THE CENTRAL AMERICAN COMMON MARKET: PROGRESS AND RECENT DEVELOPMENTS

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CHAPTER I

INTRODUCTION

Economic integration on a regional basis has become a popular trend throughout the world. Many of the developing nations of Asia, Africa, and Latin America have embraced integration as _the_ solution to their development problems. They hope to accelerate their rate of economic growth via increased intra-regional trade. Their optimism seems to have been caused by the recent success of the European Economic Community.

The Central American Common Market, CACM, has been the most successful regional integration movement in Latin America and one of the most effective in the developing areas of the world. The CACM experience may be relevant for other developing countries with equally small populations and low levels of per capita income.

The aim of this report is to review recent literature concerning the progress of the CACM in its efforts to accelerate the rate of regional economic growth through increased trade. It attempts to answer the question of whether or not economic integration is succeeding as a strategy for regional development in Central America. To achieve this aim the paper has been divided into four major parts: (1) The background chapter describes the basic economic characteristics of the five CACM member countries and their initial efforts to establish a common serve as a norm for evaluating the progress of CACM; (3) the chapter which describes the progress of the regional economy since the establishment of the common market; (4) the recent developments chapter gives a running account of the current controversy over the distribution of new integration industries and the recent military conflict between El Salvador and Honduras over the redistribution of Honduran lands held by Salvadoran squatters.

Since the purpose of this report is to evaluate the economic progress of the CACM, it seems fitting to first examine the structure of the Central American economies and the rationale that led to the establishment of the Common Market.

CHAPTER II

BACKGROUND

The Central American Economies

The nations of Central America may have similar characteristics (language, customs, and religion), but they are five individual republics each with its own distinct features, especially their economies.

Geography

The five Central American countries are located on a narrow isthmus between North and South America which covers an area slightly larger than the State of California. Mexico is their neighbor on the north and Panama borders the area on the south. The Caribbean side of the isthmus is typified by tropical rain forests and coastal plains with year-round rainfall. The Pacific side oscillates between wet and dry seasons and the monsoon season. The interior is mountainous with a temperate climate throughout the year. The large urban centers are located in this elevated region.

Land Area and Population

As shown in Table 1, Nicaragua has the largest land area of the CACM countries. Following closely with nearly equal areas are Honduras and Guatemala. Costa Rica and El Salvador are much smaller, with the latter having only one-half the size of the former.

TABLE 1

CENTRAL AMERICAN POPULATION DENSITY, 1969 ESTIMATE
(persons per square mile)

Country	Population (persons)	Land Area (square miles)	Population Density* (persons per square mile)
Costa Rica	1,580,000	19,900	79
El Salvador	3,200,000	7,700	416
Guatemala	4,700,000	42,000	114
Honduras	2,470,000	43,300	57
Nicaragua	1,790,000	57,100	31
CACM	13,810,000	170,000	81

Source: Chemical Bank New York Trust Company, "Central American Common Market," International Economic Survey, May, 1968, p. 1.

*Calculated from columns one and two.

Guatemala has the largest population (4,770,000-1969 estimate) and Costa Rica has the smallest population (1,580,000-1969 estimate).

It is no surprise that El Salvador with the second highest population, also has the highest population density with 416 persons per square mile. The next highest is Guatemala with 114 persons per square mile.

Membership

Today all the Central American countries except Panama are members of the CACM. El Salvador, Guatemala, Honduras, and Nicaragua were the original signatories of the General Treaty on Central American Economic Integration. Signed in December of 1960, the General Treaty now serves as the basis of association for CACM. Costa Rica did not become a member until September of 1963.

Agriculture

The strategic position of agriculture in the Central American economies is illustrated by Table 2. Agriculture provided employment for 64 per cent of Central America's labor force during 1962, while generating over one-third of the regional gross national product. Agriculture also supplied over half of the regional income and comprised 90 per cent of the region's export earnings as late as 1950. By 1960, 80 per cent of regional export earnings were contributed by the three leading export crops--coffee, bananas, and cotton.[1]

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[1]Roger D. Hansen, Central America: Regional Integration and Economic Development, (Washington: National Planning Association, 1967), pp. 6-7.

TABLE 2

CENTRAL AMERICAN AGRICULTURE, 1962

Country	Agriculture as Per Cent of Gross Domestic Product	Per Cent of Labor Force Employed in Agriculture
Costa Rice	32	52
El Salvador	32	61
Guatemala	30	67
Honduras	46	71
Nicaragua	38	60
Central America	34	64

Source: Informe Sobre los Planes Nacionales de Desarrollo y el Porceso de Integracion Economica de Centro-america, (Washington, D. C.: Pan American Union, 1966), p. 118.

Nicaragua and Honduras are more dependent on their agricultural sector than the other three CACM members. Both countries have requested special consideration from the CACM in the negotiation of the Fiscal Incentives Agreement because of their relatively less developed situation. The controversy that has evolved since the initial requests will be further discussed in Chapter V.

Agricultural export earnings have experienced short-run fluctuations because of the volatility of world market prices on primary goods. These fluctuations have had serious effects on Central America's over all rate of economic growth. These effects will be considered below in the discussion of growth rates.

Gross National Product

Guatemala seems to be the region's leading economy with a 1968 GNP of nearly one and a half billion dollar equivalents (1 quetzal = 1 dollar) as indicated in Table 3. El Salvador placed a distance second with 912 million dollar equivalents (2.5 colones = 1 dollar).

In contrast, Table 4 shows that Costa Rica and Nicaragua have the largest GNP on a per capita basis with $436 and $367 respectively.

Growth Rates

Total GNP increased at an average annual rate of 4.6 per cent over the 1950-59 decade as indicated in Table 5, compared to a 5.4 per cent rate from 1960 to 1968.

