scheme in Central America. At best they are a distraction; at worst they could distort the measures which need to be adopted in the CEC as a matter of urgency.

One of the principal difficulties faced by the previous integration scheme (MCCA) was the unequal distribution of benefits among the member states. Our research suggests that the distribution of benefits could again become a point of friction. Honduras and Nicaragua emerge as the republics where the balance of benefits over costs is most problematic, while Costa Rica and Guatemala appear to be much better placed. If the difficulties referred to above are resolved, then it is much more likely that all countries will be able to derive net benefits. Our research shows, however, that this will not be sufficient on its own. If Honduras, for example, is to establish its comparative advantage within the region in agricultural products, not only will it be necessary to broaden the scope of agricultural liberalization, but it will also be necessary to promote additional measures to encourage greater efficiency in Honduran agriculture. These matters deserve much more careful study.

The CEC is a new venture in Central America. It is inevitable that, just as in the case of the European Community, mistakes will be made. No integration scheme is perfect and negotiations between countries and different actors within countries are bound to involve compromises that leave some groups dissatisfied. Central America can take some pride in what has been achieved so far, but much remains to be done. It is our sincere hope that this report will provide some guidance to those individuals inside and outside the region who will have to decide on future policy.
GLOSSARY

CARICOM - Caribbean Community

CC - Cámara de Compensación
   (regional clearing house)

CEC - Comunidad Económica Centroamericana
   (Central American Economic Community)

EEC - European Economic Community

MCCA - Mercado Común Centroamericano
   (Central American Common Market)

NAFTA - North American Free Trade Area (This report uses the original
         meaning of NAFTA; now it generally refers to the Agreement under
         negotiation.)

NAUCA-II - Nomenclatura Arancelaria Uniforme Centroamericana
        (Uniform Central American Tariff Nomenclature)

ODECA - Organización de Estados Centroamericanos
        (Organization of Central American States)

PARLACEN - Parlamento Centroamericano (Central American Parliament)

SIECA - Secretaría de Integración Económica Centroamericana
        (Secretariat of Central American Economic Integration)

SCP - Sistema Centroamericano de Pagos
      (Central American Payments System)

LIST OF APPENDICES

These appendices will be published as a collection of papers at a later date.


2. Attitudes of the Central American mass public toward integration.

3. Actitudes regionales sobre la integración.

4. La integración regional en los noventa: los costos de la no integración.

5. Impact of free trade in basic grains.

6. Regional integration and trade in manufactured goods.

7. Comercio de servicios.

8. Factor mobility in Central America.

9. Sistema de pagos.

10. Armonización de políticas económicas.

11. Alternative integration schemes.


BIOPGRAPHICAL NOTES


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