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CENTRAL AMERICAN COMMON MARKET

Report by the Permanent Secretariat of the General Treaty of Central American Economic Integration

In accordance with the Calendar of Biennial Reports with respect to regional agreements adopted by the Council (L/5502), the Permanent Secretariat of the General Treaty of Central American Economic Integration (SIECA) has submitted the following report.

I am pleased to reply to your note (Ref. XXIV/208) of 2 June 1983, addressed to our office in Geneva, in which you inform us of the decision of the Council of Representatives concerning the calendar for the submission of biennial reports with respect to regional agreements and inform us that the Central American Common Market's report is to be considered in October 1983.

In keeping with the terms of your note and for the purposes indicated therein, I am sending you herewith the following documents prepared by SIECA:

Central America: Review of the economic situation (1979-1982) (SIECA/PES/03-83)

Central American macro-economic statistics (1979-1982) (SIECA/83/ESC/04)[1]

I leave it to your discretion whether to reproduce both documents for consideration by the Council of Representatives but in any case we would be pleased if document SIECA/PES/03-83 were reproduced as the report of the Central American Common Market.

[1]Available in the secretariat for consultation, Development Division, Room 2010.

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INTRODUCTION

It can be stated that since 1979 the region has been experiencing the most profound economic and social crisis in its history, resulting basically from the interaction and persistence of concomitant inflationary and recessionary pressures, both internal and external, from factors of a non-economic character and from growing monetary and financial problems.

The principal factors responsible for the crisis and its effects on the economies of the region are analysed in broad outline below[1].

1. External factors

In the last four years, Central America's economic development has been marked by a worsening of the external sector's crisis due both to a decline in domestic supply and to a contraction of demand by the industralized countries, accompanied by increasing protectionism in trade. Also of decisive influence on this development has been a marked deterioration in the terms of trade and a sudden rise in interest rates, which in addition to encouraging the outflow abroad of national capital has also raised the cost of servicing external debt. All of this has led to a pronounced scarcity of foreign exchange, which has significantly weakened the ability of each country to import goods and services from the Central American region and the rest of the world, and has brought about a deceleration in the economic activity of the countries in the region.

At the same time, public and private foreign indebtedness has grown rapidly, especially the part supplied by international private banking, with a manifest increase in short-term commitments accompanied by an increase in the proportion of medium- and long-term financing contracted at high or floating interest rates. In this connection, it must be borne in mind that the average preferential short-term interest rate in the United States rose from 9.1 per cent in 1978 to 18.8 per cent in 1981, while the average long-term interest rate in six industralized countries rose from 9.2 per cent to 14 per cent over the same period.

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[1] "Centroamérica: Comportamiento Económico y Financiero Regional" ["Central America: Regional Economic and Financial Behaviour"], July 1983. Document of the Regional Group of Co-ordinators for External Financial Co-operation, prepared with the co-operation of the Executive Secretariat of the Central American Monetary Council (CMCA), the Central American Bank of Economic Integration (BCIE), the Economic Commission for Latin America (ECLA), Mexico Office, the Inter-American Development Bank (IDB) and SIECA.

The higher cost of external resources has considerably increased the debt-servicing burden of the Central American countries and a growing proportion of the foreign exchange generated by exports must be used to deal with that obligation, thereby reducing the resources available for sustaining acceptable levels of economic activity and impeding the recovery efforts of their economies. Moreover, in recent years, the levels of external indebtedness of the region and of Latin America as a whole have contributed to the channelling of less new resources to Central America, especially from international private banking. Faced by this situation, the countries have been making prodigious efforts to negotiate terms and conditions enabling them to meet their increased external obligations.

2. Internal factors

What is more, the development of the region's economy has been affected by factors connected with its socio-economic instability and, in some countries, by a breakdown in social coexistence. National policies aimed at controlling the growing external imbalance, falling tax revenue, and declining rates of gross capital formation over three consecutive years, particularly in private investment, have combined to worsen the problem of unemployment and under-employment in the region.