TABLE 3

CENTRAL AMERICA: GROSS NATIONAL PRODUCT
IN CONSTANT 1967 PRICES
(Millions of dollar equivalents)

Year	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	CACM
1950	258	392	700	265	237	1,852
1951	264	411	713	284	253	1,925
1952	301	443	728	301	290	2,063
1953	335	457	747	321	294	2,154
1954	357	468	761	324	331	2,241
1955	373	489	783	333	343	2,321
1956	383	514	856	346	349	2,448
1957	409	538	903	384	382	2,616
1958	430	544	944	389	381	2,688
1959	446	553	989	409	388	2,785
1960	468	594	1,013	431	394	2,900
1961	482	607	1,056	433	419	2,997
1962	506	669	1,094	453	463	3,185
1963	538	697	1,197	462	496	3,390
1964	539	763	1,251	487	536	3,576
1965	594	803	1,306	520	599	3,822
1966	635	837	1,367	555	615	4,009
1967	671	882	1,416	577	641	4,187
1968	720	912	1,487	606	677	4,402

Source: Agency for International Development, <u>Gross National Product: Growth Rates and Trend Data</u> (Washington, D.C., 1969), p. 9.

TABLE 4

CENTRAL AMERICA: PER CAPITA GROSS PRODUCT
IN CONSTANT 1967 PRICES
(Dollar equivalents)

Year	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	CACM
1950	300	211	250	183	224	231
1951	297	215	246	191	232	233
1952	327	225	243	197	258	242
1953	351	226	241	204	254	245
1954	361	225	238	200	278	247
1955	363	229	237	200	280	248
1956	358	234	250	202	278	253
1957	368	238	255	217	296	262
1958	373	234	258	213	286	261
1959	372	232	262	218	283	262
1960	373	242	259	222	279	264
1961	371	240	261	216	288	265
1962	377	257	262	219	309	272
1963	387	259	277	216	322	280
1964	375	274	280	220	336	286
1965	399	279	283	228	362	296
1966	412	281	287	235	358	300
1967	421	286	288	236	360	303
1968	436	286	293	240	367	308

Source: Agency for International Development, <u>Gross National Product: Growth Rates and Trend Data</u> (Washington, D.C., 1969), p. 9.

TABLE 5

CACM: ESTIMATED AVERAGE ANNUAL PER CENT CHANGE IN TOTAL GROSS NATIONAL PRODUCT

Country	1950-1955	1955-1960	1960-1965*	1965-1968*	1963-1968*	1960-1968*	Change from Preceding Year							
							1961	1962	1963	1964	1965	1966	1967	1968
Costa Rica	7.7	4.6	4.9	6.6	6.1	5.6	3.0	5.0	6.3	0.2	10.2	6.9	5.7	7.3
El Salvador	4.5	4.0	6.3	4.3	5.5	5.5	2.2	10.2	4.2	9.5	5.2	4.2	5.4	3.4
Guatemala	2.3	5.3	5.2	4.4	4.4	4.9	4.2	3.6	9.4	4.5	4.4	4.7	3.6	5.0
Honduras	4.7	5.3	3.9	5.2	5.6	4.4	0.5	4.6	2.0	5.4	6.8	6.7	4.0	5.0
Nicaragua	7.7	2.8	8.8	4.2	6.5	7.0	6.3	10.5	7.1	8.1	11.8	2.7	4.2	5.6
CACM	4.6	4.6	5.7	4.8	5.4	5.4	3.3	6.4	6.4	5.5	6.9	4.9	4.4	5.1

*Calculated from the annual data in the right-hand section of this table.

Source: Agency for International Development, _Gross National Product: Growth Rates and Trend Data_ (Washington, D.C.: 1969), p. 2.

As mentioned above, falling export earnings have had depressing effects on the over-all rate of economic growth. World demand for Central American exports was strong during the first half of the 1950's and the regional economy grew at an annual rate of 4.7 per cent. Then in 1957, coffee prices began to fall, causing the growth rate to drop to 2.8 per cent for the remainder of the decade. The average price of CACM exports fell by 31 per cent. During the early 1960's, export prices began to stabilize with the expansion of meat, sugar, and cotton exports.[2]

Table 6 indicates that as a result of higher prices, CACM export earnings nearly doubled during the 1960-66 time period. This increase in the growth rate of export earnings coincided with an over-all growth rate of 5.7 per cent.

Hansen feels that without this boom in export earnings the Central American growth rates would not have risen substantially above the level of the 1950's.[3]

This temporary boom does not alter the fact that the long-term prospects for CACM's traditional exports will not be sufficient to support an acceptable rate of growth in the future.

> Prospects for the region's traditional exports, however, underline the problems of export dependence with regard to longer-term trends. Prospective world demand and supply conditions for these crops now appear such that Central America's export sector is more likely to grow in the future at a 3-4 per cent rate than at the 10 per cent rate of the early 1960's.[4]

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[2]*Ibid.*, p. 6.

[3]*Ibid.*, p. 7.

[4]*Ibid.*, pp. 7-8.

TABLE 6

CENTRAL AMERICAN EXPORTS, 1960-66
(Millions of dollars)

Country	1960	1961	1962	1963	1964	1965	1966
Costa Rica	85.8	84.2	93.0	95.0	113.9	111.8	135.5
El Salvador	116.8	119.1	136.3	153.8	178.1	188.7	188.9
Guatemala	112.7	110.2	114.5	151.5	164.3	185.8	226.1
Honduras	61.9	72.3	79.8	81.9	91.8	126.0	144.1
Nicaragua	62.9	68.4	90.2	106.8	125.2	149.0	142.2
CACM	440.1	454.1	513.8	589.1	673.4	761.3	836.9

Source: SIECA,* *Indicadores Economicos Centroamericanos*, No. 2, December, 1967, p. 53.

*Secretaría Permanente del Tratado General de Integración Ecónomica Centroamericana (Permanent Secretariat of the General Treaty of Central American Economic Integration).

When gross national product is considered on a per capita basis, the results are overshadowed by the 3.4 per cent current annual rate of population growth as indicated in Table 7. The average annual rate of growth in GNP per capita was 1.45 per cent for the decade of 1950's. The rate increased to 2.3 per cent for the first half of the 1960's but fell to 1.4 per cent for the 1965-68 time period. The growth rate in per capita GNP has been 1.9 per cent over the last eight years.

A New Strategy

This slow rate of growth in per capita income prompted Central American economic leaders in the early 1950's to seek new means of accelerating the growth rate.

