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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

ECONOMIC DEVELOPMENT AND PROSPECTS OF CENTRAL AMERICA

(in eight volumes)

VOLUME I

MAIN REPORT

June 5, 1967

Western Hemisphere Department

EQUIVALENTS

Currencies	=	1 Central American peso (a unit of account)
)	=	1 Guatemalan quetzal
U.S. dollar 1)	=	2.5 Salvadorean colones
)	=	2.0 Honduran lempiras
	=	7.0 Nicaraguan cordobas
	=	6.62 Costa Rican colones

Weights and Measures

1 manzana	=	1.727 acres = 0.69 ha.
1 (60 kilo) coffee bag	=	132 pounds
16.6 coffee bags	=	1 metric ton
1 short ton	=	2000 pounds
1 quintal	=	approximately 101 pounds
Approximately 20 quintals	=	1 short ton (sugar)
1 banana box	=	42 pounds
1 banana stem	=	approximately 1.35 banana boxes
1 banana stem	=	approximately 57 pounds
1 (cotton) bale	=	480 lbs. net

THE MISSION

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Members of Public Utilities Division, under the coordination of Christian Finne, prepared materials on electric power and telecommunications.

VOLUME I - MAIN REPORT

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CENTRAL AMERICA: BASIC DATA

	Guatemala	El Salvador	Honduras	Nicaragua	Costa Rica	Total Region
Area, square miles	42,040	8,061	44,480	57,000	19,700	171,280
Population, millions, 1965	4.28	2.95	2.30	1.63	1.46	12.62
annual percent growth rate 1/	3.3	3.6	3.3	3.0	4.1	3.4
Gross Domestic Product, 1965						
CA peso millions	1,415	815	514	531	604	3,871
percent rate of growth 1/	7.0	7.3	6.3	8.5	7.3	7.1
percapita	320	278	215	325	422	305
Exports, (f.o.b., million CA pesos)						
1961	115	119	74	70	84	462
percent to Central America	9.3	12.1	11.5	2.6	2.4	8.1
1965	193	189	127	149	112	770
percent to Central America	20.5	24.2	17.5	6.8	16.8	17.9
Public Finance, million CA pesos						
current revenue, 1965	122	90	55	64	72	403
percent of GDP	8.4	11.0	10.7	12.0	11.8	10.4
public investment, 1965	34	30	13	25	31	133
percent of GDP	2.4	3.7	2.5	4.7	5.1	3.4
Debt Service Burden						
total, 1966, million dollars	8.1	8.5	3.1	8.2	21.4	49.3
percent of 1965 exports	4.2	4.5	2.4	5.5	19.1	6.4

1/ 1960-1965
2/ Estimated

SUMMARY AND CONCLUSIONS

The Common Market

1. Since the early 1950's the economies of the five Central American countries have grown at a rapid rate. Despite a recession due to export difficulties in 1958-1961, overall the GDP growth rate in the last decade has averaged 5-6 percent per annum, well above the 3.3 percent annual increase in population. The major impulse to growth was in exports of traditional commodities - first bananas and coffee, and beginning in the latter 1950's, cotton. The Central American countries are open economies, and variations in exports (which have constituted 18-22 percent of GDP in the last decade) have markedly influenced investment, imports and national output.

2. Hindered by the small domestic markets and low per capita incomes, the countries sought to provide a wider basis for internal economic expansion by elimination of trade restrictions; their efforts over many years resulted in a treaty in 1960 (which came into effect from 1961 to 1963 as the several countries ratified it) which freed trade from tariffs or other restrictions on all but a small portion of the items and volume of trade. A common tariff on these freed items was also established, and a machinery for administration of the Common Market arrangements was established, including an Economic Council of Ministers and a secretariat. A clearing house for payments between the countries was established, and with a system for settlement of balances with only very small margin of credit; and directions were given to a monetary council to prepare studies aiming at eventual establishment of a monetary union. The Central American Bank for Economic Integration (CABEI) was established and, financed by subscription by the five governments and mainly by loans from several outside agencies (USAID, IDB, and the Mexican Central Bank), began a series of loans for projects of importance of regional integration and development.

3. While an aim of the Common Market policy makers is to raise income as much as possible nationally since all five countries are still low-income countries, a stated objective of integration is "balanced" economic growth; in practice, thus far, efforts in this direction are largely those of favoring the poorest and slowest growing of the countries - Honduras - by permitting special concessions in fiscal incentives for industrial development, giving preference in allocation of regional (CABEI) funds and technical assistance (from regional and international institutions). Thus far, these efforts are reasonable and desirable in terms of the potential significance of Honduras as a market and as a resource base.

4. Following these steps toward trade liberalization, commerce among the five countries soared, more than tripling in value from 1961 to 1965. This expansion contributed over half the increment in the countries' total exports during the period, and, by 1965, 18 percent of the total

exports of the five countries took place among them. As a result, the countries have generally increased their interdependence in trade and development. With integration, there have arisen needs for harmonization of economic policies with respect to industry, trade, fiscal, balance of payments, investment and other fields.

5. Against this background of economic growth, in recent years, the prospects are that recent growth rates are unlikely to be maintained in the next few years or so. This is largely because overall prospects for growth in exports of cotton and coffee are far less favorable than in the recent past, so that to 1970 exports of the region as a whole to the outside world are likely to increase about 2.5 percent annually (remaining stagnant in El Salvador and Guatemala) as compared with the average growth rate of 12.5 percent in 1961-1965. Farther off, from 1970 to 1975, the prospects are more favorable and regional exports may rise at some 4.5 percent annually While these estimates are subject to a wide margin of error, they imply that the growth rate of the Central American region to 1970 would be in the neighborhood of 2.5 percent annually, with Honduras and Nicaragua somewhat above Costa Rica and El Salvador substantially below it. This slackening of growth, together with the repercussions in a variety of fields, sharpens the policy issues for development in each of the countries and for the integration movement as a whole.

Industry

6. A pressing issue in Central American economic development, from the viewpoint of the integration of the economies and their longer-run development, is the need to revise and improve industrial policies. Industry has been growing rapidly. Value added in manufacture grew at an annual rate of 11 percent in the region; and, by 1965, it accounted for 13-17 percent of GDP in the several countries. Industry has been the chief beneficiary of the Common Market. About 85 percent of the increase in intra-reginnal trade from 1962 to 1965 was in manufactured goods. Most of the growth in industrial output and a large share of the growth in regional trade has been in traditional consumer goods (such as textiles, clothing, and processed foods). While the common tariff substantially increased the protection given to consumer goods, increased competition and widened market opportunities in a number of lines resulting from the abolition of intra-regional tariff barriers has been beneficial. Thus, generally, prices of goods manufactured in Central America with better utilization of existing capacity and specialization in related products have not increased. Despite the rapid growth of industrial output in recent years, there are still important opportunities for reasonably economic import substitution in a market of almost 13 million people, increasing at a rate of 3.5 percent annually, with a present regional average per capita income of $305, particularly as existing plants are improved and managerial and technical skills gained in recent years come into full play. The newer industries now being planned or developed - most of which relate to newer intermediate products or establishment of older lines on a larger scale - raise complex problems of suitable size,

markets, tariffs, fiscal incentives, and financing. There is danger that, if the policy of import substitution is pushed without due regard to efficiency or price, costs to consumers may rise and, more important, costs of inputs for manufacturing and for agriculture may be such as to hurt growth prospects of the region in the longer run. While prospects for industrial growth on the basis of regional demand are substantial and worth exploitation, they will be limited by the relatively small dimensions of the market; hence, further progress toward a rate of industrial growth which the countries desire and need will depend also on development of export-oriented industries which are capable of competing in world markets.

7. Whether industry will develop in these directions will depend in part on the course of tariff policies pursued in Central America and of policies followed in granting fiscal incentives for industrial development. Under the present treaties, tariff increases may be accorded to individuals by renegotiations of the common tariff, or by individual protocols approving increases for specific items, either for "integration industries" having special market privileges (of which three have been approved so far) or for "new" industries capable of meeting half of regional demand and of particular interest for development of the region. Many requests now being filed under these several provisions involve large increases in tariffs, which could result in substantial price increases; often these industries rely heavily on imported materials or components and have a low added value. While local tariff preferences accorded to "integration industries" are wiped out over ten years, there is no provision for systematic reductions of special external tariffs; and provisions as to control of price or quality in these industries' manufactures are vague. The special protection afforded to the new "infant" is likely to be continuous. Moreover, the addition of these tariff privileges on a case-by-case basis lends itself to a give and take by national interests and the criteria of tariff adjustments, particularly as regards their economic effects, have not yet been well developed. Thus, a major issue is how to develop and strengthen the process of adjusting tariffs, since, as conditions change, the tariff structure may need to be adapted to the new opportunities and new conditions in the Common Market. The mission considers that this would best be accomplished by establishing an autonomous Regional Tariff and Industrial Commission to consider all cases of tariff adjustment, with power to increase or decrease existing tariffs within a certain margin (e.g. 50 percent) without reference to further political authority. It should also be authorized to grant quotas for imports at common tariff rates in the cases of specially protected industries if needed to protect the public interest. Should the architects of the Common Market not find it feasible to give autonomy to such a commission, it should be empowered to make findings and recommendations to the Economic Council for recommendations in turn to the Governments for ratification. Such a commission, to be effective, would need strong support from the existing technical agencies, which would need to be strengthened for these purposes.

8. Closely allied to tariff policy is that of fiscal incentives, since, by granting these, the Governments virtually grant subsidies to induce industrial development. The several governments have been

competing hard in the last several years to attract new industrial investment, often through fiscal incentives applied under loose criteria. The cost of these exemptions to the economy and to the fisc, while not readily calculable in all aspects, is very considerable. This competition has increased since the beginning of the Common Market. Together with generally higher tariffs, it has increased the dangers of proliferation of industries, with resulting excess capacity and high costs, which would, in most cases, not be capable of competing outside the region. Moreover, the system of progressive taxation on business income gives motive to entrepreneurs who wish to avoid such penalties on growth in size by securing income tax exemptions under the industrial incentive law; a change in the tax laws is needed to remedy this. After some years of negotiations, agreement has been reached on a Central American convention establishing a uniform classification of privileges which may be granted; Honduras is permitted special latitude to enable her to catch up with the other countries in industrial development in accord with the doctrine of "balanced" economic growth of the region. Even the new convention, which remains to be ratified, permits generous treatment for new investment with loose economic criteria. Moreover, it would also be administered (no doubt competitively) by national administrations for up to seven years. Hence, there is need to centralize the administration of incentives; and to improve the system. This function would best be lodged in the above-suggested Regional Tariff and Industrial Commission.

9. Thus far, industry has been able to obtain adequate supplies of capital for the typically medium- and smaller-scale industries established, through profits or local capital, foreign private investment and credits, some direct official credits, and substantial official capital channeled through the Central American Integration Bank, four private financieras and the banking system. Some flow of capital takes place among countries, but the capital market is underdeveloped, and discussions at the private level are under way looking toward establishment of a Central American financiera, to assist in mobilization of capital within and outside the region, to meet continuing industrial development needs. It is too soon to say whether such a financiera should obtain support from official capital. In any case, the need for external capital, public and private, while difficult to forecast, is likely to be considerable, including the possibility of some, but relatively few, large projects now being studied (e.g. pulp and paper industries). The application of such capital would be far more effective within the context of industrial policies assuring sound growth of the region. In this respect, the most urgent and concrete measure is to establish central administration of the Common Agreement on fiscal incentives. The revision of tariff-making machinery, while urgent, is likely to involve difficult negotiations, but a beginning should be made. External funds should give priority to industries likely to endure without high tariff protection, contributing large value added, and especially to those which now or in the visible future are capable of being export oriented.

Agriculture

10. In agriculture, a major need in Central America is to develop and expand new lines of agricultural and forest products production for export. These will be needed to replace and supplement coffee and cotton, whose exports are likely to be largely stagnant; production of bananas, the other major export commodity, is being substantially expanded - mainly in Costa Rica and Honduras - but the possible extent of additional expansion is limited by world market conditions. While coffee exports have risen rapidly in the last few years, the outlook is that, with rising production, all the countries - particularly Guatemala, El Salvador and Nicaragua - will face surpluses above their probable quotas under the International Coffee Agreement from 1967 onward. Guatemala and Nicaragua are making plans to diversify out of coffee (and El Salvador is about to initiate studies of these possibilities), but it is far from clear what crops could be developed on a competitive basis as an alternative in view of the high returns to farmers under present price levels for coffee. While there appear to be real opportunities, mainly in fruits and vegetables, tobacco and livestock, it will take some time to develop these as well as assure markets, mainly abroad. Resources spent on diversification from coffee to other crops are likely to have minimal effect while coffee remains very profitable, partly as a result of the relatively low tax burden on coffee at prevailing prices. Even with somewhat lower prices for Central American coffees, there would probably be incentive to expand output. Hence, the mission considers that, if expansion of coffee production is to be discouraged to prevent unmanageable surpluses and to stimulate diversification into other products, coffee production should be taxed more heavily. The alternative of carrying forward excess stocks is expensive and wasteful of resources; direct controls are difficult of enforcement, costly and arbitrary. Moreover, the fiscal revenues of Guatemala, El Salvador and Costa Rica are or will need important reinforcements in the next few years to enable them to maintain an effective investment program, including projects and programs of importance to the agricultural sector. The prospects for achieving increased taxation are admittedly uncertain, but a concerted action by the five Governments would doubtless dampen the strong opposition of the coffee growers. If measures to prevent the rise of stocks in excess of export quotas are not taken, the coffee growers face the prospect of being unable to dispose of these stocks even at lower prices and without the advantages of the International Coffee Agreement, including access to member countries. In such case, the export earnings of the countries over the next 10 years or so might well be less than the possible amounts projected by the mission, thereby weakening the economies. While studies looking toward diversification need to be pressed and efforts made to develop new lines in part with foreign credits for agricultural development, action to increase the burden of coffee taxation appears to be a requisite for an effective program of broadening the agricultural and export bases, as well as to prevent a possible disorganization in the coffee export price structure.

11. In view of the urgency of increasing the tax burden on the coffee sector, the simplest approach would be to increase export taxes now to levels which at least would provide a sufficient margin to cover the cost of financing the excess stocks while maintaining present coffee tax revenues and possibly increasing them. While surpluses in Costa Rica in the next few years are not likely to be as large as in the other countries, increases in taxation are needed to discourage further coffee planting and to avoid surpluses likely to arise toward the turn of the decade; the same would apply to Honduras. On the basis of present situation in Guatemala, El Salvador and Nicaragua (likely to have the largest absolute and relative surpluses in the next few years) the mission considers that a minimum export tax of 20 percent ad valorem (at projected prices) should be introduced in 1967 and become applicable to exports no later than those in 1968 to achieve the purpose of covering costs of financing excess stocks plus maintaining coffee tax revenues and acting as a disincentive to production. Such a tax should be applied by all five countries; preferably it should be applied uniformly to minimize possible inducements to avoidance of taxation by shipping through countries with the lowest export tax and to help provide a basis for a common quota in the future. Further improvements in the system of coffee taxation, including revision of income tax structures or application of production taxes could come at a subsequent stage.

12. In the third major export crop, cotton, which has developed rapidly in recent years, prospects are that with production difficulties, rising costs and falling prices, export volume will remain largely stagnant. But it is likely that, in time, production difficulties and costs could be reduced by better techniques. Studies are being put to motion in El Salvador by the cotton growers association; and they need to be started also in Guatemala. While the private sector should be able to manage and finance these studies, Governments should initiate and support them if they lag. Even at lower world prices, with efficient production, returns from cotton are likely to be better than on food crops; and cotton could eventually make an increasing and substantial contribution to export earnings.

13. With these prospects in the major lines, the national and regional authorities should devote increasing effort to fostering the development of new lines. The greatest potentials lie in beef production and forest products. Meat production, for which foreign (particularly U.S.) markets are promising and for which there are abundant suitable areas in most of Central America, will require a substantial effort. Over-killing, mainly to meet foreign demand, has diminished herds; substantial credits and technical assistance to prevent disease, improve methods and the race and build up the livestock population, are required. While some of the countries have developed suitable programs of credit aimed at the larger and more efficient farms, others are lagging in the preparation of their programs, even though receiving technical assistance. High priority should

be given to credit projects for livestock development and to technical assistance for such purposes, and to the completion of those road projects which are already started and which will assist in livestock development. External finance for such credit programs will be especially needed since the rate of credit expansion by the banking system in several of the countries is likely to be far more limited than in recent years owing to constraints imposed by balance-of-payment problems.

14. Resources are abundant for development of forest products, mainly lumber or wood products for export and internal consumption, and pulp and paper for which there is a large market in banana boxing. Projects for these products have importance for regional development in view of their contribution to regional trade and import substitution. Development of major pulp and paper projects, also yielding sawn wood, depends largely on completion of feasibility studies (mainly in Honduras) and development of financial plans. In view of increasing consumption, there may be room for two projects within the next decade. But once studies are completed and assessed, external agencies could play a large part in their financing as well as the financing of roads or port facilities which will be needed in some cases. The opening of lands toward the Atlantic for forest-products' development would also contribute to livestock and other agricultural development, including land settlement.

15. The region is largely self-sufficient in production of basic foods, though imports of wheat (not suitable for large production in Central America) have increased as urbanization and higher incomes brought about consumer preference for wheat bread (instead of traditional corn products). It should be feasible to maintain food production abreast of rising populations, since there are suitable lands for exploitation and substantial margins for increases in yields and improvement of marketing arrangements. Access to new lands and improved access of present farm areas to markets is being provided by many of the principal roads being constructed or to be constructed, as well as feeder-road projects. Highway programs for the future, once the program over the next five years (which is largely determined by studies made and financing commitments completed or being arranged) is nearing completion, should give greater emphasis to the need for opening new regions and improving access of farmers to markets.

16. At present, trade amongst countries in agricultural commodities is relatively small; there are relatively few complementary situations in crude foodstuffs. A step aimed to assist in development of food production and in greater regional specialization has been taken recently by removal of trade barriers among the five countries in basic grains, under a regional treaty. Essentially, this restricts imports from the outside world (usually made through State Grain Boards) so long as surpluses are available in any of the countries; and, even if supplies are imported, grain boards will need to pay duties which they did not

formerly. A key question will be what levels of grain-support prices will be set for the region by the action of the national grain boards to be coordinated by a regional commission having limited powers to enforce the agreement. While the price policy has not clearly emerged, evidently prices will have to be sufficiently high to induce increased output, although peasant farmers may find themselves competing with newer commercial farmers if the returns become more attractive. Returns to farmers would be improved by better storage facilities; a regionally coordinated program for such storage facilities has been developed which would be modest in cost, but so far only one country has arranged funds for construction. In financing agricultural programs, external agencies should place high priority on carrying forward these storage facilities; this would also require assurance of provision of adequate funds (probably by local governments) for purchasing and holding stocks to smooth seasonal or annual supply variations. Some experience will be needed to determine whether it would be advisable to organize the administration of the main storage facilities and the trading operations under a single regional authority.

Infrastructure

17. To establish an adequate infrastructure for the further growth of their economies, the several governments established investment plans for the period 1966-69. While these plans are primarily national in scope and focus, they reflect also considerations of a regional character to a considerable degree, primarily for highways. The plans, which are ambitious, are unlikely to be achieved within the time limits set. The mission's estimates of possible investment levels, taking account of a variety of obstacles that usually arise in the execution of such plans, suggest that a total direct investment of some CA Pesos 835 million could be reached for the region for the period 1967-70. This would be about 75 percent above 1963-1966, equivalent to an annual average increase of some 15 percent. In some countries, such as El Salvador and Honduras, the rates of increase are likely to be even higher. For the area as a whole the public investment would be about 4.5 percent of probable GDP in 1970, as compared with about 3.5 percent in 1966, not an unduly high level.

18. The programs concentrate heavily on transportation facilities (mostly highways and to a lesser degree, ports); these together with electric power and telecommunications, would take up about 60 percent of the regional direct investment. Emphasis in the direct agricultural investment would be relatively small (less than 9 percent), but would be supplemented by public credit programs to the private sector. In addition to direct public investment, estimated public credit programs to the private sector for both industry and agriculture would amount to some CA Pesos 163 million, of which somewhat more than half would be for agriculture. The general balance of the program together with its composition within the various sectors appears reasonably well designed for the purposes of Central American development. The investment programs have a reasonably

large project content, though especially for the latter years, studies of a number of projects have yet to be undertaken or completed.

19. The main sectors involving issues of regional investment policy are: transport (roads and highways), telecommunications, electric power, education and agriculture. Since 1963, the five Governments have been agreed on a program to construct or improve certain "integration" roads; these consist mainly of the Inter-American Highway, important roads providing more and better connections between the several countries, and roads intended to integrate into the Central American and national economies, productive areas (mainly towards the Atlantic), not now adequately connected with the rest of the country or region. Generally well conceived, a large portion of these roads have been built or improved, or are in the process of construction or improvement. Nevertheless, probably CA$90 million remain to be built over the next four years, representing about 35 percent (in Honduras, 70 percent) of the region's highway investment outlays in the period.

20. CABEI has begun to finance a substantial part of the integration roads; its loans, thus far, amount to CA$30 million. The other lending agencies are also participating in financing these and additional roads, of which probably 60 percent or more would come from external sources. Thus far, however, the countries themselves have decided which roads to construct and when to construct them (provided foreign financing was available), including the integration roads. Moreover, in some countries, the road programs are causing real strains on administrative capacity or financing ability or both, and, in others - notably Guatemala - the programs likely to be achieved fall far short of what is needed, in part because of the lack of adequate project studies. There appears to be a real need, therefore, in the highway sector, to develop a more systematic programming of road construction and its financing, which would appear to require as much as US$125 million in new road loans for the period 1967-70 (in addition to those recently contracted). Such systematic programming is important not only for the next few years, but also in the determination of the strategy of the road program in years thereafter. This strategy should give greater stress to the opening of the Atlantic regions and to access roads, and it should be anticipated by the systematic making of feasibility studies required by the several countries. Such coordination is also in the interests of the Common Market's objective of "balanced development" of the region, since some countries are less well endowed with highway transport facilities than others in relation to their developmental needs.

21. Closely linked to the highway investment policy is the policy in regard to charges collected from inter-city highway users by the Governments. Rough estimates indicate that in Central America revenues collected by the several countries from such charges cover from about one-quarter to one-half of costs to the Governments for providing road services. With a view to assuring better allocation of resources over the

longer run, as well as contributing fiscal revenues needed by some of the countries, such charges should be increased. By how much would depend on more detailed studies of costs and their apportionment among users, taking into account also the effect of such charges on regional traffic patterns.

22. Issues of regional policy also arise in the case of port expansion. The elimination of trade restrictions within the area, together with the adoption of a common tariff, should lead to the development of ports according to regional, rather than national, traffic-flow criteria. Even now, there are a few cases in which the development or expansion of national ports raise questions as to the role which they should play in the region. Beyond doubt, Central America will need to draw up a regionwide program of port development in the next few years, if the best locations are to be chosen from the viewpoint of one Common Market economy; decisions by external financing agencies which have been active in port development in Central America on the financing of specific projects should take account of the regional implications of such projects.