Given this situation, the governments in the region proceeded in the first instance to assume a decisive and strategic rôle in mobilizing domestic financial resources and to adopt a policy of expansion of public expenditure aimed at arresting, at least partially, the depressive behaviour which private consumption and investment had been showing. However, the fact that this compensatory policy of the governments was applied in a period of unusually prolonged weakening of the external sector, accompanied by internal political and social instability, impeded the adoption of measures for broadening the tax base and had the immediate result of widening the budget deficits in the five Central American countries.

In the circumstances, the governments had recourse to greater financing from domestic sources, mainly by the central banks, which actually brought strong pressure to bear on domestic prices and the levels of international monetary reserves. In the social sphere, inflation contributed to still greater deterioration of the standard of living of the population, which becomes all the more perceptible if one considers the long period of economic growth and of price stability that had traditionally characterized the region.

Owing to the pressure exerted by the widening of budget deficits on domestic prices and the balance of payments, the governments abandoned their attempts at compensatory policy, and, from 1982 onward all of the countries adopted policies of stabilization aimed primarily at reducing domestic demand and financing and at the application of restrictive foreign-exchange measures, including adjustments of exchange rates by some countries.

Although it is premature to assess the intensity of the contraction of domestic demand being encouraged by all the countries in the various sectors of their economies, it can be stated that the socio-economic cost of that contraction is manifesting itself, at least for the short term, in a weakening of production activity and in a more severe reduction of employment opportunities. Nevertheless, positive elements are looked for in a gradual slowing of inflation and a lessening of the pressure on international reserves.

Among the economic problems being experienced by the region, the fact cannot be ignored that, in addition to the adverse effects which the recession itself has had on decisions to invest, the shrinkage of investment is connected with an uncontrolled outflow of capital, of major proportions from 1978 to 1981, which is motivated both by speculative and by pre-emptive considerations but which in any case is related to the political instability affecting the region.

To summarize, Central America is passing through the worst crisis since the depression of the 1930s, which is manifesting inter alia in:

(a) Contraction of the domestic product in real and per capita terms as a result of significant reductions in internal and external demand. The contraction in external demand has drastically weakened the ability to import, affecting especially industrial production, which is highly dependent on imported inputs, and this has resulted in considerable increases in unemployment and in levels of idle capacity in the manufacturing sector.

(b) Successive big reductions in holdings of net international reserves. These losses have resulted from successive very large current-account deficits, which were not compensated by capital inflows owing to the fall in external financing aggravated by especially heavy outflows of resources abroad.

(c) Marked contraction of intra-regional trade, which declined from US$1,129.2 million in 1980 to only US$775.1 million in 1982. At the same time, there has been a considerable increase in indebtedness associated with the settlements of the Central American Clearing House which, because they could not be liquidated in convertible currency, became a factor contributing to the contraction of that trade.

Intra-regional trade, of which more than 90 per cent consists of manufactured products, has been adversely affected by the fall in global demand in the five countries due to the reduced purchasing power of the population because of inflation and higher unemployment and, more recently, of the trade-restricting measures taken by the countries in response to the severe shortage of foreign exchange.

In spite of present conditions, the governments recognize the programme of Central American Economic Integration as essential for the region, both because of the high degree of interdependence created among the five countries during the twenty years of common market and because it is considered a suitable mechanism for initiating the economic recovery of the countries associated in the programme.

3. Response to the crisis

Faced by this sombre panorama, the Central American countries have been making huge efforts to reactivate their deteriorated national economies. However, an element which has impeded the success of those efforts is rooted in the very nature of the crisis, i.e. the coexistence and interaction of simultaneous inflationary and recessionary pressures, in that the adoption of economic policies designed to cope with one of these phenomena may intensify the negative effects of the other. The principal actions taken by the Central American countries to arrest the effects of the crisis might be divided into national and regional responses:[1]

(i) National responses

In view of the persistent external imbalance and the growing difficulties in access to international financing, the countries of the region have since 1982 adopted programmes of domestic stabilization and adjustment, either on their own initiative or under agreements with international financing bodies, particularly the International Monetary Fund and the World Bank. The limitation of public expenditure and domestic credit and the other economic-policy measures inherent in such adjustment programmes have replaced the efforts which the Central American countries had been making through compensatory programmes to cope with the recession. Specifically, as regards public finances, the governments have taken measures aimed at increasing taxes and reducing expenditure, even suspending the implementation of investment projects essential to economic development.

