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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

REPORT OF THE INDUSTRIAL FINANCE MISSION TO CENTRAL AMERICA

THE COMMON MARKET AND ITS FUTURE

(in two volumes)

VOLUME I

THE MAIN REPORT

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Industrial Projects Department

This report is based on the findings of a Mission which visited Central America in October-November 1970. Substantive work on the study was completed in January 1971. The last chapter of the report summarizes subsequent events. The report has benefitted from discussions during the past year with Central American institutions and Governments. The Mission consisted of

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The Mission gratefully acknowledges the help and cooperation received from many individuals and institutions in Central America.

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I. Introduction

1. The object of this report is to analyze industrial development, industrial policies and the framework of industrial finance in Central America. This report is not a comprehensive sector survey in the usual sense of the word. Although a number of factories were visited, the mission looked at industry mainly through talks with government officials, members of the staff of international organizations and of financial intermediaries, and in meetings with chambers of industry or commerce.

2. The present report is entitled "The Common Market and its Future" because industrial development during the sixties was affected significantly by Common Market arrangements and policies. However, the report does not attempt to analyze all aspects of economic integration in Central America[1/]. Chapter II provides some historical background and places the growth of industry in a macro-economic context. Chapter III is basically a statistical presentation of the main features of industrial growth during 1960-68. It was convenient to break the analysis at 1968 because in 1969, the military conflict between El Salvador and Honduras caused considerable disturbance. Although the armed confrontation was shortlived, the underlying crisis in Common Market relationships persisted. The events during 1969 and 1970 are discussed in Chapter VI.

3. Major policies affecting industrial development -- the dismantling of intra-regional tariffs, fiscal incentives, tariff protection -- are briefly sketched in Chapter IV. An attempt is made to assess their impact on the pattern of industrialization in Central America. The question of the reform of industrial policies is taken up towards the end of Chapter VI against the background of recent events and investment opportunities in the early 1970s. Chapter VII discusses important developments that have taken place since January 1971, after the substantive work on the study was completed.

4. One of the tasks of the mission was to assess the system of industrial finance both on a national and regional basis and to examine the performance of national and regional financial intermediaries. This is done in Chapter V. It should be pointed out that the discussion in this section is on a general plane and does not constitute a detailed appraisal of any institution.

5. A word about statistics: industrial data in Central America are weak and subject to indeterminate margins of error. Furthermore, the mission faced the problem of making comparisons among the five Central American countries, a hazardous enterprise under the best of circumstances. The easy way out would have been to eschew the use of statistics, except for broad illustrations and the like. Instead, the mission has ventured to utilize the information available for analytical purposes. It felt

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1/ In this respect, the mission's scope was considerably narrower than that of the group that visited the area in 1967. See "Economic Development and Prospects of Central America" (eight volumes) WH 170a, June 5, 1967.

compelled to construct an independent set of estimates for industrial investment, in the absence of reliable official figures. Similarly, the mission used scattered data to build up a picture of the pattern of industrial financing. While no claim is made for the precision of mission estimates, we do believe that they are not seriously misleading. We have also used the unpublished results of the Survey of Manufacturing Establishments conducted in 1968 under the sponsorship of SIECA. The reader should be warned about the many defects of this Survey and the need for exercising caution in deriving inferences.

II. Factors Conditioning Central American Industrialization

6. The countries of Central America recorded impressive rate of growth of industrial production during the sixties. The rate of advance was considerably faster than that achieved in the previous decade or that recorded in most less developed countries in other parts of the world during the sixties. High growth rates in Central America were accompanied by considerable structural change and improvements in productivity. To appreciate the significance of these developments the reader should be aware of the main characteristics of these economies and the special factors affecting industrialization during the decade under review.

7. The striking fact about Central American countries is that they are very small and their national markets for industrial goods are extremely limited. There is little scope for using modern processes, based on the principle of large-scale production. Gross domestic product, a crude measure of overall market size, varied in 1960 from $378 million in Honduras to just over a billion dollars in Guatemala. The corresponding figure for Colombia was $4 billion and for Brazil it was $19.7 billion. A substantial proportion of the Central American population remained outside the market economy practicing subsistence agriculture. This segment of the economy did not generate demand for manufactured goods. The pattern of income and wealth distribution, even in urban areas, was marked by glaring inequalities thereby reducing the potential for mass markets. Transport bottlenecks also tended to accentuate the narrowness of markets for industrial goods. The cost of moving merchandise was high and the transport system catered more to exports and imports than to the distribution of locally produced items in local markets.

8. Markets for manufactured items in the Central American countries were not only thin but also volatile. The course of national income and effective purchasing power in the market sector depended, to a considerable extent, on the outlook for coffee, bananas and cotton. These commodities, as was well known, had a long history of instability both in terms of production and world market prices. Economic conditions in Central America, in an important sense, were determined by exogenous factors; a frost in Brazil or a hurricane in Central America.

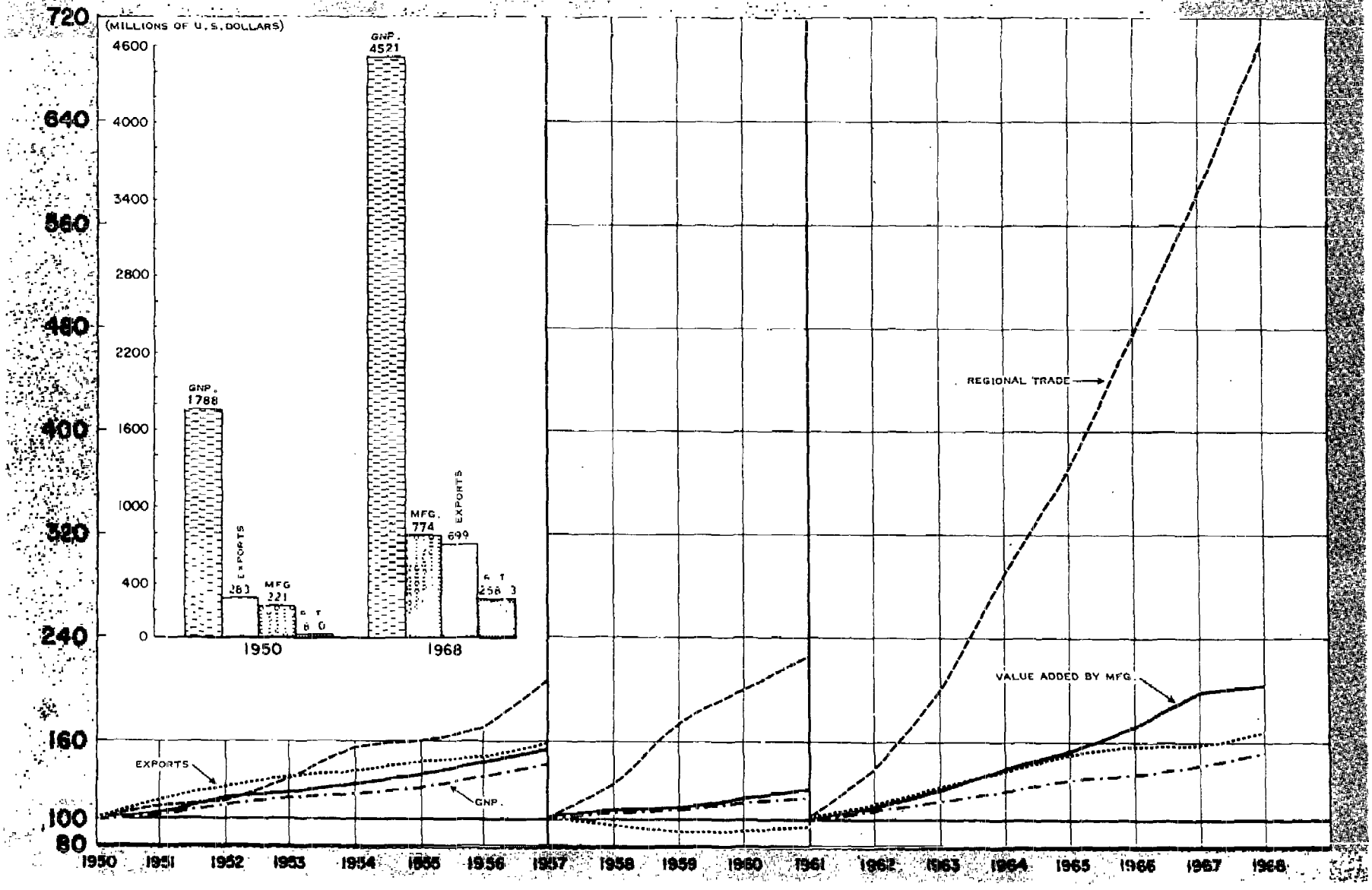
9. The prospects for industrialization were also circumscribed by the meagre natural resource endowment of Central American economies. Mountains and rainfall patterns prevented the farming of much of the area. There was no known reserve of oil or gas and major deposits of metallic ores had not been extensively explored. However, the region did have impressive forest wealth and some non-metallic mineral resources -- limestone and raw materials for ceramics manufacture.

10. There was no impediment in the supply of unskilled labor in Central American countries, as in most parts of the less developed world. Considerable unemployment and under-employment existed in 1960. While labor was plentiful, its utilization for industrial production was not so easy. Both the high rates of illiteracy, except in Costa Rica, and the lack of adequate training facilities made it difficult to create the basic skills required for industrial work. Central America had no tradition in the field of industrial management.

11. Very briefly, then, the countries of Central America in 1960 were not poised for rapid industrialization. Their markets were tiny, unstable and fragmented. Natural resources were limited and industrial skills were hard to come by. And yet, despite these adverse factors, industrial development proceeded rapidly in the decade just finished. This remarkable outcome was caused partly by fortuitous circumstances and partly by certain policy decisions adopted by Central American governments.

12. The fortuitous circumstances concerned the behaviour of Central American exports to the outside world. After increasing at a moderate pace during 1950-57, they suffered a setback. (See Graph.) The combined exports of the five countries declined from a high of $445 million in 1957 to a trough of $399 million in 1959. Since then the situation changed markedly and exports climbed up to about $700 million by 1968. This upsurge exerted a tremendous expanionary influence in the economies of the area. Effective demand, including that for manufactured goods, was buoyant and financial savings expanded greatly. The foreign exchange situation allowed monetary authorities to expand credit for financing industrial production and investment. The capacity to import foreign machinery and intermediate goods for the industrial sector increased rapidly.

BEHAVIOR OF GNP, EXPORTS, MANUFACTURING OUTPUT, AND REGIONAL TRADE IN CENTRAL AMERICA



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13. The substantial industrial progress achieved by Central America during the sixties owed much to the export boom and to the establishment and development of the Common Market. The decision to create a Common Market in Central America by eliminating tariffs and other restrictions on trade among the five member countries was undoubtedly a key new factor. In terms of sheer purchasing power, the Common Market was considerably bigger than the mini-national markets of the five members. The multiplier (i.e. the extent of the expansion of the market) varied from about seven for Honduras and Nicaragua to something less than three for Guatemala. Overnight, as it were, there was an appreciable relaxation in the constraints on industrial development. Subsequent chapters of this report will spell out the implications of this basic move. Meanwhile, the spectacular expansion in intra-regional trade, mainly in manufactured goods, that took place in the sixties deserves notice (see Graph). The total volume of trade among the five members increased from $33 million in 1960 to $258 million in 1968. Intra-regional trade as a proportion of the total rose from 9 percent to 27 percent, during this period.

14. The second major instrument in the industrial policy-nexus was the Common External Tariff on imports from the outside world. Before the Common Market came into being, national tariffs were mainly fiscal in character. Revenues from import duties constituted nearly half of the total tax collections. The Common External Tariff was set somewhere between the average and the highest level obtaining in the national schedules. More important than the new level of nominal duties was the change in policy orientation. Tariffs became a measure through which industry was to be promoted rather than a convenient source of public revenues. Effective protection of industry increased not only through the raising of nominal duties on finished products but also through the exemption of duties on imported inputs. Together with the widening of the market, the new Common External Tariff provided a powerful stimulus to investment in the industrial sector. Subsequent chapters of this report will analyze the impact of this policy in some detail.

15. The third major policy instrument was the system of fiscal incentives. In one form or another, these inducements predated the Common Market. However, as explained in Chapter IV, the establishment of the Central American Common Market introduced a competitive element which compelled member governments to expand both the magnitude and the scope of these incentives. Unlike the Common External Tariff, fiscal incentives have resisted repeated attempts at harmonization. Basically, they have provided industrialists extensive tax holidays and exemptions from import duties on industrial machinery as well as inputs. While the design of these incentives leaves much room for improvement, there is scarcely any doubt that they have contributed handsomely to the profitability of industry.

16. The remaining elements of the policy framework will be discussed in the appropriate context. Meanwhile, a summary list will help the reader to tune himself to the Central American situation in the Sixties:

(a) An open-door policy vis-a-vis private foreign investment was in effect.

(b) The Central American Bank for Economic Integration was established to finance infrastructure and industrial investment. Also, there came into being a number of public and private development finance companies of national scope operating in the industrial and other sectors.

(c) The general economic policy aimed at and succeeded in maintaining a high degree of price and exchange rate stability.

17. The overall dimensions of economic growth of Central America and the relationships among principal variables are depicted in the Graph and Table 1. Following an earlier analysis by Donald McClelland the postwar period is divided into three parts.1/ In the first, exports outside the region were clearly the dominant impulse and aggregate production as well as manufacturing rose at a respectable rate. Regional trade, starting from a very low base, also expanded sharply. In the second subperiod, exports to the outside world declined and there took place a substantial slowing down in both aggregate and manufacturing production. Regional trade continued to increase briskly in response to the Multilateral Treaty signed in 1958 envisaging free trade on a limited list of goods as a start. The third subperiod covers the duration of the Common Market which came into effect in 1961. Regional trade continued to expand at an even more rapid rate. Exports to the outside world were also growing very rapidly and both GNP as well as value-added in manufacturing increased at record rates.

1/ The following summarises McClelland's analysis: "Rounding our members, to pay due respect to their roughness without doing violence to the magnitudes, we can conclude that the analysis shows that of the roughly 7% per year annual growth in regional GNP in Central America from mid-1962 through 1965, around 4% was due to "minimum - normal" growth, 2% to the increase in export receipts and 1% to the expansionary effect of the Central American Common Market and related forces". "The Common Market's Contribution to Central American Economic Growth: A First Approximation", The Movement Toward Latin American Unity edited by Ronald Hilton; Praeger 1969.

TABLE 1

Central America: The Overall Picture 1950-1968

	1950-57	1957-61	1961-68
	Average Annual Rates of Growth		
Gross Product	4.9	3.7	6.1
Manufacturing (value added)	6.4	4.9	10.8
Agriculture (value added)	3.3 1/	4.8 2/	
Exports outside region	6.7	-1.6	7.8
Intra-regional trade	10.8	22.0	32.0

III. Major Features of Industrialization

18. The beginning of the sixties found Central America with a rather modest industrial sector. The combined value added by industry in 1960 in the five countries amounted to $380 million or nearly 14% of GDP compared to 20% for Colombia and 23% for Mexico. The previous Bank mission to Central America had pointed out that the actual level of industrialization in this area was far below its potential ("theoretical") level even taking into account the small size of the economies and the stage of their economic development 3/.