Import Substitution

The Economic Commission for Latin America prescribed import substitution--domestic production of formerly imported goods--as the remedy for the slow rate of economic growth in the Common Market countries:

> A system of protection leading to the gradual industrialization of the underdeveloped economics would thus free them from their substantial dependence upon world demand conditions for their primary products exports--conditions which seemed unfavorable and over which the underdeveloped countries had little control. Only in this way, it was argued, could these countries plan for and implement policies of sustained economic growth.[5]

The Central American countries soon realized that the limited size of their national markets would not permit the "efficient operation of large-scale modern industry."

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[5] *Ibid.*, p. 19.

TABLE 7

CACM: ESTIMATED AVERAGE ANNUAL GROWTH RATES

Country	Per Cent Change in GNP Per Capita														Current Rate of Population Growth
							Change from Preceding Year								
	1950-1955	1955-1960	1960[a]-1965	1965[a]-1968	1963[a]-1968	1960[a]-1968	1961[b]	1962[b]	1963[b]	1964	1965	1966	1967	1968	
Costa Rica	4.0	0.5	1.4	3.1	2.5	2.0	-0.5	1.6	2.7	-3.2	6.4	3.4	2.2	3.7	3.5
ElSalvador	1.7	1.2	3.0	0.8	2.0	2.1	-0.8	7.1	0.8	6.0	1.7	0.7	1.8	-0.2	3.6
Guatemala	-1.1	1.9	1.8	1.2	1.2	1.6	0.8	0.4	5.7	1.1	1.1	1.4	0.4	1.8	3.2
Honduras	1.8	2.2	0.5	1.8	2.1	1.0	-2.7	1.4	-1.4	2.0	3.3	3.2	0.5	1.6	3.4
Nicaragua	4.8	-0.1	5.4	0.5	2.7	3.5	3.2	7.3	4.2	4.3	7.8	-1.2	0.5	2.1	3.5
CACM	1.5	1.4	2.3	1.4	1.9	1.9	0.4	2.6	2.9	2.0	3.4	1.4	1.0	1.7	3.4

[a]Calculated from the annual data in the right-hand sector of this table.

[b]Calculated from data in Table 4.

Source: Agency for International Development, Gross National Product: Growth Rates and Trend Data (Washington, D.C., 1969), p. 2.

Consequently, surplus capacity in certain industries existed alongside a general shortage in industrial capacity.[6]

Trade Agreements

Once the Central American leaders realized that industrialization was being inhibited by small national markets, they began to negotiate new regional free trade on a bilateral basis. The preparatory stage for regional integration ended in a series of treaties and accords between 1958 and 1961 which now form the basis of CACM and its major institutions. The General Treaty on Central American Integration--signed in December, 1960--stated that all Central American products should be freely traded except for those goods specifically excluded. By January, 1967, over 95 per cent of the value of intra-Central American commerce was entitled to free trade.[7]

The Central American Convention on the Equalization of Import Tariffs--signed in 1959--was the second general instrument. Together with the General Treaty it established the basis for exclusive free access to the protected regional market by the Central American producers. By 1966, internal tariffs had been removed from about 98 per cent of the items in intra-regional trade. The remaining 2 per cent makes up one-fifth of the value of CACM trade. This convention and numerous protocols negotiated as part of it, have served as the basis for the formation of the

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[6] *Ibid*.

[7] Roger D. Hansen, "Time of Trial for the 'Other' Common Market," *Columbia Journal of World Business*, II (September/October, 1967), 96.

CACM's uniform external tariff. A number of special instruments were created to accelerate the transformation of existing regional economic structure. New industries employing advanced technology have helped in modernizing the traditional industrial structure. The most important of these special instruments includes: (1) the Central American Bank for Economic Integration (CABEI), (2) the Agreement on the System for Central American Integration Industries, (3) the Agreement on Fiscal Incentives to Industrial Development.[8]

[8] *Ibid.*

CHAPTER III

THEORETICAL CONSIDERATIONS

As indicated in the Introduction to this report the theory of "customs unions" will not be treated in a comprehensive manner. This chapter on theoretical considerations has been included only to serve as a framework for the evaluation of the CACM's progress.

Although all common markets are customs unions, not all customs unions are common markets as Hansen explains in the following description of the CACM:

> While the Central American integration scheme is generally referred to as a common market, it might be more accurately termed a customs union. The latter is characterized by free trade within the union and the equalization of tariffs in trade with nonmember countries. The term "common market" generally refers to an integration scheme which includes, in addition to internal free trade and a common external tariff, the abolition of all restrictions on the movement of factors of production within the union. The Central American Common Market is characterized by almost complete free trade between member countries and a common external tariff, but little has been achieved thus far with regard to the freedom of movement of labor and capital. Since the Central American integration experiment is generally referred to as a "common market," the term is used in this article.[9]

Earlier Success Through Integration

In 1841, Friedrich List observed that a striking inequality

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[9] *Ibid.*, p. 104.

of capacity to produce existed among the world's great nations.[10] That same inequality exists today between the developing countries on the one hand and the developed countries on the other.

Classical theory suggested that each nation produce according to its comparative advantage with no interference from government. This theory was acceptable for England which was already well-developed and highly industrialized. But the developing countries like the United States and Germany could not compete in a free market with England's manufactured goods. Nor were the developing countries encouraged by England to develop a balanced productive base through industrialization. The United States and Germany both decided to form common markets to solve their development problems. Today it is quite evident that both countries were successful.[11]

Current Approach to Integration

Many of the developing nations (including Central America) are now using a similar approach to accelerate economic growth:

> ...Countries following the advice given by protagonists of the balanced growth doctrine may strive for economic integration in order to ensure a sufficiently large market for the parallel development of new industries. In carrying out programs for industrialization, the exploitation of economies of scale unattainable in the small national markets will assume importance. It is also alleged that

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[10]Friedrich List, National System of Political Economy, trans. by Sampson S. Lloyd (New York: Longmans, Green and Co., 1922), p. 293.

[11]William and Helga Woodruff, "The Illusions About the Role of Integration in Latin America's Future," Inter-American Economics Affairs, Vol. 22 (Spring, 1969), p. 71.