Such programmes, designed expressly to shrink domestic demand and thereby gradually restore acceptable levels of external-sector balance, have in turn contributed to accentuating the low levels of economic activity, unemployment and the fall in the standard of living of the population in general; on the other hand, smaller losses in international reserves and a progressive reduction in inflationary pressures have already been observed.

[1] op. cit.

The countries have taken various additional domestic measures, including the following:

(a) In the area of monetary and credit policy, measures have been implemented under the stabilization programmes to reduce domestic financing in the public sector, particularly the Central Government, and efforts have been made to stimulate national saving through interest-rate policies. In the foreign-exchange field, some countries have adjusted their exchange rates or introduced multiple-rate systems, and in all of them direct control measures have been intensified to prevent the flight of capital abroad and to channel the use of available foreign exchange towards the acquisition of strictly necessary goods.

(b) In the area of trade, the countries have established lists of priority imports, whose progressive extension to products of Central American origin has adversely affected the principle of regional preference. In the same area, some countries have also increased rates of duty or established temporary surcharges on imports. At the same time, all of the countries have implemented policies to increase exports, especially of non-traditional products, to countries outside the Central American region.

(c) As to their external financial commitments, the effort which the countries have been making to meet them in spite of the great shortage of available resources is worth emphasizing; this has compelled some of them to negotiate the rescheduling of their debt with a view to fulfilling their obligations within more realistic possibilities.

(d) Development strategies and policies have been established designed to better utilize installed production capacity, to rationalize the use of human and natural resources and to lessen traditional external dependence.

(ii) <u>Regional response</u>

The individual measures and the more comprehensive adjustment processes adopted by the countries to cope with the economic and financial crisis of recent years have had very pronounced unfavourable effects on intra-regional trade. Along with the deterioration mentioned, trade among the five countries has shown a very marked imbalance particularly against Nicaragua and El Salvador as a result of the maladjustments in the production structure of these countries. The consequence of these phenomena has been the appearance of increasing unsettled balances in the Central American Clearing House and the emergence of payment problems between surplus and deficit countries.

Since the reactivation of trade among the five countries is a necessary condition for reversing the recessionary process of their economies, the institutions responsible for economic integration have made renewed efforts since 1981 to find formulas for restoring the fluidity which characterized the regional payments system up to 1980. Noteworthy among these efforts were the creation in 1981 of the Central American Common Market Fund (FCMC) in the Central American Economic Integration Bank (BCIE) and the decision of the governments to capitalize that fund, which was established expressly for the purpose of channelling external resources towards the handling of the debtor balances arising from the settlement functions of the Central American Clearing House.

In addition, in the spirit of the Central American Monetary Agreement, arrangements have been agreed between the central banks of creditor countries and those of debtor countries for the payment of balances resulting from the Clearing House's settlements, although it must be admitted that as the crisis worsened, it has proved very difficult to continue to implement those arrangements, since for the creditor countries they mean keeping tied up a large volume of financial resources which they themselves need to meet their commitments to countries outside the region.

In this connection, formulas are being studied for providing the machinery of the Central American Clearing House with new instruments for dealing with the present crisis and this could lead to the creation of a medium-term credit window as part of the scheme itself. Possible options are also being studied to enable debtor countries to meet their obligations to creditor countries, bilaterally and in local currency, through the utilization of private-sector debt instruments arising in intra-regional trade.

Apart from the above, the central banks have been making efforts to strengthen financially the Central American Monetary Stabilization Fund (FOCEM), established in 1970 to serve as a means of collective action in defence of the balance of payments of the five member countries. These efforts have been reflected in the policies annually adopted by the Central American Monetary Council to increase the participation of resources of its member banks and in the conclusion of monetary-co-operation agreements with other Lation American central banks or the negotiation of lines of credit with private international banks. As a result, by the end of 1982, FOCEM had at its disposal a volume of resources in excess of US$200 million.