19. The five countries of Central America have much in common but they are not homogenous in terms of size of population, per capita income or the extent of industrialization. (See Table 2). For example, Costa Rica has the smallest population and the highest per capita income. It had exploited, almost fully, its "theoretical" industrial potential at the turn of the decade. El Salvador, with a much bigger population and a relatively low per capita income, was also considerably ahead of the others in realizing its "theoretical" industrial possibilities. The gap between the potential and the actual level of industrialization was greatest in Nicaragua.

1/ 1950-60
2/ 1960-68
3/ The "theoretical" level was calculated on the basis of a regression equation relating industrial value added to population and per capita income. See WH 170a dated June 5, 1967, Vol VI. The results of this calculation, shown in Table 2 are somewhat different from those in the 1967 Report, perhaps owing to revisions in the basic data.

20. Understandably, Central America produced scarcely any capital goods in 1960. Sawnwood and cement were the main items falling in the category of intermediate goods. Altogether this category constituted about 12% of total value added in manufacturing (see Annex Table 7). The bulk of industrial production consisted of non-durable consumer goods -- flour, sugar, bakery and dairy items, soft drinks, beer, cigarettes, soap, clothing, footwear and furniture. Consumer industries had a share of 86% in total value added. The production process involved a simple transformation of materials to supply the home market. Almost 60% of total industrial employment consisted of artisans. More than 70% of factories employed less than 20 workers.

21. At the outset of the decade, the composition of value added among major industry groups displayed a similar pattern in the five countries (see Annex Table 7). Nevertheless, a few distinguishing characteristics should be noted:

(a) The share of the food industry was relatively high in El Salvador.

(b) The share of the textile as well as clothing and footwear industries was relatively high in Guatemala.

(c) The share of the wood related industries was relatively high in Honduras and Costa Rica.

(d) The share of the chemical industry producing consumer products was relatively high in Nicaragua.

22. This was the base from which Central American countries advanced industrially during the sixties. During the first two years the increments averaged only 7% per annum. Subsequently, the growth rate climbed up to almost 14% per annum during 1962-67. Altogether, the pace of expansion during the sixties was almost double that of the previous decade (see Table 3). The statistics show appreciable inter-country differences, but the mission hesitates to ascribe too much precision to the numbers 1/. However, it is probably true to say that Guatemalan and Costa Rican industry did not increase as rapidly as in the other three countries. It should also be pointed out that industrial production of El Salvador increased much faster during the first part of the decade than in the second.

1/ Since there are no comparable manufacturing censuses in Central America, the value added data used in this report are based on national account estimates made by central banks. Every attempt has been made to make the data comparable but it is very difficult to determine the quality of estimates and the differences of estimating procedures among countries.

TABLE 2

Characteristics of the Five Central American Economies, 1960[a]

	Central America	Guatemala	El Salvador	Costa Rica	Nicaragua	Honduras
1. Percent composition of population	100	35	23	11	14	17
2. Per capita income as percent of group average	100	106	89	146	88	81
3. Percent composition of total GDP	100	38	20	16	12	14
4. Percent composition of value added in industry[b]	100	35	21	20	12	12
5. Industrial value added as percent of GDP	14	13	15	17	14	13
6. Actual as percent of theoretical value added in industry	76	75	81	91	57	74

a/ This table was calculated on the basis of data supplied by SIECA. These data are not strictly comparable with the most recently revised figures on industrial value added supplied to the Mission by the five Central Banks and which appear in the Annex.

b/ Industry includes manufacturing and mining.

Source: SIECA, Lineamientos Generales Sobre la Creacion de un Fondo para el Fomento Industrial y Agricola, 1970.

23. The paucity of quantitative information makes very difficult a full analysis of the ramifications of industrial growth during the period under review. Nevertheless the available evidence prompts the conclusion that manufacturing activity is gaining in capital intensity. The incremental capital-output ratio for Central America is estimated at 1.98 1/, i.e. nearly double the magnitude of the average capital output ratio derived from the 1968 Survey of Manufacturing Establishments (see Annex Table 61 and 62). It is also interesting to note that both the average and the marginal coefficients are lowest in Guatemala and the highest in Honduras.

24. Industrial employment data in Central America are quite unreliable and any estimate should be treated as a rough order of magnitude. The average capital-labour coefficient for 1968 was about $4,700, according to the 1968 Manufacturing Survey (see Annex Table 61). On the assumption that the average and the marginal coefficients were the same, the total employment in the industrial sector in 1969 would be around 535,000 in 1969, or nearly 12% of the labor force. This estimate implied an increase in industrial employment of 5.8% per year since 1962 and an increase in productivity at about the same rate. There was reason to believe that the marginal capital-labour ratio was considerably higher than the average 1968 coefficient; just how much higher no one knows.

25. The Central American industrialization process has involved a high cost in the form of foreign exchange outlays. Even in 1958 imported inputs were almost a quarter of gross manufacturing output of the region and more than a third of total imports. In the subsequent decade, purchases of imported inputs have more than doubled. In 1968, they absorbed 37% of total imports. It should be pointed out that while the import bill for industrial raw materials and other current inputs was large in absolute amount ($376 million in 1968) and also as a proportion of overall foreign exchange outlays, it had not increased as rapidly as industrial production. Capital good imports for industrial investment constitute another 8% of total imports.

26. The pattern of growth, by branch of manufacturing activity, suggests that considerable structural change took place during the sixties (see text Table 4 and Annex Tables 1-6). Intermediate goods, mainly of the simple kind, were added to the list of local production. Petroleum refineries were erected in each country. Paper products, such as bags, boxes, tissue, kraft and bond paper, began to be produced in a dozen plants. One of these establishments in Guatemala processed imported chemical pulp; the others simply finished and packed. Two plants began to produce motor car tires. A caustic soda plant and another facility for the manufacture of insecticides was established in Nicaragua. Two fertilizer plants started processing imported nutrient elements; about a dozen others began simple mixing operations.

1/ The above estimate of the capital coefficient is based on a set of investment figures prepared by the mission (see Annex Table 67).

TABLE 3

Average Annual Rate of Growth of Industrial Value Added

	Average Annual Rate of Growth		
	1950-55	1955-60	1960-68
CENTRAL AMERICA	5.5	5.6	9.8
Guatemala	2.5	6.6	8.6
El Salvador	3.8	4.0	10.1
Costa Rica	9.6	6.3	9.7
Nicaragua	9.8	4.8	12.1
Honduras	9.3	5.4	10.2

Source: Annex Tables 1 - 6.

TABLE 4

Central America: Growth Rate by Branch of Manufacture and Composition of Value Added

	Average Annual Growth Rate (%) 1960-68	Share in Total Value Added (%) 1968
Petroleum and Coal Products	43	2
Electrical Appliances	34	2
Metal Products	32	5
Industrial Chemicals	30	2
Basic Metals	28	-
Paper and Paper Products	27	2
Rubber	19	2
Mechanical machinery	17	1
Textiles	14	9
Non-Metallic Minerals	12	4
Printing and Publishing	10	2
Consumer Chemicals	9	4
Leather and Leather Products	8	1
Transport Equipment and Repairs	8	2
Food	8	28
Tobacco	7	5
Clothing and Footwear	7	10
Furniture and Fixtures	7	2
Wood Products	6	3
Beverages	5	11

Source: Annex tables 1 - 6.

Nicaragua began to produce PVC and El Salvador started manufacturing polyurethane from imported materials. Altogether, the production of intermediate goods rose at an average annual rate exceeding 18% 1/. Their share in total value added increased from 12 to 21% during 1960-68.

27. In the consumer goods field, new lines of activity were concentrated in textiles, household electrical appliances and the pharmaceutical industry. Synthetic and mixed fabrics began to be produced in volume. The output of cotton yarn increased rapidly. The assembly of consumer durables was already a large operation in Costa Rica at the beginning of the decade. Since then a considerable expansion in the production of items such as refrigerators, washing machines, radios and television sets took place in all of Central America. The pharmaceutical and other industries producing consumer chemicals acquired new lines. However, this activity remains essentially a mixing, grinding, diluting and packaging operation.

28. Viewing the industrial landscape in 1970, the mission was impressed by the transformation that had taken place in the composition of industrial production in Central America. The traditional lines of manufacture -- food, beverages, tobacco, clothing, footwear -- retained their importance in the overall structure but superimposed on the scene were a wide array of new activities and new products. However, it is easy to be misled by all the novelty and the statistics. A balanced view has to recognize that Central American industrialization to date is skin-deep, so to speak. There is scarcely any production of capital goods or the heavy category of intermediates. There have come into existence a large number of plants, many of less than optimum size, which have bitten off a tiny chunk of value added at the finishing end of the processing operation.

29. The gap between the "theoretical" and the actual level of industrialization diminished considerably during the sixties. Industrial value added in 1968 constituted 17.4% of GDP and nearly 90% of the "theoretical" level, calculated according to the equation mentioned in paragraph 18. Perhaps, the most spectacular increase was achieved by Nicaragua but from a rather narrow base. The actual as a proportion of the "theoretical" level of industrialization in this country increased from 57% in 1960 to 78% in 1968. Also in terms of overall per capita income, Nicaragua managed to improve its relative position.

1/ The groupings into consumer, intermediate and capital goods industries is somewhat arbitrary, as it is impossible to break some of the subcategories included in it. For example, the consumer goods industries figures are overstated in that intermediates textiles are included in it.

30. The case of Honduras was different. This country also diminished considerably the gap between potential industrial possibilities and actual achievements. Its per capita income increased by $50; the rate of increase was faster than the overall Central American average. Nevertheless, viewed in relative terms, Honduras suffered a deterioration in its position. Whereas on the eve of the establishment of the Common Market, the Honduran per capita income was 81% of the regional average, in 1968 the corresponding proportion had slipped to 71%. While statistical measurements are subject to considerable margins of error, available evidence confirms the generally held view that Honduras has not improved its relative economic position in Central America.

IV. The Policy Instruments and their Impact

A. The Dismantling of Intra-Regional Tariffs and the Pattern of Specialization.

31. The movement aimed at the political and economic integration of Central America has a long history. While the ultimate objective of political unity proved elusive, the record of progress was impressive by any standard. One has only to turn to events in the rest of Latin America or in other parts of the less developed world to appreciate the progress made by the five countries of Central America.

32. Bilateral trade agreements among the five gained currency during the fifties. They were rather limited in scope and ad hoc in character. The first major step towards economic integration came with the signing of the Multilateral Treaty for Free Trade and Economic Integration in 1958. Although the list of freely traded items remained small, the treaty envisaged a full "customs union" over a period of ten years. This piecemeal approach was superseded by the General Treaty on Central American Integration which came into effect in 1961. Reversing the approach of the earlier agreement, the General Treaty brought into effect a regime of free trade in all Central American products except those for which reservations were made in the document. This was a change of revolutionary significance, a dramatic departure from the past pattern. At the moment the agreement became effective nearly three quarters of the items listed in the tariff schedule became entitled to free trade within the region.

33. The General Treaty set the stage for rapid expansion of intra-regional trade. However, the founders of the integration movement realized that the dismantling of tariff barriers was not enough. Also necessary was a transport network geared to trade among the five countries. Therefore, they created the Central American Bank for Economic Integration (CABEI) and gave it the mandate for improving the infrastructure required for trade and development. During the last decade, the road network had improved considerably and the telecommunication system had been developed. Equally remarkable were the steps taken to build the monetary framework for facilitating intra-regional trade

and payments. The central banks established in 1961 a multilateral clearing arrangment designed to economize on the use of foreign currencies in settling trade balances. This arrangement had worked successfully and provided an added impetus to the growth of commercial and business relationships in the area. In 1964, there came into being the Central American Monetary Council to oversee the gradual process of monetary integration. In 1969, the central banks established a Monetary Stabilization Fund with the object of alleviating temporary exchange problems faced by members of the Common Market.

34. The rapid growth of intra-regional trade that took place during the sixties was the combined result of all these institutional and policy changes. Despite substantial progress, certain obstacles remained. There were several exceptions to the general rule of free trade within the region:

(a) A group of 11 products were subject to temporary restrictions. These included sugar, wheat-based items, tobacco, cigarettes, certain paper manufactures, glass containers and petroleum products. (See Annex Table 30.)

(b) Ten products were subject to indefinite restrictions. These include cattle, cheese, coffee, fermented fruit juices, alcoholic beverages, jute textiles and matches. (see Annex Table 31).

(c) There was no intra-regional trade in beer as a result of an informal arrangement among producers who enjoy a monopoly position in their own national markets.

35. Certain obstacles are related to the fact that the function of administering trade regulations and collecting import duties remained in the hands of national governments. On many occasions free trade arrangements had been breached and one member or another had unilaterally imposed restrictions, followed by retaliatory moves and short-lived deadlocks. The very high sales tax in Nicaragua, with a rate structure which seemed to discriminate against items imported from Common Market members, was a case in point.

36. A more important impediment was the lack of detailed regulations for determining the origin of products. Free trade status was enjoyed only by "Central American" products and items which were simply assembled, packed, bottled or diluted in the region were excluded. The origin of about 50 products had been challenged in the course of the decade ranging all the way from rice to cosmetics. (See Annex Table 32.) The Executive Council, consisting of representatives from the five members, was responsible for settling these questions. Their decisions do not reflect any consistent policy. While air conditioners and refrigerators were determined to be Central American, automobiles, radios and television sets were barred from this category. The origin of pharmaceuticals, with very low value added, had never been challenged.

There was no doubt that the ad hoc decisions of the Executive Council had a major impact on trade and development of manufactured goods. The frequency of disputes concerning origin had tended to diminish over the years.

37. Before the Common Market came into existence, Central America was geared to supplying the major markets of North America and Western Europe. There was little intra-regional trade; total exports to Central America were less than 5% of the grand total. Manufacturing operations in Central America were geared to the five national mini-markets. The impetus generated by the liberalization of intra-regional trade and the dismantling of tariffs was reflected in the enormous expansion in commercial relationships among Central American countries that took place during the sixties. This boom had a very special significance for the manufacturing sector. While intra-regional trade in primary commodities increased fourfold during 1958-68, trade in manufactured items increased more than 17 times. During these ten years a decisive change in the market orientation of Central American industry had taken place.

38. Some processed foods, beverages and tobacco products were not traded within the Common Market to any large extent. Many products of this kind were perishable or bulky; others remained subject to restrictions. Processed meat and sugar were sold abroad, largely to the United States. Excluding the food industries, the share of manufactures sold outside the home country in total output increased sharply (see Table 5). The regionalization of manufacturing activity took place very swiftly. The bulk of the change was over by 1964, although the proportion of production exported continued to mount in subsequent years. The orientation towards the Common Market was particularly strong in those segments of manufacturing which were established for the first time during the sixties. Sales outside the national market exceeded 25% of total output in 1968 in the case of electrical appliances, rubber products, chemicals and textiles (see Annex Table 58).