> establishing a union furthers economic development by increasing the bargaining power and reducing the external vulnerability of the member countries. Finally, the increased interest in integration in the underdeveloped countries may be attributed in part to a desire to imitate the European example and to deliberate efforts to counteract possible trade-diverting effects of the European Common Market.[12]

Economists are sharply divided in their opinions on the chances that the Common Market will be successful. Their expectations vary according to the criteria--static or dynamic--which they use to evaluate the effectiveness of customs unions in general.

Static Criteria

Representing the traditional, static point of view, Jacob Viner has proposed that the test for effectiveness be whether or not a customs union is trade creating or trade diverting. Trade creation refers to a shift from high-cost domestic production to lower-cost production in a partner country; trade diversion involves a shift from the lowest-cost external producer to a higher-cost partner.[13]

Trade creation and trade diversion are static welfare concepts designed to evaluate the effects of a customs union on the allocation of economic resources both within the union and in the rest of the world. Other static welfare effects are

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[12] Bela Balassa, The Theory of Economic Integration (Homewood, Illinois: Richard D. Irwin, 1961), p. 6.

[13] Rolf Sannwald and Jacques Stohler, Economic Integration (Princeton, New Jersey: Princeton University Press, 1959), pp. 45-46.

concerned with the location of consumption, and the terms of trade.[14]

Traditional "customs union" theory deals with the re-allocation of resources after the formation of the union and emphasizes specialization of production according to comparative advantage--the basis of the Classical argument for gains from trade.

This traditional, static approach has attempted to evaluate the progress of a customs union by the degree of specialization achieved upon the elimination of internal tariffs from the free trade area. Such an approach seems quite reasonable for a customs union of industrialized countries, like the Europe Economic Community. However, the possibilities of specialization are dependent on the volume of intra-regional trade, which in a customs union of developing nations, like the CACM, expands significantly only in the long-run through the process of industrialization and the growth of effective demand.[15]

Dell has stated that traditional "customs union" theory has no place in the evaluation of regional integration in the developing areas of the world:

> As regards underdeveloped countries. . . the conventional theory simply misses the basic point. Being designed to explore the problem of optimal allocation of given resources, under given condition of production, within a competitive framework, it cannot illuminate situations, such as those which arise in underdeveloped countries, in which neither

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[14]Richard G. Lipsey, "Economic Unions," International Encyclopedia of Social Sciences, 1968, VII, 543.

[15]Bela Balassa, Economic Development and Integration (Mexico: Centro de Estudios Monetarios Latinoamericanos, 1965), p. 34.

> resources nor condition of production can be taken as given, and in which immobility of factors of production obstructs the operation of market forces. For any underdeveloped country contemplating closer economic ties with its neighbours the primary question is not--will this enable us to use our present resources more efficiently? Still less is it a question of whether such associations would lead to a more efficient utilization of world resources as a whole, for underdeveloped countries are surely entitled to look after themselves first and foremost and let the developed countries fend for themselves--as indeed they are very well able to do. The primary question for any potential grouping of underdeveloped countries is whether discriminatory encouragement of trade with one another would tend to accelerate the rate of *growth* or not. (Italics mine.)[16]

Hence static theory has shown little concern for the interdependence between economic integration and development. It has tended to overlook the dynamic impact of the fusion of national markets. Little attention has been given to the factors in a customs union that could lead to the development of existing resources in the less developed countries. This seems reasonable because, prior to the last decade, integration theory dealt exclusively with customs unions among the industrial economies.

Yet the most important question is *not* how much intra-regional trade will expand when discriminatory restrictions are removed, but rather how much economic development will contribute to the increase in intra-regional trade within an integrated area. Only a dynamic analysis can help answer this fundamental question.[17]

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[16] Sidney Dell, *A Latin American Common Market?* (New York: Oxford University Press, 1966), pp. 16-17.

[17] Balassa, *Economic Development and Integration*, p. 34.

Dynamic Criteria

Bela Balassa holds that a dynamic analysis is essential because the benefits of a customs union among developing nations are based on the rapid rate of increase in economic growth following a sudden expansion of the market size. The traditional static criteria are inadequate for evaluating such a customs union.[18]

Lipsey has defined the dynamic welfare effects to include: (1) the rise of economies of scale, (2) the effects on market structures, and (3) the effects on the underlying growth rate of member countries.[19]

The economies of scale will be discussed briefly in connection with market size and also industrialization. The discussion on "development strategies" below will consider the dynamic effects of integration on the underlying growth rate. The effects on market structure will not be discussed in this paper.

Market Size and Economic Growth

Adam Smith stated long ago that specialization is limited by the extent of the market.[20] Today, the most formidable obstacle to expanded import substitution in the developing countries is the limited size of the national markets. Allyn

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[18] *Ibid.*

[19] Lipsey, p. 543.

[20] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Modern Library ed; New York: Random House, Inc., 1937), p. 4.

Young held this opinion as early as 1921. "Taking a country's economic endowment as given . . . the most important single factor in determining the effectiveness of its industry appears to be the size of the market." Young has defined the size of the market by the volume of production.[21]

The size of the national market cannot be satisfactorily measured by a country's population because such a measure would overlook the fact that effective demand varies with the individual's wealth and income. Gross national product is a more appropriate measure because it excludes persons outside the money economy. The limited size of the market in the Central American nations is due as much to low level of development--effective demand--as it is to the small national population or geographic area. Hence it is hoped that economic integration will widen the Central American market by raising the rate of growth in per capita income in addition to the immediate five-fold expansion in geographic area and population.

The goal of most leaders and economists in the developing countries is the highest possible rate of long-term growth. How these countries should go about achieving this goal is a much more controversial issue. Several different strategies for economic development have been tried by the Central American countries.

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[21]Allyn Young, "Increasing Returns and Economic Progress," Economic Journal, Vol. XXXVIII (December, 1928), pp. 532-39.

Development Strategies

Export Expansion

Export expansion of primary products was long considered an "engine of growth." It is based on the doctrine of international comparative advantage. Through the division of labor and specialization, the world as a whole and therefore individual nations are economically better off if they specialize in the production of those goods which they can make the most efficiently and exchange part of the output with other nations.