In addition, the five central banks have arrived at a preliminary approach, at technical level, for the progressive elimination of the exchange restrictions at present affecting trade among the countries; such eliminination would be facilitated by the acquisition of external resources, part of them to be used to strengthen the Central American Common Market Fund.

The difficulties being experienced by the countries members of the Central American Common Market have fortified the intention of the governments to strengthen the integration programme institutionally. With that in view, the Ministers Responsible for Central American Economic Integration, as the leading organ of the regional programme, have recently reaffirmed the importance of the Common Market and, accelerating the frequency of their meetings along with those of the central banks through the Central American Monetary Council, are determined to sign as soon as possible a monetary agreement formalizing the close co-operation they have maintained since the 1970s.

Moreover, the common external tariff, in force since the signature of the Central American Tariff Equalization Agreement in 1962, is being revised with a view to converting it into a more effective instrument for stimulating development and for better meeting the changing needs of the countries and of the region as a whole.

In the strenghtening of regional institutions, of special importance is the rôle to be played by the Central American Bank of Economic Integration Bank (BCIE), established as the financial body of the regional economic integration programme. In this connection, the governments decided at the beginning of 1982 to raise the Bank's authorized capital from US$200 to US$600 million. The governments' support has enabled the BCIE to develop an active campaign to obtain funds in various financial sources, and since its foundation it has secured external funds in the amount of US$1,084 million, in addition to the US$175 million of capital paid in by the member countries and US$141 million of reserves generated by the net results of its operations. In view of restrictive international credit policies, the BCIE agreed in 1980 to accord banks and other financial institutions of the region guarantees or endorsements for the purpose of helping them to obtain resources abroad to enable them to finance the imports of machinery and equipment, raw materials, supplies and other inputs required by duly qualified industries.

4. <u>Short-term and medium-term economic outlook</u>

In the prevailing climate of uncertainty concerning the future of the international economy, it is risky to attempt to quantify the behaviour of the Central American economy in the medium term.

As regards exports of the region's principal traditional products, prices are not expected to recover in the immediate future, so that the generation of foreign exchange will continue to be very limited. The Central American countries are consequently aware that they must make a greater effort to diversify and promote their exportable products and must adopt a more aggressive policy in their sales abroad. It is to be hoped, however, that the probable rate of economic recovery in the industralized countries in the next three years and the financial support which the region may receive from the international community will be decisive for reversing the depressive trend of the last few years.

As to imports, it is felt that to reduce them even further would mean bringing them down to a level which would be clearly incompatible with the efforts the countries are making to sustain their present levels of production with a view to the earliest possible reactivation of the economy. What will be of special significance in this connection is the attainment of balance in the external sector and the efforts the Central American countries are making to exploit their own capacities to the maximum in an atmosphere of greater internal stability and renewed co-operation among them.

If present estimates of trade in goods materialize and the behaviour of the services sector over the last three years is maintained, Central America can be expected in 1983 to show a deficit on current account similar in size to that registered in 1982.