39. El Salvador exploited adroitly the opportunities thrown open by the creation of the Central American Common Market. Several factors were favorable. There already existed a substantial industrial base, and a small group of talented as well as aggressive entrepreneurs. The country enjoyed an advantageous location for regional trade. The port serving San Salvador provided easy access for imported equipment and materials. Wage levels for industrial labour were considerably lower than in other Central American countries, except Nicaragua (see Annex Table 59). Prices of Salvadorean manufactures were more competitive in an international sense than those of other Common Market members owing to the fact that for many important products, such as clothing and textiles, the national tariff of El Salvador had been pitched at a lower level than that in neighbouring countries. Even at the end of the 1950s, Salvadorean manufacturing was somewhat more export-oriented than in other countires (see Table 5). This lead was maintained throughout the sixties.

TABLE 5

Exports of Manufactured Goods to Central America as Percent of Total Manufacturing Production

(Excluding Food, Beverages and Tobacco)

	1958	1964	1968
Guatemala	2	9	15
El Salvador	6	21	33
Costa Rica	2	13	16
Nicaragua	1	7	13
Honduras	5	9	14
Central America	3	16	19

Source: Annex Tables 10 - 17.

TABLE 6

Percent Share in Intra-Regional Exports of Manufactures

	1958	1964	1968
Guatemala	23	31	31
El Salvador	49	37	35
Costa Rica	10	17	16
Nicaragua	4	7	10
Honduras	14	8	8
Central America	100	100	100

Source: Annex Tables 15 - 17.

40. The Costa Rican story was roughly similar. This country too enjoyed an initial advantage on account of its relatively developed industrial structure, but its locational position and its wage-price structure were not equally attractive assets. After a headstart and a strong advance during the early sixties, Costa Rican exports to the Central American Common Market tended to slow down in recent years.

41. Nicaragua, on the other hand, started with a distinct disadvantage on account of its lagging industrial development. However, a very forceful industrial policy implemented largely through a government-owned development finance company (INFONAC) enabled the country to raise substantially its share in total regional trade. Honduras had not displayed the same talent and its share in regional exports of manufactures remained relatively limited.

42. Trading conditions in the Common Market did not approach perfect competition by any means. An examination of 57 product lines, which account for the bulk of regional trade in manufactured goods, showed that individual member countries held a near monopoly position in 5 cases (see Table 7). In some instances there was a single firm which dominated regional production and trade. For example, CAVISA in Guatemala was the only manufacturer of glass bottles, Phelps Dodge in El Salvador was the sole producer of electric cables, ELPESA in Nicaragua was the only manufacturer of caustic soda, and chlorinated insecticides were manufactured only by HERCASA in the same country. In 39 product lines one or the other member country commanded a dominant position. In the remaining items trading conditions were fairly competitive, at least in terms of the distribution of market shares among members.

43. Guatemala had the largest and oldest textiles industry in the region but the Salvadorean textile establishments were more efficient. Nearly 54% of the total output of the latter was exported to the CACM (see Annex Table 58). Similarly, the clothing and footwear industry was tuned to the regional market. The comparative advantage of El Salvador in these product lines was based on higher labor productivity and competitive wage costs. A survey carried out by the Economic Commission for Latin America in 1962 substantiated this proposition (see Annex Table 60). There was also some indirect evidence suggesting that El Salvador secured differential economies in the use of raw material. Japanese foreign investment and technology have probably helped this country in building up a relatively modern textile sector. El Salvador had specialized in synthetic fabrics (other than rayon), cotton yarn, light cotton fabrics, cotton underwear, other cotton clothing, textile bags and textile footwear. Meanwhile, Guatemala had retained a semi-monopoly in knitted textiles and a commanding position in rayon fabrics and heavy cotton fabrics.

44. The pattern of specialization in the Common Market was not based on differences in natural resource endowments among Central American Countries. In fact, differences of this kind were not large enough to exert a decisive impact on the pattern of industrialization and regional trade. Also, the policy framework of the sixties was not conducive to the exploitation of such differences as did exist. Developments during the sixties were dictated, in the main, by past history, differences in labor conditions, locational advantages and the initiative exercised by business groups as well as national policymakers.

TABLE 7

Characteristics of CACM in Selected Product Lines 1968
(Percent Shares of Member Countries in Intra-regional Exports)

Items with Single Country Share 90% and above[a]	Items with Single Country Share 50% to 89%[a]	Items with Highest Single Country Share Less than 50%[a]
Knitted Textiles (G)	Plastic Kitchenware (S)	Stockings (synthetics)(G)
Glass Bottles (G)	Plastic Footwear (S)	
Electric Cables (S)	Processed Vegetables (G)	Vitamins and other pills (G)
	Packed Meat (G)	
Caustic Soda (N)	Sugar Manufactures (G)	Paints (G)
Chlorinated Insecticides (N)	External Medicines (G)	Margarine (C)
	Sauces and Spiced Items (G)	Ladies Underwear (Synthetics) (C)
	Rayon Textiles (G)	
	Heavy Cotton Fabric (G)	Galvanized Sheets (C)
	Cosmetics (G)	Plywood & Veneer (C)
	Plastic Fencing (G)	Vegetable Oils (N)
	Cosmetics (G)	Textile Bags (S)
	Tires (G)	Textiles Footwear (S)
	Bond & Kraft Paper (G)	Furniture (S)
	Steel Tubes & Pipes (G)	Leather (S)
	Polyester Fabrics (S)	Metal Manufactures(S)
	Light Cotton Fabric (S)	
	Cotton Underwear, Knitted (S)	
	Cotton Underwear, Other (S)	
	Cotton Clothing (S)	
	Cotton Blankets (S)	
	Leather Footwear (S)	
	Shampoos & Soaps (S)	
	Cotton Yarn (S)	
	Cardboard Boxes (S)	
	Steel Angles, Profiles & Sections (S)	
	Insecticides (excl. chlor.) (S)	
	Phosphatic & Complex Fertilizers (S)	
	Plastic cloth (S)	
	Agricultural Handtools (S)	
	Plastic Bags (C)	
	Radio Equipment (C)	
	Nitrogenuous Fertilizers (C)	
	Plastic Materials (N)	
	Camphorated Organic Chemicals (N)	
	Detergents (H)	
	Sawnwood (H)	
	Kenaf textiles (S)	
	Towels (S)	

a/ Abbreviations in parenthesis indicate the country holding the largest share: G = Guatemala, S = El Salvador, N = Nicaragua, C = Costa Rica, H = Honduras.

Source: See Annex Table 21.

B. Fiscal Incentives for Industry

45. National programs providing fiscal incentives for industry came into effect in the late forties and early fifties. The establishment of the CACM gave these programs a new significance. A considerable expansion in their scope and magnitude took place during the sixties. The main object was to promote industrial development by providing tax exemptions for considerable periods of time to potential investors. The principal concessions were exemptions from tariff duties on industrial inputs and machinery imported from outside Central America and from income as well as capital taxes (see Table 8).

46. New industries were given bigger advantages than established industries. Industries were "new" if they produced items which were either not manufactured in the country at all or which were fabricated in insufficient quantity or through primitive methods. Also classified as new were established firms which introduced improvements in the manufacturing process. The preference given to new industries, as against those falling into the established category, was much greater in Guatemala, El Salvador and Nicaragua than in Costa Rica and Honduras. Superimposed on the new versus established classification was a system of priority ratings in three of the five countries. The criteria for assigning priorities were diverse and they were seldom defined in specific fashion. The scope and magnitude of benefits received depended on the determination of priority. This was particularly the case in Honduras and Nicaragua, where activities falling into the third priority category received very few benefits compared to those enjoyed by activities assigned first or second priority.

47. The number of fiscal incentive contracts signed increased very rapidly from about 137 in 1960 to 466 in 1965; since then the number had dropped off considerably (see Annex Table 35). The decline in the second half of the decade affected all countries, except Honduras. The total number of contracts signed was nearly three quarters of the total number of industrial establishments included in the Manufacturing Survey of 1968 (see Annex Table 36). The corresponding proportion was relatively high in Nicaragua and relatively low in Honduras. A part of these differences might be the result of uneven coverage of the Survey. However, the mission believed that the low figure for Honduras also reflected the tighter administration of fiscal incentives. There were many Central American firms operating in the traditional spheres of manufacturing activity--food, beverages, tobacco, printing and publishing, clothing, footwear, wood--who had not received fiscal incentives. However, almost all firms producing new items, which developed for the first time during the sixties, were entitled to these special privileges.

48. The administration of fiscal incentives was characterized by a high degree of competitiveness among CACM members. National procedures and criteria were greatly modified in the attempt to provide local firms, or foreign enterprises resident in the country, the same or greater advantages as were given by other governments in Central America. This desire not to be

TABLE 8

Summary of Principal Fiscal Incentives Given Under National Legislation Prior to 1969

(Number of Years of Exemption from Taxes)

		Exemption from Import Duties			Exemption From	
		Production Inputs	Machinery, Equipment, and Construction Materials	Fuels	Income Tax	Capital Tax
New Industries:						
Costa Rica		X	X	X	X a/	X
Guatemala		10	10	10	10 a/	-
El Salvador	1st Priority	10	10	-	10 a/	10 a/
	2nd Priority	8 e/	8	-	-	-
Honduras	1st Priority	10	10	10	10 b/	5
	2nd Priority	10	5	10	6 b/	3
	3rd Priority	3	5	3	5 c/	3
Nicaragua	1st Priority	10	Y	10	10 a/	5
	2nd Priority	5	Y	5	3	3
	3rd Priority	-	Y	-	-	-
Established Industries:						
Costa Rica		X	X	-	X b/	-
Guatemala		-	5	-	5 b/	-
El Salvador	1st Priority	-	5	-	-	-
	2nd Priority	-	5	-	-	-
Honduras	1st Priority	5	5	5	6 b/	3
	2nd Priority	5	5	5	5 c/	-
	3rd Priority	3	3 d/	3	-	-
Nicaragua	1st Priority	5	Y	5	3	3
	2nd Priority	-	Y	-	5 a/	-
	3rd Priority	-	Y	-		-

NOTE: 100% exemptions unless otherwise specified.

X: In Costa Rica, duration of exemptions was specified on a contract by contract basis. Exemptions were for 99% of tax liabilities for new industries, 90% for existing industries.

Y: Exemptions given for installation of new project.

a/ 100% of tax liability for first half; 50% for second half.
b/ 100% of tax liability for first half; lower percentage for second half given only if profits reinvested in new fixed assets of firm.
c/ 50% exemption given for profits reinvested in new fixed assets of firm.
d/ Not applicable to construction materials.
e/ 50% of tax liability for first five years; 25% for last three.

Source: SIECA, Informe sobre Industrias Clasificadas en los Paises Centroamericanos, May 1968.

outbid was reflected in the following features:

(a) There was a provision in most countries according to which companies already located in a country would receive benefits at least equal to those offered by other Central American governments to firms with the same product line who were actual or potential competitors.

(b) The proportion of activities classified as new was relatively high in Guatemala and El Salvador; these were among the countries in which established industries were treated much less favorably than those in the new category (see paragraph 46).

(c) More or less the same proportion (25%) of activities were given the lowest priority rating in El Salvador, Honduras and Nicaragua. These firms were entitled to the least favorable treatment (see paragraph 46).

49. The fiscal incentives program proved to be a costly instrument of industrialization. Current government revenues as a proportion of GDP of Central America stagnated at a rather low level of 9-10% during the sixties, despite substantial growth rates in overall economic activity. This fiscal record, which jeopardized the effectiveness of the government sector, was the result of many factors including the policy regarding fiscal incentives to industry, the dismantling of tariffs on intra-regional trade and the low rates of taxation on exports of primary goods.

50. Import duties constituted almost half of central government revenues of the five governments before the establishment of the CACM. Even in 1962 the proportion was 40%. The absolute amount collected from tariffs declined during the sixties. This resulted from the freeing of intra-regional trade, changes in the structure of imports, and also because of exemption from import duties granted under the fiscal incentives programs. These exemptions amounted to $68 million in 1968 or 15% of total revenue collections (see Table 9). The volume of exemptions was relatively unimportant in Honduras but disproportionately large in Costa Rica. The share of import duty collections in total Central American public revenues had dropped to 23% by 1969.

51. Direct tax revenues increased in relative importance during the sixties (see Annex Table 39). However, very little of this increment originated in the industrial sector. Available evidence suggests that income taxes paid by the industrial sector averaged far less than 1% of total industrial output in 1969 or roughly 4-6% of profits. (see Table 10). These estimates, based on fragmentary data, confirm the mission's general impression that much of the potential for easing the fiscal squeeze by tapping the rapidly growing industrial sector was squandered by the indiscriminate granting of fiscal incentives in addition to poor tax administration and large-scale evasion.

52. Central American governments made an effort to substitute taxes on domestic transactions for import revenues which were withering away. Revenues from this category of taxes now constitute 41% of total revenues. In addition to general sales taxes, there were exercise duties on a relatively limited number of traditional manufactured items. (see Annex Table 40). Furthermore, Nicaragua, Costa Rica and Honduras had imposed special consumption taxes with a rate structure which varied inversely with the essentiality of the item concerned.

53. Many knowledgeable people in Central America were concerned with the high price paid for fiscal incentives. There was no doubt that the price paid by public authorities, in the form of revenues foregone, could have been moderated had it proved possible to adapt the overall tax structure to the imperatives of industrial policy. There was also considerable concern that the price of fiscal incentives was disproportionately large in relation to their benefits.

C. The Evolution of Tariff Policy

54. Liberalization of intra-regional trade was the first step towards economic union in Central America. Closely associated with this and stipulated in the Multilateral Treaty on Free Trade and Economic Integration of 1958 was the imposition of a common tariff barrier. The Central American Convention on the Equalization of Import Tariffs signed in 1959 provided the basis for the establishment of the Common External Tariff (CET).

55. While there were significant differences among countries, the tariffs of the fifties were quite high 1/. The arithmetic average for all manufactured consumer goods was about 54% and for non-durable consumer goods about 67%. The tariffs for intermediates were somewhat lower. The tariffs on intermediate goods for industry averaged about 33% (see Table 11). For capital goods in industry tariffs were even lower, averaging less than 9%.

1/ Measuring the level of nominal tariffs in Central America is not an easy task, since the Central American countries typically have had a two-column tariff consisting of a specific and an ad valorem rate of duty. The most recent study of the tariff was done by the International Monetary Fund with the assistance of the Central American Monetary Council. The mission has used the IMF figure with some adjustments. For an explanation of the methodology used in the IMF study and the adjustments made by the mission, see Notes to Annex Table 27. The Table also shows tariffs at the product level.