The relatively slow growth in CACM's export earnings in the last twenty years indicates the limited possibilities for accelerating economic growth merely through export expansion of primary products.[22]

Specialization in the production of primary products has been ineffective in bringing about a more rapid rate of growth because: (1) primary commodities are historically vulnerable to fluctuation in price and export earnings which can produce a major crisis if sudden falls in foreign exchange earnings has a restricting effect on capital imports, (2) the long-term growth in the demand for primary commodities will continue to be slow and is therefore inadequate as a stimulus to economic development, (3) the secular terms of trade have turned against the developing countries.[23]

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[22] Hansen, Regional Integration, pp. 7-8.

[23] Ibid., p. 5.

Import Substitution

Import substitution was adopted by the Central American countries in the early 1950's as an alternative to export expansion. Import substitution has contributed significantly to economic growth but the products chosen to be produced have been based more on immediate feasibility than on economic efficiency and cost of production. A more important consideration is the fact that the era of easy import substitution is over. In the past import substitution concentrated on nondurable consumer goods requiring little capital investment and uninvolved technology. Import substitution has now moved into the intermediate products--consumer durables and capital goods. This latter category of goods is more difficult to manufacture and requires a much larger market than the Central American countries have available. By widening the market through integration the opportunity to accelerate economic growth can be brought about through industrialization.[24]

Industrialization and Integration

Industrialization through regional economic integration has become Central America's new strategy for development. It is hoped that industrialization will diversify the Central American economies and help to offset the negative effects of specialization in primary products with these positive effects: (1) less vulnerability to world price fluctuation, (2) no more

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[24] Ibid., pp. 47-52.

declining terms of trade, (3) less reliance on foreign capital inflows.[25] Industrialization can also reduce the economic costs that arise from the import substitution process. Some of these costs arise from: (1) the establishment of inefficient firms and monopolistic market structures, (2) the narrow national markets leading to excess capacity industries and high average cost firms, (3) the expansion of import substitution beyond the manufacture of consumer goods. The exploitation of potential economics of scale following an expansion of the regional market is the most important economic gain from industrialization for the developing countries.[26]

There are limits to the possibilities of industrialization through simultaneous expansion of interrelated industries. However, external economics may result from the operation of input-output relationships among these industries. Broad-based expansion is dependent on the quantities of available factors (especially capital) and the market size. If the limitation of factor inputs does not permit the exploitation of economics of scale along a broad front, concentrated growth may be the second best solution. Concentrated growth may also be more conducive to technological progress since the rapid expansion of output would allow the innovation of new techniques. However, unbalanced growth is not realistic for small national markets with little effective demand.[27]

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[25] Ibid., p. 33.

[26] Ibid., pp. 23-24.

[27] Belassa, Theory of Integration, pp. 154-55.

Economic integration can provide the setting needed for combining the advantages of both balanced and unbalanced growth.

> ...within the framework of an enlarged regional market, particular industries can be permitted or encouraged to advance ahead of the rest of the economy, because they can be assured of effective support in the markets of particular countries. The economics of scale and the stimulating effect on technological progress inherent in concentrated growth can be fully appropriated. More important, however, large external economics can be exploited through interdependence of industries in production and consumption, in the case through interdependence with the industries newly established in partner countries on the basis of some kind of agreed specialization.[28]

Combining a balanced and unbalanced approach required the creation of a regional institution for the coordination of industrial investment and structure. The customs union's "centers of growth" can be established in a coordinated manner among the member countries so that rapidly expanding industries and sectors can provide the incentive for faster development of the lagging industries and sectors.[29]

Transportation could become an important source of external economies. Nevertheless, the currently inadequate system has, in effect, parcelled each Central American country into many small isolated markets with limited trade among them.

Air service is relatively abundant because of the limited expense necessary to clear an area for landing small aircraft. However, air transport cannot integrate the numerous local markets due to the limited capacity of each plane and the tremendous bulk of the primary goods offered for sale.

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[28]Kitamura Hiroshi, "Economic Integration of Underdeveloped Countries," Latin American Economic Integration: Experience and Prospects. (New York: 1966), pp. 54-56.

[29]Belassa, Theory of Integration, p. 156.

CHAPTER IV

PROGRESS IN THE CENTRAL AMERICAN COMMON MARKET

The five instruments discussed in Chapter III have made the CACM the most exhaustive effort at economic integration in the developing world.

The progress that has taken place to date in the Common Market centers around three achievements: (1) "Improved allocation and use of existing resources through the process of trade creation" (static criteria), (2) structural changes in the regional economies through industrialization and diversification of productive capability--the result of increased investment aimed at the expanding regional market, (3) the successful attraction of increasing international assistance in financing new industry and building a regional intrastructure.[30]

"The extremely rapid growth of Central American regional trade reflects both the first and second achievements. While much of the increased trade suggests better use of established traditional industry, it also reflects expansion of investment into new and more complex product lines."[31]

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[30]Hansen, Regional Integration, p. 33.

[31]Ibid., pp. 33-34.

Intraregional Trade

Tariffs

Internal tariffs had been removed from 98 per cent of the goods traded within the area by 1966. Nevertheless, the other 2 per cent makes up one-fifth of the value of Common Market trade including essential items like refined petroleum products and important foods. Presently, the Common Market members levy the same import duties on 95 per cent of all outside imports under a single external tariff. Effective May, 1972, all the Common Market countries must adjust their duties on some 25 additional items. "This will raise the coverage of products equalized to 98 per cent with the remaining tariff classifications covering items that are charged duties under each individual country's external tariff.[32]

Growth

Between 1961 and 1967 intraregional trade increased by 478 per cent, as indicated in Table 8, rising to an absolute level of $214 million. Seven and a half per cent of total Central American imports were intraregional imports in 1961; by 1967, almost 21 per cent of those imports originated in Central America. This increase in intraregional trade was "due chiefly to the development of import substitution industries and the elimination of trade barriers."[33]

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[32] U.S., Department of Commerce, Overseas Business Reports, Latin American Economic Integration: Implication for U.S. Business (Washington, D.C.: Government Printing Office, April, 1969), No. 7, p. 9.

