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 <u>the</u> 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 Centroamerica, (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, Gross National Product: Growth Rates and Trend Data (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, Gross National Product: Growth Rates and Trend Data (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
Guate-mala	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
Hon-duras	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
Nica-ragua	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.