TABLE 9

Value of Exemptions From Customs Duty Due to Fiscal Incentives
(million US dollars)

	Guatemala	El Salvador	Nicaragua	Costa Rica	Honduras
1963	n.a	2.6	3.4	2.1	1.1
1964	n.a	5.1	4.9	5.6	2.4
1965	5.7	6.7	7.1	9.9	2.8
1966	6.0	8.7	8.6	11.8	4.5
1967	13.0	10.4	10.3	14.8	3.8
1968	14.8	10.1	12.3	27.5	3.8
1969	13.6	10.6	13.0	n.a	4.3

TABLE 10

Income Tax Collections

From Manufacturing Sector 1969

Estimated collections ($ million)	4.5	1.8	2.0	5.6	n.a
Collections as % of gross manufacturing production	0.7	0.5 a/	0.7	1.3	n.a
Estimated exemptions due to fiscal incentives ($ million)	2.0	n.a	n.a	n.a	0.3 b/

a/ Based on 1968 production data.

b/ 1966.

Sources: Based on data provided by national Ministries of Finance.

56. There is general agreement that the Common External Tariff is an upward revision of the average of the previous national duties. Since the CET was negotiated, the rates usually fall somewhere between the average and the highest of the previous rates of the five countries. By 1969 about 99% of the 1,551 items listed in the tariff schedule had been negotiated through six protocols.

57. In addition to the upward revision embodied in the negotiations of the Common External Tariff, some duties have been increased subsequently. Tariffs can be changed by three methods. First, any producer can request a tariff increase provided that it proves that it has "undue competition" from imports. Second, a new producer can request an increase in tariff under the Special System for the Promotion of Productive Activities ("etereo"), first introduced in 1963. The increase becomes effective, if the producer can prove that he has the capacity to supply at least 50% of the regional demand. Third, all producers who enjoy the status of "integration industries" can receive an increase in tariffs. As with the original tariff negotiations, the process of change is quite lengthy because it requires the approval of national legislatures. On the average, it has taken four years to change any given tariff item.

58. The major characteristic of the "etereo" system is that it allows for substantial tariff increases. Sharp tariff increases have seldom been accepted under the regular tariff negotiations. Light bulbs, agricultural handtools, metallic cylinders, PVC, sulfuric acid, tissue paper, aluminum foil, are the most important items receiving benefits under the "etereo" regime. Despite large increments in duties on these items, the resulting level remains generally under 50%. (see Annex Table 29).

59. Also receiving special tariff treatment are the so called "integration industries" 1/. Only four products have been granted integration status and the tariff accorded to them has been moderate. Tires have been granted a duty averaging about 30%, chlorinated insecticides received about 15% protection, caustic soda approximately 30% 2/. Flat glass was also given integration

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1/ The System of Integration Industries, established in 1958, was designed to ensure an equitable distribution of industry among the five countries, and to encourage new industries which due to the small size of the individual markets had not previously located in the region. The scheme offers a series of incentive such as free regional trade (while competing regional producers must pay duties); a protective tariff on competing extra-regional imports; and exemptions of import duties on equipment, raw materials and of taxes. In order to obtain the benefits, the "integration producer" must demonstrate that its capacity is large enough to meet the Common Market demand, he must agree to maximum prices for his products, and must maintain quality standards.

2/ Because the specific component of the duty is very important, the ad-valorem equivalent of the rate varies substantially with the world market price for the product.

TABLE 11

Average Nominal Tariff for Selected Groups of Manufactured Products

	Guatemala	El Salvador	Costa Rica	Nicaragua 1/	Honduras	Arithmetic Average - CACM
A. National Tariffs before the Common Market, 1959						
Consumer Goods	50.4	52.2	58.1	59.6	50.0	54.1
Non-durable Consumer Goods	63.8	65.9	66.0	69.3	63.8	66.8
Clothing and Textile Manufactures	89.3	54.8	67.2	93.8	62.7	73.6
Durable Consumer Goods	19.7	20.7	39.9	37.2	18.3	27.2
Intermediate Products	24.4	37.8	28.3	33.0	31.6	31.0
Manufactured Intermediates for Agriculture	0.8	29.2	1.8	1.7	0.3	6.8
Intermediates for Industry	28.0	42.5	28.9	32.6	31.7	32.7
Capital Goods	6.0	9.8	10.0	14.0	2.9	8.5
Capital Goods for Industry	6.0	9.6	10.4	14.6	3.5	8.8
B. Common Market Tariffs, 1967						
Consumer Goods	79.8	79.3	85.5	92.2	91.9	85.7
Non-durable Consumer Goods	98.3	100.3	100.4	110.9	118.5	105.7
Clothing and Textile Manufactures	131.4	116.1	115.5	147.8	156.0	133.4
Durable Consumer Goods	37.2	31.6	51.5	49.2	30.9	40.1
Intermediate Products	28.6	38.1	32.8	56.1	35.7	38.3
Manufactured Intermediates for Agriculture	6.8	10.3	9.7	9.5	8.0	8.9
Intermediates for Industry	33.0	38.0	33.7	33.9	38.8	35.5
Capital Goods	10.3	10.2	11.8	12.6	9.9	11.0
Capital Goods for Industry	10.8	10.9	12.0	13.0	10.5	11.4

1/ Figures used for Nicaragua apply to 1960 and 1968, respectively.

Source: Annex Table 27.

status and granted 40% protection but the plant was never built.

60. The Common External Tariff continues to be a two-column tariff. The usual difficulties of measuring nominal protection are compounded by the Common Market framework. First, the tariff nomenclature adopted by the CACM is based on a trade classification which, unlike standard tariff nomenclatures, groups together dissimilar products 1/. An input and an output are frequently grouped together in the same tariff group. Second, since all tariffs have a specific duty component in them, if the products imported by the different countries have different weights (heavier versus lighter synthetic textiles, for example) the ad-valorem equivalent of the tariff rate for particular products will be different in each country. Third, tariffs in the Common Market have been progressively equalized over 5 years in general. Hence the 1967 rates, shown in Table 11 do not represent the fully equalized tariff.

61. In spite of the discrepancies among countries, certain general conclusions can be reached regarding the structure of nominal protection in Central America and the increase since the late 1950s. The nominal tariff on non-durable consumer goods has risen appreciably and the present arithmetic average for the five countries is about 106%. Present duties are particularly high on clothing and other make-up textiles (106%), cosmetics (108%), cigarettes (232%), footwear (297%), alcoholic beverages (260%), plastic kitchen ware (60%), and glassware (56%). (see Annex Table 27). Also high are the tariffs on textiles. In 1967, the average tariff on cotton textiles averaged about 70% but these rates have since been increased 2/. In durable consumer goods the average tariff increased from about 27% to about 40%. It should be noted that the common external tariff for many of these products, such as electrical appliances and automobiles, have not yet been negotiated and trade is governed by national policies.

62. On most intermediates used for industry there has been no appreciable increase in the tariff level. For those items produced domestically, the tariff is somewhat higher than the average for intermediates but by no means exorbitant. Hence while the tariff on pulp is about 7% and on synthetic fibers 15%, the tariff on paper bags is about 46% on cardboard boxes about 56% and on leather about 32%. Nominal tariffs on intermediates have eroded under the impact of fiscal incentives which have exempted most enterprises from the payment of

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1/ Nomenclatura Arancelaria Uniforme Centroamericana - NAUCA - which is based on the standard international trade classification.

2/ The textile protocol, which raised the protection for most cotton textiles, is included in the second Managua Protocol (1967).

duties on imported inputs. This is so despite legislation forbidding the exemption of tariff payment to products similar to those manufactured in Central America. Article IX of the General Treaty states that

> The Governments will not grant exemptions or reductions on tariffs for imports coming from outside Central America for goods produced in Central America in adequate conditions.

63. The Executive Council of the Common Market, moreover, established regulations for the implementation of this Article at the national level (Regulation 26). Specific restrictions against granting tariff exemptions for Central American products also appear in several regional treaties. Tariff exemptions for such products have nevertheless been granted on the grounds that the Central American production of the equivalent product is not competitive in price, quality or quantity. The Executive Council has ruled that there is sufficient local production of over sixty products. The list of products brought to the attention of the Council includes textiles, integration industry products such as caustic soda and products made by industries which have benefited from the "etereo" regime (see Annex Table 29). While in the earlier years of the Common Market the main complaints brought to the Executive Council concerned origin of products questions, in recent times, the largest number of problems raised have involved Regulation 26.

64. The impact of fiscal incentives on the level of effective protection has been considerable. While the nominal duty on clothing is about 115%, the effective rate of protection is about 200% assuming that the producer pays duties on imported inputs. If it is assumed that the producers succeed in avoiding the payment of duties on inputs, then the effective rate of protection increases to 250%.

65. The Central American countries have imposed a surcharge on all imports under the San Jose Protocol to the General Treaty which became effective recently. An economic stabilization tax amounting to 30% of the value of the duties owed on account of the Common External Tariff was imposed. The surcharge will be in effect until 1973 and is supposed to be applied equally to all imports whether they be finished goods or industrial inputs. The protocol provides that exemptions can be granted for imports by industries of "particular interest in the economic development of Central America". Also exempted from the surcharge are a group of pharmaceutical, intermediate, and capital goods which are listed in the protocol itself (see Annex Table 28). Because of the delays by Costa Rica in ratifying the San Jose Protocol and because of the disruptions in Common Market activities, no regulations have been prepared to guide the national administrative agencies in its application. Consequently, the surcharge has been applied differently in all countries. Since the ratification by Costa Rica last September, El Salvador, Guatemala and Costa Rica applied the surcharge across the board, exempting from taxation only those products specified in the protocol. Nicaragua and Honduras have continued to grant wholesale exemptions on industrial inputs.

66. From what has been said above, it becomes apparent that the level of protection is hardly common to the five countries. There has been lack of uniformity in the implementation of fiscal incentives, which has altered the level of effective protection for finished goods. Moreover, fiscal exemptions eroded what little nominal protection intermediates enjoyed. The absence of a uniform application of the import surcharge has only compounded the disparities, as many finished products now have different levels of nominal protection in the different countries. Lastly, the unnegotiated items account for 13% of Central American imports from the outside world.

D. The Effect of the Policy Mix

67. The combined impact of the major policy instruments - fiscal incentives, dismantling of intra-regional trade restrictions, protection against imports from the outside world - was twofold. First, investment in manufacturing became much more profitable in the sixties than heretofore. Secondly, the increased profitability of this sector was not an across-the-board phenomenon. Owing to the specific design of the policy instruments, the effects of the new incentives depended on the origin of inputs used, the mix of factor proportions and the market for the product. The new policies were biased in favor of import and capital-intensive production geared to national or other Central American markets. There was very little incentive for cultivating the extra-regional markets in the rest of Latin America, United States or Europe. The policy framework was not conducive to production based on indigenous materials and local labor.

Profitability and Capacity Utilization

68. Precise data on the profitability of manufacturing operations were not available but the mission's discussions confirmed the general impression in Central America that rates of return in this sector were very high. The Manufacturing Survey of 1968 suggested that pretax profits averaged 45% of total fixed assets (see Annex Table 71) or more than 30% of total fixed assets plus inventories. These data were scarcely credible but they provided general support for the proposition that a lot of money could be made under the existing framework of industrial policy.

69. Fiscal incentives increased rates of return in several ways. Exemptions from import duties on industrial machinery, which average 11%, reduced the original outlay by the investor. Exemptions from import duties on industrial inputs, which averaged 36%, lowered substantially the operating cost of the project. Exemptions from income and capital taxes allowed the investor to enjoy the full return from his venture without sharing it with the government. Three project studies made by CABEI suggested that fiscal incentives raised the rate of return on investment to the extent of 5-11 percentage points. Similarly, the Common External tariff had the effect of raising the profitability of industrialists selling their products in Central America by allowing them to charge prices above the world market level. Tariff protection was not fully exploited by industrialists for various reasons (see paragraphs 80-84). However, there

were cases in which local prices exceeded international levels and allowed producers to secure large margins at the expense of consumers.

71. In response to the new alignment of prices and profits, private foreign investors moved into the manufacturing sector in large numbers during the sixties. The evidence for this influx is presented in Chapter V. Many a foreign firm which had exported to Central America previously now felt compelled to get behind the Common External Tariff, establish an assembly or processing plant, obtain fiscal incentives and cultivate the combined market of the five countries.

72. Handsome profits in Central American manufacturing apparently coexisted side by side with sizeable under-utilization of capacity. Of course, no precise measurement was possible but the existence of idle capacity in a large number of activities was confirmed by plant visits and interviews with knowledgeable industrialists. The mission also gained the impression that Central American industrialists were not terribly concerned with the problem of under-utilization, except where it was chronic and threatened the financial viability of the enterprise. This general tolerance for idle capacity might be explained in terms of the impact of policy measures which tended to subsidize the price of capital. The generally low interest rate policies of CABEI and the public fomentos were a case in point (see Chapter V). Also relevant was the design of fiscal incentives which allowed somewhat larger benefits for the use of capital than for the employment of labor 1/.

73. The existence of idle capacity was the result of many factors; some of these were specific to particular plants or activities while others were more general in character. Among the latter was the constraint imposed by the technically determined minimum size of machinery in the context of the very small Central American market. For example, while the Guatemalan tire plant was utilizing capacity to the extent of about 60% on the whole, the Banbury Mixer was being used much less intensively. Another factor which had general significance was the misreading of the market potential by foreign firms contemplating the establishment of a new plant. For example the largest pharmaceutical establishments, many of which are subsidiaries of foreign firms, had an average capacity utilization ranging from 13% (ointments and pomades) to 30% (pills and tablets) in 1968 2/. Similarly a food processing firm owned by a United States concern and operating in Central America was working at 30% capacity because the extent of the market had been grossly overestimated.

Pattern of Import Substitution

74. Foreign or Central American firms considering a new manufacturing operation did not as a rule think of selling outside the region. The new framework of policy encouraged import substitution. Selling outside Central

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1/ In fact, there were no fiscal benefits directly related to the use of labor.

2/ Source: ICAITI, Study on the Pharmaceutical Industry (unpublished).

America, if at all feasible, was distinctly less profitable than sales in national or regional markets behind the tariff wall. Although exports of manufactures outside the region increased sharply from $7 million to $94 million during 1958-1966, the great bulk of such exports consisted of sugar and processed meat: products which were basically agricultural in character. Virtually no new investments in the industrial field during the sixties were designed to produce for foreign markets.

74. The balance of incentives favored import substitution rather than exports. However, Central American import substitution was quite distinctive compared to patterns observed in other less developed countries. The share of imports from outside Central America in the overall supply of manufactured goods declined from 38% to 29% during the decade, but there was no corresponding increase in the share of national production (see Table 12). This would have been the outcome had import substitution occurred behind national tariff walls. Such a development would have implied much more inefficiency and waste than actually occurred. Owing to the freeing of intra-regional trade, imports from the outside world were displaced in many cases by imports from members of the Common Market and not necessarily by national producers. The enormous expansion of exports of manufactured goods from Central American countries to other Central American countries was part and parcel of the process of import substitution, viewed from the regional standpoint. As noted earlier (see Section A), a measure of specialization had taken place at the product level and the element of competition in intra-regional trade had undoubtedly improved efficiency and productivity in many lines.