23. An adequate regional telecommunications system has long been recognized as a priority need for economic integration of the region. Studies of national areas and a regional system were completed in 1964. However, the recommendation that an autonomous regional corporation be established to finance, construct and operate such a system (which would involve relatively modest sums, a total of about CA$10.0 million) has not gained the necessary acceptance among the countries. Instead, the countries agreed in 1966 to go ahead with the regional system with each country constructing and financing its segment of the network, with bids and construction to be coordinated by a technical committee. Before the countries can proceed effectively with the project on a coordinated basis, they will need to ensure that the coordinating committee has sufficient powers to carry out construction smoothly; it would also have to plan for the next stages of expansion.

24. Electric power interconnections among the countries have not yet been developed. The most important project - between Honduras and El Salvador - has been under discussion for some time; but decisions to proceed with local projects which had to be made before agreement could be reached on the interconnection has deferred this interconnection project for some time. Power interconnections among the countries do not appear to be a pressing need for the next several years, since the possible benefits to be gained by interconnections of the present relatively small-sized systems would not be sufficient to justify the necessary investment in transmission lines. In the longer run, however, as power demand and power systems increase in size, mutual benefits could be achieved by interconnections. Experience in other countries shows that substantial problems are encountered in working out coordinated international power connections so that studies need to be made with long lead time. Hence, preliminary studies of possible interconnections in Central America

should be made well in advance. Work on such studies has been started by existing regional committees, with the assistance of U.N. and ECLA, and this should be continued and reinforced to lay a foundation for future joint planning of integration of power systems.

25. Improvement and expansion of educational systems is a priority need in all the countries, although Costa Rica has made large advances in comparison with the others. Most countries are programming increased but relatively modest investment in educational facilities to meet deficiencies. However, the education programs emphasize expansion of physical plants and do not adequately provide for improvement of the performance of the educational system, particularly in the supply and quality of teachers. Secondary educational and vocational training are in particular need of expansion. While most of these problems can be dealt with at the national level, joint action in several fields would advance the common interest. Thus, greater support by the countries and external agencies should be given in sending students to selected centralized institutions for post-graduate training under a program developed by a regional council. Support is also needed to strengthen a central institution for educational research and improvement. Consideration should be given to establishment of a regional institute for training of secondary school teachers in fields of specialization which could not economically be provided in one country, particularly science and vocational or technical training.

26. In general, the public investment programs of the Central American countries are well adapted to new needs in the coming 10-15 years. In the main, the programs, while not uniform, are consistent with each other. The transportation, telecommunication and power programs, if carried out, would contribute importantly to the essential infrastructure of all the countries; moreover, they are in effect not inconsistent and are inter-related. There are no important examples of an investment or development program in one country being adversely affected by deficiencies in the structure of investment in others, although, as indicated above, there are various projects of regional significance which are being or will need to be tackled with regional considerations in mind. Aside from these, however, failure of any of the countries to substantially carry out their programs would eventually have an adverse effect upon the possibilities that others may achieve their potentials within the common goal of integration.

Financing Investment

27. The major issue immediately facing the region generally is how to sustain a higher level of investment required for further growth of the economies and the integration of the region when, in the next few years, the rates of GDP growth will be declining and the balance-of-payments' positions of the countries deteriorating. The policies adopted in order to deal with it may be largely the responsibility of individual countries, but their decisions will, in many aspects, affect the welfare or interests

of the others, as well as the success of common programs or policies for integration.

28. To sustain the levels of public investment needed for national progress and regional integration, as outlined above, the countries will need to obtain very large amounts of foreign financing for projects. For 1967-1970, drawings on external sources (including those from CABEI) by the five countries would need to run at about US$115 million annually for direct investment (plus some US$28 million annually for development credits for industry and agriculture); these would cover about 54 percent of the total investment outlays (varying somewhat among the countries). While such a proportion of gross external financing is somewhat higher than the 50 percent prevailing in 1962-1965, it is not unreasonable, given the effort to increase public investment for development, at a time when GDP will be growing at a slower pace and balances of payments often will be in difficulty.

29. To secure such flows on external funds, the countries would need to obtain new loan commitments amounting to about US$575 million during 1967-1970. More than half would be for transportation and electric power projects. On the average, such project loans, based on prevailing practices of lending institutions, would cover about 62 percent of the total costs of the projects financed (varying from 60 percent in Nicaragua to 70 percent in Guatemala and Honduras). Even with this new borrowing, debt service in relation to projected foreign-exchange earnings would rise to moderate peaks by 1975, ranging from about 5.0 percent to about 7.5 percent among the five countries, though in the meantime Costa Rica's ratio would be higher (18 percent in 1966 and 9 percent in 1970).

30. To complement the external funds, all five countries will need to increase the level of public savings both absolutely and in relation to GDP. Restraints in nondevelopment current expenditures will be needed particularly to permit current developmental expenditures to increase as needed. Costa Rica, Guatemala, and El Salvador will need to increase their internal public savings effort by considerable margins - the first two countries urgently - by enacting new revenue measures. In Costa Rica, the need is particularly acute, since the past financing pattern of recourse to private bank loans abroad and a failure to restrain current outlays and to provide more revenues has led to a financial and exchange crisis. The position of Honduras, with its present taxes and revenue projects, is likely to be close to balance. Nicaragua, which has sharply stepped up its tax effort, has increased its savings; on the basis of present expenditure patterns, it would generate some surpluses; but these ought to be used to augment the lagging investment effort in certain sectors, particularly education and public health, which may occasion some increase in current outlays.

31. While there are possibilities for increasing public savings by higher charges for public services or, in some cases, by reductions in Central Government transfers to independent agencies, the major effort in Costa Rica, Guatemala, and El Salvador will have to come from a greater tax effort; by 1970 this would need to produce some 10-25 percent more than presently forecasted revenues in those countries. While the objective

is revenues, it would be important, from an economic viewpoint, to: (a) increase the burden of taxes on the coffee sector throughout the area (whether by export or other taxes) to stimulate diversification out of coffee; (b) increase consumption or sales taxes to discourage demand for imports, preferably on nonessential items; (c) increase property taxes since these are now very low and moderate increases, even on present valuations, would close a large part of the gap in the three deficit countries. Aside from these measures, others set forth in a recent detailed study prepared under the joint auspices of the OAS and IDB could be undertaken. Losses from fiscal exemptions granted for industrial development could be reduced and the competitive role in granting them abated if these were replaced by uniform provisions for accelerated depreciation and if income taxes on companies were levied on a proportional basis rather than on the basis of the progressive personal income tax now applied to them by four of the countries. In addition, there is a case in all countries for increasing road users' charges, bearing in mind, however, their implications for regional aspects of transportation.

32. Tax reforms are needed not only to solve the short-run fiscal problems in three countries but also, throughout the area, to lift the levels of government revenues which are low. Revenues are now 9-12 percent of GDP in the five countries; these percentages are no higher than they were before the boom got under way five years ago, in part because of substitution of duty-free imports from the Common Market for dutiable imports from abroad and liberal granting of fiscal exemptions as industrial incentives. Levels of fiscal revenues and public savings throughout the region need to be raised to enable the countries to contribute beyond 1970 a higher proportion from domestic resources to the higher investment levels they will be trying to attain.

33. Recourse to the banking system cannot substitute for increased fiscal effort to finance the investment programs, given the need to reserve any increase in bank credit facilities to permit private-sector growth in the next few years. As noted below, the prudent margin for internal credit expansion in the next few years is very slim indeed.

34. If the necessary internal savings are not created to fill the financing gaps, particularly in Costa Rica, El Salvador, and Guatemala, their investment programs would inevitably be reduced. Since it would probably be necessary to reduce or postpone some projects financed in part abroad, the amount of the reduction in investment would probably have to be considerably greater than the shortfall in local currency requirements. Heavy reductions in public investment would adversely affect the prospects for longer-term economic growth, and the mission did not try to postulate alternative reduced investment programs since it considered that it would be feasible, with tax measures such as those suggested above, to close the gaps and avoid the heavy sacrifice in investment program.

Growth Prospects and External Finances

35. At best, over the period to 1970, the growth rate in all the countries will slow down because of less favorable prospects for the major

exports to world markets. Expansion in the Common Market will be affected by this weakening in export earnings, and trade within is likely to grow much less rapidly than in recent years. Annual GDP growth rates in 1967-70 are likely to range between one percent in El Salvador and Costa Rica to 2 percent in Guatemala, and 4 and 5 percent in Honduras and Nicaragua. With continuing rapid growth of population, per capita GDP is likely to fall, except in Honduras and Nicaragua where it may rise slightly.

36. Implicit in these growth rates is a slower rate of import growth, particularly in El Salvador, Costa Rica, and Guatemala; import growth rates in Honduras and Nicaragua, while less than in recent years could still be substantial. There seems little room for relieving this import restraint by drawing down reserves. In these circumstances, excessive internal credit expansion would immediately add to balance-of-payments' pressures, given the high tendency to import. Thus, net internal credit growth, which doubtless will be affected in any case by a falling off of deposits as export receipts weaken, could probably not exceed some two percent annually in Guatemala, about one percent in El Salvador, and two percent in Costa Rica; in Honduras and Nicaragua, it could probably run at some 5-6 percent.

37. Imports of capital goods, which accounted for a major share of the rise in imports from abroad in recent years, will doubtless be affected by the slower rate of internal expansion. However, the advance of industrialization, bringing with it needs to continue imports of replacement parts, raw materials, or semi-finished inputs has created an element of rigidity in the import structure. The authorities may well need to take measures to restrain internal demand and, consequently, demand for imports for industry for the less essential types of consumer goods (e.g. by restraints on consumer credit, selected sales taxes). These difficulties of adjusting to lower growth of import capacity serve to underline the need for re-examination of the policy of granting industrial incentives for industries relying heavily on imported inputs and adding relatively little in value in the process of production.

38. While cost increases internally have affected the profitability and hence export possibilities of some commodities (particularly cotton, due to cost of combatting plagues and trying to increase output by applying more fertilizer), and a weakening of export prices may well affect the major commodities in varying degree, there seems to be no general case at present for promoting exports by devaluation of the exchange rate. Such a move on the import side would doubtless discourage imports, but with restraints on credit and appropriate tax measures, imports could be kept under control. As for individual countries in the region, membership in the Common Market implies severe restraints in correcting balance-of-payments' pressures by altering their exchange rate. When one of the countries makes a change in its exchange rate, the others are immediately affected, as has been shown recently when Costa Rica instituted a dual-rate system, part of which was a free rate applying to certain commodities, whatever their origin. While the Costa Rican system was soon changed so as to leave imports from the Common Market at the earlier rate, the countries now face the complex question of whether a member of the Common Market may maintain certain rates for transactions within the Common Market

and others for transactions with the outside world. The Costa Rican experience may yet demonstrate that imports from outside through other Common Market countries cannot be prevented indefinitely and that its multiple rate system is therefore not a solution to its problems. Such a development would precipitate for the first time critical and difficult issues as to which balance-of-payments' policies are consistent with the Common Market relationships and which are not. The other countries could, of course, provide credit to the country in difficulty, based on understandings as to corrective policies, and thereby avoid the difficult issue of exchange-rate adjustment in the Common Market. However, the possibilities of such intra-regional transfers now are limited by the relative shortage of resources of all the countries.

39. The unfavorable outlook for growth of exports and domestic output in the next few years reinforces the need for public authorities, national and regional, to promote possibilities of increasing exports, including new lines (as suggested in Chapters II and III). It also reinforces the need to give priority to the use of available local and foreign funds in special credit programs giving early results in output and exports. The mission's estimates of public investment include provision for such special credit programs. These are estimated at about CA$40 million average annually during 1967-1970 for the region (including the use of some US$28 million of foreign funds annually) to levels rising somewhat through the period. External loans for these purposes could be disbursed fairly quickly if administrative organization is adequate and would have an early impact on production. The public authorities, both national and regional, should therefore push forward with the preparation and execution of projects for channeling foreign funds in development credits to the private sector to achieve at least the levels projected by the mission and if possible to surpass them. These programs for utilization of foreign funds warrant high priority also because prospects are that internal credit expansion over the next few years will need to be kept within much narrower limits than in the past in order to restrain import growth; particularly in Costa Rica, Guatemala and El Salvador. To the extent that such programs can be increased efficiently, they would both help to relieve balance of payments restraints on domestic credit in the next few years and also benefit the longer-range growth potential of the countries. While an increase in foreign lending for such programs above the levels assumed by the mission would raise the debt service burden above the ratios mentioned earlier (paragraph 28), there is still room for moderate additional debt service provided the countries keep on growing.

40. To sum up, it appears feasible for the countries of Central America to sustain a rise in public investment in the face of lower rates of growth of exports in the next few years, provided foreign financial assistance for project loans is forthcoming and is matched by additional internal fiscal measures in at least three of the countries. The measures adopted by any one of them - to control credit, remedy their fiscal or balance-of-payments' imbalances, promote industrial growth - will affect the prospects of the other countries. Hence, harmonization - that is, mutual adjustment of policies to achieve consistent common objectives -

will be increasingly important in a variety of fields, mainly taxation, fiscal policy, tariffs and industrial incentives, educational programs, coordinated programs in infrastructure (particularly transport, power, telecommunications, grain storage, and education) and monetary policies. Such harmonization would be advanced if the countries strenghtened their capacity to make decisions on vital matters of common interest much more rapidly and effectively than in the past. It was suggested above that a tariff and industrial commission be established. The Governments should also strengthen the central body of the integration organization - the Economic Council - by taking the necessary internal measures to enable its members to speak for their governments on all issues which should come before it rather than solely on those which fall within the jurisdiction of the economic ministries.

41. Similarly, the external agencies will need to look at their lending operations increasingly in the context of regional considerations and emerging issues of regional policy. By and large, external lending agencies have, in the past, regarded the countries of Central America as individual unrelated economic entities, though support has been given to the regional bank and some investment programs of regional significance. Future assessments of the economic situation and projects of individual countries will need to take account of what is happening in the rest of the region, particularly to assure that their projects and policies do not run at cross purposes with those of other countries and the development of the region as a whole. In several sectors, external lenders will need to consider projects in terms of their part in a regional program (e.g. highways, grain storage) or in terms of the fact that they cannot be carried out suitably except on a regional basis (e.g. telecommunications, education) or because their role transcends national boundaries (e.g. ports) or because they constitute the best solution to supplying emerging needs (e.g. potentially electric power interconnections) or a combination of these several factors. External lenders will also need to be concerned with the improvement of industrial and tariff policies in the Common Market, particularly to centralize the granting of industrial incentive privileges, to improve tariff making and revision of processes so as to secure an efficient and economical industrial establishment and to develop export-oriented industries. Too, they will need to concern themselves with the agricultural policies to be followed to diversify out of coffee (including concerted adoption of heavier taxation on that sector) and to provide financing and technical assistance for development of new production and export possibilities - such as, livestock and forest products.

42. The bold action of the Central American countries to create a Common Market undoubtedly has broadened the basis for economic growth of all of them. The rapid growth of regional trade should not, however, obscure the fact that the Common Market cannot be an end in itself. But with support from abroad, within the framework of effective national and regional policies, it could become not only a basis for more rapid internal growth but also a more effective means of developing the new exports needed for longer-term growth.

PREFACE

This report was prepared by a Bank mission which visited Central America in April-June 1966 to evaluate the development programs and the economic prospects of the Central American countries within the context of the economic integration of that area which has been taking place since the early 1960's. The framework of that movement is commonly known as the Central American Common Market. The countries included in the Common Market, and covered by this study, are Guatemala, El Salvador, Honduras, Nicaragua and Costa Rica. Panama, which is linked to these countries geographically and tied to them culturally, has long been considering participation in the Common Market but thus far remains in the role of interested observer.

As a result of the efforts of planning authorities of the five countries, which received important assistance from the Central American Joint Planning Mission, each of the countries in the region has a national investment plan. There are also a number of regional arrangements and agreements, as well as institutions, which reflect regional development policies and bear upon the implementation of these policies and national plans. The Bank mission discussed these investment programs, agreements and policies with officials at the national level, in Government ministries and agencies, financial institutions and in the private sector, and also with officials of several regional agencies and of the Economic Commission for Latin America which continues to be active in this field. This report presents the results of the mission's work. It attempts to identify the economic prospects and the principal economic problems in the region and, in this context, to appraise the development and investment programs and policies of the several countries and their plans for financing them. Part I of the Main Report deals with the region as a whole while Part II deals in summary form with problems of the individual countries.

PART ONE

I. RECENT GROWTH EXPERIENCE IN CENTRAL AMERICA

A. The Region

1. Stretching for almost 1200 miles overland from the Mexican border in the northwest to the Panamanian border in the southeast, the five Central American countries have until recently developed in their own separate ways. Spanish rule, which had provided a unified administration until 1821, was succeeded by a federation which functioned sporadically until 1838. While efforts over the following century to achieve some political or economic integration were unsuccessful, historical connections and the community of language and culture supported attempts to revive regional unity. Particularly since 1950 efforts were increased, and beginning in the latter part of the decade a rapid succession of measures for economic cooperation were taken. Beginning in 1961, a Central American Common Market made great strides toward a uniform external tariff and the elimination of internal tariffs and trade restrictions; important agreements for government action or policy were established in related fields, particularly industry, transportation, agriculture, education and regional payments. Henceforth, development prospects in the Central American states will need to be considered not only in terms of their national economies but also in terms of Central America as an economic region. The analysis of development plans in Central America in this report is based upon this premise.

2. The common characteristics of the five countries are more striking than their many differences. With some variations and with the notable exception of Costa Rica, public affairs have been characterized by political instability, dictatorships and the preponderance of the military in the conduct of political life in the several countries. In some cases, political uncertainty has not only interfered in the planning and execution of development programs but also affected the expectations of private enterprise and the growth of this sector of the economies. Other important common characteristics are the importance of exports of two or three main commodities in the movement of the economies and the general similarity of their production activities. The Governments of Central America, with some exceptions such as Costa Rica, have played a relatively limited role in orienting the direction of their economic development. With the coming of the Common Market and faced by the rapid growth of population together with the desire to raise per capita incomes, the Governments have in recent years become more active in planning development.

3. The area as a whole covers about 170,000 square miles (or 442,000 square kilometers); with a population of 13 million people, the density of population is low, averaging 29 inhabitants per square km. over the region. El Salvador, the smallest of the countries, accommodates an average of 148 persons per square kilometers. Generally about a third of the population lives in urban centers, these are widely distributed, and relatively small;

the seven largest cities in the region range from 75,000 to 575,000 inhabitants. Most of the population is still concentrated in the central highlands and mountainous regions which enjoy temperate climates and generally have rich volcanic soils; more recently the population has increased along the Pacific coastal slopes. Mountainous and upland areas dominate the region contributing to difficulties of transport. The coastal plain along the Pacific, with alternate wet and dry seasons is generally very productive but averages only about 50 kilometers in width; extensive plains with abundant rain fall are found in eastern Guatemala, down along the Atlantic coast in Honduras, narrowing in Costa Rica, although inland in Costa Rica (San Carlos), near the Nicaraguan border there are abundant good soils.

4. There are still available substantial areas of land for development, especially toward the eastern portions, although information on the types and locations of their soils and their adaptability to different crops is far from complete. Large forest areas including extensive stretches of pine in Guatemala, Honduras and Nicaragua, offering possibilities of development of forest products, including wood pulp, are still available for exploitation. There are few mineral deposits, particularly of nickel and bauxite, which may lead to the establishment of moderately large modern operations in the next decade. Iron ore and ferrous sands exist in some quantity in Honduras and Costa Rica and studies are being made as to the possible exploitation of these. There are no important supplies of fuels (coal or petroleum) but the abundant water supplies of the region have provided the basis for recent hydroelectric power development which is far from completely exploited. Central America also has an advantage in its relative geographical nearness to the large U. S. market.

5. Growth of population in all five countries has been very rapid. Even a decade ago it increased 3 percent annually in the region, and in the last four years, the increase has averaged about 3.5 percent annually, ranging from about 3.0 percent in Nicaragua to about 4.1 percent in Costa Rica. This rapid population growth has increased the pressure for economic expansion. In view of the limitations imposed by the smallness of national markets, which even in 1965 ranged from 4.3 million persons in Guatemala to about 1.5 million in Costa Rica and with GDP's per capita ranging from about $215 in Honduras to about $420 in Costa Rica, averaging about $300 for the region, efforts were made to break down the trade barriers between the countries in order to widen the markets, mainly to provide a basis for further industrial expansion in the region.

B. Trends in Growth

6. Thus far these efforts have taken place during a period of substantial economic growth in the region. While the economic progress of the five Central American countries in the last ten or fifteen years has not been continuous, the overall results have been encouraging, particularly if compared with most other less developed countries. GDP in the region as a whole grew at an annual rate of 5-6 percent in the last decade. At the same time, population growth averaged 3.3 percent annually in the region, so that per capita income rose in real terms from about US$240 equivalent in 1955 to about US$300 in 1965, or at an average annual rate of 2.3 percent.

Between 1960 and 1965, however, regional GDP grew at an even higher rate, averaging 8.1 percent annually, while per capita GDP rose 4.4 percent annually. This rapid growth of income was achieved with low levels of gross domestic investment in relation to GDP, at a regional level of 12-13 percent of GDP during most of the decade, though reaching 15 percent in the mid-fifties and the boom years of 1964 and 1965. Most of the investment was in the private sector; direct public investment varied from 20 to 30 percent of total gross domestic investment over the decade. While the private sector was the most dynamic element in this economic expansion, public sector investment provided essential infrastructure - mainly roads and electric power. In addition, public agencies channeled foreign funds in development credit to private industry and agriculture; these were an important factor in the development of some countries, notably Costa Rica.

7. The Central American countries are open economies: the single most important influence upon movements in investment, imports and output have been the variations and prospects for the major agricultural exports. Export earnings for the aggregate of the five countries have typically accounted for 18-22 percent of GDP in the last decade, although this average conceals fairly wide variations between the countries, from 33 percent of GDP in Nicaragua to 15 percent in Guatemala in 1964. With the stagnation and decline of export earnings in 1958-61, per capita income fell or stagnated in all countries. More recently, in the last five years, the Central American boom was fed by a sharp growth in total merchandise export earnings; for the five countries, these rose from US$433 million in 1960 (at the trough of recession) to US$770 million in 1965 (or from US$400 million to US$634 million after excluding intraregional trade among the countries). Thus the combined merchandise exports of the five countries grew at a rate of 12.2 percent annually from 1960 to 1965 and even for the decade 1955-65 as a whole, the average annual rate of growth was a substantial 6.1 percent.

8. While the variation of export prices was a major factor in the stagnation and decline of exports in 1958-61, the recovery of export earnings since then has resulted only partially from increases in export prices, the most important of which was in coffee. Previously the average price of coffee fell from 65 US cents per pound in 1956 1/ to about 35 US cents in 1962 and 1963. From the end of 1963, prices rose to 44 US cents in 1965; this recovery contributed 30 percent of $170 million expansion of exports in 1964 and 1965. Yet, by 1963, when coffee prices had reached their lowest point, the majority of the Central American countries were already well launched on an export boom. One main new element in the boom was the spectacular increase in cotton production after 1961. This was not the result of changes in cotton price, which stayed constant from 1960-65. Rather it reflected the reaction of the private sector to the preceding fall in coffee earnings and to the increased opportunities for cotton growing offered by the opening up of the rich Pacific coastal lands through road construction. The other main new source of export growth was

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1/ This is the average for the coffee earnings of the five Central American countries.

the rapid expansion of manufactures, one-fifth of which went into the accelerated increase in trade among the five countries as tariff barriers were removed under the Common Market arrangements. These intraregional exports of manufactures constituted the major portion of the rise in intraregional trade, from $37 million in 1961 to $136 million in 1965. This growth accounted for almost 44 percent of the total increment in exports of the five countries from 1961 to 1965.