[33] Ibid.

TABLE 8

IMPORTS, TOTAL AND INTRA-CACM, 1961 AND 1965-67

Country	1961		1965		1966		1967	
	C	M	C	M	C	M	C	M
Costa Rica	4	107	15	178	23	179	34	194
El Salvador	15	109	42	200	52	220	55	224
Guatemala	9	134	32	230	34	207	42	247
Honduras	6	72	27	122	33	149	41	165
Nicaragua	3	74	21	161	32	182	42	204
CACM	37	496	137	891	173	936	214	1,030
Per Cent CACM of Total	7.4		15.4		18.5		20.8	

[C]Intraregional imports.

[M]Total imports.

Source: U.S., Department of Commerce, Overseas Business Reports, Latin American Economic Integration: Implications for U.S. Business (Washington, D.C.: Government Printing Office, April, 1969), No. 7, p. 9.

Trade Patterns

As noted above, the CACM regional trade has tripled as a percentage of total trade. Along with this increase in regional trade, CACM has experienced a shift of emphasis in the over-all trade pattern from primary production to industrial production. Table 9 presents a clear picture of the direction and extent of the trade shift. Regional trade in industrial goods rose by 532 per cent over the 1960-65 time period; while regional trade in agricultural goods increased by only 108 per cent.

New Industry

New industry is a further indication of Common Market achievement in its slow but deliberate progress toward industrialization. New lines of production have expanded beyond the traditional food processing and consumer nondurables. Production has begun in several new areas: tires, metal structures, copper cable and wire, caustic soda and chlorine, insecticides and fertilizers, petroleum products and other new materials for the chemical industry. This investment was stimulated by an expanded regional market and by the special agreements discussed in Chapter I. The production of new industries specializing in intermediate goods increased as a percentage of total Central American production from 9 per cent to over 13 per cent during the 1960-64 period. The intermediate goods include pulp and paper, rubber, new intermediate chemical products, petroleum and coal derivatives, and nonmetallic mineral products. The chemical industry is the leading component of industrial production,

TABLE 9

GROWTH OF CENTRAL AMERICAN TRADE BY TYPES OF COMMODITIES
(in thousands of dollars)

Commodity	1960	1963	1964	1965	Per Cent Increase 1960-65
Total trade	$32,675	$72,098	$106,399	$135,976	316
Agricultural products	15,872	24,014	27,549	33,000	108
Fishery products	75	120	184	250	233
Forest products	1,032	2,170	2,404	4,000	288
Mineral products	139	443	379	400	188
Industrial products	15,500	45,391	75,794	98,000	532

Source: Andrew B. Wardlaw, The Operations of the Central American Common Market (Washington, D.C.: Agency for International Development, 1966), p. 19.

making up more than half of all intermediate-industry production. New plants producing fertilizers, insecticides, and detergents "represent one of the fastest growing Central American industrial sectors."[34]

"The impetus to industrialization provided by the Common Market may be judged in part by the recent increase in manufacturing as a percentage of gross national product for the region." Even though that sector is only 16 per cent of the regional GNP, its value added showed a 6 per cent average rate of increase over the 1950-62 period and has averaged more than 9 per cent annually since 1960."[35]

A higher growth rate in the industrial sector has contributed to the acceleration in the growth rate of aggregate economic activity since 1960. As Table 5 indicated, the rate of economic growth in the decade preceding the establishment of the Common Market in 1961[36] averaged 4.6 per cent annually. On the other hand, the growth rate for the region averaged 5.4 per cent per annum between 1960 and 1968, or a 1.9 per cent increase in per capita GNP.

Private Investment

The formation of the Common Market has raised external tariffs and widened the internal market demand. Both these

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[34]Hansen, Regional Integration, p. 38.

[35]*Ibid.*, pp. 39-40.

[36]The General Treaty of Central American Economic Integration was signed in Managua in December, 1960 and now serves as the basis of association for the CACM.

factors have contributed significantly to the pattern of increased private investment--domestic and foreign. Private investment as illustrated in Table 10 has grown by 57 per cent from $263 million in 1961 to $414 million by 1965. This new investment has made possible the industrial expansion described above. The export earnings from primary products has historically supplied the majority of domestic saving for industrial investment in Central America. Since 1960, rapidly expanding export earnings (see Table 4) from coffee, cotton, and bananas have contributed to these industrial investment funds. It is quite common to have these potential investment funds flee the country because of domestic instability or scarcity of profitable investment opportunities within the country. "To the extent that the regional investment opportunities provided by the integration scheme encourage the channeling of export earnings into domestic investment, the Common Market is performing a crucial function in accelerating Central American economic growth."[37]

Private foreign investment has been expanded by the developed countries for at least three reasons: (1) The enlarged market has attracted companies who had previously considered the national market in Central America too small for efficient production, (2) by establishing a uniformly high protective tariff, foreign firms were encouraged to build plants inside the region in order to avoid the tariff wall, (3) industrial incentives including very few rules on foreign exchange and sending

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[37]Hansen, Regional Integration, p. 41.

TABLE 10

GROSS FIXED CAPITAL FORMATION, 1961-65

	Annual Totals (In millions of 1960 dollars)					Annual Growth Rate			
	1961	1962	1963	1964	1965[a]	1961-62	1962-63	1963-64	1964-65[a]
Total	358.5	401.7	440.4	493.5	530.3	12.1%	9.6%	12.1%	7.5%
Public	95.6	99.6	98.6	118.0	116.4	4.2	-1.0	19.7	-1.4
Private	262.9	302.1	341.8	375.5	413.9	14.9	13.1	9.9	10.2

[a]Provisional figures.