75. Certain important features of the process of import substitution should be recognized:

(a) The share of national producers in the total supply of manufactured goods increased appreciably in Honduras and less notably in Nicaragua (see Table 12), unlike the situation in the remaining three countries or in Central America as a whole.

(b) The decline in the share of extra-regional imports was much more swift in 1964-1968 than in the preceding six years (see Table 12).

(c) The replacement of extra-regional imports was most marked in intermediates - paper products, metal products, industrial chemicals, tires - and in more modern branches of the consumer industries - textiles, clothing, cosmetics, pharmaceuticals, electrical appliances (see Table 13).

76. While many consumer industries (textiles, processed foods, wood furniture) and some intermediates (plywood) are resource oriented, much of the import substitution that took place under the Common Market has only replaced foreign manufactures at the finishing end of the operation. This was basically a reflection of the stage of industrialization and the constraint imposed by the small size of even the combined markets of the five countries and the limited

TABLE 12

Sources of Supply of Manufactured Goods (Total)
(percentages)

	National Production	Imports from Central America	Imports from Outside Central America
Central America			
1958	61	1	38
1964	61	5	34
1968	62	9	29
Guatemala			
1958	70	0	30
1964	68	4	28
1968	69	5	26
El Salvador			
1958	61	2	37
1964	58	7	35
1968	61	11	28
Nicaragua			
1958	55	1	44
1964	53	5	42
1968	57	11	32
Honduras			
1958	40	4	56
1964	49	9	42
1968	47	14	39
Costa Rica			
1958	62	0	38
1964	62	2	36
1968	63	8	29

Source: Annex Tables 22 - 24 and 41 - 46.

TABLE 13

Percent Share of Extra-Regional Imports in Apparent Consumption of Manufactured Goods in Central America

	1958	1964	1968
All Mfd. Goods	38	34	29
Consumer Mfrs.	23	20	16
Food	10	8	5
Beverages	5	4	4
Tobacco	1	1	1
Textiles	59	37	27
Clothing	10	4	2
Furniture	6	2	2
Publishing & printing	16	16	19
Consumer Chemicals	51	43	39
Electrical Appliances	88	88	61
Automotive	79	82	77
Mfd. Intermediate Goods	66	54	44
Wood	3	2	2
Paper	86	57	52
Leather	32	21	10
Rubber	77	53	33
Industrial Chemicals	90	79	71
Petroleum Products	100	55	39
Non Metallic Minerals	33	29	23
Basic Metals & Metal Mfrs.	88	69	47
Mfd. Capital Goods	94	93	86

Source: Annex Tables 50 - 52.

resource base of the region. However, on this structural aspect was superimposed the impact of powerful policy variables. The common external tariff was much higher on finished goods than on semi-processed manufactures. Fiscal incentives provided much greater benefits to industrialists using inputs purchased from outside Central America than to firms relying on locally purchased materials. The gross violation of Regulation 26 of the Executive Council (see paragraph 63) compounded the difficulty of firms attempting the production in Central America of semi-processed goods.

77. The industrialization policy of the Common Market has led to a high import dependence in precisely those industries which developed in the late sixties and which were heavily dependent on the regional market: paper, chemicals, metal manufactures and electrical appliances. Some of these activities had the integration industry status (caustic soda, insecticides) and many benefited from the "etereo" system (metal cylinders, handtools, light bulbs and PVC). Central America had none of the inputs required for the development of the chemical and metal industries. For instance, the caustic soda plant located near Mangua depended on salt imported from Mexico. It is usual for pharmaceutical and cosmetic firms to undertake little more than mixing and packaging operations in developing countries. However, in Central America, the structure of incentives is such that the manufacturers import even some of the packaging materials. Since there is very little production of metals in Central America and no steel production, all metal manufactures rely on imported inputs. While some of these industries, such as kitchen ranges, involve a considerable degree of processing, ethers are very simple operations (production of galvanized sheets, gas cylinders and wire, for example).

78. Unlike the chemical and metal industries, Central America can integrate backward its paper industry. However, much of the tissue paper industry consists of finishing operations. Only recently did Scott Paper in Costa Rica and Kimberly Clark in El Salvador establish productive facilities for the manufacture of the rolls of tissue paper from imported pulp. Tissue was an "etereo" industry. On the other hand, bond and kraft paper, produced mostly in Guatemala, had for sometime been manufactured from imported pulp.

79 Also indicative of the nature of the incentives is the increased dependence of the established industries on imported inputs. While many traditional industries depend mostly on local raw materials, there is evidence that the newer plants producing for the regional market are importing a considerable share of their inputs. Such is the case with the modern sector of the clothing and footwear industries. The larger clothing manufacturers import many of their textiles, arguing that local textiles do not have the quality or the variety needed for production of clothing. The same is true of the modern footwear sector. Generally, high quality leather is imported from outside the area while the low quality product is purchased in Central America. High quality leather was not available in Central America partly because untill recently no premium was paid on undamaged hides.

Behavior of Manufactured Goods Prices

80. Considering that the present level of the Common External Tariff was much higher than most national tariffs before the Common Market, the mission expected to find a widespread increase in prices of locally produced manufactured goods. Such increases had taken place in a number of items which had taken root during the sixties. However, what was equally, if not more, impressive, was the decline in prices of many manufactured goods moving in intra-regional trade. This downward movement could be explained in terms of the favorable impact of an expanded market on production costs, the introduction of inter-country competition among Central American producers and cost savings resulting from the operation of fiscal incentives.

81. Price statistics in Central America are generally unreliable. Therefore, the mission has based its analysis on unit values in regional and total import trade 1/ . Such an approach has its defects, but these do not destroy the general conclusions of the analysis. These are that prices declined in a high proportion of the cases, remained steady in a fair segment and increased in the rest (see Table 14). The mission's examination of price data for 1964-1968 generally leads to the same conclusions as the study by Donald McClelland for an earlier period.

82. Prices of manufactured goods - food, beverages, tobacco, wood, non-metallic minerals - which were well established before the Common Market did not exhibit appreciable changes. Some products of the cotton textile and clothing industry experienced a substantial decline in prices. This was also true of the footwear industry. Such an outcome reflected economies of scale and vertical or horizontal specialization in the context of an expanded regional market. It also reflected the impact of cost savings resulting from exemptions on import duties extended under the fiscal incentive program. As noted above, many firms in these branches engaged in regional trade, had switched from indigenous to imported inputs (see paragraph 79). These savings in costs were passed on to the consumer in the form of lower prices because of the pressures of intra-regional competition. In some of these lines El Salvador and Guatemala held commanding country shares (see Table 7). The evidence of a decline in prices suggested that there must exist a substantial measure of competition among rival firms of the same nationality or among large firms from the two countries.

83. The large increase in prices was concentrated in products which got started for the first time during the sixties. Important examples were synthetic textiles, cosmetics, toilet articles, several pharmaceuticals, cardboard boxes, electric wire and cable, radio parts, dry batteries, steel products and some metal manufactures. In several cases, the producer firms held a near monopoly position or eliminated price competition through implicit agreements to share the regional market.

1/ This follows the study made by Donald McClelland (unpublished).

TABLE 14

Changes in Unit Values in Import Trade

(percent distribution of number of products)

	Intra-Regional Trade	Total Import Trade
	1962-66[a]	
Decline in Prices	44	36
No Appreciable Change in Prices	17	17
Increase in Prices up to 10%	13	18
Increase in Prices exceeding 10%	26	29
	1964-68[b]	
Decline in Prices	57	48
No Appreciable Change in Prices	9	8
Increase in Prices up to 10%	6	16
Increase in Prices exceeding 10%	28	28

a/ The sample consists of 67 items of great importance in regional trade.

b/ The sample consists of 79 items covering the bulk of regional trade.

Sources: Donald H. McClleland unpublished manuscript for the period 1962-66.

Mission estimates on the basis of official data for the period 1964-68.

TABLE 15

Rough Comparison of Prices of Selected Manufactured Items in Central America and Abroad

	Present Actual (Foreign Ex-Factory Price = 100)	Hypothetical assuming full utilization of protection (Import c.i.f. price = 100)
A. Actual Price less than or equal to Foreign Price		
Vienna Sausages	95	162
Women's Panty Hose	48-98	176
Blue Jeans	97-115	192
Men's Cotton Shirts (lowest price)	76	192
Men's Shirt Blended Fabric (specified brand I)	59-68	181
T-Shirts	89-150	204
Pullovers	100-135	220
Tomato Paste	100-122	217
Yarn carded 20/1 Cotton	88	142
Yarn combed 40/2 Cotton	83	142
Caustic Soda	95-138	134
Barbed Wire	78-104	130
Galvanized Wire	89-96	130
B. Actual Price not more than about 30% above Foreign Price		
Tomato Catsup	122-137	217
Men's Socks, nylon	125-133	176
Satin	130	161
Kraft Paper	120-135	139
Auto Tires, nylon, tubeless, white walls 520-13	108	135
Auto Tires, nylon, tubeless, white walls 695-14	131	135
Truck Tires, nylon 700-18	120	135
Truck Tires, nylon 1200-20	130	135
Ammonium Nitrate	106	108
PVC	112-158	197
Cement Portland	124-138	132
Steel Reinforcing Rounds	105-110	126
C. Actual Prices more than 30% above Foreign Prices		
Vegetable Oil	135-150	186
Men's Shirts blended fabric (specific brand II)	136	181
Men's Nylon Shirts	152-316	176
Car tires 800-14	180	n.a.
Car tires 615-16	157	n.a.
Twill, Cotton 60-68 lbs/yd. 45"	132-137	161

84. Finally, the mission made an attempt to compare ex-factory prices of selected items in Central America and abroad (see Table 15). No precise meaning should be read into these figures, which are rough and subject to limitations. Nevertheless, it is interesting to see that in 13 products Central American prices, at present exchange rates, were not out of alignment with those prevailing abroad. This was so despite the fact that nominal tariff duties in many cases would have allowed local prices to be more than 150% of c.i.f. import prices. In another 11 cases, local prices were above international prices to the extent of about 30% and available protection was utilized, at least partially. In the remaining 8 cases local prices were considerably above the world market level and available protection was being exploited in full measure.

V. The Industrial Financial System

A. The Level of Industrial Investment and the Main Sources of Finance

85. The volume of annual fixed capital formation in Central American industry doubled between 1962 and 1967; this was a somewhat larger increase than took place in other sectors 1/ 1967 was the peak year for industrial investment and it was followed by a 15% drop in the following year. The level in 1969 was only slightly higher than the year before. Meanwhile, fixed investment in other sectors continued to increase during the last two years. For the whole period 1962-69, industrial gross fixed investment averaged 3% of regional GDP compared to 15% for total fixed capital formation.

86. The estimate of total financial requirements of the Central American industrial sector made allowances for the purchase of land, increments in working capital, etc., besides outlays associated with machinery and equipment. These estimates were built on a series of assumptions derived from an inspection of industrial survey data available in several countries. While the mission does not claim a high level of precision for these figures, there is reason to assume that the general orders of magnitude are not misleading.

1/ The mission was compelled to develop independent estimates of industrial investment as official figures were found to contain serious weaknesses. The methodology used by the mission was spelled out in Annex Table 64. Our estimates were appreciably lower than official figures in Costa Rica, Guatemala and Nicaragua. They were higher than official figures in El Salvador and Honduras. For Central America as a whole, mission estimates were 23% lower than the sum total of national figures during 1964-68. See Annex Table 67.

87. Financial intermediaries in Central America played a rather modest role in the overall scheme, compared to resources generated internally by industrial firms as well as direct loans and equity investments from abroad (see Table 16). The residual category, comprising 28 percent of total financial requirements consisted of reinvested profits of local investors, equity as well as loans from non-institutional parties, including those from the large primary goods export sector.

88. The pattern of industrial finance portrayed by the Table is scarcely surprising. The large share of depreciation reserves and the residual category is a general characteristic of industrial finance. These items accounted for about 40-66 percent of total financial requirements of industrial corporations in a sample of eleven countries in Asia and Latin America.[1] The corresponding proportion for Central America was 58 percent. Perhaps, a distinguishing feature of industrial finance in Central America was the heavy reliance on foreign funds. However, it should be recognized that it was not only the industrial sector but the overall economies of Central America which displayed this characteristic. Total capital formation in the region was financed from abroad to the extent of 31 percent, compared to 27 percent for industry.

89. There was some evidence that the relatively large industrial firms in Central America managed their financial operations rather conservatively. Surveys conducted by the Central Banks of Guatemala, Nicaragua and Costa Rica showed that the average debt equity ratio of firms included in the sample was about 1:1. Liquid assets held by these firms exceeded their short-term liabilities by about 60 percent. These results were comforting but the mission had no way of assessing the representativeness of firms included in the surveys. There was reason to believe that these firms were relatively large and presumably well established. The financial position of small and medium-size enterprises in Central America was not clear. It was possible that these firms encountered difficulties in obtaining access to funds both for working capital and for the financing of fixed investment.

B. The Role of Financial Intermediaries

90. The sixties witnessed a considerable elaboration of the financial infrastructure geared to the industrial sectors of the five countries. Commercial banks, which remained by far the most important financial intermediaries, reoriented their lending policies in favor of industry. Private financieras were established in all the Central American countries with the object of

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1/ UNIDO: Industrial Development Survey, Volume 1, New York, 1969, P. 217.

TABLE 16

Pattern of Industrial Finance 1962 - 69

		Million Dollars	Percent Distribution
Gross Fixed Investment		953	63
Land, Increase in Working Capital, etc.		571	37
Total Financial Requirement		1,524	100
Financed by:	Commercial Banks (Net)	131	9
	Private Financieras (Net)	36	2
	Public Fomentos (Net)	32	2
	Other Institutions and unidentified (Net)	24	2
Total National Financial Intermediaries		223	15
New Foreign Direct Investment		145	10
Reinvested Earnings of Foreign Firms		114	7
External Lending (Net): CABEI		37	2
External Lending (Net): Other		117	8
Total Foreign Sources		413	27
Depreciation		453	30
Residual Category		435	28
Total Depreciation and Residual		888	58

Source: Mission Estimates.

facilitating general and industrial development. Public fomentos also became vehicles of industrial advancement. Altogether, the share of national financial intermediaries in industrial finance increased from 14 percent in 1962 to a peak of 21 percent in 1965 and then tapered off again. Outstanding credit from all financial institutions to the industrial sector expanded much more rapidly than gross industrial production or value added. The ratio of outstanding credit to value added in Honduras rose from a paltry 7 percent in 1962 to 31 percent in 1969. (See Annex Table 69). The increment in Nicaragua was also impressive, although the proportion declined in 1969. A tapering off was also visible in El Salvador and Costa Rica.