9. Against this background of overall growth, the general prospects are that recent growth rates are unlikely to be maintained in the next few years or so. As will be indicated in detail later in the report, prospects for growth of major export crops are far less favorable than in the past: in cotton, prices will be less favorable and difficult production problems have to be mastered; in coffee, probable exports within the international quotas designed to prevent a complete breakdown of the price structure in the face of increasing world supplies with slow growth of consumption, will require checking the fast rate of coffee production in Central America; and the prospect of growth in bananas while fairly favorable, will not impell overall growth to past rates. The merchandise exports of the region as a whole to the outside world are likely to increase about 2.5 percent annually through 1970. In the succeeding five years as a result of rising world consumption and to some extend development of new lines, export prospects would improve so that possibly exports might rise at a rate closer to five percent annually. While these estimates are subject to a wide margin of error, they imply that regional GDP will rise at about 2.5 percent annually from 1965 to 1970 (with variations above or below this rate among the countries). This slackening of growth in the next few years, together with the repercussions in a variety of fields, sharpens the issues for development in each of the countries and for the integration movement as a whole.

C. The Common Market

10. In the early 1950's several of the countries began to arrange bi-lateral agreements freeing trade between them so as to widen the basis of economic growth. Since then continuous studies and negotiations took place which by a series of steps led to the General Treaty of Central American Economic Integration of December 13, 1960, now in effect between all the five countries. 1/ This came into force for Guatemala, El Salvador and Nicaragua in 1961, for Honduras in 1962 and Costa Rica in 1963. While the Treaty aims at the creation of a common market, its provisions are directed mainly at the establishment of free trade within the area and a common external tariff but not to the free movement of capital and persons. The structure of integration includes a Uniform Code for Customs Procedures adopted in 1963, an agreement to regulate trade in basic grains (1965), and a convention for common rules on fiscal incentives for industrial development (negotiated in 1962 but not yet in force). The main administrative structure includes the Central American Economic Council, consisting of the Ministries of Economy of the several countries, a superior body to direct the integration of the Central American economies and to coordinate their economic policy.

1/ For a more detailed description of the instruments of the Common Market and related developments, see Appendix A.

The Permanent Secretariat of the Integration Treaty (SIECA) serves as a technical body for the Economic Council and carries on studies and preparatory work for negotiations concerning the common market. It is closely assisted by the Mexico Office of the Economic Commission for Latin America. Recently it incorporated the personnel of the Central American Joint Planning Mission which has been assisting the countries in their planning work and which helped formulate the national development plans for 1965-1969.

11. Progress thus far in trade matters has been striking. A common tariff on imports from outside the area has come into effect and tariffs on trade within the region have been eliminated on all but 32 tariff sub-items. In 1964, trade on these latter items represented about 18 percent of the region's total imports and 6.5 percent of intra-regional imports. Wheat and wheat flour and oil products accounted for approximately half of the total still pending agreement and assembly goods (such as radios, automobiles, refrigerators) for the other half. Most of the countries engage in processing wheat flour and refining petroleum and some have assembly industries. Discussions for further liberalization on these items are still in progress.

12. Generally the common tariff represents a shift toward distinctly higher rates on imports from outside the area; these shifts are discussed more fully in Appendix A and Chapter III on Industry. The common tariff particularly increased the duties on consumer goods, which are now very substantial and often high by any criteria of evaluation. The common duties on raw materials, machinery and equipment are relatively low; even these are often waived administratively under the industrial incentive laws. Nevertheless, in each of the economic categories, the common tariff is higher than the average of the five previous national tariffs in such categories. Protected by higher tariffs and stimulated by the general rise of purchasing power generated by exports to the outside area while taking advantage of unused industrial capacity, intraregional trade grew rapidly. Exports among the Central American countries rose from CA$37 million in 1961 to CA$136 million in 1965. In 1965 this intraregional trade constituted 15 percent of total imports of the countries compared to some 7.5 percent in 1961. The greatest rise was in manufactured goods which now account for some 60 percent of all the regional trade; trade in crude materials and foodstuffs increased at a slower rate. Evidently there has been substitution of regional production for imports from abroad in many categories of goods but because of sharp increases in imports of raw or semi-finished materials from outside required by regional industries, there was no overall net substitution (as indicated in Chapter V).

13. While intra-regional trade is still heavily concentrated in the northern three countries (Guatemala, El Salvador and Honduras) the common market is providing a stimulus for Costa Rica's exports to neighboring Nicaragua as well as the other countries. The common market thus is becoming important for each of the countries as an outlet of exports or a source of imports or both. Trade balances of each country with the rest have not developed marked surpluses or deficits except for Nicaragua which has had a persistent and increasing deficit. While the Nicaraguan authorities have expressed concern at this development, it is the overall trade and balance

of payments position of each country which is of primary importance and its balance or imbalance regionally should be viewed in that context. Moreover, Nicaragua has several important industrial projects underway which, when they come into production, should increase Nicaragua's regional exports. The increasing trade inter-dependence of these five countries is already creating pressures for harmonization of policies affecting their mutual trade positions, including exchange policies.

14. While it is too early to judge whether the slackening in the growth of intraregional trade in 1965 signifies the passing of the initial stage of import substitution, the general outlook is that increases will not continue at the same high rates over the coming years. Part of this will be due to general limitations of the market, which is still relatively small, and the slackening of growth of incomes in all the countries due to the levelling off in the rate of growth of major exports to the outside world which appears likely in the next five years, as elaborated in subsequent portions of this report.

15. The rapid economic growth of recent years in the region has not been taking place at equal rates among the countries. Growth of income in Honduras, at present the poorest of the five countries, has in fact, been somewhat slower than in the other four economies. This is generally recognized by the Common Market policy makers. While their general aim is to raise incomes as much as possible nationally, since all five countries are still low income countries, various preferences have been accorded to Honduras (in fiscal incentives, allocation of regional resources and technical assistance) with a view to speeding its economic growth. As yet, however, differences in income and employment opportunities among the countries have not been sufficient to lead to pressures for permanent migration from one country to another. Although some temporary migration across borders takes place because of seasonality of harvests, at present there exist no provisions permitting large scale employment of labor outside their native country in the other Central American countries, nor is there vocal pressure for such a liberty of movement or employment.

Development of Central American Financial Institutions

16. In 1961, the Central American Bank for Economic Integration (CABEI) began operations; its general objective is to promote the economic integration of the region and the balanced growth of the member countries. Total lending resources to the end of mid-1966 were approximately $102.7 million, of which $17 million constituted capital paid in by the five countries. Major sources of CABEI's external funds have been the U.S. AID ($62.5 million), the Inter-American Development Bank ($14 million) and Mexico ($6 million). 1/

1/ Early in 1967, the Inter-American Development Bank approved two loans equivalent to US$15 million to CABEI to be used for financing of infrastructure projects of regional scope.

17. To mid-1966, CABEI had committed loans of almost $77 million. A little over 40 percent ($33 million) of these commitments were for industry (including technical studies). Another $33 million was committed for infrastructure projects, the great bulk of this recently and almost exclusively for highways; the major portion of the remaining loans (some $10 million) were for housing.

18. CABEI's loan disbursements to mid-1966 totalled almost $26 million, about four-fifths for industry. Total disbursements on loans from all external sources to the public sector of the five countries (including development credits for industry or agriculture) were approximately $316 million for 1962 through 1965. Of this amount, CABEI disbursed about $22 million. However, CABEI's rate of disbursements will probably rise in the near future as the new series of road loans are drawn upon. CABEI's loans by country range between $13 to almost $19 million, the largest amounts being for Honduras and Nicaragua with El Salvador following closely, owing to substantial earlier industrial loans in that country.

19. Loans by CABEI for roads recently have been covering 100 percent of project costs at an interest rate of 3.5 percent with a term of 25 years including 7 years grace; these roads are the "integration" roads, selected because of their importance to the development of a regional road infrastructure. Industrial loans are substantially less liberal, covering up to about 60 percent of project cost with interest rates currently at 7 or 8 percent, (somewhat higher than before mid-1965). CABEI's available funds have been quickly committed; as of mid-1966, CABEI's available loan funds were about $25 million of which $13 million were reserved for industry under terms of the loans received by CABEI. Hence CABEI's future activities depend in large part on its ability to arrange for new external funds. 1/ Further increases in local government subscriptions would at best be relatively small.

20. In addition to its loans for direct investment, CABEI has financed a series of studies, including the large study of future requirements in Central American transport and some new studies of export opportunities abroad, which should contribute to the development of exports.

Regional Clearing House

21. The framework of the Common Market also includes a Regional Clearing House under which over 80 percent of intraregional trade was compensated in 1965. These compensations took place with very limited credit since each Central Bank is obliged to grant a maximum of CA$500,000 in regular credits to the other four, with settlement in cash every six months; however, some obligations might be carried forward without cash

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1/ Early in 1967, the Inter-American Bank announced approval of two new loans to CABEI totalling the equivalent of US$15 million to be used for financing of infrastructure projects of regional scope.

settlement by voluntary bi-lateral credit arrangements. A stated objective of integration set forth in the General Treaty is a monetary union among the countries. The achievement of this objective is under study by a Central American Monetary Council consisting of the presidents of the five Central Banks. The Council provides for closer and continous consultation and is guiding the studies of problems of the monetary union. The goal of monetary union will require considerable progress in several fields of policy which will take quite some time, but in any event the common market has a machinery for consultation on monetary matters which should assist in progress toward that eventual goal.

D. Conclusions

22. Each of the five Central American countries has emerged from the rapid growth of recent years with a more diversified and stronger economic structure than a decade ago. Exports came to depend principally upon three major products instead of two and minor imports have been increasing in importance. Infrastructure necessary for growth has been expanded. Advances have been made toward a modern transport system between the main economic centers. Large new power capacity has been installed and the institutions responsible for power development have been strengthened and new ones created and put into operation; these are capable of providing for the substantial further expansion of power facilities which will be necessary. Institutions designed to provide medium and longer term credit for the development of private agriculture and industry are being developed. The capacity of the public sector to plan and execute new investment programs has increased markedly. In the private sector, a new entrepreneurial and managerial group is emerging and showing considerable vigor and industrial development has made great strides. Nevertheless progress in some areas has been slow; thus, while public expenditures on education have increased substantially, the abilities of the educational systems of most of the countries to produce the skills and manpower needed for future growth are still severely limited. In agriculture, the low income peasants, who comprise over half the population and are responsible for the production of food staples, remain with poor skills and low incomes scarcely better than a decade ago. While peasants have demonstrated that they can respond to price and market incentives and food output has managed to keep up with population, their income appears to have grown at a much slower rate than the rest of the economy. The uncertain outlook for the improvement of their lot remains a most pressing and difficult problem.

23. The strengthening of the Central American economies and of the export sector and the progress of the integration movement has provided a stronger basis from which they can attack their basic development problems. The means for largely overcoming these problems - discussed in the following chapters - will be contingent largely upon the success of the efforts of the Central American Governments, independently and jointly, in maintaining momentum in economic growth during the next few years when prospects are that some of the main factors of strength, primarily export performance, appear unlikely to be maintained. Within the common market there remain urgent questions bearing upon the more effective use of regional instruments in effecting the allocation of resources which will provide the basis for

economic growth, including that of the export sector. In the past the Governments of Central America, with the exception of Costa Rica, have played a fairly limited role in orienting the direction of economic development. For the future, with aims to provide more adequate incomes to their ever increasing populations and with the increasing complexity of economic arrangements, the several governments will have to be more active in promoting development projects and pursuing more clear cut development policies to realize the potentialities of their resources. Increasingly, they will need to do so in consultation with each other, since, within the Common Market the impact of one country's actions is often likely to react and have effect upon plans or developments in other countries and, in addition, common action in promoting development of material and human resources is likely to be more effective and productive than unconcerted single actions. While an encouraging beginning has been made in this direction in recent years, there is a wide variety of serious problems that have yet to be overcome.

II. AGRICULTURE

A. General Characteristics

24. Agriculture provides the major share of income, employment and foreign exchange earnings of the five countries. However, in the last decade the agricultural sector did not grow as fast as the overall economies. Its share of GDP in the region fell from about 40 percent in 1955 to 33 percent in 1965, varying in the latter year from 44 percent of GDP in Honduras to 30 percent in El Salvador. Even so, agricultural exports still account for about 95 percent of merchandise exports of the region to the outside world and agriculture absorbs about 60 percent of total identifiable employment. Expansion of agricultural exports in the last several years has been the main absorber of wage labor.

25. Agricultural structure and performance are broadly similar among the five countries. Widespread and backward peasant agriculture, producing mostly food for domestic consumption, co-exists with a well-organized and efficient export sector. The commercial farmers producing for export have expanded their operations, while achieving some of the highest yields in the world in coffee and cotton production. They have been the main beneficiaries from the opening of new and fertile lands on the Pacific coast of Guatemala, El Salvador and Nicaragua, following the control of malaria in the early fifties and the construction of the Pacific highway and the improvement of several ports. With the lower profitability of coffee production resulting from the drop in prices starting in 1957, farmers turned increasingly to the exploitation of these lands, principally in production of cotton. This expansion was aided by substantial internal and external credit. Cattle and sugar production as well as some other minor products also increased. These developments stimulated the growth of export earnings while reducing the dependence on coffee and banana exports. Whereas, in 1955 coffee and bananas accounted for 79 percent of the $413 millions of exports to the outside world, in 1965 they represented 59 percent of exports of $634 million. However, the prospects for further development of the principal export crops is not as favorable in coming years as in the past; these prospects are discussed in following sections of this chapter.

26. No such major changes have occurred in agriculture producing for the domestic market. Agricultural production for the domestic market, largely foodstuffs, such as corn, beans, rice, sorghum, fruits, and meat and dairy products, is carried almost entirely in small farms; about 80 percent of all farms in Central America in the mid-fifties were "minifundia", or very small farms. Of approximately 12 million hectares reportedly under cultivation in Central America (out of a total land area of 42 million hectares) about 2 million are in grains, mostly in farms under 5 hectares. Except in Costa Rica, the peasant farmers operate with little credit and assistance for improving production practices or in marketing their crops. Credit for basic grains is very small in proportion of total agricultural credit and this has

not risen in recent years. Aside from the economic weakness of the small farms, the widespread uncertainty as to title to land has inhibited the extension of credit to small farmers. While the number of farmers lacking clear title appears to be increasing, as in El Salvador and Honduras, in the latter country this reflects in part the spontaneous settlement of unoccupied lands toward the Central and Eastern part of the country.

27. Despite the absence of technical improvements in production for the domestic market, food production has kept pace with the rapid growth of population. Imports of food in relation to GDP have remained practically the same despite rising incomes from 1961 to 1965 with no evidence of rising prices. Increases in domestic output of food - mainly corn, rice and beans, and also to some extent, fruits, vegetables and dairy products - have resulted mainly from expanding acreage. There are indications, as in the case of rapid expansion of corn exports from Honduras to El Salvador in some years, that existing peasant agriculture is responsive to market opportunities.

28. There is still much agricultural land in Central America available for development. Sizeable investments in transport, would be necessary to open up new areas. There are also some signs of increasing population pressure in certain areas, particularly in El Salvador and also in the long-settled areas in the Central Plateau of Costa Rica, Western Honduras and some parts of the Guatemalan highlands. Thus, while there is scope for improvements of production and income of peasant farmers through introduction of better technology, more adequate credit and marketing, there will be a rising need to bring new areas into production, particularly toward the Atlantic seaboard. While climate and soils of the Atlantic regions are less favorable generally than on the highlands and pacific slopes, these areas could develop production for export of beef, bananas, and forest products and could relieve the rising population pressures in congested areas. But to accomplish this dual objective will require inputs and build up of institutions and personnel for agricultural development, as well as careful orientation of future infrastructure projects.

29. In addition there is need to improve transport and communication in existing rural areas; their inadequacies have inhibited agricultural development in many ways - ranging from difficulties of marketing to introduction of improved methods and better education.

B. Main Export Products; Developments and Prospects

30. Coffee production is the largest economic activity in Central America and the single largest employer. It accounts for between 8 and 12 percent of GDP in the three major producing countries, Guatemala, El Salvador and Costa Rica, which are especially endowed with soils and climatic conditions for coffee production. Returns on coffee production have been high, probably better than on any other crop in most of the post-war period. Under these conditions output in the last ten years increased by 75 percent. The increase in production was largely the

result of higher yields in El Salvador and of the area cultivated in the other countries. The Central American countries have not produced quantities of coffee for export in excess (in any important degree) of the quotas established under the International Coffee Agreement. This was mainly because crops were smaller than expected in Guatemala and El Salvador in 1964/65 and because Costa Rica's production fell due to a volcanic eruption and disease. Over the next five years, however, Central America is likely to develop a substantial export surplus (about 20 percent over probable export quotas) under the International Coffee Agreement as a result of double planting, better pruning and increase in acreage in certain countries in the last two or three years and increasing use of fertilizers. Prospects are that coffee exports from Central America are likely to increase foreign exchange earnings very little (less than 10 percent) from 1965 to 1970, although for Costa Rica, which is still recovering from the reduction caused by the volcanic eruption, the increase would be about 40 percent.

31. The authorities in Guatemala and Nicaragua are carrying on studies or instituting programs aimed at stimulating diversification from coffee into other crops, in order to prevent the emergence of unmanageable surpluses. El Salvador has asked UNDP for assistance in similar studies. But coffee is likely to remain a more profitable crop than most of the alternatives. If the expansion of coffee production is to be discouraged to prevent unmanageable surpluses and to stimulate diversification into other products, the mission considers that authorities should make coffee production less attractive through increasing the burden of taxation. With the exception of El Salvador, the Governments of the five countries have captured little of the increase in the value and average price of coffee exports in the last three or four years. The tax burden on the coffee sector is generally low: the export tax rate at present prices does not exceed 15 percent of f.o.b. prices and the burden of income taxes on the coffee sector is probably rather low. In El Salvador, income from coffee production is free of income taxes; in Guatemala a large initial deduction for agricultural producers in effect also exempts coffee income from income taxes; but in Nicaragua coffee growers are subject to income tax which is collected directly by deductions from export proceeds. The export taxes actually paid in recent years appear to have been somewhat lower than what should have been collected (the rate applicable at a given f.o.b. price): the highest effective coffee export tax rate in 1965 was 10.8 percent in El Salvador, and the lowest 2.5 percent in Nicaragua (see Volume III, Appendix A). While the export taxes are progressive in relation to price in Guatemala, El Salvador and Costa Rica (the taxes in Honduras and Nicaragua are specific), the progressivity is very mild and they have probably not been significant in diminishing the incentive to expand production in the period of higher prices since 1964. While in 1962 and 1963, coffee export taxes collected were 9.2 percent of coffee export earnings for the three countries, they had risen to only 11.6 percent in 1965.

32. Mission projections of possible export earnings from coffee indicate a somewhat more rapid growth from 1970 to 1975, about 12 percent. But these assume that the Governments will have taken action which would

adjust production to possible exports under the International Coffee Agreement. More specifically, this means that they would have substantially increased taxation on the coffee sector in the late 1960's, despite the vocal political opposition of coffee growers to increased taxation of the coffee sector, through export, production or income taxes, or taken other steps to restrain a further increase in output. Otherwise the non-saleable surplus is likely to be such that it would be unmanageable and the financing of excess coffee stocks would divert substantial funds which could be used for higher priority tasks. The prospects for achieving increases in coffee taxation are admittedly very uncertain, but a concerted approach by the five Governments together might help dampen the strong opposition of the coffee growers. Alternatively, coffee growers face the prospect of direct controls on planting, difficult and arbitrary in enforcement, or the prospect of being unable to dispose of stocks unless they are willing to forego the advantages accruing from the International Coffee Agreement including access to markets of member importing countries. In addition, the Central American countries would probably benefit if they were to join together and arrange a common quota under the Coffee Agreement; this would allow unfilled quotas (occurring because of an unexpected shortfall in production) to be used to supplement the quotas of other countries having surpluses.

33. In view of the urgency of increasing the tax burden on the coffee sector, the simplest approach would be to increase export taxes now to levels which at least would provide a sufficient margin to cover the cost of financing the excess stocks while maintaining present coffee tax revenues and possibly increasing them. While surpluses in Costa Rica in the next few years are not likely to be as large as in the other countries, increases in taxation are needed to discourage further coffee planting and to avoid surpluses likely to arise toward the turn of the decade; the same would apply to Honduras. On the basis of present situation in Guatemala, El Salvador and Nicaragua (likely to have the largest absolute and relative surpluses in the next few years) the mission considers that a minimum export tax of 20 percent ad valorem (at projected prices) should be introduced in 1967 and become applicable to exports no later than those in 1968 to achieve the purpose of covering costs of financing excess stocks plus maintaining coffee tax revenues and acting as a disincentive to production. Such a tax should be applied by all five countries; preferably it should be applied uniformly to minimize possible inducements to avoidance of taxation by shipping through countries with the lowest export tax and to help provide a basis for a common quota in the future. Further improvements in the system of coffee taxation, including revision of income tax structures or application of production taxes could come at a subsequent stage.

34. Cotton expansion has provided the major element of diversification of agricultural production and exports since 1961 in Guatemala and El Salvador. Nicaragua's production was already substantial in the fifties, and output doubled between 1961 and 1965. The role of highway and port construction, and availability of credit in this expansion has been mentioned previously. While in Honduras production has also expanded in the last few years, it is still small, limited by availability of suitable soils on the Pacific plains. Costa Rica began a significant expansion in 1964/65, but

production is still small, cotton has competed for land with rice production enjoying a high support price, which has been lowered for 1966/67. Cotton expansion in Central America has been made possible not only by opening new lands, but also by increased yields, which are among the highest in the world for non-irrigated land. In 1965 there was some slow-down in the cotton boom; production fell by 10 percent, mainly as a result of droughts and pests, especially in El Salvador. The cotton policy of the U.S. has already led to some weakening of prices in the world market. Cotton production and exports of Central America depend in substantial degree on the extent to which pests may be brought under control, and on more efficient use of fertilizers and insecticides, so that production costs may be reduced to offset drops in prices. Efforts are being made on these lines in some of the countries. Central American cotton production in the next five years is likely to be only slightly higher than in 1964/65; export volume will barely rise and, with a probable fall in prices, export earnings may be about $130 million, some 13 percent less than in 1965. By 1975, however, the prospects are that more efficient producers would increase their output, even if prices remain stable, and that, despite a rising off-take for domestic industry, export earnings should increase by about 40 percent over 1970, totalling about $170 million. The principal increases would come from the major producers - Guatemala, Nicaragua and El Salvador.