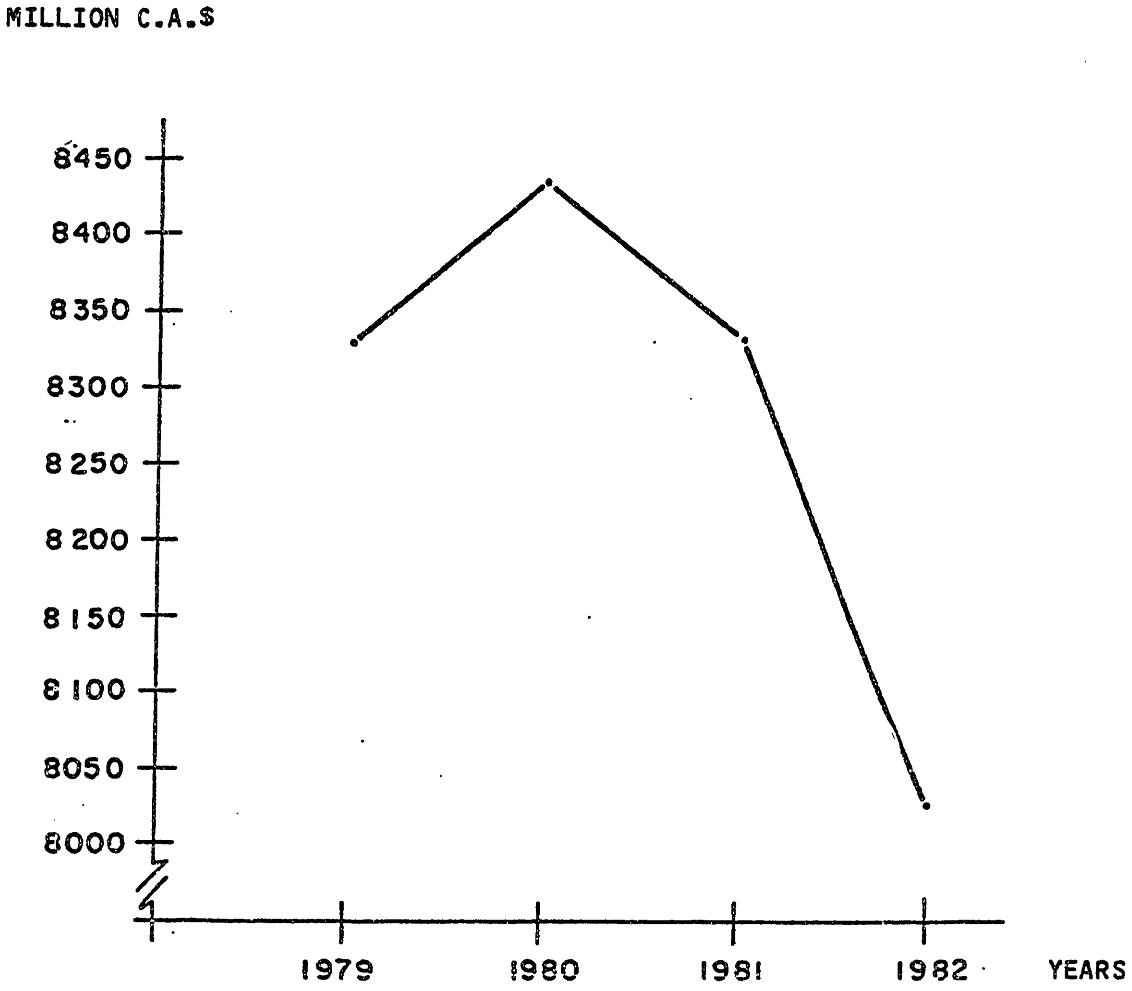
It is hoped that the inflationary pressures which in recent years have drastically affected the external balance and the purchasing power of the population will continue to weaken throughout 1983. If that proves to be the case, it will be a factor having constructive implications for economic reactivation efforts.

As to the prospective behaviour of the world economy, it suggests that by 1983 the region might reach production levels similar to those registered in 1982, thereby halting the strong downward trend of the Central American economy during the 1979-1981 triennium.