91. Commercial banks were particularly important in Costa Rica which had no public fomento and in Guatemala where institutions specializing in industrial finance were not yet firmly rooted. The bulk of commercial bank credit was for the financing of working capital with maturities of less than one year. The Banco de Costa Rica, however, had built up a specialized department responsible for administering term-credit to industry for project financing. For this purpose, it used resources from international lending agencies, such as the World Bank (whose funds were made available through loans extended to the Central Bank from 1956 to 1961), and IDB, more recently.

92. Monetary policy had regarded industrial credit as a preferred sector of commercial bank operation. Although lending was subject to quantitative limits in Costa Rica and Nicaragua, the ceilings for industry were not as restrictive as for commerce and allied activities. All Central Banks, except that in Nicaragua, rediscounted commercial bank industrial paper on a preferential basis. Overall credit expansion had been circumscribed by monetary authorities in the interest of price stability and external payment equilibrium. Resources of commercial banks in the form of demand and savings deposits increased by about 143 percent or by about 1.0 to 1.8 percent of GDP each year. In Costa Rica, which experienced a rapid growth in financial savings, a substantial part was redirected to the public sector through the issue of government bonds with very attractive features.

93. Commercial banks in Costa Rica were nationalized. In other countries most banks were owned by a rather narrow group of families; in many cases the same interests which dominated industry, large agricultural estates and commerce. Accordingly, barriers to entry were high. The small new investor lacking connections and/or collateral found it difficult to raise funds from these institutions. In some countries state-owned commercial banks administered special programs in the small industry field. The mission did not have the opportunity of studying the effectiveness of these facilities.

94. Public fomentos had played a particularly important role in El Salvador (INSAFI) and Nicaragua (INFONAC) 1/. These two DFCs were responsible for

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1/ The Guatemalan fomento (INFOP) and the Honduran one (BANAFOM) have catered much more to agriculture than to industry. INSAFI in El Salvador was the only fomento exclusively specialized in the industrial sector.

providing about a quarter of the total institutional finance to the industrial sectors of their countries. Their contribution to the supply of medium- and long-term loans was even more significant. About 66 percent of INFONAC's loans were classified as such. The corresponding proportion for INSAFI was 91 percent. Furthermore, these two public fomentos had displayed initiative and a strong promotional drive. INFONAC, in particular, had built up a sizeable equity portfolio which constituted more than one-fifth of its total portfolio (see Annex Table 70).

95. Recently, the operations of public development banks were circumscribed by severe financial and management difficulties. They were incurring losses or barely breaking even. Their administrative costs averaged 4.5 percent of total assets; a high coefficient (see Table 17). Many fomentos had an unsatisfactory collection record. Meanwhile, problems arising from discontinuity of management and lack of focus had plagued the operations of these institutions. INFONAC's position, in particular, had been jeopardized by the inability of the Nicaraguan government to transfer resources, as promised, to make up for losses sustained in operations.

96. Five new private financieras were established in the Central American countries during 1964-69 under the auspices of the United States AID. Their contribution to industrial finance averaged 23 percent of the total provided by the institutional sector during 1965-67. Subsequently, their role diminished to about 10% towards the end of the decade. COFISA in Costa Rica and FDI in El Salvador were heavily specialized in industrial business; about 70 percent of their overall operations were in this sector. The corresponding proportion for BFH in Honduras and FIASA in Guatemala was less than 40 percent. CNI in Nicaragua was in the middle. The contribution of private financieras was not concentrated in the area of medium- and long-term funds for the financing of fixed investment. As much as 56 percent of CNI's loans had a maturity of less than one year and the corresponding proportion for other financieras was 30 percent or more 1/. In this respect, private financieras had the character of commercial banks lending for a variety of purposes to individuals and firms. These institutions had not engaged in the equity field to any large extent, with the conspicuous exception of CNI.

97. The pattern of ownership of private financieras was similar in all countries. They were controlled by groups who represented the rather narrow ownership of commercial banking and industry. Foreign commercial banks had minority interest in most cases. While the distribution of ownership and control provided financieras with good contacts in the business world, it might have prevented financial assistance from reaching new entrepreneurs. The lending procedures of the financieras followed by and large the practices of commercial banks. There was little in the way of systematic project appraisal based on technical and other studies. The decision to lend was frequently hinged on an assessment of the financial strength and the personal standing of the client in the business world.

1/ FIASA, a relatively new institution in Guatemala was an exception; the proportion of medium and long-term loans in this case was quite high. Central Bank regulations prohibit loans with a maturity of less than three years, except in the context of financing new firms.

98. Operational ratios relating to profitability, administrative costs, leverage and the growth rate in assets of the five private Central American financieras were similar to those relating to the group of Colombian financieras who borrow from the World Bank (see Table 17). The main difference is that the Central American institutions are about half the size of their Colombian counterparts in terms of the value of their assets. The Central American private financieras are one-fourth the size of public fomentos in the region. They are, of course, much smaller than CABEI. The very small size of the financieras and their extremely limited professional staff, averaging 7 persons, imposes a severe constraint on the building up of specialized skills required for expert project analysis.

99. Besides the five private DFCs associated with USAID, there exist a large number of finance, investment and insurance companies. Their operations, however, were of marginal interest to the field of industrial finance. Most of their activities were geared to real estate, home mortgages and the financing of consumer durables.

100. The Central American Bank for Economic Integration (CABEI) is an important part of the institutional framework for industrial finance. CABEI is a multinational, autonomous, public institution owned in equal parts by the five Central American governments. CABEI's contribution during 1962-69 to Central American industry was about equal to that of all the five public fomentos put together or that of the five private financieras. (See Table 16.) Investment associated with CABEI projects constituted about 15% of overall capital formation in the industrial sector in Central America..

101. CABEI had acquired considerable experience in project appraisal. The Industrial Department of this institution had a staff of 25 professionals. The mission was favorably impressed by their competence and sense of involvement. The system of project appraisal was well-organized and aimed at examining all the relevant aspects of the proposed investment. The quality of CABEI's project appraisal compares favorably with that of DFCs in other parts of the world with which the IBRD has an active relationship. However, there remains room for improvement in CABEI's project appraisal.

102. Financially, CABEI is in a strong position. Its profit as a proportion of equity has increased progressively as a result of some increase in leverage, a relative reduction in administrative expenses and an increase in the yield on temporary placement of idle funds. The present profit rate of 8% is still modest and the main factor underlying this is the level of interest rates CABEI charges its customers. This policy relating to lending rates requires reconsideration. CABEI's liquidity position is adequate. Its share capital is adequately protected against potential losses on account of bad debts. Considerable improvement has taken place in the situation regarding arrears.

TABLE 17

Financial Ratio Comparisons

	Five Public DFC's[a]	CABEI	Five Private Financieras[a]	Five Colombian Financieras[a]
	(Central America)			
Before-Tax profits as % of average net worth	0.4	8.1	16.7	18.8
Term debt/equity ratio	2.7	2.2	2.2	n.a.
Overall debt/equity ratio	4.4	2.2	4.5	5.0
Equity portfolio as % of equity + term loan portfolio	12.1	-	4.8	16.6
Net worth/paid-in capital ratio	n.a.	1.3	1.2	1.4
Payout ratio (3-year average)	-	-	39%	63%
Administrative costs/Total assets	4.5%	1.8%	2.3%	1.9%
Gross Income/Avg. total assets	7.3%	6.6%	7.8%	6.7%
Financial Costs/Avg. total assets	3.2%	2.2%	2.5%	
Total Assets (in millions of dollars)	46.2	104.5	12.4	27.9
Growth Rate of Total Assets[b]	10%	21%	24%	24%

a/ Averages are unweighted.

b/ Average annual rate for 3-year period, excluding FIASA which started operations in 1969.

Source: Annex Table 70.

103. The organizational structure of CABEI reflected its aims and purposes. The management had demonstrated a capacity to adjust this structure in the light of emerging needs. The major weakness of CABEI was that it had confined its activity to the financing of projects presented to it. So far it had not played an active promotional role. Its posture in the field of equity investments was hesitant. There was a lack of men with experience in private business who could assist in establishing a closer relationship between CABEI and potential investors. CABEI had cooperated with a number of the public fomentos by extending lines of credit and by jointly financing projects but had not established close relationships with the private financieras.

C. The Role of Official Foreign Agencies in Financing Intermediaries

104. The USAID was the chief creditor of Central American financial intermediaries. It participated in the discussions leading to the establishment of CABEI, contributed to its equity and extended credits for all types of projects, amounting to $143 million, on very concessional terms. As mentioned earlier, AID played a crucial role in the establishment of the five private financieras. Its commitments to these organizations amounted to $36 million. Furthermore, AID has financed INSAFI and INFONAC - the public fomentos in El Salvador and Nicaragua. Most of these loans to financieras and fomentos were two-tier operations channelled through host governments. However, most of the benefits of AID concessional terms were passed on to the financial intermediaries.

105. The Inter-American Development Bank (IDB) was also a sizeable creditor in relation to Central American financial intermediaries. Its commitments to CABEI amounted to $42 million. The bulk of IDB loans were also on concessional terms. The IDB had not supported the private financieras, but it was providing considerable funds to the public fomentos (INSAFI, INFONAC, BANAFOM) or to commercial banks in Costa Rica and Guatemala for industrial operations. Its total commitments to these borrowers were $32 million. These credits also carried concessional terms.

106. About 22 percent of the operations of Central American intermediaries were financed by official foreign aid agencies. In addition, Central American institutions have borrowed from foreign banks and supplier's credit agencies on a more or less commercial basis. On the whole, the costs of borrowing remained low, although restrictions on the sources of procurement had limited the flexibility of these institutions. They had not done much to mobilize domestic resources for industrial use.

D. Interest Rates for Industrial Borrowers

107. Cooperation among monetary authorities in Central America had stopped short of a coordinated approach to the subject of interest rates or credit policy. There was a common market for goods but the formal arrangements did not envisage the free flow of funds among member countries. El Salvador and Guatemala maintained exchange restrictions. In practice, little movement of financial resources had taken place even among the remaining three countries. The interest rate structure in the region was a complex one.

108. Interest rates charged by commercial banks on industrial loans were the lowest in Costa Rica (8%) and the highest in Nicaragua (12%). In both these countries monetary authorities had placed ceilings on lending rates to industry and these maximum rates were below the general limit (see Table 1c). These countries had also imposed quantitative restrictions on total commercial bank credit and advances to the industrial sector. El Salvador had no statutory limits on lending rates. Honduras had allowed the banks to charge a higher lending rate to their industrial customers as against others. The idea was to stimulate commercial banks to take special measures to develop industrial business.

109. The lending rates of public fomentos for medium and long-term funds were slightly lower than those charged by commercial banks for short-term money. Likewise, the lending rate of CABEI (7-8%) was lower than that of most commercial banks in the region and even lower than rates charged by the fomentos. In general, rates charged by private financieras were quite a bit higher than those of CABEI and about the same as rates charged by commercial banks. Financieras sponsored by USAID were under a contract obligation not to exceed specified ceilings with respect to the use of AID funds and in certain cases with respect to all loans.

110. The general level of interest rates in Central America had to be assessed in the light of the long record of price and exchange rate stability in the region. On a real basis, that is after allowing for movements in the overall price level, Central American interest rates for medium and long-term funds were higher than in many Latin American countries. However, rates prevailing in the organized money and credit market of Central America were low in relation to those charged by institutions and private parties operating on the periphery of the system. The Mission believes that the structure of interest rates must be revised.

E. Direct Foreign Investment

111. The sixties witnessed a sharp rise in private foreign investment in the Central American industrial sector. The bulk of this flow originated in the United States. Foreign investors responded to investment opportunities created by the Common Market as well as to the policy climate that existed in this part of the world for business from abroad. Central American governments competed with one another to attract foreign investors by offering them fiscal incentives as well as other facilities. As explained earlier, under the Common Market arrangements it was crucial for governments to do everything possible to get new industrial projects located within their borders. The decision of a foreign investor to locate in another member country left the government with the prospect

TABLE 18

Structure of Lending Rates, 1970

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
General rediscount rate	7	6.1	6	5	4-12
Rediscount rate on preferred industrial paper	4	4	2½ - 4	4	8 a/
Commercial Banks					
Maximum lending rate	12	10 b/	8 c/	n.a.	13
Industrial lending rate (including commission)	8	10 b/	9 c/	11 g/	12
Private Financieras					
Industrial lending rate (including commission)	12	10 b/	10 b/	- d/	13½
Public Financieras f/					
Industrial lending rate	-	8½ - 9½	9 d/	10 d/g/	10 - 11

a/ Rediscounting facilities have not yet been made available to private financial institutions.

b/ No official limit exists. A 3% spread may be charged on Central Bank loans and rediscounts.

c/ A 2% margin is allowed on resources obtained abroad even if it exceeds this rate.

d/ Subject to same restrictions as commercial banks.

f/ CABEI charges rates between 7%-8% for feasibility studies and fixed investment and 9% for working capital.

g/ Borrowers were obliged to hold compensatory balances; the maximum legal limit was 10%. The interest rate of 11% includes the impact of this practice of holding compensatory balances.

Source: Mission estimates.

of foregoing import revenues without obtaining any of the advantages of additional investment and employment. The attempt to coordinate policy on foreign investment at the regional level did not succeed.

112. The large bulk of United States investment in Central America at the beginning of the 1960s was in the primary export sector (see Annex Table 82). A study of 187 United States based multinational corporations, which account for 80 percent of all US direct investment abroad, showed that there was not much interest in the Central American area till the mid-fifties 1/. Up to 1960, these corporations had established 47 subsidiaries for manufacturing operations in this area. However, in the subsequent seven years 79 more subsidiaries were born. About 64 percent of the total increase in U.S. foreign direct investment in Central America during 1963-1969 was in the industrial sector 2/ (see Table 19).

113. Statistics were not available to measure precisely the relative importance of U.S. direct investment in industry in the aggregate picture. Some data for Guatemala indicated that the U.S. accounted for nearly 80 percent of total foreign direct investment in industry. Rough estimates made by the mission showed that the flow from the United States during the sixties was about three quarters of the total. The assumptions underlying these figures were based on the best evidence available but they are subject to an indeterminate margin of error. Altogether, foreign direct investment contributed 17 percent of total financial requirements of Central American industry, according to mission estimates (see Table 16). The corresponding proportion ranged from a high of 21 percent in Nicaragua to a low of 14 percent in Honduras.

114. There are virtually no restrictions on private foreign investment in Nicaragua, Honduras and Costa Rica (see Annex Table 83). By contrast, El Salvador and Guatemala have adopted slightly more restrictive postures vis a vis overseas investors. El Salvador prohibits foreign firms from the field of small-scale industry and commerce, it imposes a higher tax on remittances of non-domiciled corporations. Although these restrictions have recently been eliminated, in the past El Salvador required local participation as a condition for granting fiscal incentives and limited profit remittances to 10 percent of registered capital. Guatemala imposes an additional tax on remittances and it has limited the application of the 1960 treaty with the U.S. regarding insurance against the risks of ex-propriation or inconvertibility. In addition to these legal restrictions, there existed restraints exercised through administrative

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1/ J.W. Vaupel and J.P. Curhan, The Making of Multinational Enterprise, 1969. The data includes the Caribbean area excluding Mexico and Cuba.