35. While production and export prospects for bananas are encouraging, they are likely to provide a major stimulus only for Costa Rica and to a lesser extent Honduras. Nicaragua does not have suitable soils for banana production on her Atlantic coast; however, trial plantations on her Pacific slopes are being made to ascertain whether climatic conditions are suitable for bananas. In Guatemala, the transfer of banana cultivation from the Pacific side to the Atlantic side has not been so far very successful due to water-logging and possibly also because of political unrest in the area; prospects are therefore still uncertain. Due mainly to the considerable expansion of Ecuadorean banana exports, Central American exports remained stagnant in the last fifteen years at around 800,000 tons annually. The banana companies preferred to expand in Ecuador mainly due to the higher costs of handling large plantations in Central America, "blow-downs" caused by hurricanes and the onset of disease and floods. It also proved possible in Ecuador to obtain production from many smaller producers and without making large scale investments. But with the spread of the Panama disease in Ecuador and their large investments in Central America, the companies are turning again to the area for new supplies. Thus banana exports from Honduras rose sharply to reach 590,000 tons in 1965, from a level of about 350,000 tons in the previous four years, while Costa Rica's exports reached 320,000 tons, compared to 273,000 tons five years earlier. The fruit companies are now actively engaged in expanding production on the Atlantic side; in Costa Rica, this expansion rests mainly on long-term contracts with independent producers. On the basis of present plans, already well advanced, Central America's banana exports may be able to reach 1.4 million tons by 1970, or about 75 percent increase above 1964, with prices at a slightly lower level than at present. In Costa Rica, the increase would require expansion of port facilities on the Atlantic (already being considered) and increased credit facilities for the independent farmers.

Credit would be also required in Honduras for increasing the production of independent farmers. Further expansion of banana exports in volume and earnings after 1970 is likely to be somewhat slower, say about 5 percent annually.

36. Overall, for the major export crops, the prospects are that export earnings are likely to increase from 1965 to 1970 at a rate of about 1.4 percent annually. Thereafter, they should be somewhat better, increasing at a rate of slightly over 4 percent annually from 1970 to 1975, when they would total about $665 million. Nevertheless, such growth is far from satisfactory. Hence there is and will continue to be a very pressing need for diversifying and developing new export products, as suggested below, and to actually implement the projects of banana expansion.

C. Minor Export Products - Developments and Prospects

37. Among the lesser export products to the outside world, the largest gains over the last five years have been in beef, sugar and the "other" category embracing a large variety of products. Taken all together, these minor exports have increased by 26 percent from 1961 to 1965 when they reached a total of $116 million. Progress in diversifying exports has thus been made, but they will have to be strongly pushed in the face of the prospects of coffee and cotton, which in 1965 still accounted for 68 percent of total exports of the region to the outside world. The greatest potential for further expansion based on agriculture lies in beef production and forest products.

38. For beef production, so far concentrated on the Pacific side, Central America has large land areas on the Atlantic side well suited for pasture, is free of foot and mouth disease and is close to the large market in the Eastern United States. Honduras and Costa Rica, where some sizeable operations toward the Atlantic are already taking place, appear to have large possibilities; potentialities probably exist in Nicaragua. Future development will require expansions of the road network, some of which is already taking place or being programmed. Construction or expansion of Atlantic ports in Costa Rica and Honduras are planned and a possible Atlantic port in Nicaragua, now the subject of preliminary study, would also assist in expansion of livestock output. However, a basic pre-condition is to build up the herds. In recent years these have been badly depleted by slaughter for the attractive export market, despite efforts of governments to regulate slaughtering and the volume of exports.

39. Aware of the need to build up the herds, the banking systems have provided increasing amounts of credit for livestock development. Thus in Guatemala, El Salvador and Honduras, total outstanding credit for livestock rose from $14.5 to $24.4 between 1960/61 and 1965. About two-thirds of this credit was taken up by the larger producers. Substantial additional programs for livestock credit are in an advanced stage of preparation by the public authorities in several countries - mainly Costa Rica and El Salvador. Technical assistance in project preparation by international financial agencies is being provided in all five countries. Costa Rica probably will not need to import breeding stock, as

will the other countries, which may find that the scarcity and expense of such supplies from abroad may limit their rate of expansion. The possibility of exports to the U.S. market will depend on keeping Central America free of the foot and mouth disease. Measures being applied by the Central American authorities for this are in need of reinforcement. If the foreign credits envisaged become actually available and are adequately supervised and used to increase the herds, their growth may increase from the present 1.5 percent annually to 3 percent annually. On this basis, the value of livestock exports, to the outside world, could, despite slightly lower prices, more than double from 1965 to 1975, reaching a value of about $40 million (and a volume of 185 million pounds). About 60 percent, or some 115 million pounds, of 1975 meat exports would probably go to the United States. Since January 1, 1965, U.S. legislation permits the President to impose import quotas; total imports in any year may be limited to 110 percent of an adjusted basic quantity. U.S. imports have been well below this permissive level. In the future, if it were strictly applied, legislation might operate to limit meat imports by the U.S., including those from Central America. 1/ Such a development is unlikely considering consumer pressures in the U.S. for restraint on beef prices and the permissive character of the legislation.

Forest Products

40. Approximately one-half of the land of Central American countries is forested and is thinly populated, although El Salvador has little forest area. The majority, or a large proportion of forest land is publicly-owned (except in El Salvador). Most of the forest resources consist of a wide variety of hard-wood species in evergreen rain forests on the Atlantic plains, containing well-known valuable tree species. Not more than one-third of these valuable hard-wood species are utilized by local industry and the number of species exported is even more limited. Much of the broadleaved forest has lost its best timber or has become degraded. But there still remain vast untapped tracts of forest which constitute one of the largest remaining reserves of tropical hard-woods relatively near North America, where demand for these woods has been expanding vigorously (as it has in other major importing areas). Some of these broadleaved forests, including several in Costa Rica, Honduras and Nicaragua, would seem to permit industrial utilization with comparatively little infra-structural investment. In other areas, such as the Peten in Guatemala and the Olancho district of Honduras, utilization would require substantial improvements in transport.

41. Forests of coniferous species are most extensive in Honduras; there are also large areas in Guatemala and Nicaragua and a small area in El Salvador, while Costa Rica has practically none. These areas cover an estimated 4.4 million ha. containing 166 million m3 of timber, much of it in mountain country, making transport difficult. The conifers are

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1/ In 1965, actual U.S. imports were 737 million pounds as compared with the quota which might have been imposed of 931 million pounds. Central American exports to the U.S. in 1964 were 62 million pounds.

a potential source of supply of long-fiber pulpwood for manufacture of papers of high strength, as well as sawn wood, and are exploited much more intensively than the hard-wood forests. In the more accessible localities, coniferous forests have been depleted and in other areas they contain a large proportion of overmature trees capable of yielding sawlogs but also susceptible to damage from insects and disease and thus liable to become a focus of infection. Rational management in pine forests containing overmature timber will be an increasing necessity for conservation of coniferous resources in the entire region.

42. The wood-using industry in Central America includes sawmilling, board products and manufacture of paper and paperboard (see Volume V, Forestry and Wood-Using Industries and the following chapter). There is widespread local production of sawnwood by small sawmills scattered through the area, mostly for domestic use. Total exports of forest products from Central America to outside markets have been rather stagnant in the last few years, due basically to the loss of the Cuban market and the inability to replace it by new markets in other countries without reducing prices. However, Honduras, the largest producer has begun to export high-quality pine wood to new European markets. On the basis of new projects being prepared, the mission estimates exports of wood products and timber to the outside world at about $21 million by 1970 and $28 million by 1975. Production of pulp and paper products is also likely to become important: trade in these products would be mainly within the common market within the visible future. Thus Honduras could export some $8 million of these products within the Common Market by 1975 if the Olancho project moves forward fairly soon.

43. The growth of sugar exports will be limited by the high cost of production and the internal prices higher than world prices, as well as rapidly increasing local consumption. Production almost doubled from 1960 to 1965 when it reached 500,000 tons, as a result of high world market prices in 1963 and the obtaining of a share in the former Cuban quota in the U. S. market. But even if world prices rose to 4 cents per pound, Central American sugar could not compete in the world market except in the protected U. S. market under legislation in force until 1971. The combined quota for the five countries varies from 143,000 to 187,000 short tons, depending on the U. S. requirements from abroad. Thus sugar exports, are unlikely to contribute significantly to the expansion of Central American exports in the visible future.

44. The production and export of cigar tobacco has made a good start in Honduras and the National Bank of Nicaragua is beginning a credit program for that crop. While U. S. demand for cigar tobacco is rather stagnant, Central America is well placed to gain a larger share of that market. Since cigar tobacco production is a delicate activity requiring careful cultivation, and its high unit value yields a high gross return per hectare, it is particularly suited for small farms, where the production of cheap crops is not sufficient to support a family. The same is true of several fruits and vegetables, such as tomatoes and others, except citrus. These crops also are very labor-intensive and offer possibilities of increasing both employment and incomes in agriculture, in contrast to

livestock, in which the labor intensity is low compared to the fixed investment required for efficient production. The largest potential for a significant contribution to agricultural exports and income among these crops exist in citrus and pineapple, for which the U. S. market is very large and growing and whose present suppliers are experiencing substantial increases in production costs; important market possibilities exist in several European countries and Canada. However, large scale and efficient production of citrus and pineapple require larger farms than is the case for tobacco and other fruits and vegetables.

45. The development of these newer types of crops on a scale sufficient to make a significant contribution to agricultural income and foreign exchange earnings calls for special and sometimes difficult efforts. Such efforts, however, are already starting. El Salvador, with its scarcity of arable land, is already well advanced in the preparation of two irrigation projects intended to increase intensively cultivated land by 15,000 hectares in the next eight years, a significant amount for that country. A credit program for agricultural diversification is also being prepared by El Salvador for external financing. The Costa Rican banking system has plans ready for a $10 million three-year program to expand beef, bananas and cotton production. In addition, a $2.5 million loan was obtained recently from a private U. S. bank to expand banana production. Guatemala has obtained a loan of $3.3 million from IDB to continue long-term lending to farmers, mostly for livestock. Similar programs are being financed also by the Inter-American Bank in Honduras and Nicaragua.

46. All these efforts in lending for the development of export products, especially livestock, mostly directed to medium and large farmers capable of making effective use of the funds and requiring less technical assistance than the small producer, are needed to improve the production and export prospects of all the countries in the next few years. For certain high value crops, such as tomatoes, pineapples, citrus and others, good quality and uniformity of the produce and steady supply is essential for entering the export markets. Efforts are being made, and will need to be pursued vigorously to interest distributors in the external markets in the development of these exports, including joint investment ventures, since their knowledge of techniques and of marketing arrangements would provide greater and quicker assurance of success.

D. Grains and Other Foods for Domestic Consumption

47. It should be feasible to increase production of food for domestic production. Suitable land is available and there are substantial possibilities of increasing yields and improving marketing arrangements. Only in El Salvador are land areas for expansion limited. To gain access to new lands it will be necessary to give feeder roads a larger place than in the past in the transportation investment programs of the countries. These roads would facilitate the marketing of products in the urban centers and reaching the farmers with credit and technical assistance. However, planning for such roads will need to be based on more adequate soil studies than has often been the case hitherto.

48. Supervised credit programs to develop production and yields of small farmers have been initiated in almost all the countries; these vary greatly in scope and effectiveness. The well-established credit program of Costa Rica, embracing over half the number of farms, is an important factor in improving their agricultural performance. In El Salvador, the Government Rural Welfare Agency (ABC) started in 1963, has reached only about 2 percent of the farm units, while in Honduras the supervised credit to small farmers is scarcely evident. While the investment programs of the Government for the next three years envisage the expansion of these programs, they will have to be accompanied by substantial increases in field staff to be effective, particularly in Guatemala, El Salvador and Honduras.

Storage and Marketing

49. With the exception of Costa Rica, present grain marketing arrangements are marked by lack of financing and of storage capacity. Thus, generally the peasant sells at low prices at harvest time, usually through an intermediary. Seasonal variations in the prices received by the farmer are wide and often prices outside the harvest season are about 50 percent higher than during the harvest season. Existing storage capacity is usually concentrated at one or two cities in each country; in some cases these operate well below capacity due to the lack of working capital to acquire grain. Local or regional storage capacity is generally lacking. To remedy these shortcomings, the national grain boards in the several countries have developed under the aegis of SIECA, a regional program which would double storage capacity in the next five years or so, provided construction is carried forward without delay. These should permit a level of purchases by the grain boards consistent with the maintenance of reasonably stable prices to the producer. The cost of the additional capacity is estimated at about CA pesos 7 million; most of it would be in Guatemala, Honduras and Nicaragua. As yet, however, none of the countries, except Nicaragua, has so far arranged the necessary funds to begin construction. Moreover, the programs ought to include more storage facilities at the local level as well as provision of adequate working capital for the grain boards.

The Grains Agreement

50. Thus far, there has been relatively little trade among the countries in agricultural products since they are substantially similar in agricultural structure. However, some livestock has moved from Honduras to El Salvador and Guatemala, and, in recent years, during the cotton boom in El Salvador, corn and beans were imported in substantial quantity from Honduras. Shortfalls in supply in other countries were met by imports from the outside through the state grain boards. 1/ In the future, the pattern of production of basic grains in the region may well be influenced

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1/ At present world prices, the common external tariff amounts to about 140 percent for corn and about 200 percent for milled rice. In fact, imports from the outside are almost exclusively by the state grain boards, which are exempt from the payment of duties.

by the Special Treaty on Grains, which came into effect as of mid-1966. This agreement wiped out the remaining tariff and quantitative barriers on trade in grains between the countries, except on corn traded between El Salvador and Nicaragua and on wheat and flour among all the five countries. Local flour mills, importing wheat grain from abroad, have been successful thus far in maintaining protected national markets. The key provision of the Grains Agreement is that each grain board must give first priority, in meeting shortfalls in supply, to imports from other Central American countries. Imports from outside the region may only be made after consultation with the other countries, and, if made, must pay a duty equal to the difference between the import price and the official internal support price which is fixed by coordinated action among the national grain boards. Thus, the Grains Agreement aims to provide an incentive for the Central American area as a whole to continue being self-sufficient in grains. A coordinating commission with limited powers has been established to enforce the Protocol. If in fact first priority is given to grain imports from within the area, the grains agreement could lead to increased competition among Honduras, Guatemala and Nicaragua in providing exports of corn to El Salvador; it could also result in competition among Nicaragua, El Salvador and Guatemala in exports of rice to the other two countries. At this stage it is difficult to judge, especially for corn, what changes in increases in specialization of production or changes in pattern of trade might take place under the new agreement.

E. Colonization and Settlement

51. As indicated at the beginning of this chapter, the wide existence of minifundia and population pressures in certain areas, have been building up pressures for resettlement of small farmers. The colonization and settlement programs now underway in Central America vary in extent and orientation but generally are small in scope and not very effective. The Agrarian Settlement Institute (ICR) in El Salvador, to be more effective, requires a better coordination with the credit agencies and additional feeder roads. Despite the limited availability of land, the Institute has been able to acquire 100,000 hectares for resettlement in the last two decades (about 7 percent of the total area in farms in the country). It has stepped up its activities in recent years, and since 1963 has distributed about 3,000 parcels of land on long-term sale contracts. Guatemala's land reform agency (INTA), operating since the early fifties, has in recent years settled only several hundred families on the Pacific Coast. Its plans for a large settlement near the south of the undeveloped Peten forest region on the Atlantic side, a difficult venture at best, have not materialized. Costa Rica's Land and Colonization Institute, established in 1962, has settled only about 1600 families thus far. It has decided to concentrate its efforts outside of the densely-populated Central Plateau, and about 600 families have been settled as part of a project for the production of bananas for export under long-term contracts. In Honduras and Nicaragua, the colonization institutions have had similar experience. While all these efforts are costly and difficult to administer, they are bound to continue and must be regarded as part of the general sweep of social and economic change.

52. For the future, given the need to develop agricultural exports, the quickest and most economical results of new investment resources will be obtained by concentrating them on medium and large producers. But major efforts in this direction - bananas, cattle, forest products - will require exploitation of newer regions toward the Atlantic, though some Pacific areas still remain to be developed. Under these circumstances, public agricultural policy should be oriented toward linking such development with colonization and land settlement schemes designed to induce rural migration to new areas from the present congested zones of the Costa Rican Central Plateau, Western Honduras and the Guatemalan Highlands. Projects for agricultural expansion and diversification through medium-size and large producers, might well be supplemented by programs for nearby smaller farmers who, while not necessarily an integral part of larger projects themselves, could benefit from their proximity by absorbing improved agricultural practices as well as supervised credit.

53. The prospects of improving the level of skills and technology of the small farmer depend in part on improvement of the educational system. The present educational system and programs are grossly inadequate for this purpose in all the countries. The percentage of rural children in school will have to be substantially raised in all the countries (the proportion of rural children aged 7 and 12 actually in school is at best about 40 percent in Guatemala, 50 percent in El Salvador and about 85 percent in Costa Rica); and a large proportion of rural schools - except in Costa Rica - provide only the first and second grades of primary education (see Volume VII, Education). The national programs for investment in education are in general likely to result in a substantial proportional increase in rural enrollment. However, there also is urgent need to begin to adapt the content of education in rural primary schools to the needs of pupils most of whom are likely to remain in farming and receive only primary school training.

F. Conclusions

54. In summary, the prospects for agricultural growth in the next five years are less favorable than in recent years in two of the commercial export crops - cotton and coffee - which have been the main factors of growth in the recent past; although over the years thereafter they should improve appreciably. In substantial measure these changes in prospects reflect circumstances of the external markets. Policies and measures to minimize the effects of adverse outward changes will need to be adopted and implemented. Further expansion of coffee production should be arrested to avoid the creation of unmanageable surpluses. Concerted action by governments in the region to tax the coffee sector more heavily is needed as a discentive to production beyond the foreseeable export markets; it would also be a means of obtaining additional government revenues needed especially in Guatemala, El Salvador and Costa Rica for their public investment programs. At the same time the studies in Guatemala, Nicaragua and El Salvador to diversify agricultural production in coffee areas into other alternative crops, need to be pushed forward. In the case of cotton, the basic need is to overcome the production difficulties which have affected the sector in the last few years through a

more careful and economic use of fertilizers and insecticides and better storage and transportation facilities to further reduce costs. The pooling and inter-change of experiences in improving production techniques to lower costs and improve quality could be undertaken jointly by the producers' associations, which have enough resources for undertaking the necessary studies of production problems.

55. The development or expansion of new lines of agricultural production for export - livestock, bananas, fruits and vegetables, forest products - for which the region enjoys certain advantages and markets are favorable, need to be pushed vigorously and urgently. Some of these lines, like livestock will take several years to develop for their potential to be realized, but this should be only an additional reason for accelerating the implementation of the several projects already prepared by public authorities and to prepare new ones. Central America, on the basis of estimates of public projects being prepared or to be prepared for foreign financing, appears to need external loan commitments for agriculture of close to $100 million over the period 1967-70, to help finance projects costing almost $180 million (not including feeder roads). More than half of these commitments would represent agricultural credit programs mainly for commercial and export crops and storage, the effect of which could be felt well within the next five years provided that their preparation and negotiations for foreign financing proceed without delay. These are needed particularly to attenuate the slackening effects of the pace of growth of some of the major export crops.

III. INDUSTRY

A. Recent Trends and Factors in Growth

56. Manufacturing has been the fastest growing sector of the Central American economies from 1962 through 1965, during which value added in manufacturing for the region as a whole expanded by an average annual rate of 11 percent in real terms. While the rapid growth of manufacturing in Central America is not a new phenomenon - during the fifties it averaged 6 percent annually - the considerable acceleration of this expansion in recent years is a new feature. Among the main factors which have made possible this acceleration has been the growth of the market; this took place through rapid increase in internal purchasing power as a result of the export boom which began in 1962, and through the liberalization of trade between the five countries beginning in 1961. Moreover, there was a substantial increase in the availability of finance for industry, particularly from foreign official loans and foreign direct investment. Even with this rapid expansion, however, the manufacturing sector is still a relatively small contributor to the output of the five countries, and in 1965 accounted for 15 percent of the GDP of the region.

57. As in many less developed countries, the so-called "traditional" consumer goods industries - primarily food processing, beverages and tobacco, textiles, shoes and clothing - predominate, accounting for about 75 percent of industrial output. Domestic demand for these products rose with the sharp rise in disposable incomes after 1962; as a result, output of these lines expanded substantially, though slightly less than the level of total manufacturing. New branches of industry were established in most of the countries in the late fifties and early sixties, and were responsible for a slight change in the composition of total industrial output; these included petroleum refining in particular but also chemicals and metal products.

58. During this first stage of expansion, a considerable portion of production evidently came from increased utilization of previously underutilized capacity. However, there was a considerable increase in investment for the modernization of the traditional industries and for the establishment of the new branches of industry which are generally more capital intensive than the traditional lines. Overall, the growth in employment in manufacturing has been considerably less than in output. While employment data are not altogether satisfactory, available data indicate that during 1950-1964, in four countries (excluding Guatemala), employment grew at an annual rate of growth of 2.6 percent while output grew by as much as 7 percent.

59. The highest rates of growth in manufacturing have been reached in Guatemala and El Salvador, which have the largest and longest-established industrial sectors, and account for two-thirds of the industrial output of the region. The expansion of manufacturing in the other countries has started from a lower base and with smaller internal markets; but even in

Honduras and Nicaragua, the rate of growth of manufacturing also speeded up in 1963 and 1964, reaching about 12 percent annually in both countries in these years.

	Annual Percentage increase in value added to manufactures 1963-1965	Percentage share manufacturing in GDP	Total value added by manufacture (in million CA pesos)
		1965	
Guatemala	14	15	219
El Salvador	12	17	136
Honduras	7	14	68
Nicaragua	9	13	69
Costa Rica	10	15	80
Total Region	11	15	572

60. Of the increment to manufacturing activity in the years 1963 through 1965, three-quarters was due to the rise in local or national demand and 20 percent to the expansion of intraregional trade in industrial products. For some countries, however, the growth of trade in these items with their Common Market partners was of greater significance: for El Salvador and Costa Rica, the increase in these exports accounted for 30 and 35 percent respectively of the increment to industrial output. Exports of manufactures to the outside world have been relatively small, accounting for the balance (5 percent) of manufacturing expansion in 1962-1965, by far the largest portion being processed foods (meat and sugar).

Growth in intraregional trade: characteristics and structure

61. Industry was the main beneficiary of the growth of trade following the rapid elimination of custom barriers between the countries which began in 1961. Some 85 percent of the increase in intraregional trade from CA$50 million in 1962 to CA$136 million in 1965 was in manufactured goods. In 1965, trade in manufactures (including processed foods) amounted to CA$105 million.

62. As indicated in the tabulation below, covering about 90 percent of the increment in intraregional trade in manufactured products from 1962 to 1965, less than half came from the traditional products (largely processed foods, textiles, shoes and clothing). These industries have been primarily dependent upon national markets and the recent increases in their exports to the Common Market trade have represented only a small portion of the increment to industrial production. Of the increase in trade in non-traditional products, somewhat over one-fifth was accounted for by fertilizers and petroleum products due to certain factors (mentioned below) which may not be of a permanent nature. The other non-traditional products consisted principally of a variety of chemicals and metal products, produced by industries largely new to the region and intraregional trade

has taken an important share of the recent growth in their output. All these newer non-traditional industries depend to a great extent on imported raw materials and intermediate goods. As indicated in Chapter V, imports of these categories of goods from outside areas have been increasing rapidly and their share of total imports from outside the area has risen substantially.