Source: Economic Commission for Latin America, <u>Economic Survey of Latin America</u> (New York: United Nations, 1967), p. 170.

earnings home have attracted even the most wary foreign investors.[38]

This new inflow of foreign investment has been essential in Central American development because: (1) It helped overcome a perennial shortage of foreign exchange, (2) financed most of the new industries, and (3) overflowed into traditional manufacturing fields and new assembly plants.[39]

Carlos Castillo stated that private investment envisioned simply to meet the Common Market demand--including both existing and currently initiated projects--amounted to nearly 100 million dollars during the 1961-65 period.[40]

Public Investment

Lack of an adequate transportation network is now the most formidable obstacle to increasing the effective market size. The mere removal of tariff barriers could not have caused intra-regional trade to expand rapidly without the roads, rails, and airports to make increased trade feasible. The Central American governments have given priority to the construction of a regional transportation network. They have been aided in their efforts by several international groups including the International Bank for Reconstruction and Development and the Inter-American Development Bank. The United States has made a significant

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[38] *Ibid.*, pp. 42-43.

[39] *Ibid.*

[40] Carlos M. Castillo, *Growth and Integration in Central America* (New York: Frederick A. Praeger Publishers, 1966), p. 94.

contribution to the infrastructure projects both through country aid programs and through its loan of funds to the Integration Fund.[41]

In 1961, the Central American Bank for Economic Integration opened with capital supplied jointly by the Central American countries and the United States. Its stated purpose is to promote economic integration by directing domestic and external resources to "finance infrastructure projects, long-term industrial investment programs, agricultural and livestock project integration adjustment assistance, and other undertakings having a favorable regional impact. All projects financed by the Bank (CABEI) must be 'economically sound and technically feasible', have regional impact, and promote 'balanced economic development' of the area. . . . By 1968, the Bank's resources had climbed to $211 million."[42]

The Central American Integration Fund was organized in 1964 with $35 million--40-year loan--from U.S. and $35 million CACM countries. This fund is run by Central American Bank for Economic Integration and is used for financing regional infrastructure projects.[43]

During the five-year period 1961-65, public investment (see Table 10) expanded by only 21.6 per cent from $95.6 million to $116.4 million, as opposed to 57 per cent for private investment over the same period.

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[41]Hansen, Regional Integration, pp. 44-45.

[42]U.S., Department of Commerce, No. 7, p. 11.

[43]Ibid.

It seems that the majority of public investment plans have been successful, but as indicated by the above statistics the funds available for infrastructure projects have not been adequate to achieve a truly integrated market.

CHAPTER V

RECENT DEVELOPMENTS

Balanced Growth Controversy

The most immediate and crucial economic problem confronting the CACM today is the continuing clash over the issue of the equitable distribution of new industrial activity among the member countries. The market tends to force new industrial investment to concentrate itself in the more developed countries within the integrated area. This conflict came to the fore at the September, 1966 meeting of the Central American Economic Council, when the Minister of Economy from both Nicaragua and El Salvador announced their intentions to withdraw should the Council refuse their "mutually exclusive" demands. Nicaragua planned to withdraw if it were refused certain forms of preferential treatment within the Common Market under the Fiscal Incentives Agreement. El Salvador threatened to withdraw if preferential treatment was granted to Nicaragua.[44]

The Less Developed Countries of CACM

As noted above in Chapter I, Nicaragua and Honduras have requested special consideration from the CACM because they consider their countries at a relatively less developed stage than

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[44]Hansen, Regional Integration, p. 55.

the other members of the Common Market. Like Honduras in 1966, Nicaragua based its request for special treatment on the fact that Nicaraguan economic development has been hampered rather than helped by its membership in the Common Market. The Nicaraguan case is supported by regional trade statistics. A negligible trade deficit of $249,000 in 1960 has mushroomed to $11 million in 1965. Meanwhile, Honduras went from a trade surplus of over $3 million before the CACM was established to a 1965 deficit of 4.3 million. Both countries have been forced by the common external tariff to purchase large amounts of their manufactured products from the other three CACM members. Regional production is usually more expensive and poorer in quality than that previously imported from outside the area. In contrast, Nicaragua and Honduras have continued to export mostly traditional agricultural goods. These trends clearly indicate that industrialization resulting from the establishment of the Common Market has been concentrated in Guatemala, El Salvador, and Costa Rica. Honduras and Nicaragua felt that they had been supporting the growth of manufacturing in the other three countries through their own expanding industrial imports while they were receiving little in return. They demanded the right to encourage their own industrial development in exchange for their continuing support of the regional integration scheme.[45]

Backwash Effects

New industrialization tends to occur in the more advanced

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[45] *Ibid.*, pp. 55-56.

members of integration schemes. Gunnar Mydral referred to this movement of capital and skilled labor toward the more advanced centers and the investment of new industries in these areas as the backwash effects. These effects "are related to the availability of overhead capital, skilled labor and linked industrial processes, when the latter not only provide ready markets and low-cost inputs but also contribute to future improvements through the exchange of technological information and induced technical change."[46]

The System of Integration Industries

The System of Integration Industries has been considered the most important integration instrument in achieving an equitable distribution of industrialization. This agreement included: (1) The designation of a major industry of regional importance for each of the member countries, (2) the guarantee that no country would be awarded a second such industry until each country had received their first one. The System has been slow to function as planned. Only four enterprises had achieved "integration" status by 1967. The highly complicated procedures involved in attaining such status can take several years. Opposition by the United States and international lending agencies has also been responsible for the extremely slow application of the System. The U.S. is opposed because the System does not follow the directive of an AID study that "the best combination of transportation, low-cost power, adequately trained labor

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[46]Bela Balassa, Economic Development and Integration, p. 123.

force, and supply of raw materials and intermediate products should determine industrial locations. . . ." The U.S. argument was based on a static concept of comparative advantage which can be misleading when applied to the developing countries. The development process is much too dynamic in nature for such a static approach. In support of balanced growth Roger Hansen concluded: "There appears to be no sound economic reason why, over the long run, Honduras and Nicaragua should not industrialize to the same extent as other Common Market members."[47]

New Approach

CACM's Industrial Coordination took a new direction in January of 1966 when the Central American Economic Cooperation Committee passed a resolution calling for a commission on Industrial Coordination to work with the Economic Council in selecting new status and in accelerating the process of preliminary studies. The Committee also expressed the need for a protocol giving the Economic Council the power to confer integration status upon an industry without ratification by the national legislatures.[48]

In September, 1966, after a nine-month halt in CACM negotiations, Honduras was finally allowed to offer a more attractive investment incentive to new industries than the other member countries.[49]

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[47]Hansen, Integration and Development, pp. 59-61.