2/ Including petroleum (mainly refining and distribution).

TABLE 19

Foreign Direct Investment in Central America
(million dollars)

Item	From All Sources	From U.S.A.
A. Total: For All Sectors		
1. Book value: End of 1962	n.a.	355
2. Book value: End of 1969	n.a.	630
3. Total flow during 1963-69	403	275
4. New investment during 1963-69	242	231
5. Reinvested profits during 1963-69	161	36
6. Outflow of dividends 1963-69	246	162
7. Royalties, fees and other outflows 1963-69	n.a.	n.a.
B. For Industrial Sector		
8. Book value: End of 1962	n.a.	100
9. Book value: End of 1969	n.a.	275
10. Total flow during 1963-69	233	175
of which:		
Guatemala	59	n.a.
El Salvador	43	n.a.
Nicaragua	58	n.a.
Honduras	32	n.a.
Costa Rica	41	n.a.
11. Outflow of dividends 1963-69	n.a.	19
12. Reinvested profits during 1963-69	107	12

Source: Annex Tables 80-82.

practices. The mission learnt that in fact these legal and administrative provisions did not amount to very much. There were well-known ways of circumventing them. Many knowledgeable people in Central America felt the need to rationalize national policies relating to foreign investors and to adopt a common approach. In 1965, the Ministers of Economy made a move in this direction but there was little follow-up action (see Chapter VI).

115. The reverse flow of investment income on all foreign investment remitted abroad rose from $15 million in 1962 to $52 million in 1969 (see Annex Table 79). On a purely cash basis, the Central American economies had experienced a negative resource transfer on account of private capital. The outflow had exceeded the inflow since 1965. The negative balance was particularly high in the case of Honduras and Nicaragua. This cash deficit on private captial account made no allowance for outflows in the form of management fees or royalty payments. These items were equal to outflows arising from investment income payments in the case of Latin America as a whole, according to estimates made by the U.S. Department of Commerce.

116. The negative resource transfer, defined on a cash basis, characterizing the total private capital account for Central America probably did not apply to transactions relating to the industrial sector. However, the data is fragmentary and no firm conclusions are possible. On the benefits side of foreign private investment, no quantitative assessment is possible. There is no doubt that Central America profited from the transfer of technology and experienced management that accompanied foreign investments. The framework of policy led overseas investors to produce goods for the national or regional market rather than for sales overseas. The output of these firms was probably just as import and capital intensive as that of other establishments not associated with foreign capital (see Chapter IV).

117. Mission estimates showed that external loans (other than those from CABEI) made directly to industrial concerns accounted for 8 percent of total financial requirements. Our figures for this category might have a significant upward bias. Conceptually, these transactions consisted of supplier's credits, credits from foreign commercial banks, and loans and investments from IFC or institutions such as ADELA extended directly to industrialists in Central America. The country distribution of these direct external loans to industry was similar to that for foreign private investment. Presumably, firms in Central America associated with foreign private capital had readier access to external creditors than locally owned enterprises.

F. The Residual Category

118. The reader will recall that the residual category (see Table 16) consists of reinvested profits of local investors (profits ploughed back

by foreign investors were included under the heading of "foreign sources"), loans or other contributions made by the circle of close relatives or friends of controlling shareholders and public issues of debt or equity instruments held by individuals or non-financial concerns.

119. The mission could not obtain much information on the extent to which industrial firms ploughed back part of the large profits earned during the sixties. Foreign investors (in industry and other sectors) reinvested something between half and one-third of total profits. A Costa Rican study estimated this proportion to be in the neighborhood of 40 percent 1/. In Guatemala and El Salvador the practice seemed to be to pay out large dividends and retain very little in the firm. On the other hand, Honduran and Nicaraguan firms were reported to reinvest a higher proportion of total profits.

120. There was no tax advantage for the retention of profits in the firm. On the contrary, as there was no separation between the personal and the corporate income tax, the growth of enterprises was subject to a heavy tax penalty 2/ . A higher income, whether personal or corporate, paid a larger proportion in taxes under the progressive rate structure of the general income tax. Also dividends and capital gains were exempted from income taxation 2/ . Given this tax situation and the heavy concentration of industrial ownership in a limited group of families, it was probable that an appreciable part of the residual category consisted of loans and capital contributions from the close circle of relatives and friends. Most industrial establishments were owned by individual proprietors or set up as limited companies. Even the corporations listed in the Manufacturing Survey of 1968 were fairly closely held. A random sample of 175 Costa Rican corporations showed that 77 percent had only two shareholders 3/ . In El Salvador only 26 corporations had more than 20 shareholders 3/. Under these circumstances it made good sense to pool investible resources within the framework of a family rather than within a firm.

121. Very little industrial investment was financed through the public issue of debt or equity securities. There were no effective bond or share markets in Central America either for new or old issues. Shares of about 40 companies were traded to a limited extent. The El Salvador stock exchange, the only one in the area, had an annual trading volume in corporate securities of less than $40,000 in 1969. An important impediment in the way of developing capital markets was that the present industrial establishment was reluctant to sell ownership rights to the

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1/ D.C. Loring, "The Law and Corporate Formation in Central America". (Draft unpublished).

2/ El Salvador was an exception in this respect.

3/ The Loring Report, op.cit.

general public. Such public issues as have occurred have taken place as a result of pressure exercised by international agencies, parent companies abroad or government requirements. Another impediment in the way of developing capital market was the lack of interest among potential purchasers. Surveys showed that less than 1 percent of Nicaraguan households owned shares and the corresponding proportion in El Salvador was even lower. Finally, only very few financial organization were prepared to intermediate between potential buyers and sellers. There was scarcely any organized underwriting. Development finance companies tend to regard the brokerage function with distaste.

VI. The 1969 Crisis and the Outlook Ahead

122. The outbreak of hostilities between El Salvador and Honduras in mid-1969 jolted the Common Market arrangements. Direct traffic between the two member countries on the Inter-American Highway came to a halt. For a while El Salvador could not export to Honduras, Nicaragua and Costa Rica. Later, the connection with Nicaragua and Costa Rica was resumed through the use of ferry boats, which allowed traffic to by-pass Honduran territory. On the average, transport costs between San Salvador and Managua increased by about 18 percent as a result of the ferry charge. Similarly, products exported by Honduras to Guatemala had to travel the much longer and more difficult northern route. Average transport costs between Tegucigalpa and Guatemala City increased by about 21 percent on this account.

123. The volume of intra-regional trade, which had increased at a spectacular pace year after year without interruption, suffered an absolute decline of about 4 percent in 1969. Naturally enough, the chief victims of this setback were the two combatant countries. The exports of Honduras to the Common Market declined by 24 percent and those of El Salvador by 16 percent. The exports of the other three countries increased but at a markedly lower rate than that experienced in recent years. Preliminary data for the first half of 1970 showed that Honduras and El Salvador continued to lose ground. The trade debacle had an adverse impact on the manufacturing sectors of El Salvador and Honduras. Value added continued to rise but at rates much lower than those experienced in recent years (see Annex Table 85).

124. The breakdown of Common Market arrangements, the setback in intra-regional trade and the adverse repercussions on industrial production in some member countries seemed to undermine business confidence. Industrialists were concerned about the present and uncertain about the future. The general climate for industrial investment had deteriorated. Statistics on investment were too rough to allow an accurate measurement of year to year changes. Estimates made by the mission showed that the level of fixed capital formation in industry tapered off in recent years

(see Annex Table 67). Particularly notable was a sharp decline in Honduras.

125. The Ministers of Economy of the five countries made an attempt to repair the Common Market arrangements and to work out a modus operandi. Unfortunately these discussions, which lasted over six months during 1970, proved abortive. The failure of these talks has deepened the gloom and Honduras has imposed tariffs on imports from the Common Market on January 1, 1971. The other four countries have declared their intention to maintain the Common Market. They have invited Honduras to rejoin on the basis of negotiations aimed at a complete overhaul of the framework of policies and procedures.

A. The Nature of Honduras' Complaint

126. Such a thorough re-examination of the Common Market framework will require an expert analysis of the underlying issues and a clear exposition of the policy options confronting Central America. For example, it will be necessary to define the nature of the Honduran complaint and the extent to which it is valid. If available statistics are anywhere near accurate, they suggest that Honduras has made considerable economic progress during the sixties, although her relative position has deteriorated somewhat. Most of the major indices - per capita income, industrial output, exports, total investment, the extent of infrastructure facilities - have increased fairly rapidly (see Table 20). Could Honduras have made comparable progress by remaining outside the Central American Common Market? There is no easy answer to this question. Honduras has made some gains by participating in the Common Market:

(a) The rapid progress made in building roads would have been more difficult without the existence of CABEI, a regional road program and a considerable injection of external funds channelled through a regional organization.

(b) The fast increase in industrial production was partly due to the possibility of exporting manufactured goods to CACM countries. The dependence of Honduran manufacturers on the markets of Central American countries increased from 5 to 14 percent during 1958-1968 1/.

(c) Entry into the Common Market did not imply a large increase in the cost of Honduras' imports 2/. On the contrary, unit

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1/ Excluding food, beverages and tobacco. See Table 5.

2/ This conclusion was based on the evidence presented in Chapter IV, paragraphs 80-84. No special study was made of unit cost of Honduras imports. See Table 14.

values of imports in intra-regional trade declined or remained the same in more than 60 percent of the cases. Consumers in Honduras derived considerable benefits by switching purchases from national firms to relatively cheaper imports from Common Market members. This "trade creation" had to be offset against "trade diversion" which occurred when Honduran consumers had to buy goods produced within the Market under a protective umbrella instead of importing from the outside world.

127. Honduras incurred a trade deficit vis a vis the CACM totalling $40 million during 1960-68. Its imports from Central America increased much faster than its exports to the same area. The annual trade surplus with the Common Market during the early sixties disappeared in 1965 and in 1968 Honduras had a deficit of $17 million. These figures have acquired a disproportionate significance in the thinking of Central American officials. If the price level had risen sharply in intra-regional trade, the large deficits incurred by Honduras with the Central American Common Market would have implied a substantial loss. But this has not happened.

128. Honduras has benefited from the Common Market but it has not obtained an equitable share of the total advantages generated by the 1961 Treaty. Its relative position in the Common Market had deteriorated. Honduras' per capita income and industrial output in 1968 were lower in relation to the Central American Common Market averages than at the outset of the decade (see Table 20). Its share in intra-regional exports has been reduced by half. This relative deterioration is at the heart of Honduras's plea for "balanced growth". Why has development in Central America occurred in an imbalanced fashion? There are two answers. First, the free play of the market mechanism generally leads to an accentuation of inequality. The initial advantage enjoyed by El Salvador, Costa Rica and Guatemala owing to their level of development in 1960 led to a concentration of new investment (including private foreign investment) in these countries. Availability of infrastructure, industrial skills and ancillary activities influenced the location of new investment around existing growth poles and hindered the establishment of new factories in Honduras and Nicaragua. The latter was able to offset the natural process of polarization by the adoption of countervailing policy measures at the national level. Honduras did not follow such a strong industrial policy.

129. The second answer was that the framework of policies at the CACM level was not conducive to a more equitable distribution of the benefits of economic integration. At the regional level:

(a) there was no effective policy regarding the location of industry designed to bring about an equitable distribution of new activity;

TABLE 20

Rough Indicators of Economic Progress for Honduras in Relation to the CACM

	1960	1968
Per capita GDP (in dollars)	204	253
as percent of CACM average	81	71
Per capita value added in industry[b] (in dollars)	27	41
as percent of CACM average	75	72
Imports from CACM (in million dollars)	5	49
as percent of total CACM trade	16	19
Exports to CACM (in million dollars)	7	31
as percent of total CACM trade	23	12
Roads per 1,000 square km. (in kilometers)	8[c]	20
as percent of CACM average	21[c]	32
Percent of population with access to electricity	10	13
as percent of CACM average	51	54
Per capita total investment (dollars)	28	45
as percent of CACM average	80	87
Per capita industrial investment (dollars)	n.a.	9
as percent of CACM average	n.a.	100

a/ This table was calculated on the basis of data supplied by SIECA. The industrial value added figures are not strictly comparable with the most recently revised figures which were supplied to the Mission by the five Central Banks and which appear in the Annex.

b/ Includes mining.

c/ 1958 figures.

Source: SIECA, Lineamentos Generales Sobre la Creacion de un Fondo para el Fomento Industrial y Agricola, 1970.

(b) there was no common policy regarding private foreign investment which played an important role in deciding where to locate new plants;

(c) although CABEI gives special treatment to Honduran industrial projects, the commitment of the Bank's loans to this country were only 20 percent of the total as of June 1970;

(d) there was no common policy regarding fiscal incentives for industry. In 1969 an agreement was ratified envisaging a common policy which allowed preferential treatment for Honduran firms. However, this had not yet come into effect owing to the absence of detailed regulations;

(e) there was no transfer of resources from the more developed Central American Common Market members to Honduras either through the flow of private funds or on public account.

130. In considering the future framework of policies, Central American governments will have to tackle this question of equity among nations; an issue which remains unattended within these countries. For this and other reasons, the solution will not be easy. It will be even more difficult to reconcile the demand for equity with the criterion of efficiency. However, concessions to equity required to sustain the Common Market should prove worthwhile for all concerned. There is no doubt whatever that, under the circumstances of Central America, a Common Market arrangement will be a far more efficient solution than return to autarkic industrial development behind national tariff walls.

B. Profile of Industrial Investment 1970-75

131. The prevailing uncertainty regarding the Common Market's future made it difficult to focus on the next phase of industrial investment in Central America. Nevertheless, the mission formed a rough impression of the investment profile for the next five years by studying a list of project proposals which CABEI considers technically and economically feasible. The total amount of investments under consideration during 1970-75 is $838 million (see Annex Table 84). However, feasibility studies have not been prepared for mahy of these projects. More than half of the total potential investment considered in CABEI's list is the cost of four large projects - nickel, alumina, pulp and paper, and steel. Many of these project ideas have been around for a long time. The Bank Group is familiar with three out of the four large projects: nickel, alumina and paper.

132. The Guatemalan Nickel Project involves an investment outlay of $250 million to mine, smelt, refine and export something like 27,000 metric tons of metal per year. Outlays of about $28 million have already been incurred during the last decade on engineering and exploratory work. However, the final go ahead awaits the completion of negotiations relating

to the financial package. The mining concession is owned by EXMIBAL, a subsidiary of a Canadian company1/ The latter expects to retain a 70 percent share in the project. IFC has had discussions concerning the possibility of participating in the financing of the project together with CABEI. The other large export-oriented project involves the mining of bauxite and the processing into alumina of ores in Costa Rica by ALCOA. Alumina would then be exported to Mexico and further processed into aluminum. The total project cost os $60 million.