	Absolute value of increase in intra-trade 1962-1965 (million CA pesos)	Share of total increase in intra-trade (percentages)
Manufactured foods 1/	8.8	11.6
Textiles	11.4	15.1
Clothing and shoes	10.8	14.3
Wood products and furniture	4.3	5.6
Fertilizers	4.0	5.3
Petroleum products	3.2	4.2
Toiletries, cosmetics and related products	5.5	7.3
Other chemicals	6.4	8.5
Basic metals and fabricated products	4.3	5.6
Machinery and transport equipment	3.9	5.2
Total	62.6	

1/ Including inedible fats and oils.

The role of the common tariff

63. Aside from the removal of trade barriers within the Common Market, a main instrument of integration has been the common tariff; this has important implications for industrial development. At present, the common external tariff and elimination of restrictions on intraregional trade (or the phased achievement of both) cover products accounting for more than 80 percent of total imports and almost 95 percent on intra-regional trade. In general, the common tariff, while differing in many individual instances from the national tariffs previously in effect, is essentially similar to them in overall structure. Broadly, it gives heavy protection to consumer goods and their components, has low rates on raw materials not found in the region, and gives little or no protection on capital goods. However, on most items, in particular consumer goods and their inputs which are important in regional trade, the common tariff is higher than preceding national tariffs (see Volume IV, Industry). Appendix A contains an analysis of the differences between the previous national tariffs and the current common tariffs for a sample of 83 products

which accounted for a substantial share of total external imports in 1964 as well as of the growth in intra-trade, particularly in regards to consumer goods. For the sample, the median of the list of rates applicable under previous national systems was 44 percent while under the common system it is 64 percent. The shift to higher duties is shown in other measures; for example, under the national tariffs, ad valorem rates of 70 percent or more were in effect for only 18 percent of the items in the sample but under the Common System, such rates applied to 41 percent of the products.

64. No reliable data are available to show whether the higher tariffs which have been gradually put into effect since 1961 have led to higher prices to the purchasers. The available consumer price indices (Table 17) are probably correct in suggesting that the cost of living for the bulk of the low-income population in the capital cities has risen only slowly in recent years (by 1-2 percent annually). Certain major producer goods, such as cement, construction materials, certain metal structures, have fallen in price in some countries with the establishment of local plants and the consequent elimination of costly ocean freight. On the whole, it is probably true to say that while some local price increases have resulted from the boom in manufacturing generally the price levels have not been increased. The factors responsible for this situation are to be found in the basic conditions underlying both production and trade for the products which until now have accounted for the expansion in intraregional trade.

65. The expansion in regional trade at the expense of imports from third areas is most readily seen in the case of a number of important inputs for traditional or consumer goods industries. For example, within the textile group - which has accounted for 15 percent of the increase in intra-regional trade in manufactured products - most of the trade expansion has taken place among cotton products in which there has been a substantial growth in both regional output and demand. For cotton cloth, the common tariff represented a substantial increase in comparison with most of the previous national tariffs - more than doubling on the medium and lighter fabrics, and about 70 percent higher on heavier cloths. Cotton cloth imports from outside the region fell in both relative and absolute terms (from CA$19.5 million in 1962 to CA$18.6 million in 1965) while intra-regional trade expanded considerably (from CA$1.1 million to CA$5.8 million) But the increase in competition which has developed in this industry as existing plants throughout the region have been seeking to take advantage of the new regional market and to expand output to meet the increasing local demand - by increased utilization of capacity, modernization of production methods and often specialization by product lines - has operated to limit price increases thus far.

66. The development of specialization as a result of the widening of the market (the trade expansion effect) is clearly seen in the case of shoes, clothing and processed foods. Previously production of such items was scattered throughout the region but plant output was limited by the smallness of the national markets. Where there was no production of such products in a country, the items had to be imported. With high tariffs under the national systems, the relatively high cost of such goods kept imports, as well as consumption, at low levels. The removal of tariffs

on these items within the region, coming at a time of rising personal incomes, gave consumers easier access to a wider range of consumption goods produced within the region. Consequently intraregional trade in these products rose very sharply (proportionately more than their total production or consumption). As indicated in the tabulation below, the increase in intraregional trade in these items accounted for practically all of the increase in their total imports and, in some cases, there was a decline in the region's imports from external sources.

	Percent increase in value of total imports 1962 to 1965	Imports from CACM 1/ as share of total imports 1962	Share of increase in intraregional trade in total increase 1962-1965
Clothing	74.7	24.4	95.2
Shoes	234.3	62.0	106.6
Processed fruits and vegetables	117.4	31.6	67.4
Candy and sugar preparations	125.4	70.7	112.0
Wood products	183.5	65.4	110.7
Furniture and accessories	126.5	21.7	95.9

1/ Central American Common Market

Expansion in New Industries

67. The growth of intraregional trade in non-traditional products is also due in some cases to factors other than trade liberalization, even though in most cases it has been linked to the liberalization process (as reflected in the high proportion of output of these items that enter regional trade). A specific instance is refined petroleum products, which is one of the few items not yet duty free in regional trade. The recent interchange in these products, practically all concentrated in exports from El Salvador to Guatemala, is due mainly to the delay in 1964 and 1965 in the coming on-stream of the second refinery in Guatemala (at Escuintla) so that it was convenient to import petroleum products from the refinery in El Salvador (at Acajutla) which had begun operations in late 1963. It is unlikely that this trade will expand and in fact the 1965 level was well below that of 1964.

68. Similarly, practically all the intraregional trade in fertilizers originates from a plant in Costa Rica producing various fertilizer mixes, based on imported ammonia and phosphate rock. This plant has been having difficulties in selling to the region, both in meeting prices of fertilizers imported from other areas (the common tariff is very low - effectively 5 percent *ad valorem* on the basis of 1964 import values) and in adjusting the composition of its product mix to satisfy local requirements; the level of trade has fallen markedly since 1964 and, as matters stand, does not appear likely to expand in the immediate future.

69. The bulk of the expansion in intra-trade in the non-traditional category has occurred in chemicals, pharmaceuticals and cosmetics, basic metals and metal fabricated products and items such as paper and rubber manufactures. Their production is based on imported inputs; local inputs and/or value added are generally quite low. In some instances, the economies of transport and handling justify the establishment of local production facilities (which often is nothing more than assembly). However, for the pharmaceuticals and cosmetics in particular as well as for some of the other products, the growth of both production and trade is linked to the existence of industrial development incentive laws in each country; as currently administered they have been excessively liberal in permitting tariff-free imports of inputs required for manufacturing the final product. The latter are generally subject to relatively high tariffs; even in those cases where duties may be superficially moderate in level, in relation to value added they are often extremely high.

Fiscal Incentives for Industrial Development

70. Comprehensive laws to promote investment in industry were adopted in all five countries, toward the end of the 1950's (Honduras and Nicaragua in 1958, Costa Rica and Guatemala in 1959, and El Salvador in 1952 but widened substantially in 1961). In most instances the broad sweep of the legislation represented a new approach by the governments to industrial promotion, establishing for the first time elaborate systems of incentives and the criteria for their application, which have a number of common characteristics among the countries.

71. Fiscal incentives in the form of exemption from income taxes and from tariffs on imported capital equipment and inputs are granted to individual enterprises in accordance with certain classifications which are established under specified but fairly broad criteria. In two countries, Guatemala and Costa Rica, the only criteria are whether the product to be produced is new or whether it is already established in the sense that it is already being produced domestically in excess of a certain proportion of existing national demand. In addition to this general distinction between "new" and "established", in the three remaining countries economic characteristics of the product are considered in determining the benefits to be granted. Thus different benefits are accorded to "necessary" industries in El Salvador as distinguished from "convenient"; and in Nicaragua and Honduras benefits depend on whether industries are classed as "fundamental" (or basic), "necessary" or "convenient". The criteria for classification in these cases are extremely vague or cover many elements and, in practice, the classification accorded depends almost completely on administrative discretion. While the range and type of exemptions vary among the countries, it is fairly usual for "new" or "fundamental" industries to receive complete exemptions on customs duties on imported machinery, equipment, construction and raw materials and fuels for 10 years; complete exemption on sales taxes for 5 years (and sometimes an additional five years for one-half of sales taxes); complete exemption on income tax for 5 years and exemption on one-half for another 5 years; plus complete exemption for five years on taxes on capital plus partial exemptions for another 5 years. Exemptions on other economic categories are usually considerably less, but still generous.

72. In recent years, an increasing number of enterprises have been classified under these laws in all of the countries and received corresponding benefits 1/. Recourse to fiscal exemptions has been stimulated in part by the fact that in 4 countries (i.e. excluding El Salvador) business income taxes are levied on the same basis as personal income taxes, with a progressive rate; this is a disincentive to the establishment of larger scale enterprises which has encouraged wide use of the provisions of the incentive laws.

73. The number of business enterprises which are accorded benefits considerably exceeds those which have actually gone into production and used their benefits. Aside from delays in putting a business into operation, evidently some promoters of projects succeed in obtaining classification before their proposals are fully formulated as a means of pre-empting the product field. In addition, for certain products for which plant location is not critical, entrepreneurs have apparently applied for benefits in more than one country in order to determine which will grant the most favorable conditions. The possibility of competition among the countries for industrial plants is, in fact, explicitly recognized in two of the national incentive laws (Guatemala and Honduras as recently revised). In both instances, national enterprises may receive benefits additional to those for which they qualify under the relevant legislation, if they can show that similar enterprises in other countries receive better treatment.

74. As a result of this competition, there has been a proliferation of small or medium size mixing or assembly plants producing mainly consumer goods, based on tariff-free imports of the intermediate inputs with high tariff protection afforded to the final product. Among the pharmaceuticals and cosmetics, the competition in the market has developed intensively particularly as regards foreign brands, and prices to consumers have been relatively favorable thus far. But growth of production has required higher imports of materials or other inputs to produce finished items on which high tariffs had been imposed to curtail imports from abroad and/or to produce government revenues.

75. On the other hand, the competition among countries to secure for themselves the location of important plants of this type, with resulting uncertainty as to the possibility that future competitors might obtain more favorable conditions from another country in a different site may have hindered investment in larger scale enterprises producing either intermediate or final goods in the chemical and metal fabricating industries. Although a main motive for economic integration was to create larger markets and encourage the establishments of the larger enterprises, only a few such plants have come into operation or even under construction since integration began. Even these have generally had direct links with buyers of the products to ensure disposition of output.

1/ In one country, 369 enterprises were granted fiscal benefits from 1960 to 1965; the annual number rose steadily from 8 in 1960 to 108 in 1964 and 97 in 1965.

76. Perhaps the single most important instance in which competition for plant location by giving fiscal privileges has given rise to uneconomic investment is petroleum refining. Five relatively small plants designed to satisfy local or national needs have been constructed in four countries (two in Guatemala, one each in El Salvador, Nicaragua and Costa Rica) and a sixth is in the planning stage in Honduras; all of these must import the crude oil required. In terms of total demand within the region, one large scale installation would probably be more efficient both in achieving lower costs of production as well as providing adequate supplies of by-products, as a basis for other production processes, although consideration of transport costs to the main consuming centers might justify the establishment of two smaller installations. While the desire of each of the five governments to have national refineries has played a fundamental role, the foreign oil companies undertook the investment with a view to ensure their continued presence and operations in the area.

77. The fiscal impact of duty exemptions under the existing national industrial promotion laws has been considerable. The percentage of exempted to assessed duties has risen sharply in all countries from 1962 to 1965; in the latter year it ranged from 11 percent in Honduras to 16 percent in Guatemala, and from 23 to 24 percent in Nicaragua, Costa Rica and El Salvador; the total of such exemptions was some CA$33 million in 1965 (Table 13). To offset such losses of current revenues, Costa Rica began in mid-1964 to impose sales taxes on many of the final products encouraged by the incentive laws (i.e. automobiles, television sets, radios, detergents, cosmetics); these taxes are also intended to have a dampening effect on imports although in general they have only partly made up for the tax revenue lost through the exemptions. The impact of exemptions granted on income and other direct taxes is not known, and hence the cost of exemptions is not readily calculable, although with the existing income taxes applicable to businesses, which pay the same rates as persons in most countries, the revenue impact is likely to have been substantial.

B. Prospects for growth

78. As indicated previously, the growth of major exports to the outside world is likely to slacken considerably in the next five years - though quickening in the quinquennium thereafter - with the overall prospects that growth of GDP in the region is likely to be considerably lower than in recent years, probably about 2.5 percent annually. Given these prospects, it is most likely that the rate of growth in demand for manufactured goods will rise at much lower rates than in the recent past. The mission's projections for intraregional trade reflect this outlook, even though account is taken of the probable effect of new industries where this can be estimated. Intraregional trade increased by an annual average of 60 percent from 1960 to 1965 but the rate of increase slackened to 29 percent in 1965. For 1965-1970, the projected increase in intraregional trade is of the order of 6 percent per annum and the growth in the following five years to 1975 about 9 percent per annum. The proportion of intraregional exports to the total value of overall exports of the region would probably rise from some 18 percent in 1965 to about 22 percent in 1975. Probably a

major portion of the increase in intraregional trade - some 80 to 90 percent - will be in manufactures. These projections of intraregional trade are subject to especially wide margins of error, given the relatively short period of experience with industrial production and trade movements in the Common Market. Particularly it is difficult to judge how far the process of import substitution, opened up by the larger market created by integration, may go further. There are evidently important possibilities of furthering the process. All the countries have possibilities for further industrial growth and this margin has been increased by the creation of the Common Market. Nevertheless, the five countries combined still represent a relatively small population with a relatively low purchasing power, given the low per capita incomes for the region. Hence, while the possibilities of industrial growth on the basis of regional demand are still significant and need to be exploited, they are not sufficiently large at this stage to achieve a rate of industrial growth which most countries would desire. Thus further progress in industrialization will be intimately linked, first, to general developmental policies aimed at raising incomes in all sectors, and, second, to the development of export-oriented industries. The strategy should therefore be two-pronged: (a) to pursue policies and measures to encourage the growth of industries serving the regional market, to meet growing consumption and a changing structure of demand within the regional economy, and (b) to promote export-oriented industries, involving maximum elaboration of those natural resources which the region contains in some abundance. These elements are not mutually exclusive; in fact, they are complementary in large measure since the expansion of exports will require a healthy development of regional industries which can compete in world markets.

Possibilities for industrial growth

79. Imports from outside the area still remain heavily concentrated in finished manufactures - both producers and consumers goods. Even with a slower rate of growth than previously, import substitution possibilities will emerge. Given the wide range and substantial number of industries covered by existing feasibility and pre-feasibility studies often made by foreign consultants, 1/the mission was not able to examine in detail specific products or projects. Nevertheless a review of some of them and discussions with both public and private sector officials concerned with industrial growth provide a basis for identification of broad categories of goods having growth possibilities.

80. Among consumer goods, there is room for expansion of textiles, particularly the newer synthetics and mixed fabrics; demand for these has proven to be highly income elastic in the range of incomes prevailing in the urban centers. Similarly, there is potential for expansion of processed foodstuffs to supply the growing urban population, especially canned fruits and vegetables, 2/meat and dairy products.

1/ The quality and depth of these studies varies widely. However, even a brief review reveals a general need to greatly strengthen the cost analyses made of possible new lines or products, as well as technical problems to be dealt with. Many studies, in fact, have all but ignored the cost aspect, providing no more than demand or market projections.

2/ Export possibilities for these items also appear promising and are discussed below.

81. Among producers goods, personal income growth as well as expansion of public construction over coming years provides a basis for increased output of a wide range of construction materials, such as cement and concrete blocks, ceramics and structural steel. With greater research and promotion, there may be substantial scope for low-cost housing based on properly treated wood products. 1/

82. Some possibilities also exist for expansion of production of fertilizers, insecticides and fungicides; these agricultural inputs bulk large in imports of the region. The basic compounds for their production are subject to very substantial economies of scale in output; hence under current demand conditions, local plants would tend to be high cost producers. There remain, however, possibilities for establishing local mixing plants and some simple transformation processes. A similar situation prevails for plastics and synthetics. The former have had growing use both for industrial and household uses, based on imports of intermediates such as powdered poly-vinyl-chloride, polyethelene and polysterene. Project proposals for establishing plants to produce the basic compounds for these items are now being prepared but pose the same scale problem as the other chemicals.

83. A number of project proposals have been prepared for the establishment of various assembly industries covering both consumer (e.g. passenger cars radio and television sets) goods and some producers goods (e.g. trucks). A protocol is now under consideration which would specify the procedure and criteria to be used to permit the extension of the common tariff to these products and to free intra-regional commerce in them. In view of past experience in Central America as well as in other areas, such plants should be carefully screened before fiscal incentive privileges are granted so as to insure that the advantages to be obtained (in terms of employment for example) at least offset the possible losses in government revenues, effects on the volume of imports and the impact on other economic activities if the items are produced at a high cost. Moreover, the effects of these projects in creating rigidities in the import structure will need to be carefully assessed.

84. The existence of forests of suitable conifers and the rapidly growing demand in the region for packaging papers, including cardboard liner and corrugating medium now in almost universal use for manufacture of boxes for the export of bananas, provides a basis for establishment of one or two large pulp and paper projects in the region in the next several years. Several relatively large projects are in various stages of study (see Volume V) and appear promising. Perhaps the best known is the Olancho (Honduras) pulp and paper mill project which has been under study in one form or another for almost 20 years. As presently conceived - though some important aspects are still to be worked out - a plant would be constructed to produce pulp and packaging paper including cardboard liner and corrugated medium. High grade sawnwood would also be produced, primarily for export to Europe. The investment required would be substantial, in the order of

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1/ See discussion in Volume V, Forestry and Wood-Using Industries.

CA$50 million. The Government of Honduras in 1966 commissioned the preparation of detailed feasibility studies and a financial plan. When these are ready, the project would warrant urgent consideration in view of the contribution which such a project could make, not only directly to economic growth in Honduras but indirectly to the entire region (stimulating the establishment of supplier industries, for example). Consideration should be given to other projects in this same field as studies are completed in view of the evidence that demand for packaging materials may be exceeding earlier expectations.

Export-oriented industries

85. At present, there appear to exist excellent opportunities for expanding exports to world market of processed foods and wood products. Expansion of processed foods for export, particularly meat and canned fruits and vegetables, will depend in the first instance on expansion and improvements in raw product supply and quality which will often require programs of official assistance. Production facilities for meat have already been established and are being planned. Eventually there will be need to expand processing plants for fruits and vegetables; these now have underutilized capacity and efforts should be made to utilize this as a basis for initiating export programs in order to ascertain the most advantageous pattern of future expansion. Particular emphasis must be given to developing means of marketing given the inexperience in the region and the economies of scale in distribution. Current exports of wood products to other areas are well below the region's capacity in view of its resources and increasing world market demand. Emphasis should be given in official programs of assistance, both technical or financial, to the creation of production facilities for such items as sawnwood, veneer, plywood, and chip board as well as to the establishment of marketing facilities.

86. The possibilities for exporting more elaborated products with a higher labor component, such as cotton textiles and clothing, appear to be promising, as recent intra-regional competition has been encouraging the establishment of modern and reasonably efficient plants in these branches. In general, the region would in the immediate future have its best opportunities for developing exports products characterized by both high labor inputs (taking advantage of the prevailing reasonably low wage rates) and locally produced low cost raw materials. Some proposals are being considered to create export industries on the basis of imported raw materials or intermediate goods (with tariff exemptions). These should take into account the external competition from areas such as the Far East where wages are considerably below those prevailing in Central America. Wage rates for factory workers are low in absolute terms in Central America, averages for the five countries ranging between CA$0.20 to CA$0.27 per hour, excluding social charges. However productivity also tends to be low. While employers are often content to train their own labor, there is need to raise labor productivity by improving skills and capacities, especially among the foremen and supervisors. Hence the prospects for increasing the efficiency of labor, depending in large part on management, would be improved by betterment of the educational system, including

vocational training, and by raising the level of education, which at present is very low. Thus a key element in the industrial prospects of Central America will be the extent to which the countries succeed in effecting badly needed improvements in the educational system. Efforts in this field warrant a high economic priority (see Volume VII, Education). While the entrepreneurial and managerial class in Central America is in its beginning stages of development, it has shown strong evidences of vitality and growth. Improvements in training and education are also needed to help overcome growing shortages of administrative and managerial personnel.

Industrial Tariff and Incentive Policy Issues

87. With the generally narrow raw material base of the area, the new industries serving the regional market will be increasingly dependent upon imports of the necessary inputs. Moreover, they will tend to be found among products for which economies of scale in production will limit the possibilities of competition within the region. In these circumstances, the development of appropriate tariff and incentive policies to ensure the establishment of economically sound enterprises becomes increasingly important. These will be particularly important for the future in order to avoid the possibilities that policies on these matters might operate to limit competition, with adverse effects on prices and qualities of goods produced.

88. The present common tariffs represents the result of long and complicated negotiations among the five countries. Yet economic conditions change and it can be expected that pressures for various adjustments on tariffs will grow. SIECA has in fact already received a number of requests for tariff adjustments and the Executive Council is to act on these at its forthcoming sessions. If approved, they would require ratification by the several governments. While there may be resistance to reopen negotiations so laboriously completed, it is hardly avoidable that new adjustments should take place; moreover it is desirable if the region is to continue to grow. It is vitally necessary that some agreement be reached on criteria for adjusting the tariffs. Where upward revisions are requested, their approval should be based on the expectation of achieving a cost of production reasonably competitive with world prices, in a reasonable time. In other instances, productive sectors, such as agriculture, which require access to low-cost intermediate products, so that they may operate efficiently, particularly if they face competition in world markets, may need reductions in tariffs if these affect them adversely.

89. Most likely the major revisions in the tariffs in the immediate future are likely to be sought by recourse to the Special System for the Promotion of Productive Activities, part of the San Salvador Protocol to the Integration Industry Agreement (1963). The special system was designed to stimulate establishment of "new" industries "of particular interest" for the development of the region. Under it, special tariff increases may be granted by protocol to come into effect upon a determination that the proposed beneficiary industry has sufficient installed capacity to satisfy 50 percent of regional demand. The first two expressions are loose and the capacity criterion has no apparent economic justification.

Prices are not set in the individual tariff protocols, although the Executive Council is charged with maintaining vigilance to avoid prices excessively higher than those prevailing in world markets and imports from abroad may be authorized at the former lower common tariff level (or former national tariff if applicable) in such instances. But there is no mechanism specified to ensure systematic determination of prices and costs. Moreover, there are no provisions for any systematic or periodic tariff reviews or adjustments, and the criteria for the applicability of this special system are loose, and open the door for what could turn out to be dangerously large increases in tariffs. Tariff increases under this system have gone into effect recently for plants producing electric light bulbs, glass bottles and machetes and a large number of additional requests have been filed for tariff increases under this provision, including some types of insecticides.