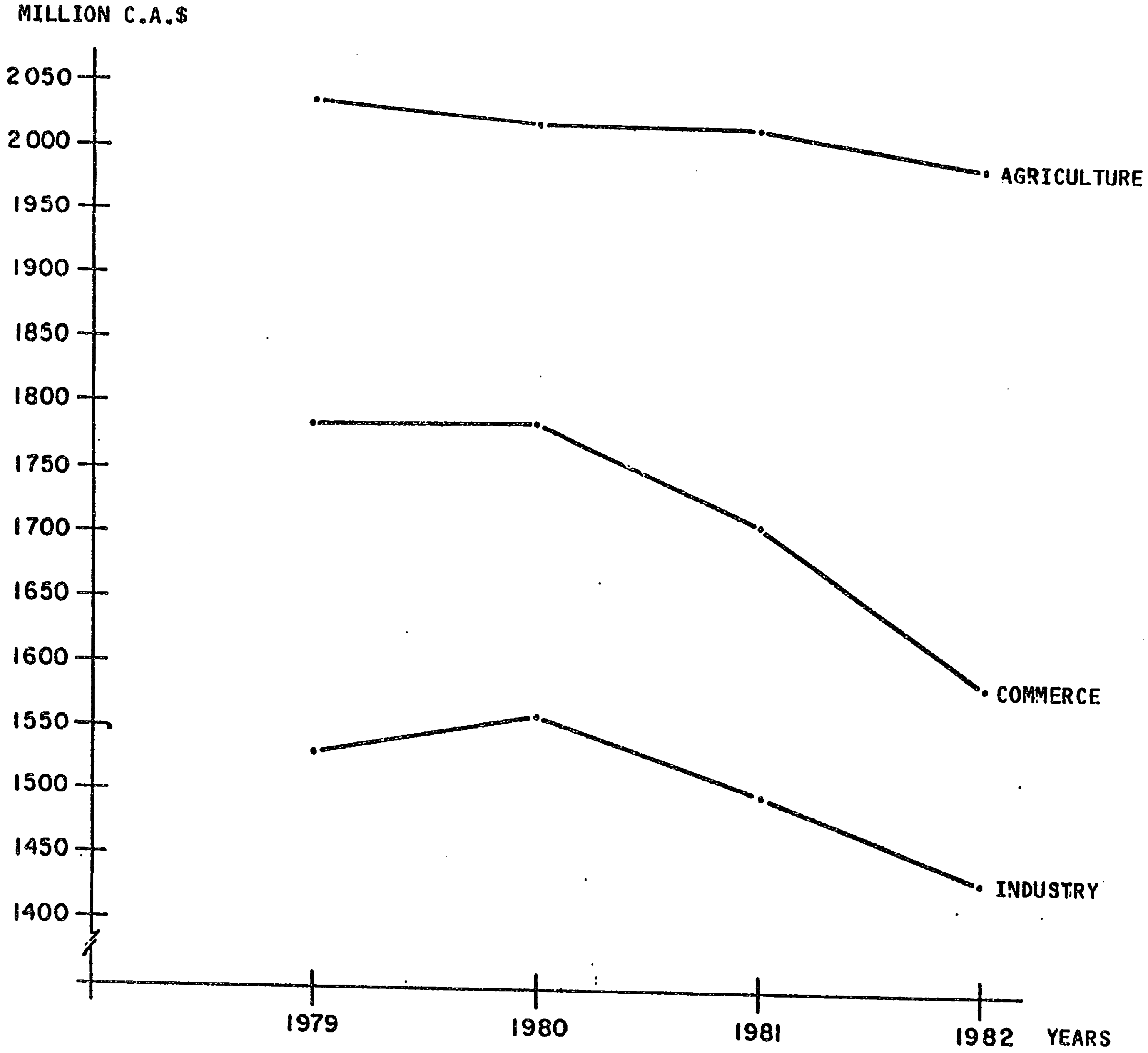
In the sphere of domestic policies, the governments of the Central American countries are acting to achieve greater participation of the business sector with a view to earliest possible reactivation of the production structure. Moreover, on the basis of the various development plans and investment programmes, increasing investment of the public sector in support of directly productive activities and a renewed spirit of co-operation among the region's five countries are anticipated.

There are expectations that by 1985 the economy will be in a process of recovery and it is hoped to see positive growth rates in that year and in following years. A basic assumption for such a slow but perceptible reactivation is linked to the dynamism to be shown by the world economy, for which there are already favourable indications. However, the benefits of the behaviour of the world economy would not effectively reach the countries of the region unless there are a greater demand and better prices for the region's products, and a greater influx of capital sufficient to reverse the negative trend of the last three years in the global balance of payments. For both these expectations, there is hope of greater co-operation from the developed countries, which would supplement the domestic efforts of the countries.

CENTRAL AMERICA: GROSS DOMESTIC PRODUCT
(IN CONSTANT 1970 PRICES)



CENTRAL AMERICA: TRENDS OF AGRICULTURAL, COMMERCIAL AND INDUSTRIAL SECTORS, 1979-1982
(Value Added to GDP at Constant 1970 Prices)



CENTRAL AMERICA: PERCENTAGE CHANGES IN GROSS DOMESTIC PRODUCT (AT CONSTANT 1970 PRICES)