133. A large project, involving an investment outlay of about $100 million to manufacture pulp and paper in Honduras, has been brewing for years. Untill recently, the International Paper Company was prepared to become the majority shareholder, the technical partner and the distributor of the plant's output of pulp, timber, banana boxes and bags. However, there were long delays in concluding an agreement with the Honduran Government about infrastructure related to the project and other matters. Recently the International Paper Company has declared its intention to withdraw from the project and now the other partners, including IFC, are searching for a suitable foreign firm to take its place.

134. A number of ideas for the manufacture of steel in Honduras have been put forward. The one favored by BANAFOM (public development bank) involves an investment outlay of $40 million to install an integrated mill for the production of 120/180,000 ingot equivalent tons per year of merchant products. The plant would be located in Agalteca (near Tegucigalpa) and would use local iron ore and charcoal2/. Another idea favored by a CABEI advisor is to install a rotary kiln for the direct reduction of ore near the mine and to ship iron pellets to small electric furnaces, located in several countries, for the manufacture of steel.

135. The mission was not able to obtain an updated version of the proposed project. Apparent consumption of finished steel products increased on the average by 10.6% annually in the sixties, and ECLA/IDB projected a CACM consumption of merchant shapes equivalent to 310,000 m. tons of ingot steel by 1975, and 443,000 m. tons by 1980. In this context, proposed size of the BANAFOM project appears to be on the low side. Thought should be given to an upward revision to balance regional market demands and exploit economies of scale. Furthermore, even if a bigger initial capacity is considered, plans for future expansion must be included. In this light it is not sure that a site based on the location of relatively modest ore deposits is the most suitable. The importation of supplementary raw materials including coke, must be allowed for, and the possibility of using timber resources for more valuable products studied. From this standpoint, and also considering the distribution of regional steel markets, a coastal site may be preferable.

1/ Owned by International Nickel Company (80%) and Hanna Mining Company (20%).

2/ The proven reserves could support such a plant for about 30-40 years. No coking coal is available.

136. Besides these four giant projects, the CABEI proposals envisage investments aggregating $143 million in the chemical and petrochemical sectors. Future development in this area is complicated by at least three factors:

(a) Efforts are underway to find oil and/or natural gas but no conclusions are available.

(b) As each country has built its own refinery, certain options have been foreclosed.

(c) Activities in this sector are so closely inter-related that there is an imperative need for some kind of joint planning for which there is no machinery at present.

137. The mission's judgment is that the production of a number of chemicals mentioned in the CABEI proposals, would be premature during the first half of the seventies. The expected size of the Central American market by 1975 will not permit the installation of plants of an economic size in several cases, such as polyethylene and polypropylene. In other instances, such as rayon and DDT, there is some question whether present demand will be sustained in view of worldwide trends towards substitute products. However, the mission believes that profitable investments can be made in the field of synthetic fibers. The apparent consumption of these materials has risen very rapidly during the sixties and further growth is expected to continue, albeit at slower rates. Available projections show that the offtake of nylon should reach 7,100 metric tons and that of polyester fibers 5,500 metric tons by 1975. The anticipated demand levels are sufficient to justify the expansion of capacity for nylon fiber and for a new plant to produce polyester fiber based on imported monomers. Several countries have plans for installing plants and it will be necessary to take coordinated decisions at the regional level so as to avoid the building up of excess capacity.

138. There also seems to be room for further investment in the fertilizer industry. At present, there is no production of nutrient elements. The installed capacity is sufficient for producing ammonium nitrate and complex fertilizers with a nitrogen content of 57,000 metric tons, based on imported nutrients. Apparent consumption in 1966-69 was 107,000 metric tons and was expected to double during the next six years. Accordingly, there is the need to expand capacity for the existing products and to consider establishment of new capacity for the manufacture of phosphoric acid and ammonium phosphate. There will be enough demand for ammonia to justify a plant for its manufacture by 1975.

However, it will not be wise to make this investment till the results of oil and natural gas exploration are known.

139. The CABEI proposals envisage investments of the order of $52 million in processed foods of various kinds including processed meat, canned fruits, vegetables and frozen and canned fish, as well as other products. These project ideas, some of which are not yet well defined, have received considerable impetus by a recent USAID $30 million loan to CABEI for the promotion of agro-based industries whose output can be marketed outside Central America. The preparation of projects in this field is still at an early stage, although considerable effort is being made to secure speedy utilization of this loan. Sizeable investments ($48 million) are also being considered by CABEI in textiles. Some of the proposals, such as the manufacture of fish nets and ship cordage, appear to be doubtful from the standpoint of demand. However, owing to the need to modernize the existing textile industry, the gross investment required might well reach levels near those projected for the food industries.

C. New Industrial Policies

140. Many pundits have come to the conclusion that the process of import substitution is exhausted in Central America. This is not the mission's view and an analysis of project ideas under consideration by CABEI provides confirmation that many opportunities for worthwhile investment remain to be exploited in the period ahead. Similarly, the CABEI pipeline shows that large export-oriented projects may materialize in the mineral and paper fields. There exists considerable export potential for agro-based manufactured products which will have to be exploited through patient promotional work and technical assistance at the plant level. Viewed in this light, the objective of new industrial policies should be to generate market signals:

(a) which do not favor investment or production for the national or regional market at the expense of export-oriented activities.

(b) which favor the least inefficient import substitution possibilities, and

(c) which do not favor unduly import or capital-intensive investment and production.

141. In this context, the Central American Fiscal Incentives Agreement, ratified in 1969 and the proposed regulations (called REIFALDI) are steps in the right direction. The details are spelled out in Annex Section A and they show a considerable reduction in the magnitude of new fiscal incentives. They also show a much more discriminating approach in the criteria for the selection of eligible enterprises than existed in the separate national programs. However, these advantages will not materialize quickly. REIFALDI has not yet come into effect and even when it does, there remain certain transitional clauses which will delay the effectiveness of the new provisions. Furthermore, the administration of fiscal incentives will remain in the hands of national governments for seven years and there will be no guarantee against the risk of manipulation of statistics to suit parochial interests.

142. Even the substantive criteria, underlying the new fiscal incentives, are based on considerations of national rather than regional scope. For example, an industry is defined to be "new" if it produces an item for which existing national output is less than 20 percent of that country's apparent consumption. This open disregard for the regional angle is inconsistent with the underlying conception of the Fiscal Incentives Agreement. A similar concession to national feeling is embodied in the calculation of foreign exchange savings of a project. Export and import implications of projects are defined in relation to individual nations rather than to Central America considered as a unit. The new tests for determining eligibility of an enterprise for fiscal incentives are far superior to national standards prevailing heretofore but the incentives remain biased in favor of import-intensive and capital-intensive activities. These biases result from the character of the benefits offered (namely exemption from a portion of duties on imported inputs and industrial machinery) rather than from the eligibility tests.

143. The new fiscal incentives continue to serve the policy of import substitution. The criteria for import replacement are fairly selective as far as consumer manufactures and intermediate goods are concerned. The pure assembly and packaging type operations are assigned low priority and receive very little concessions. However, the treatment of capital goods requires reconsideration. These are automatically placed in the category which receives maximum benefits, irrespective of any efficiency considerations. Furthermore, the time has come for Central American policymakers to rethink the balance between import substitution and export promotion. The present system of incentives -- fiscal, tariff, other -- is heavily skewed in favor of import replacement and the mission questions the advisability of prolonging this situation 1/. It should be possible to reorient the criteria for granting fiscal incentives to emphasize the need for selling in markets outside Central America. Furthermore, governments should examine the feasibility of extending cash subsidies to manufactured goods exports. There will be the need to coordinate this policy at the regional level to avoid wasteful competition among Central American countries. Policymakers ought to think in terms of a "common external subsidy" for manufactured goods as a counterpart of the common external tariff. Once export incentives are comparable to those for import replacement, export promotion institutions will have a fair chance of becoming effective.

144. There is general awareness in SIECA and official circles of the need to restructure the Common External Tariff. Some moves have been made in this direction. Anomalies in the schedule have to be ironed out. The tariff nomenclature should be changed to permit a more coherent approach to protection. Specific duties should be eliminated. Apart from these technical considerations, policymakers have to rethink the appropriate level of tariff duties. As pointed

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1/ The existing export promotion measures and prospects for manufactured exports are spelled out in Annex Section B. These measures are of limited usefulness and they are not coordinated on a regional level.

out in Chapter IV, there are many cases in which the present level is far too high and is not being utilized. Downward adjustments in these items will be painless and will serve to realign the tariffs to the realities of intra-regional competition. The mission is not able to determine the optimum level of protection for the industrial sector as this is affected by a host of considerations outside its terms of reference. For example, consideration ought to be given to the nature of incentives and/or taxes affecting the non-industrial sectors as well as to the exchange rate, employment policy and the like. There is also the question of the appropriate duration of tariff duties. The ECLA office in Mexico, which is working out guidelines for the revision of the tariff, considers that the initial level of duties ought to be scaled down over five to six years. This principle of scaling down does not imply that industrial protection should be eliminated entirely. It only suggests that the investor should be aware that the magnitude of tariff incentives will be reduced over time so that he has a strong inducement to improve efficiency and reduce costs.

145. At present there exists a major inconsistency in the protection policy bearing on intermediate goods. On the one hand enterprises producing these goods have been granted tariff protection, albeit in moderate doses. On the other hand, the market for locally manufactured intermediates has been undercut by the granting of import duty exemptions in gross violation of Regulation 26 of the Executive Council. (See Chapter IV.) Effective action needs to be taken to iron out this inconsistency in policy so as to assure the healthy development of intermediate goods industries.

146. A restructuring of the policy framework along the lines suggested above should allow Central America to derive greater benefits from private foreign investment than accrued during the sixties. There is the need to evolve a common approach to foreign investors. Guidelines for such a regional policy were put forward by the five Ministers of Economy in 1965, but there was no follow-up. These guidelines envisaged

(a) demarcation of activities in which foreign involvement would be particularly helpful owing to the large input of new technology and management skills;

(b) identification of fields in which foreign involvement would not be necessary owing to the familiarity of Central American producers with the technology and managerial expertise required;

(c) that foreign firms should be required to employ Central Americans in responsible positions and to provide adequate training facilities;

(d) that foreign firms should be required to give opportunities to local investors to purchase shares within a reasonable time period.

147. The mission believes that such a coordinated approach on the part of Central America to the foreign investor would be a useful adjunct to industrial policy. Private foreign investment in Central America is not a controversial political issue as it is in many parts of Latin America. The object of policy should be to take preventive measures so as to avoid future crises. The aim should be to conserve the bargaining position of Central America and not allow the foreign investor to play one Common Market member against another. What is envisaged are not detailed administrative procedures with restrictionist intent but rather a clear definition of the ground rules to safeguard the basic interest of local enterprise and to facilitate the working out of specific agreements with foreign partners. The mission believes that CABEI can perform a very important function in the process of identifying interested investors overseas and in selecting that foreign firm which presents the most advantageous package of technology, management, marketing outlets and financial arrangements.

148. Finally, there remains the question of a regional policy for industrial location, particuarly in cases where a single plant of reasonable economic size is sufficient to satisfy the entire demand. The mission is convinced that it will be necessary to define a policy based on a combination of efficiency and equity considerations. Exclusive reliance on the criterion of efficiency in the context of Central America is likely to aggravate the process of polarization between the more and the less developed members of the Common Market. Therefore, it will be necessary, on occasion, to depart from the least cost solution in the interest of holding together the regional system. There will be the need to find means to prevent the establishment of competing plants to avoid the build up of excess capacity. There will be little incentive to install such duplicating plants if benefits provided by fiscal incentives and tariff protection are not excessive. Steps should be taken to deny fiscal benefits to investors who wish to install plants in non-favored locations. CABEI should participate in the promotion of new industries and in spelling out recommendations related to their location. Furthermore, as the regional development bank, CABEI should withhold support for plants which do not fit into the strategy of the Common Market.

VII. Postscript

149. The Common Market remains in a state of crisis. After Honduras imposed duties on imports from Central American countries in January 1971, the other four countries retaliated by imposing barriers against Honduran exports. In June 1971 Costa Rica introduced trade and payment restrictions on some regionally traded goods, mainly imports from El Salvador and Guatemala. This move provoked El Salvador and Guatemala to retaliate by restricting imports from Costa Rica.

150. The process of disintegration of the Common Market was arrested in July 1971 when the trade restrictions introduced in June were removed and a high level Commission (Comision Normalizadora) was formed, consisting of the Ministers of Economy and special representatives nominated by the Presidents of Costa Rica, Guatemala, El Salvador and Nicaragua. The Commission was granted similar powers to those of the Economic and Executive Councils of the Common Market, including authority to negotiate tariff changes, regulate regional trade and agree on special benefits to industry. Decisions of the Commission are reached by simple majority. So far, the Commission has established a system of temporary controls on exports within the region aimed at avoiding market disruption in some important products such as footwear, clothing, textiles and certain food items. It has also approved the regulations for the implementation of the Central American Fiscal Incentives Agreement and has put into effect the regulations for the San José Protocol. The Commission is evolving a strategy for the textile sector and expects to elaborate the basis for a regional industrial policy.

151. Honduras does not participate in the Commission on the grounds that its terms of reference are too limited. In its view, the problems encountered by the Common Market are so fundamental that mere "normalization" within the existing framework would not be sufficient. Precisely what structural changes are favored by Honduras remains unclear, but it seems that Honduras will not readily accept the principle of unrestricted free trade unless some mechanism is devised to give it a preferential status. Meanwhile, Honduras is attempting to negotiate bilateral trade agreements with other Central American countries.

152. Recent events have adversely affected trade, production and investment in the area. The volume of intraregional trade, which had increased at a spectacular pace in the 1960's, suffered an absolute decline of about 4 percent in 1969 as a result of the Honduras/Salvadora conflict. The level of trade recovered by 19 percent in 1970 but fell again in 1971. In that year it amounted to $276 million, compared to $297 million in 1970. The momentum of industrial production was also interrupted. Guatemala and El Salvador, the largest exporters within the region, were affected the most by the disruption in trade. In Honduras, protectionist policies have had a detrimental effect on the industrial sector. Manufactured goods prices increased partly as a result of tariff levies on imported articles. Also, many Honduran firms, denied a regional export outlet, were forced into uneconomic production runs for the small domestic market. In addition, under the umbrella of high protection, several plants have come into operation which are unlikely to be able to compete in the Common Market.

153. What is said above is not intended to update fully the findings of the report. However, developments during 1971 confirm the main lines of analysis contained in the preceding chapters. Despite its difficulties, the Common Market experiment deserves support as a rational basis for a strategy for Central American development. The present crisis springs from deep-seated factors and its resolution will not be easy. Considerable work is being done in regional and national institutions to devise a new framework. It is hoped that some of the suggestions made in this Report may be helpful in devising this new framework.