90. The Special System was, in essence, designed to supplement the Regime for Integration Industries formulated in 1958 before the decision was taken to move rapidly to complete freedom in intra-trade; once the countries moved toward this liberalization, the incentive features of the Regime were of little effect. Under the Regime, industries (in practice, individual plants or establishments) designated as "integration industries" would be given free access to the whole Central American market, with special tariffs and tax incentives. Imports from outside would only be allowed if the plant could not meet the needs of the market, and other competitors would be subject to existing Central American tariffs in diminishing degree over 10 years. Moreover, since unanimous agreement would be needed to give similar privileges to a new competitor, a monopolistic position was in effect assured. In exchange for these privileges, the designated integration industry would adhere to specified quality standards and price limits and follow non-discriminatory pricing practices. Under the integration industry scheme, the advantages of size would be obtained without, in theory, the evils of monopoly; equitable or "balanced" distribution of its benefits would be assured by the proviso that no country could have more than one such plant before the others had one. So far, "integration industry" status has been concluded for a tire and tube factory now in operation in Guatemala, and for caustic soda and chlorated insecticide industry to be completed in Nicaragua in 1967. A protocol granting integration status to a sheet glass plant for Honduras was agreed in 1965 but has not yet been ratified. A draft protocol for another tire plant in Costa Rica has been prepared but has not yet been acted upon by the Executive Council even though the plant is under construction. The margins of protection accorded to these industries have been considerable (in the case of tires, the effective tariff in 1964 was 126 percent ad valorem as compared to an average of 10 percent under the previous national tariffs), in some instances the prices fixed by the protocol were at levels lower than the c.i.f. prices plus approved duties mainly as protection of "unfair" or "dumping" competition from abroad. Once the countries moved toward trade liberalization, the incentive of internal tariff advantages for an "integration industry" over potential competitors lost its effect. Hence the integration industry scheme appears to have doubtful practical significance for the future.

91. There is need to subject the applications for tariff increases under the Special System to the economic tests and administrative procedures suggested in connection with possible renegotiations of items in the common tariff. There is danger that the Special Regime, by providing the outward appearance of technical criteria and regional considerations, may become an instrument for the trading of reciprocal concessions among the five countries in the name of regional industrial development without due regard to costs and efficiency. Procedures and standards now in effect for tariff adjustments are deficient: all changes are by protocols, to be ratified by five national assemblies and the criteria for adjustment are lost in inadequate analyses plus the process of bargaining for mutual advantage. The mission believes that an effective approach to these problems would be through the creation of a Tariff and Industrial Commission discussed below.

92. As noted above, there has been excessive competition among the countries in granting fiscal privileges for industries. The need to harmonize the national legislation on fiscal incentives was recognized in 1962 when an Agreement on Fiscal Incentives was negotiated. This has not entered in force since Honduras made its ratification dependent upon preferential treatment; this was later agreed in a protocol in September 1966 which must be ratified by the other countries before being ratified by Honduras. Meantime, the national incentive systems remain in force.

93. Even when the Agreement on Fiscal Incentives comes into force, it will be administered by national agencies. Qualification and classification of industries for exemption shall, according to the Agreement, take place on a "Central American basis" not later than the seventh year. It is not clear whether this means that administration shall be vested in a Central American authority within seven years. Even if such an interpretation, often adduced by Central American officials, is valid, there will still be national administration for up to seven years. While the Agreement is somewhat more explicit than national laws as regards the criteria of classification, it still leaves substantial room for administrative discretion. Only on complaints from other countries may the Executive Council review the classification given by a national authority. Under these circumstances a central administration should be established as soon as possible. Moreover, the application of the criteria should be based on more careful review than hitherto of the benefits to be achieved and the contribution of the industry to economic growth, as well as to prevent the proliferation of plants which may be uneconomic and create substantial excess capacity. While central administration would be a long step forward in reducing competition in granting of fiscal privileges, it would not fully end it. Income taxes (unlike tariffs) are not uniform and exemptions from them may be more significant in one country than another. Thus there is need to revise and improve the industrial incentive system. In fact SIECA has recently been instructed by the Economic Council to prepare a general revision. The mission considers that in so doing, it should give great weight to: (a) the elimination of exemptions on income taxes and to the institution of proportional taxes on business incomes in four countries; (b) a shift to accelerated depreciation of investments, and (c) the granting of tariff exemptions for products rather than for specific enterprises so as to avoid difficulties in distinguishing between new and established industries.

An Industrial and Tariff Commission

94. From the foregoing review of tariff issues and the fiscal incentive system, the mission concludes that one of the most urgent needs of the integration movement is to establish a regional authority to administer centrally the granting of all concessions or privileges under the terms of the Central American Agreement on Fiscal Incentives for Industrial Development. Decisions on incentives should take account of protection provided by existing tariffs or which would result if requests for tariff adjustments were granted. Public action in the tariff and incentives fields could best be coordinated by establishing an autonomous Regional Tariff and Industrial Commission to administer centrally the industrial incentives system and to consider all cases of tariff adjustment with powers to increase or decrease existing tariffs within a certain margin (e.g. 50 percent), without further reference to political authority. The Commission should also be authorized to exercise powers to grant quotas for imports at the common tariff in the case of the specially protected industries if needed to protect the public interest; such powers are now vested in the Economic Council.

95. The proposal to centralize authority over these matters in an autonomous regional body may well encounter serious political difficulties. Should the architects of the Common Market not find it feasible to give autonomy to such a Commission, it could then be empowered to make findings and recommendations to be acted upon by the Economic Council, for recommendations in turn to Governments for ratification. Both SIECA and ICAITI 1/ should be strengthened to enable them to make adequate economic, financial and technical studies and recommendations on tariff and incentive problems coming before the Tariff and Industrial Commission. The economic justifications and consequences of tariff adjustments and fiscal privileges will require better analysis and evaluation than has been the case hitherto if the improvements in the decision-making process suggested above are to become effective.

C. Investment and Financing

96. Rough estimates of investment in industry, based on imports of industrial equipment, suggest that it was in the order of CA$65 million in 1962 rising to CA$100 million in 1965. The traditional lines - textiles, clothing, shoes and food processing - accounted for two-thirds of industrial equipment imports in 1962, but fell to one-half as a result of the growth of the newer industries. Growth of industrial investment was especially marked in El Salvador, embracing newer industries such as metalworking and chemicals, as well as textiles. The traditional reliance on private savings and reinvestment of earnings (including those from agriculture or commerce) for investment in industry was buttressed by expansion of commercial bank lending to industry. Year-end balances of commercial bank credits to industry rose from CA$48 million in 1961 to CA$110 million in 1965, mostly on relatively short term, and reflected the sharp increase in needs for working capital as industrial output and regional trade grew.

1/ Central American Institute for Technical and Industrial Investigation.

97. Long-term capital came from a variety of sources. INSAFI (El Salvador) and INFONAC (Nicaragua) - both public development institutions - disbursed CA$1-2 million each annually; INFONAC also made some equity investments. Direct U. S. private investment, including reinvestment, rose rapidly reaching about US$15 million in 1965 for manufacturing alone; in addition, private investment in petroleum refining reached US$20 million in 1964 though this has since declined as the major construction of refineries was completed. Direct private investment from countries other than the United States evidently has been on a far smaller scale. Suppliers credits also have financed private industry, although, with the availability of foreign official funds at easier terms, such credits have probably not been substantial. Foreign commercial bank funds channeled through the Central Banks in El Salvador and Guatemala to private industry ranged from US$2-3 million annually from 1962 to 1965.

98. Official external funds from IBRD, IDB, AID, IFC and, lately, the Bank of Mexico, were channeled to industry through CABEI, national public and private intermediaries, Central Banks as well as directly to individual enterprises. CABEI confined itself to direct loans. About one-fourth of CABEI's industrial loan commitments totalling CA$32 million came from its own resources and to that extent its loans were not external to the region. As of mid-1966, CABEI had borrowed abroad some CA$36 million for industrial lending - from AID (CA$17 million), IDB (CA$13.8 million) and Mexico (CA$5.0 million). Actual flows of official funds to industry are summarized below.

	1962	1963	1964	1965	Total 1962-1965
		(in millions CA pesos)			
Total official external financing to industry	2.3	8.9	10.5	15.5	37.2
Indirect	1.3	2.6	3.0	8.9	15.8
via private financieras 1/	-	-	0.8	3.9	4.7
via other agencies 2/	1.3	2.6	2.2	5.0	11.1
Direct	1.0	6.3	7.5	6.6	21.4
from CABEI 3/	0.6	4.6	6.7	5.8	17.7
from other sources 4/	0.4	1.7	0.8	0.8	3.7

1/ From AID

2/ From IBRD, IDB, AID

3/ Excludes financing of industrial studies, amounting to approximately CA$0.4 million.

4/ From IFC and IDB directly to individual firms.

99. Total foreign loan disbursements (including CABEI), together with direct U.S. private investment, some loans from foreign commercial banks, increased sharply from about CA$5 million in 1962 to CA$16 million in 1963, CA$23 million in 1964, and CA$34 million in 1965. External lending thus played a large part in financing the rise in annual manufacturing investment in the last few years.

100. A new channel for industrial finance was opened up in 1964 when private development banks or "financieras" were established in El Salvador, Honduras, Nicaragua and Costa Rica. The impetus to their formation was provided by AID loans of US$5 million (US$3 million in Nicaragua) on 20-year repayment terms with low rates of interest (2-2.5 percent); matching local equity was CA$1.0 million in each instance. The financieras initially tended to place their capital in a variety of ventures, some non-industrial in character, on short term, in order to earn a return pending the development of longer range projects. However, their portfolios, from a development point of view, have been improving as industrial projects were worked up and financed. The financieras in Nicaragua and Honduras have committed their funds rapidly and have requested new loans from AID for US$5 million and US$3 million respectively.

101. At the end of 1965, the undisbursed balance from existing loans to industry made by CABEI and external agencies, was approximately CA$23 million. In addition, as of mid-1966 CABEI had available for commitments for industrial loans about CA$13 million (including CA$8 million from an AID loan and CA$4.3 million from the Mexican loan). The present availabilities from these balances are not excessive, amounting to a little over 2 years disbursements at recent annual rates.

102. Despite the uncertainty as to the rate of growth in coming years, it seems likely that a continuing and substantial supply of foreign loans and equity capital will be needed. Further rises in output are likely to require new investments among a diversity of industries, even though the overall supply of local capital is not likely to expand rapidly in the next few years. While there will be a need for direct lending for the larger projects now under consideration, such as the Olancho pulp and paper mill, there would be advantage in channeling a substantial portion of new external funds through a regional financial intermediary, which could gauge the changing needs of the area close to the scene. Such an intermediary could assist the existing financieras, work with the public intermediaries, and engage in direct operations, either singly or in participation with other regional or local institutions, in direct financing of new enterprises requiring relatively large capital sums. Proposals have been under discussion in Central America looking toward the creation of a joint investment company sponsored by the existing private financieras (and possibly a Panamanian financiera) with additional participation of external sources, including ADELA. These proposals are evidently at an early stage of discussion and their details are yet to be worked out.

103. So far, no regional capital market exists in Central America. There have, it is true, been direct investments by nationals of one country into another country (mostly from El Salvador into Honduras), and there have also been a few major industrial projects with equity participations from various countries (for example, the glass bottle factory recently opened in Guatemala, in which the breweries of several of the countries have an interest). With the present pattern of ownership in Central American industry, which is either in foreign subsidiaries or in companies with a small closed number of stockholders, who are either relatives or close friends, a capital market which could mobilize domestic savings, including those of the growing middle-class, for financing industry will take time to develop. Nevertheless, as capital requirements become larger, such a development will become a necessity: the Central American "financiera" discussed above could help lay the basis for such a development.

D. Conclusions

104. The substantial expansion of industrial output in Central America in recent years has contributed to overall economic growth, although the share of industry in total GDP is still low. The industrial structure continues to be dominated by the "traditional" industries, such as food processing, beverages and tobacco, textiles and shoes and clothing, which account for three fourths of total industrial output. In the last few years, however, the output of newer branches of industry - including petroleum refining, chemicals and metal products - grew more rapidly than the traditional industries. Many of these industries require a large component of imports for their operation, add little to the final value and do not contribute much to employment.

105. Recent industrial expansion was stimulated by increased incomes arising from the export boom and by removal of trade barriers within the Common Market. Exports within the Common Market accounted for about one-fifth of total increase in industrial output. The Common Tariff, although generally higher than the average of the previous national tariffs - very often substantially so - was a stimulus in some cases. But there have not been appreciable rises in general indices of prices, largely owing to increasing competition, particularly stemming from specialization by product lines. While national systems of fiscal incentives existed before the Common Market was created, the larger regional market permitted such fiscal incentives to play a much greater role in stimulating industrial investment, hence competition among the countries in granting privileges developed rapidly. New or expanded national and regional financial institutions, with increased resources, also contributed substantially to industrial growth as did foreign private investment.

106. Industrial production has been the main beneficiary of free trade in the area; manufactures accounted for about two-thirds of the expansion of intra-regional trade in 1962-65. Substantial, and in some lines total, import substitution took place. The expansion of regional trade represented trade creation rather than trade diversion. However, the growth of imports of capital goods, raw materials and semi-manufactures needed by Central American industries caused the ratio of imports from the outside to GDP to increase (see paragraph 162). On the whole the industrial expansion of 1962-1965 was a positive factor of economic growth in real terms.

107. Substantial and worthwhile opportunities for import substitution still remain. Industrial growth on this basis in coming years will probably be much more restricted than in the recent past; with a much slower rate of growth of major exports to the outside world than in the recent past, growth of incomes and hence internal regional demand is likely to be less rapid than previously. With the limitations of the size of the Common Market, public policies and activities should be increasingly aimed at the development of exports to the outside world; several elements of public influence could play a part, such as the granting of fiscal incentives, assisting in financing, providing technical assistance in studies or promotion of new lines. The most promising possibilities are forest products, meat, canned fruit and vegetables, and possibly textiles; these would involve processing resources which the region has or could develop in abundance.

108. For these industries as well as lines which still offer possibilities in the internal market, the public authorities, in exercising their influence and power, will need to give greater consideration to production costs and efficiency than they have in the past. This is particularly true for products which constitute inputs for other productive activities, principally agriculture, which must compete in the outside markets. In this respect, the most essential step is to put an end to competition among the countries in granting privileges which seems bound to occur even under the Agreement on Fiscal Incentives for Industrial Development, still to be completely ratified. Administration of privileges should be centralized in a regional authority so as to reduce the competition which will take place under national administrations, and the system itself should be improved. Moreover, the process of adjusting tariffs, which may need to be adapted to new opportunities and new conditions within the Common Market, should be improved. The functions of administering fiscal privileges and of tariff revision should be coordinated; thus they should both be lodged in a single Regional Tariff and Industrial Commision with powers to consider all tariff adjustment cases, and to raise or lower tariffs within stated margins. If these improvements in adjustment of tariffs and administration of fiscal privileges are to become effective, it will be necessary to strengthen SIECA and ICAITI to enable then to make adequate studies on problems coming before the Regional Commission.

109. Industrial growth should continue to receive assistance of external public and private captial, possibly for some large projects now being studied, both directly and through financial intermediaries. It is too soon to say whether a regional financiera, supplying capital to industries or intermediaries of the region and helping to mobilize local capital, which has been under discussion, should obtain support from official capital. Application of external capital would be far more effective within the context of policies fostering sound industrial growth of the region. An urgent and concrete measure is to establish central administration of the Agreement on Fiscal Incentives and to improve the system. Revision of tariff making machinery, while urgent, is likely to involve difficult negotiations, but a beginning should be made. In any event, external funds should give priority to industries likely to endure without high tariffs, contributing large value added and especially to those capable of being export-oriented now or in the visible future.

IV. PUBLIC INVESTMENT

A. Public Investment in the Recent Past

110. Public investment has not been a major component of aggregate demand in Central America. For the region, it has fluctuated between 4.4 and 2.8 percent of GDP over the last decade staying usually slightly above 3 percent. These levels have not differed significantly among countries, although they have been usually lower in Honduras and somewhat higher in Nicaragua and Costa Rica. Despite an increase of 48 percent of regional GDP over the same period, the ratio has remained practically stationary in three countries over the last eight years, and even dropped in Guatemala and Honduras. Due to its small relative magnitude, public investment has not been important as a stabilizing influence on the level of economic activity, which continues almost wholly dependent on exports, the dominant factor in determining output, incomes and public revenues in all countries of the region.

111. Direct public investment has played, nevertheless, an important role in the economic progress of the past decade by substantially expanding the basic infrastructure required for economic growth. Broadly, direct public investment has corresponded to the most essential and urgent needs of the individual countries and their economic integration. The construction of the Pan American Highway in the early fifties and of the Pacific Littoral Highway through Guatemala and El Salvador, provided overland transportation and facilitated development along the Pacific slopes, where the main population centers and production areas are located. The Atlantic Highway in Guatemala, the Western Highway in Honduras and the road from Tegucigalpa to the Pan American Highway - which will link to the North Road from Tegucigalpa to Northern Honduras now under construction - have linked large areas of these two countries to the main transportation arteries along the Pacific side, thus linking the most important developing areas of the five countries. The construction of other roads in El Salvador, Nicaragua and Costa Rica to their shipping ports in the Pacific and in Guatemala and Honduras to their main ports in the Atlantic, have complemented the railroads which were the only transportation facilities to the shipping ports up to relatively recent times. The roads built over the last two decades and those programmed for completion or improvement over the next few years thus serve the multiple purposes of promoting growth of exports to external markets, linking the countries more closely together and facilitating intraregional traffic and travel and stimulating development of new agricultural and industrial areas. Closely related to the development of overland transport were important port development works, particularly in Nicaragua, Guatemala and El Salvador.

112. The expansion of the road network was accompanied by a very substantial growth in traffic. Vehicle registration slightly more than doubled in the past ten years, both as a result of the greater use of passenger vehicles resulting from the process of urbanization but, more important, the increase in commercial traffic, which rose especially in the last few years; truck registrations practically doubled in the decade

and their carrying capacity undoubtedly increased even more. Truck hauling has taken up most of the substantial increase in the volume of trade with countries outside the region. Intraregional traffic, moved almost exclusively by truck, increased from 45,000 tons in 1961 to 222,000 tons in 1965. A substantial increase in land utilization and growth of population has occurred between 1952 and 1963 in the areas traversed by the roads constructed or improved (see Map I); a striking example is the development of cotton production in the Pacific coastal plains of Guatemala and El Salvador following the construction of the Littoral Highway.

113. Besides roads and ports, air transport has progressed substantially. Airports in capital cities have been enlarged and improved to accommodate jet aircraft, thus providing cheaper and faster transport services which may be of importance for promotion of exports of certain categories of products, some of which are beginning to take place. Many local airports were built enabling the Central American countries, with their difficult topography, to advance from primitive transport modes, sometimes changing from mule back and cart hauling directly to the airplane. While trunk and feeder roads are needed for the large bulk of cargo traffic, air transport has an important role to play in movement of certain categories of goods and passenger travel. Given the physiography of the Central American area and the dispersion of many potentially productive areas, air transport often offers cheaper and more feasible transport in linking these areas to regional markets and international air routes than second class or difficult local roads.

114. Electric power has been second only to transportation in public investment in Central America. Installed capacity and power generated have increased by about one and one-half times in the last ten years, and consumption more than trebled. Economic growth was thereby stimulated: while residential and government consumption has doubled, industrial consumption has grown about five times and commercial consumption about four. Public enterprises play the major role in power expansion. Although they have been strengthened and are generally capable of administering and maintaining their systems efficiently, some of them are still weak in long-term planning.

115. Public investment in education has been a minor part - about 4 percent - of total public investment in Central America in the last decade; in proportion to GDP it was much lower than in many countries with lower per capita incomes. Educational systems were significantly expanded in the last fifteen years by increasing the number of classrooms and teachers at the primary and intermediate levels. Despite large increases in school-age population, four of the countries have succeeded in raising appreciably the ratio of enrollment to school-age population. This expansion has been reflected, however, in substantial increases in recurrent expenditures while fixed investment in school buildings, laboratories and libraries has remained small. The needs and problems of the five countries are very similar. Hence the countries have entered into an agreement (in force among all countries except Costa Rica where ratification is pending) by adopting a similar structure of courses and minimum curricula at the primary and intermediate levels. The agreement recognizes the validity of national training certificates throughout the region and

validates services rendered by teachers in the different countries for purposes of promotion and retirement; these provisions aim to facilitate the use of the teaching force throughout the region. The possibilities of education projects which could offer definite advantages if undertaken on a regional basis will be examined later in this chapter.

116. Direct public investment in agriculture and industry has been very limited in Central America; the bulk of investment outlays in these fields originate in and are made by the private sector although special credit programs by which public financial intermediaries channel public domestic and foreign funds to the private sector have been growing in importance and have played an important role in some countries, notably in Costa Rica. These have been discussed in the Chapters II and III.

B. Public Investment Programs Through 1969 and 1970

117. The Central American countries, through the National Planning Offices in each country, with assistance provided by the Joint Planning Mission sponsored by ECLA, the OAS, BID, CABEI, and SIECA, formulated national development plans for 1965-1969 (in Costa Rica from 1964-1968). The development plans, while national in character, were to be harmonized at the regional level, so as to avoid inconsistencies and ensure that individual programs might not have adverse effects upon the possibilities of other countries achieving their potential within the common goal of economic integration.

118. The tabulation below summarizes the planned investment expenditures for 1966-1969 in comparison with those achieved in 1962-1965.

CENTRAL AMERICA: ANNUAL AVERAGES OF DIRECT PUBLIC INVESTMENT
1962-1965, Actual Expenditures; 1966-1969, Official Country Programs
(in million CA pesos)

	Guatemala		El Salvador		Honduras		Nicaragua		Costa Rica	
	1962-1965	1966-1969	1962-1965	1966-1969	1962-1965	1966-1969	1962-1965	1966-1969	1962-1965	1966-1969 3/
Transport	11	27	5	12	6	20	9	13	5	20
Telecommunications	1	3	1	1	1	1	1	1	1)	11
Power	3	15	4	6	4	6	5	6	10)	
Education	1	6	1	6	1	2	1	3	1	4
Health and water	3	15	3	6	1	6	2	5	4	10
Housing	2	8	3	13	- 2/	3	1	6	2	6
Agriculture 1/	2	21	1	6	- 2/	10	- 2/	6	- 2/	- 2/
Other	6	6	2	8	3	6	2	2	1	2
Total	29	101	19	60	15	54	21	42	25	52

1/ Excluding credit programs.
2/ Less than CA$1 million.
3/ The Costa Rican program extended to 1968 only.

Comparing the levels of investment planned for 1966-1969 with those achieved in 1962-1965 for the region as a whole, the average annual increase would amount to some 28 percent. These planned levels are on the ambitious side and will probably not be achieved in full due to the variety of factors examined in the following chapter (and in individual country chapters in Part II). However, the mission believes that it should be feasible to raise investment levels in 1967-1970 about 75 percent above their 1963-1966 levels, bringing investment up to some 4.5 percent of GDP in 1970 as compared with 3.5 percent in 1966. 1/ The mission's estimates of 1967-1970 direct investment, by countries, in comparison with levels achieved in 1963-1966, are shown below.

Country	Annual Averages (in million CA pesos) 1963-1966 1/	1967-1970	Average annual % increase 1963-1966 1/ over 1959-1962	1967-1970 over 1963-1966
Guatemala	27	45	-3.5	14.0
El Salvador	24	51	15.6	21.1
Honduras	16	37	9.9	22.6
Nicaragua	25	41	14.8	12.8
Costa Rica	28	36	11.4	7.4
Total Region	120	209	7.5	15.0

1/ 1966 investment data based on estimates of national authorities.
Source: Tables 18a-e and 20a-e.