[48]Ibid, pp. 61-62.

[49]Ibid.

Recent Crisis

The most recent economic crisis for the CACM began in December of 1968 with the refusal of the Costa Rican National Assembly to ratify the Protocol of San Jose which had been agreed upon by the Presidents of the CACM member countries. The delay in action by Costa Rica was believed to be directly responsible for the acuteness of Nicaragua's balance of payments problem. The Protocol of San Jose called for a 30 per cent surcharge on luxury goods coming from outside the common market area. The increase in duties was aimed primarily at the consumption of luxury goods, but some primary goods were also causing problems for the area's balance of payments vis-a-vis the outside world. The Protocol was also expected to provide additional revenue for badly needed common market projects.[50]

In March of 1969, Nicaraguan President Anastasio Somoza reimposed import duties on goods from other CACM members. He stated that the reestablishment of customs duties was necessary because of Nicaragua's unfavorable balance of trade with the other CACM counties. Nicaraguans believed that the other four countries had overlooked a matter of vital importance to them. Nicaragua has traditionally experienced a trade deficit with the other CACM countries. A few days after President Somoza's action the governments of Guatemala, El Salvador, Honduras, and Costa Rica agreed to take punitive action against their fellow Common Market member, Nicaragua, by removing duty-free privileges for

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[50]"Costa Rican Inaction Endangers Central American Trade Block," New York Times, Dec. 10, 1968, p. 8.

her exports entering other common market countries.[51]

The Nicaraguan President pointed out that there were eleven Protocols that had been passed but were not in force either because they were not ratified or not deposited with Common Market authorities. He felt that this situation could be very detrimental to the whole process of economic integration in Central America. He cited the example of the Protocol on Uniform Fiscal Incentives for industrial development which gives Honduras preferential treatment because of her relatively backward economy. This Protocol is not in effect at this time because El Salvador did not give its approval. El Salvador says approval will be withheld until Honduras has deposited the instruments of ratification for the Protocol of San Jose. Honduras has replied that the deposit will be made when El Salvador approves the Protocol giving Honduras preferential fiscal incentives.[52]

Soccer War

The latest evidence of political unrest in Central America is the recent military conflict between El Salvador and Honduras over the redistribution of Honduran lands held by Salvadoran nationals (July 15, 1969). At the present time, an uneasy truce is being administered by the Organization of American States.

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[51]"Nicaragua Hit by Trade Action," Ibid., Mar. 9, 1969, Sec. 3, p. 7.

[52]"A Ponerse al Dia," Vision, March 28, 1969, p. 16.

It is too early to judge whether or not this "Soccer War" will have serious repercussions on the future of the CACM. Success will come only after the underlying problems have been resolved and cooperation again becomes the dominant force.

CHAPTER VI

CONCLUSION

The CACM has been one of the most successful regional integration schemes in the entire developing world. It was responsible for the acceleration of growth rates in both intra-regional trade and regional investments--public and private. However, the forces of nationalism and political stability have threatened to disrupt this progress.

In the long run, the survival of the CACM will ultimately depend on two factors: (1) The willingness of member nations to cooperate in integration efforts, especially on balanced industrial growth, (2) the ability of the CACM countries to maintain political stability, both on a national and regional basis.

The traditional, nationalistic spirit of the Central American Republics has been a formidable obstacle to regional integration. As related in Chapter V, there have been several conflicts among the CACM countries. The most evident among these conflicts is the battle between the more developed countries on the one hand and the less developed on the other, over the geographical distribution of new industries within the Central American area.

The roots of political unrest in Central America can probably be found in the disenchantment of the lower income class with their miserable existence and the extreme inequality of income distribution among the peoples of CACM.

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THE CENTRAL AMERICAN COMMON MARKET: PROGRESS AND RECENT DEVELOPMENTS

by

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The Central American countries of Nicaragua, Costa Rica, El Salvador, Honduras, and Guatemala have accepted economic integration as their new strategy for accelerating regional economic growth through increased intraregional trade. These five countries have significantly improved their economic well-being by forming a regional economic community known as the Central American Common Market (CACM). The results of this economic union have been to step up the rate of economic growth and increase trade both within and outside the area.

The average annual rate of growth in total GNP was 0.8 per cent higher from 1960 through 1968 than during the previous decade. The over-all growth rate of 5.7 per cent from 1960 to 1966 was reinforced by a doubling of export earnings.

A larger volume of trade has allowed the area producers to take advantage of the economies of scale, thereby improving the efficiency with which existing capital is utilized, making further investment more attractive. The 5.4 per cent increase in economic growth has been offset by a 3.4 per cent current annual increase in population.

The new strategy includes import substitution on a regional basis to expand the national markets and permit both the efficient operation of large-scale modern industry and the development of a sufficiently expanded market to insure the simultaneous development of new industries.

The traditional static approach is not an appropriate criterion for evaluation of the CACM, because it tends to overlook the dynamic impact of the fusion of national markets. The primary question is whether the formation of the common market has accelerated the rate of economic growth and how this development will contribute to the increase of intraregional trade. The rapid increase in intraregional trade that comes about immediately after the tariff barriers are dropped, is greatly enhanced if the participating countries are already industrialized. Since the Central American countries have not yet reached this stage of their development, the major gains from increased trade should come after industrialization takes place.

Market size may be the single most important factor in determining the effectiveness of a customs union in expanding intraregional trade. The limited national markets of CACM are due to the small number of consumers and the low level of per capita income (effective demand).

Progress has been made along three broad fronts: (1) Improved allocation and use of existing resources, (2) structural changes in the regional economies through industrialization and diversification of productive capability, and (3) the successful attraction of increasing international assistance in financing new industry and regional infrastructure.

Specific achievements include: (1) 500 per cent increase in intraregional trade between 1961 and 1967, (2) emphasis in the over-all trade pattern has shifted from primary products to industrial production, (3) faster growth in the industrial sector has contributed to the acceleration in the annual growth of aggregate economic activity from 4.6 per cent before 1961 to 5.4 per cent between 1960 and 1968, and (3) the expansion of private investment by 57 per cent from 1961 to 1965.