In addition to direct public investment, the mission has also estimated possible indirect investment, in the form of credit programs to the private sector for both agriculture and industry. They might amount to an average of CA Pesos 40 million annually in the region, of which more than half would be for agriculture. The country programs have a fairly high proportion of prepared projects with a reasonably high degree of priority; this represents a major achievement compared to the situation ten or even five years ago and should permit the needed increases in inflows of foreign funds to supplement local public savings.

119. The Government's investment plans are primarily national in scope, though they also reflect considerations of a regional character to some extent, primarily for highways. With five well-defined centers of economic activity and little permanent migration between the countries, it is not surprising that the programs for housing, water supply, health and education are almost entirely designed to cope with national problems. The main sectors where regional considerations ought to enter and which have in varying degrees been discussed among the countries are communications (road transport, ports, and telecommunications) and to a lesser

1/ The mission estimated possible investment levels in 1970, based on known programs and projects of the several countries (see Table 20 a-e).

extent electricity (interconnections among the country systems), agriculture (especially the regional grain storage program) and some areas of education; these are discussed in the next section.

120. By and large, the government programs are generally well conceived in terms of objectives and balance among sectors and largely correspond to their priority needs. The programs still are heavily concentrated in transport. This is understandable as, despite important progress in the last several years, the road construction and improvement programs for the next few years represent in large part the completion or improvement of the basic road network in the Pacific side and the linking to these main arteries of large areas in Western Guatemala and Northern Honduras and some highly productive agricultural areas in Eastern Nicaragua and Northern Costa Rica. While providing for national needs, the programs include important roads which would help complete the regional road network.

121. The larger than average proportion that transportation represents in the total investment program of Honduras reflects its larger needs in comparison with the other countries, particularly the need to link the rich and rapidly developing northern area of the country with its central part and the main arteries of regional traffic. The lower than average proportion of transport in El Salvador's total investment program reflects the greater advances made by the country in this sector; in good part, the transport investment programmed is for improvements in the main trunk routes of the Pan American and Littoral Highways. The programs in Nicaragua and Costa Rica contain projects which in the opinion of the mission are not of as high priority as others and which could therefore jeopardize or delay the completion of priority roads since the full programs may be too large to be carried out fully as planned.

122. The investment in ports represents expansion or modernization of the main Corinto port of Nicaragua - on the Pacific - and of Honduras and Costa Rica on the Atlantic. Except Costa Rica, where insufficient priority appears to have been given to the road from Siquirres to the Atlantic seaboard to provide access to the much needed port contemplated in the development plan, the port and road programs fit well together.

123. The investments projected in electric power are generally well designed to satisfy needs for expansion. However, past delays in executing major projects in Guatemala, El Salvador and Nicaragua, and to a lesser extent in Honduras, may require supplementary installations to avoid shortages in the next few years should demand continue to increase at past rates. The investments planned in education, while a substantial improvement compared to the past, still fall short of the needs of the next few years if the educational systems, which suffer from serious deficiencies, are to be improved in quality and output. However, even the relatively modest levels programmed in education may not be achieved because project preparation has been lagging in the last two years. The outlays planned in public health and water supply and sewerage are much needed, but seem to the mission considerably beyond the present capabilities for implementation in most of the countries.

124. The mission's estimates of the distribution of possible public investment for 1967-1970 among sectors is shown below:

CENTRAL AMERICA: DISTRIBUTION OF PROJECTED DIRECT PUBLIC INVESTMENT BY SECTORS AND BY COUNTRIES, 1967-1970
(in percentages)

Sectors	Central America	Guatemala	El Salvador	Honduras	Nicaragua	Costa Rica
Transportation	40.0	43.3	25.1	50.2	38.3	47.5
Telecommunication	5.1	5.3	5.8	5.5	3.2	5.4
Power	14.9	18.2	11.9	12.1	19.4	12.8
Education	9.8	7.2	13.6	8.4	6.9	11.6
Health and Sanitation	11.4	9.4	14.9	9.3	10.3	12.1
Public housing	10.3	8.5	15.4	6.4	12.3	7.2
Agriculture	8.6	8.0	13.2	8.1	9.3	3.4
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Tables 20 a-e.

In all cases transportation is the largest individual sector ranging from 25 percent of total investment in El Salvador, which is tending to level off its road construction effort, to about 50 percent in Honduras and Guatemala mainly due to large major highway investments. Telecommunications and electric power together are next most important in size, constituting from 17 to 23 percent of the total in the several countries. Investment in the social sector - education, health and sanitation, public housing - varies considerably from country to country but overall it comprises about 25 to 30 percent of the total investment in four countries; in El Salvador, however, it would be almost 45 percent because of its efforts to provide its dense population with education, water supply and housing, after having invested heavily in physical infrastructure. Direct investment in agriculture constitutes a relatively small share of total investment - a little over 8 percent for the region - rather lower in Costa Rica and highest in El Salvador where important irrigation projects are being scheduled. This relatively small share, as indicated above, is likely to be very substantially increased by government efforts to channel local and external public funds to agriculture through special credit programs.

C. Projects of Regional Significance

Roads

125. The five Governments have for several years discussed the needs for a regional road construction program. 1/ In 1963 they designated 13 roads as Central American "integration" roads (designated by a "CA" number)

1/ See Volume VI - Transportation and Map I.

basic to the region and agreed to complete new construction or improvement. These C.A. roads have a combined length of some 5,000 kms; about three-fifths have been constructed, some 1,500 kms are under construction and 750 kms still to be constructed or improved. Likely expenditures on these roads, in 1966-1969, are estimated by the mission at about CA$97 million, or about 35 percent of the probable combined outlays of the five countries on all types of roads.

126. After the United States Government, following the visit of President Kennedy to Central America early in 1963, offered to assist in financing a Fund for Central American Economic Integration, the five Governments and the United States agreed that this fund, at least in its first stages, should be used to finance the improvement or construction of roads in the Central American system. The fund, administered by CABEI, was initially established at US$42 million, of which US$7 million equivalent is contributed by the countries and the remainder comes from a USAID loan. A first tranche of loans totaling US$30 million has already been committed in 1966 and early 1967; the distribution of the remaining US$12 million is still under consideration. (In early 1967 the Inter-American Development Bank approved loans of US$15 million equivalent to CABEI for the Integration Fund.) The conditions of the first tranche loans were designed to stimulate the interest of the several countries in constructing regionally important roads; thus they cover 100 percent of the estimated project cost and bear an interest rate of 3.5 percent per annum with a maturity of 25 years (including 7 years of grace).

127. An important aspect of the Integration Fund from the regional point of view is that while the national contributions are in equal shares, the use of the funds are not to be related to national contributions, but should be apportioned among the countries in accordance with the investment needs of the region considered as a whole. It is to be a common, regional fund to be utilized on the basis of regional rather than national considerations. Each of the five countries in fact received part of the first tranche loans from the fund, some for roads deemed to be of regional importance even though they had not been designated as "integration roads." However, Honduras, centrally located in the region and lagging in road construction relative to the other countries received the largest share, almost one-third of the first tranche.

128. The road construction covered by the first tranche of loans from the fund would cover roughly a third of the countries' combined proposed investment in integration roads in the period 1966-1969. Substantial portions of the integration road system, particularly in Honduras and Costa Rica, are to be constructed or improved with financial assistance from IBRD/IDA, IDB, and Eximbank.

129. The strategy of the large integration road program is to improve the Inter-American Highway, the main artery of the Common Market, up to a uniform standard in all the countries, to construct or improve other important roads providing better connections between the countries, and to begin integrating into the Central American and national economies productive areas, mostly towards the Atlantic, which do not at present have an

adequate road connection with the rest of the region. One such area is the Coban area in northern Guatemala, which will ultimately provide access to the southern Peten and the farming and forestry resources of the Polochic Valley. 1/ Another is the northern coast of Honduras which, although it is the main banana producing area in Central America and has a recognized potential for livestock production, does not have an adequate land connection with the rest of the country. However, the Eastern Highway to the Atlantic in Nicaragua, and the road linking the Central Plateau to the Costa Rican Atlantic port of Limon are not listed among the "integration" roads. In terms of development potential and of providing a road connection to a major area of the Costa Rican and also of the Central American economy, the latter project probably deserves a high priority in the immediate years ahead in a Central American highway program.

130. Among the connections between countries which have in principle been agreed upon as integration roads are two new roads between Honduras and Nicaragua; however, no plans have yet been made to finance the construction of the Honduras side of one of these connections. Another regional connection would be a road between the Atlantic ports of Guatemala and Puerto Cortes in Honduras: such a connection would provide the industrial center of San Pedro in Honduras with a market in Guatemala, develop a relatively accessible and fertile agricultural area, and at the same time permit a more efficient use of the three ocean ports serving the area. Two of these ports are now fed in Guatemala by the Atlantic Highway, and on the Honduran side, by the Western Highway connecting with El Salvador and by the North Road from Tegucigalpa. A good road already connects Tegucigalpa to the Pan American Highway. The improvement of all these roads was or is being carried out with the help of IBRD or IDA financing. While the Honduran road to the Guatemalan border is under way, no concrete plans existed (as of mid-1966) for Guatemalan construction of the remainder of the link between the Atlantic ports.

131. The agreement reached by the countries in 1963 in selecting the "integration" roads to be built or improved during 1965-1969 and the inclusion in the national development plans for that period of most of such roads represented a major step in approaching public investment in roads from a regional point of view. However, experience to date suggests that identification of "integration" roads can present difficulties. National and regional priorities, have, in some cases, not been adequately related. Agreement regarding identification of interconnecting roads and schedules for feasibility studies and construction will be required if the further development of the Central American road network is to proceed without unnecessary delay and waste. Moreover, the preservation of an adequate regional transport network will require agreement among the five countries on minimum standards of maintenance and observance of such standards. External lending agencies could play a useful role in assisting the countries in these matters.

1/ The financing contemplated for this road from the Integration Fund at present includes construction only as far as Purulha which is a little over half the distance from El Rancho, on the Atlantic Highway to Coban.

132. As a result of programs of regional and national road construction, Central America is likely to have by the early part of the 1970's the kind of highway network which is envisaged for the late 1960's. After the substantial investments in the Inter-American Highway and the Pacific coastal highway in the 1960's and following upon investments which will have been made or are in process in providing major road connections to the Atlantic seaboard, the investment programs in the 1970's should probably place heavier emphasis on opening up new areas with penetration roads and on developing the feeder road system.

Ports

133. While investment in roads of regional significance in the next few years will reflect decisions taken at the regional level, agreement on port development programs does not yet exist. There are only a few cases where one port might serve an area transcending national boundaries instead of several national ports; but these cases could in the next few years become important for the coordinated port development of the region. In view of the removal in recent years of tariff barriers within the region and the creation of a regional common tariff, port planning should begin to reflect regional, rather than primarily national, traffic flows.

134. The Gulf of Fonseca, which includes the shorelines of El Salvador, Honduras, and Nicaragua, is the principal case in point. Nicaragua and El Salvador already have ports serving the general area. At present the Salvadorean port (Cutuco) is operated by the private International Railways of Central America and the wharf is accessible only to rail traffic. Complex problems of railway - government relationships will have to be solved before its expansion could be undertaken. The Nicaraguan port (Corinto), whose expansion is being planned, will become economically accessible to Honduran traffic when the road shortcut from Honduras is completed (probably in the early 1970's). But the Honduran authorities have felt for some time that a major Honduran port on the Pacific coast might be necessary for the more rapid development of its Pacific coastal region even though it might be more economical to ship through Nicaragua, once the new road is built, or even through El Salvador. 1/ SIECA has been endeavoring for some time to develop the bases for a joint study of the agricultural and industrial potentialities in the Gulf of Fonseca area and of the transportation facilities needed to provide a sound basis for regional development. Funds for port feasibility studies have been included in the US$4.6 million loan made by the Bank in 1966 to Honduras for the development of Puerto Cortes. Clearly, there should be close consultation among the countries, the responsible Central American organizations, and the external financing agencies before decisions to initiate important new port facilities in this area are made.

135. Two other areas might be suitable for coordinated regional port development. The Guatemalan authorities have been planning to construct a modern deep-water port on the Pacific coast (at San Jose or Champerico)

1/ Preliminary evidence is given in Central American Transportation Study, T.S.C. Consortium, 1964-1965.

to replace the two lighterage ports now in operation. At the same time, the capacity of the Salvadorean port of Acajutla (120 miles from Guatemala City) is being increased, as part of a long-range expansion. While expansion of cotton production in Guatemala in the seventies might supply substantial traffic for a Guatemalan port, given the large expenditure investment (probably CA$16 million) required for a new port, the alternative of relying on expanded facilities in El Salvador should also be explored. One other case is that of the Atlantic ports of Guatemala, one of which is at present being expanded, and Puerto Cortes in Honduras, which is about to be improved with the help of an IBRD loan. At present, the ports serve two distinct hinterlands; however, with the possible improvement of a shortcut road from El Salvador to Guatemala's Atlantic Highway and the construction of a road connecting the ports on both sides, there would be increasing choice for Salvadorean shippers among the Atlantic ports of Honduras and of Guatemala. Although the next stage of expansion of the Atlantic ports - beyond the present one - is still some years away, the decision on this further stage should take into account the coordinated development of the Atlantic ports in both countries.

136. Aside from these three cases the other major port development projects in Central America do not pose significant issues of regional coordination. But the cases described make it clear that Central America will need to draw up a region-wide program of port development in the next few years, if the best locations for expansion are to be chosen from the point of view of one common market economy.

137. Taken together, the road and port development investments will have substantially integrated the five countries and their main economic areas in a physical sense by the early seventies. During the same time, a common external tariff will have been established on all items and the limited barriers to trade within the area will have been removed. Under these conditions, the choice of routes and of ports in receiving imports and shipping exports will be determined exclusively by transport costs. If such total transport costs differ significantly among routes, changes in the existing traffic patterns may take place which may have far reaching effects. For example, they could affect custom duties revenues of the individual countries and thus the prospect of achieving the customs union which is one of the main objectives of the General Treaty. If the countries cannot agree soon on a system of apportioning the regional import duties revenues among the countries, later shifts in the pattern of trade may make negotiation of the customs union more difficult. Again, the harmonization (by adopting common standards) of port handling and road user charges, which now vary widely among countries, will need to be accomplished in a not too distant future if the transport network and ports are to function at optimum efficiency.

Telecommunications

138. There has long been general agreement in all the Central American countries that a system of modern telecommunications between the countries is necessary. The rapid increase in regional trade has increased the urgency of providing a regional system, which would require a relatively

small investment. At present, service between the countries is expensive, slow and unclear, and some of the telephone calls have to be channeled through the United States. In addition, the lack of a Central American system impedes the establishment of a wider Latin American system from Mexico to South America. Since 1965, the Aerial Navigation Corporation of Central America (COCESNA) has been leasing a few channels for private telephone service, but these facilities are very limited and will eventually be needed to service the rapid increase in air navigation.

139. In 1961, the five countries and Panama jointly approached the United Nations Special Fund and were granted financial assistance for a study of a regional Central American network and national telecommunications needs of the several countries. The IBRD was named executing agency and the study was completed by French consultants early in 1964. It recommended, in view of the differing stages of skills and development of the national telecommunications authorities, that an autonomous regional corporation be established to finance, construct and operate the regional system. The idea of a separate regional corporation failed to obtain the support of the majority of the countries, and, as an alternative, the countries in April 1966, in the Treaty of Managua which is still to be ratified, agreed to go ahead with the construction of a regional system on the specifications proposed in the UNSF study, but with each country constructing and financing its segment of the network. A coordinating technical committee would be responsible for arranging the coordinated calling for bids, construction and operation; but without establishing an autonomous corporation. The countries are at present discussing the ways in which to put the Treaty into practice and are seeking the necessary financing for the equipment. With revisions in the design of the system to provide for higher initial capacity and also to provide for possible transmission of television programs, the total cost of the regional facilities would be about $10 million. Before the countries can proceed effectively with the project on a coordinated basis, they will need to ensure that the coordinating committee has sufficient powers to carry out construction smoothly and to plan for the next stages of expansion. Arrangements remain to be worked out with the Panamanian authorities and the private telephone company there (which were not parties to the Managua Treaty) and Mexico under which the Central American system would be connected to the existing systems of these countries and other parts of the world. In relation to the relatively small investments needed, the proposed regional telecommunications network is the highest priority regional investment in Central America at this time.

Electric Power

140. Until recent years, no need was felt in Central America for electrical interconnections between countries. With demand for electricity principally limited to the capital cities and taking into account the distance involved between these cities and the relatively limited size of their power systems, there has been little scope for possible interconnections between the systems.

141. One exception is the proposed interconnection between the main systems of Honduras and El Salvador. This has been under discussion for some years between the two countries and in the United Nation's Central

American Mission for Electrification and Hydraulic Resources and the subcommittee on electrification. The main feature of the project, as described in the feasibility study, 1/ was to construct a transmission line to San Salvador from Lake Yojoa in Honduras where a 40 mw hydro plant would be constructed near the existing plant. About half the output of the new plant would be reserved for El Salvador. As envisaged in 1964-1965, when the project was under most active discussion between the two national power authorities, its immediate purpose would have been to bridge a gap in El Salvador's power requirements at the end of the sixties. The Honduran Government, however, has been slow to decide whether to go ahead with the project, partly because it felt that its development plans for the Pacific Coast would absorb all the energy produced by the new plant in Honduras. As a result of the delay, El Salvador had to reach a decision on expansion of generating capacity to meet its growing needs and it proceeded with the construction of a thermal plant at Acajutla. While the need for the proposed interconnection is no longer immediate, the two countries have continued discussions to establish whether there is a basis for working out an agreement for a long-term exchange of power which would justify the construction of an interconnecting transmission line, but progress has been slow.

142. Two other interconnection projects which have reached the stage of preliminary discussion among governments are local in character and do not involve linking the major national networks. One proposes linking the Golfito area in Costa Rica with the Chiriqui system in Panama and relying on one larger source of supply rather than on the two small plants now serving the area; however, the proposed site in Panama can only be economically developed once a much larger demand exists than that of the two systems combined in the foreseeable future. A similar arrangement has been discussed for the border area of Nicaragua and Costa Rica, but discussions have so far been preliminary.

143. In the next several years, the interconnection of the systems of the various countries will probably not be a pressing need, since the possible benefits to be gained by the interconnection of the relatively small-sized systems would not be sufficient to justify the necessary investment in transmission lines. In the longer run, however, as power demand and the power systems increase in size, mutual benefits would be achieved by interconnections. Experience in other countries shows that substantial problems are encountered in working out coordinated power development programs across international borders; hence a sufficiently long period of time will have to be allowed for preliminary studies of interconnection possibilities and problems. In Central America, work in this field is already being carried forward by the United Nations Central American Mission on Electrification working with ECLA and with a subcommittee including representatives of the power utilities in the five countries which meet regularly to discuss common problems. This cooperation should be reinforced and expanded to lay the foundation for the future joint planning of integration of power systems.

1/ Honduras-El Salvador Electrical Interconnection and the San Buenaventura Hydroelectric Project, February 1964, prepared by Harza Engineering Co.

Agriculture

144. In the field of agriculture there are possibilities of developing on a regional basis, the program of grain storage that is required for the operation of the Special Treaty on Basic Grains that the countries adopted in mid-1966. If adequate working capital for the purchasing operations of the National Grain Boards is provided by the respective Governments, the external lending agencies could have a useful role to play in helping to finance the construction of the storage facilities needed.

Education

145. While most of the educational problems can be handled at the national levels, there are several fields in which joint projects or action would serve the common interest of the five countries. The program begun by the Council of the Central American Universities (CSUCA) aims at concentrating all the region's postgraduate training in certain fields; 1/ the selected institutions should be more adequately supported and the specialized institutions should be strengthened. Generally, thus far, this program has not made satisfactory progress, in large part because governments have failed to provide funds to finance travel and living expenses for their respective nationals eligible to attend these specialized centers. Another fruitful field for centralized regional effort is research on improvement of education and harmonization of educational standards. Formerly IIME (Institute for Educational Research and Improvement), supported by the five Central American countries and financed by a grant of USAID, carried on useful work in this field. In recent years, due to lack of support, IIME's activities have faltered. IIME should be strengthened and given greater support by the five countries, possibly under the aegis of ODECA (the Organization of the Central American States). Consideration should be given also to establishing a regional institute to provide training for secondary school teachers in fields of specialization which could not be economically provided in one country, particularly science and vocational or technical training. In the field of training for business administration, a matter of importance for the future, an interesting beginning is being made by a nonpublic institution located in Nicaragua, supported by Central American businessmen, with advice and assistance from a leading United States university.

D. Conclusions

146. The public investment programs of the five Central American Republics as outlined by them for the next few years are all ambitious and unlikely to be completely achieved. Even so, it should be feasible to substantially increase the levels of investment over those of recent years to meet national needs and carry forward projects for regional development. Much remains to be done in project studies particularly for

1/ The fields selected thus far are: sanitary engineering, public health, chemistry and microbiology; and at the undergraduate level, veterinary science and animal husbandry and microbiology.

those which will begin in 1969-1970 and the need is acute in agriculture (including credit programs) and in fields in which planning and execution of projects with foreign financing have lagged in the past such as education and public health. On the whole, the general balance of the investment programs and the composition of the various sectors appears to be well designed for purposes of development.

147. The investment programs clearly reveal the need for coordinated or regional planning or action in several fields - principally highways, ports, telecommunications, grain storage, education, and electric power. In these fields and eventually possibly others, the countries and the regional authorities as well as the external lending agencies will need to take account of the regional aspects of projects in the various national public investment programs; increasingly there may be difficult questions of relative priorities between projects of national and regional importance at the regional level. Coordination of investment planning of the five countries has been taking form. The heads of the five National Planning Offices meet fairly regularly to review investment problems and act as an advisory body to the Economic Council (formed by the Ministers of Economy). Ministers responsible for particular fields in their respective countries increasingly meet together as do various subcommittees such as those on electric power and telecommunications to coordinate their respective programs and to plan for studies of immediate or future problems. Assistance from JOPLAN, now a part of SIECA, and ICAITI in helping countries formulate investment projects or programs which should be suitable for international financing - making use of available assistance from international agencies - would be a rewarding field for regional action on investment problems. Moreover, as the economic integration and development of the region advances, the need for coordination of investment plans and the development policies of the five countries will become increasingly apparent.

V. DEVELOPMENT FINANCING AND GROWTH

A. Introduction

148. The major issue immediately facing the region generally is how to sustain a higher level of investment required for further growth of the economies and the integration of the region when, in the next few years, the rates of growth of GDP will be declining and the balance of payments positions of the countries deteriorating. The policies adopted in order to deal with it will be largely the responsibility of individual countries. This issue presents itself in somewhat different manners and dimensions in each of the countries. Hence the particular situation and prospects of each country are summarized separately in Part II. However, the decisions of each of the countries, will, in many respects, affect the welfare or interests of the others, as well as the success of common programs or policies for integration. The present chapter therefore attempts to present a general view of the dimensions of the region's problems and the major elements in its solution. Necessarily, the discussion at many points is couched in statistical terms. These, particularly as they refer to the future are intended to illustrate and define the direction of trends amd magnitudes of problems, based on assessments and estimates made by the mission. They are, however, subject to wide margins of error and in the event they may well be influenced by the actions within the powers of the governments of Central America, individually or combined.

B. Needs for External Financing

149. The levels of public investment needed for national progress and regional integration during 1967-1970 by the five countries, as estimated by the mission, would total some CA$840 million for direct public investment plus some CA$160 million for indirect investment through special credit programs for agriculture and industry. As part of the pattern of financing such levels of investment, governments would need to increase their levels of public savings substantially, as described in the next section of this chapter. To complement their internal savings, the countries will need to obtain large amounts of foreign financing for projects of both national and regional significance. The possible amount of such external financing has been estimated by the mission on the basis of probable drawings on existing loan balances, plus possible drawings on new loans which may be made during the period by external lending agencies (including CABEI) for projects suitable for external financing (as discussed below). For the five countries, the total of such estimated drawings on external loans in 1967-1970 would be in the order of CA$560 million, including CA$450 million for direct public investment projects and about $110 million for special credit programs for the development of private industry and agriculture. The drawings for direct investment in 1967-1970 would be twice the amount realized in 1962-1965. While the levels of external financing would vary from year to year during 1967-1970, they would generally tend to rise over the period, as the investment program advanced.

150. For the region as a whole, such external funds would contribute some 54 percent of direct public investment during 1967-1970, ranging from 51 percent to 55 percent among the five countries. (Net of external debt amortization, the external funds would amount to 45 to 51 percent of investment, except in Costa Rica, where extremely heavy repayments scheduled on external bank credits would bring the percentage down to 16 percent for the period.) Such a proportion of gross external financing would be slightly higher than the five country average of 50 percent which prevailed in 1962-1965 (mainly because of increases in the proportion of external financing for Guatemala, El Salvador and Nicaragua, despite decreases for Honduras and Costa Rica). However, the mission considers this proportion not unreasonable in view of the effort to raise the levels of public investment for development, at a time when GDP will be growing at a slower pace and the balance of payments of countries often will be in difficulty.

151. To assure such flows of external funds, the five countries would need to obtain new loan commitments in the order of US$575 million. Of this amount $325 million might be committed during 1967-1968 (including $20 million already signed in late 1966), and the remaining $250 million in 1969-1970. More than half the external borrowing of the region would be for transportation and electric power projects, which have a high foreign exchange component. Based on the practices followed by the several external lending agencies for projects, the total of project loans would be equivalent to about 62 percent of the total of the project costs (varying from 56 percent in Costa Rica to some 70 percent in Honduras and Guatemala). Specific projects already studied or in preparation can be identified which would lay a basis for most of the borrowing in 1967-1968. However, identification of projects is less complete and their state of readiness less advanced for loans to be committed in 1969-1970, and the countries will need to exert greater efforts in the preparation of projects to avoid slippage in their borrowing programs.

152. The terms of lending to the Central American countries by the several external lenders vary considerably. Generally, there has been - except in Costa Rica in recent years - little accumulation of relatively early maturing debt. Some loans will probably be obtained on virtually concessional terms, and a small portion of borrowing may be repayable in local currencies. The mission has therefore considered that on the average the new borrowing would be at an interest rate of 6 percent, with a maturity of 20 years (including a grace period of 4 years). In the case of Costa Rica, however, this would require a change in the policy of contracting substantial amounts of privately-placed debt with early maturities. On this basis, debt service payments on the new debt which might be contracted through 1970 for public investments projects, plus that already incurred, would rise in the future somewhat in all countries, except in Costa Rica, whose present high debt burden should fall as the existing medium-term debt is amortized. The total debt service burden in relation to foreign exchange earnings in 1970 would be between 5 and 6 percent in four countries and 9 percent in Costa Rica in 1970. Even in 1975 the burden on such debt would range between about 5.0 percent to 7.5 percent among the five countries. Generally these overall burdens are not excessive in and of themselves and would be within the power of the countries to service without excess strain provided that investment programs outlined were followed and related economic policies necessary to maintain financial stability were implemented.

C. Needs for Additional Domestic Financing Effort

153. To complement the external funds, all five countries will need to increase the level of public savings both absolutely and in relation to GDP. Fiscal revenues of the five countries increased rapidly in the last several years in response to the boom in exports and incomes. But, while GDP had increased rapidly (46 percent from 1961-1965) fiscal revenues in 1965 remained 9 to 12 percent of GDP, not appreciably higher than they were five and ten years earlier (except in Nicaragua and Honduras). Thus the tax systems evidently failed to increase the fiscal share of the rising income brought about by the expansion of exports and the growth of industrial output. Taxes on property remained very low, and generally the highly profitable export sector was not taxed more heavily than before. Meanwhile the development of the Common Market and the related industrial policies affected the revenue base adversely; there was a substantial substitution of duty-free imports from within the Common Market for imports from the outside world, especially in finished manufactures for consumption, and a growth of exemptions from import duties to promote industrial development. The share of foreign trade taxes in total revenues dropped in all countries between 1961 and 1965. Hence in order to maintain revenue growth, all countries introduced new tax measures. Consumption taxes were a principal source, but receipts from direct taxes also rose substantially in four countries, partly as a result of changes in tax structures and also because of improved collection practices. They rose rapidly in Nicaragua where the tax on income of the main export sector was levied by retention of export proceeds.

154. Current expenditures evidently rose less rapidly on the average than the current revenues of the Central Governments in all the countries except Costa Rica; current savings of the Central Governments tended to increase, except in Costa Rica. Total public sector savings appear to have moved roughly in line with those of the Central Governments. The public savings effort of the various countries in relation to GDP improved significantly in most countries over 1962-1965, as shown below, except in Costa Rica where they decreased; however, the level in Guatemala is still very low, and only moderate in the other countries except in Nicaragua.

Country	Public Savings in Relation to GDP (Percentages)	
	1962	1965
Guatemala	1.2	1.6
El Salvador	1.1	2.7
Honduras	1.0	2.6
Nicaragua	3.0	5.6
Costa Rica	3.1	2.8

Internal credit, including non-bank credit, was used in varying degrees in the several countries, but the tendency was to use bank credit for the public sector in relatively modest amounts.

155. Revenue prospects in the several countries to 1970 have been estimated by the mission taking account of some improvement in collection of present coffee taxes, lower rates of growth of foreign trade than in the past, and possible implementation of certain consumption and property taxes which were either being taken or considered at the end of 1966, i.e., with no change in present policies. In projecting current expenditures the mission has considered that it will be necessary for the several governments to exercise great restraint in non-development current expenditures so that current outlays for developmental purposes might increase as needed with the growth of population and the projected investment programs. It has also allowed for growth in savings of the autonomous agencies, which however will be absorbed in their investment programs. On this basis, the internal public savings effort of three of the countries will fall short of the amount needed to finance the projected public investment in 1967-1970, even with the assistance of the inflows of external funds, referred to above, which the public savings must complement. Thus, Costa Rica, Guatemala and El Salvador will need to increase their internal public savings effort by considerable margins, in order to finance the projected public investment programs. The first two need to do so urgently by enacting new revenue measures. In Costa Rica, the need is particularly acute; failure to restrain rising expenditures, and to provide more revenue leading to borrowing abroad from commercial banks at relatively short term, thus raising debt service sharply, and recent recourse to the Central Bank, has resulted in a financial and exchange crisis. The position of Honduras, with its present tax system and revenue prospects (and the foreign financing prospects indicated above), is not likely to be out of balance. Nicaragua has sharply stepped up its tax effort in recent years. It therefore may be able to generate public savings large enough to result in some surpluses; should they arise, they ought to be used to augment the lagging investment effort in certain sectors, especially education and public health, which may occasion some increase in current outlays.

Central America: Public Sector Investment and Its Financing by Countries, 1967-70
(In million CA pesos)

	Guatemala	El Salvador	Honduras	Nicaragua	Costa Rica
Public Investment	214	242	162	207	175
Direct	180	202	146	161	149
Credit Programs	34	40	16	46	26
Financing	185	191	162	234	107
Public Savings	83	77	80	137	75
External Credit (net)	98	114	82	97	28
(Gross)	(125)	(132)	(90)	(118)	(97)
(Amortization)	(-27)	(-18)	(-8)	(-21)	(-69)
Net Internal Bonds	4	-	-	-	4
Gap or Surplus (-)	29	51	0	-27	68

Source: Tables 20 a-e

156. While there are worthwhile possibilities in some of the countries for increasing public savings by higher charges for public services, or, in some cases, by reductions in Central Government transfers to independent agencies, the major effort to close the gaps shown above will need to come from a greater tax effort. By 1970 this effort would need to produce some 10 to 25 percent more than the revenues forecasted by the mission, with present policies. This might best be accomplished by concentrating on (a) increasing the burden of coffee taxes; (b) increasing consumption or general sales taxes (preferably at the wholesale level) to discourage demand for imports, preferably non-essential items; (c) increasing property taxes since these are now very low and a small increase, even on present valuations, would close a large part of the domestic financing gap in the three deficit countries. Aside from these measures, others set forth in a recent detailed study of taxation prepared under the joint auspices of the OAS and IDB could be undertaken. The losses from competitively granted fiscal exemptions could be reduced if these were replaced by uniform provisions for accelerated depreciation and if income taxes on companies were levied on a proportional basis rather than on the basis of the progressive tax applied to personal incomes by four of the countries (see para. 72). Also, there is a case in all countries for increasing road user charges, bearing in mind, however, their implications for regional aspects of transportation.

157. Tax reforms are needed not only to solve the medium-term fiscal problems in three of the countries but also, throughout the area, to enable the countries to raise the proportion of domestic financing after 1970 in the higher levels of investment which they will be trying to attain.

158. In the coming years, the prospects are that recourse to the banking system could not be relied upon as a substitute for an increased fiscal effort to finance the investment programs. Any increase in bank credit facilities will need to be reserved to permit private sector growth in the next few years. As noted below, the prudent margin for internal credit expansion in the next few years is very slim indeed.

159. If the necessary internal savings are not created to fill the domestic financing gaps which appear likely to arise in Costa Rica, El Salvador and Guatemala, their investment programs would suffer reductions. Since it would probably be necessary to reduce or postpone undertaking some projects which would be expected to be financed in part abroad, the amount of the total reduction in investment would probably have to be considerably greater than the shortfall in local currency requirements. Heavy reductions in public investment would adversely affect the prospects for longer-term economic growth. The mission did not try to postulate alternative reduced investment programs for Costa Rica, Guatemala and El Salvador, since it considered that it would be feasible, with tax measures such as those suggested above, to close the gaps and avoid heavy sacrifices in the investment program.

D. The Balance of Payments and Growth Prospects

160. Despite the rapid growth of exports in recent years, by the end of 1965 both the trade and the current account deficits rose substantially in all countries, except El Salvador and Honduras. However, inflows of private and official capital in 1961-1965 more than offset the current account deficits in El Salvador, Nicaragua and Honduras (which increased their net international reserves) and all but a small margin in Guatemala which had a slight fall in reserves. But Costa Rica's balance of payments position deteriorated so rapidly that, despite substantial private bank borrowing abroad toward the end of the period, its net reserves disappeared and became negative by the end of 1965. Even in the other four countries, the ratio of net international reserves to imports remained modest in 1965, ranging from about 15 to 20 percent, affording comparatively little margin for compensating for adverse fluctuations in exchange receipts.

Industrialization and the Balance of Payments

161. The overall balance of payments position of each of the countries was not materially affected by expansion of intra-regional trade, except in Nicaragua. As barriers to trade with the region were removed and the process of import substitution accelerated, exports to the Common Market added substantially to the expansion of total exports of the countries and became an increasingly important share of their total exports.

Intra-Regional Exports and their Relation to Total Exports

Country and year	Exports to region (millions of CA$)	Percentage increase in exports to region 1961 to 1965	Increase in exports to region as percentage of increase in total exports 1961 to 1965	Percentage of exports to region to total exports 1961 and 1965
Guatemala				
1961	10			9
1965	38	269	37	21
El Salvador				
1961	14			8
1965	45	213	45	24
Honduras				
1961	8			12
1965	22	166	25	18
Nicaragua				
1961	2			3
1965	10	444	11	18
Costa Rica				
1961	2			2
1965	18	840	60	17

Source: SIECA

162. Differences between annual intra-regional exports and imports of the individual countries within the region have been fairly small between 1961 and 1965; most countries have experienced alternating surpluses and deficits; only Guatemala has had consistent though not large surpluses and only Nicaragua has had increasing trade deficits with the rest of the region. As there have been no significant intra-regional investment income or intra-regional capital movements, the substantial growth of intra-regional trade in itself in the last five years had little effect on the overall balance of payments position of the countries, and even Nicaragua's overall trade balance was in surplus from 1962 to 1965 despite her adverse balances in Common Market trade. But the structure of trade has been undergoing important changes. Imports from outside the area rose more rapidly than exports to the outside in the last few years. Moreover, the process of industrialization has affected the structure of imports from the outside; thus imports of raw materials, semi-manufactures and capital goods from outside increased faster than imports of finished manufactures from the outside were replaced by domestic production. As a result, the individual

Central America: Imports by Economic Category 1/

(Percentages)

Category	Guatemala	El Salvador	Honduras	Nicaragua	Costa Rica
Total Imports: 1965					
Consumer goods	31	30	44	33	36
Intermediate goods	10	13	7	10	5
Raw materials	6	6	2	4	1
Capital goods 1/	53	51	47	53	57
Total 2/	100	100	100	100	100
Increments: 1962-1965					
Consumer goods	26	15	48	27	38
Intermediate goods	8	10	7	15	3
Raw materials	8	12	1	9	2
Capital goods 1/	59	63	44	50	56
Total 2/	100	100	100	100	100

1/ Including unfinished

2/ May not add due to rounding

Source: SIECA data classified by the mission

countries and the region as a whole increased their dependence on outside imports, as measured by the ratio of imports from outside to GDP, which increased from 17.1 percent to 19.4 percent between 1962 and 1965. But if imports from outside of finished capital goods are excluded, the ratio of imports from outside to GDP of the remaining categories of goods increased by 1.2 percentage points. Thus through 1965 the region was able to increase substantially its stock of capital equipment - either by modernization or net addition or both - without appreciably increasing the ratio of all other imports to GDP. Imports of crude materials and semi-manufactures from outside the region grew at rapid rates.

Composition of Imports from Abroad into Central America, by Economic Categories, and Annual Average Rates of Increase, 1962-1965
(Percentages)

Category	Shares of Total in 1962	Annual Average Rates of Increase	Shares of Total in 1965
Consumer goods 1/	39.5	8.8	35.5
Crude materials	2.3	39.3	4.4
Semi-manufactures 2/	14.8	17.2	16.3
Finished capital goods	43.4	12.3	43.8
Totals	100.0	13.0	100.0

1/ Includes crude foodstuffs, manufactured foodstuffs and other finished manufactures for consumption.
2/ Includes semi-manufactures for consumer goods and for industry.

Source: SIECA official trade figures as classified by the mission.

163. The growth of crude materials imports, shown in the table above - 39 percent annually - reflects to a large extent the substitution of crude and semi-refined oil for gasoline imports as local refineries were built in four countries. But, even after taking account of this factor, crude materials imports grew at a yearly average rate of 25 percent, and semi-manufactures at 17 percent. Raw materials and semi-manufactures will no doubt have increasing weight in future imports from abroad if the process of industrialization along recent lines advances further and will thereby introduce new rigidities in the balance of payments of the region.

164. In its first four years the Central American Common Market has been a positive factor of economic growth. Value added in manufacture and employment in industry has increased without appreciable rise in internal price levels. However, while the creation of the Common Market has widened the margins for industrial growth, for which there appear to be substantial possibilities, further industrialization through import substitution alone faces serious constraints in the prospective balance of payments positions of the individual countries. With the present pattern of industrialization these are likely to be felt increasingly.

Hence, as already indicated in Chapter III, an essential condition for further industrialization and for the fuller utilization of the remaining opportunities of internal growth will be to develop exports, including industrial products, to international markets.

Prospects for Economic Growth

165. Should the exports of major commodities to world markets develop much more slowly in the future, as estimated by the mission on the basis of available market and production indications, this would adversely affect the prospects for growth of the economy of Central America. The main export factors have been discussed in Chapter II: in summary, international cotton prices are likely to weaken and affect output which has encountered production difficulties resulting in cost increases; export quotas under the International Coffee Agreement, likely to rise slowly due to slow increases in world demand, are expected to be applied strictly, in the face of declining coffee prices; banana production in principal producing areas is likely to rise only slowly with a secular increase in world demand. Such slowdowns in growth of export proceeds to the outside world are likely to affect demand for Common Market manufactures and intra-regional trade would therefore be likely to grow less rapidly than in recent years (as indicated in Chapter III).

166. Estimates of possible exports of goods and services for 1970 and 1975 by the mission are summarized below. Given the substantial uncertainties of future market and production developments, there may well prove to be substantial variations from these estimates. Moreover, some new hitherto overlooked or underestimated export possibilities may yield additional earnings. But these estimates serve to illustrate

Total Exports of Goods and Services, Actual 1965 and Estimated 1970 and 1975
(million CA pesos)

Country	Actual 1965	Estimated 1970	Estimated 1975	(Percentages) Average annual growth rate 1960-1965 1/	1965-1970 2/	1970-1975 2/
Guatemala	228	260	350	11.6	2.6	6.1
El Salvador	213	220	275	13.0	0.6	4.6
Honduras	130	160	210	13.8	4.2	5.6
Nicaragua	174	210	260	15.9	3.8	4.4
Costa Rica	138	195	260	9.4	7.2	5.9

1/ From national accounts data.

2/ These figures exceed estimated future commodity exports (Table 28a-e) by a fixed margin, based in each case on a fairly stable relationship in recent years between invisible and visible exports: about 20 percent in Guatemala; 10 percent in El Salvador; 5 percent in Honduras; 20 percent in Nicaragua; and 20 percent in Costa Rica.

Source: Official data and mission estimates

probable trends as they now can best be foreseen. They point to average rates of growth in export earnings during 1965-1970 which would be substantially less than in recent years for all countries except Costa Rica, where the fall off would be relatively minor mainly owing to improvement of banana exports and recovery of coffee exports. Such low rates of export growth would in all likelihood result in rates of economic growth much lower than in the last five years and than the satisfactory average rate of 5-6 percent achieved in the decade 1956-1965. So far as can be estimated annual GDP growth rates in 1967-1970 would be likely to range between one percent in El Salvador and Costa Rica to 2 percent in Guatemala and 4 to 5 percent in Nicaragua and Honduras. With growth of population at recent rapid rates, per capita GDP is therefore likely to fall during the period, except in Nicaragua and Honduras where it may rise slightly.

167. Implicit in such rates of economic growth are slower rates of import growth, particularly in El Salvador, Costa Rica and Guatemala; these would range from an annual average of about one percent to 3 percent during the period. In Nicaragua and Honduras, import growth rates, while less than in recent years could still be substantial, in the order of 6 and 9 percent annually. As indicated above, there seems to be little room for relieving restraint on imports to this degree by drawing down net international reserves. Given the high propensity to import, excessive internal credit expansion would immediately add to balance of payments pressures. Within the limits of the foreign exchange earnings as estimated by the mission, net annual internal credit growth, which doubtless will be affected in any case by a falling off in growth of bank deposits as growth of export receipts slackens, would need to be restrained to modest limits. Thus, it probably could not exceed something in the order of one percent in El Salvador and two percent in Guatemala and Costa Rica; in Nicaragua and Honduras it could probably run at about 5 to 6 percent annually. With such prospective limitations on credit growth, the financial authorities can hardly look to bank credit to assist in financing deficits in the public budget, since the available increases in bank credit will be needed for the private sector.

168. A slower rate of internal growth will doubtless affect imports of capital goods which accounted for a large share of the incremental increase in imports from abroad in recent years, although, to some extent, capital goods imports will be covered by financing from abroad. Generally, however, the advance of industrialization, bringing with it needs to import of replacement parts, raw materials or semi-finished inputs, has increased the elements of rigidity in the import structure. It may well become necessary for the authorities to pursue policies intended to restrain internal demand, and consequently demand for imported inputs for manufactures, especially for the less essential types of consumer goods (e.g. by restraints on consumer credit, selective sales taxes). In the view of the mission, the lower growth of import capacity and the consequent difficulties of adjusting to it, serve to emphasize the need for reexamination of the policy of granting industrial incentives for industries relying heavily on imported inputs and adding relatively little in value in the process of production.

169. While the outlook for export growth in coming years appears unfavorable there seems to be no general case, at present for promoting exports by a devaluation of the currencies. Some increases in internal production costs have affected the profitability and hence the export possibilities of some commodities (particularly, cotton, due to costs of combating plagues and attempts to increase output by applying more fertilizer), and a weakening of export prices may well affect the major commodities in varying but relatively small degree. But export markets for cotton, coffee and bananas are not likely to be increased by devaluation (given the peculiarities of their markets, such as the importance of U.S. price policy for cotton, the quota system for coffee, and the slow rate of increase in consumption of bananas). Moreover, there are good prospects that studies of techniques of cotton production (now going on in El Salvador), may bring down present costs of production, which, in some cases, rose because of speculative development of production under previous market conditions. The prospects for new export lines depend mainly on establishing markets and developing latent production capacities; thus far prices abroad do not seem a principal determent. On the import side, a devaluation would doubtless discourage imports, but with restraints on credit and appropriate tax measures, imports could probably be kept under control.

170. As for individual countries in the region, membership in the Common Market implies severe restraint in recourse to alterations of their exchange rates as a means of dealing with balance of payments pressures. When one of the countries makes a change in its exchange rate, the others are immediately affected, as has been shown recently when Costa Rica instituted a dual-rate system, part of which was a free rate applying to certain commodities, whatever their origin. Costa Rica soon changed this system so as to trade with the other Common Market members at the earlier official rate. However, should this arrangement continue, the countries will continue to face the complex question of whether a member of the Common Market may maintain certain rates for transactions within the Common Market and others for transactions with the outside world. The Costa Rican case may yet demonstrate that imports from the outside through other Common Market countries cannot be prevented indefinitely and that a multiple rate system is not a solution to its problem. Such a development would precipitate for the first time critical and difficult issues as to which financial and balance of payment policies are consistent with the Common Market relationship and which are not. The Common Market partners therefore have a vital interest in the choices made and in the means of correction of the causes leading to the balance of payment difficulties. They could, of course, provide credit assistance to the country in difficulty based on understanding as to corrective policies and thereby avoid the difficult issue of exchange rate adjustment in the Common Market context; however, the possibilities of such intra-regional assistance now are limited by the relative shortages of resources of all countries. This experience also serves to emphasize that they have a vital common interest in the pursuit of economic and financial policies which would avoid or minimize crises of this kind; for this, they will need to begin to coordinate their policies.

171. The unfavorable outlook for growth of exports and domestic output in the next few years reinforces the need for public authorities, national and regional, to promote possibilities of increasing exports, including new lines (as suggested in Chapters II and III). It also reinforces the need to give priority to the use of available local and foreign funds in special credit programs giving early results in output and exports. The mission's estimates of public investment include provision for such special credit programs. These are estimated at about CA$40 million average annually during 1967-1970 for the region (including the use of some $28 million of foreign funds annually), the level rising somewhat through the period. External loans for these purposes could be disbursed fairly quickly if administrative organization is adequate and would have an early impact on production. The public authorities, both national and regional, should therefore push forward with the preparation and execution of projects for channeling foreign funds in development credits to the private sector to achieve at least the levels projected by the mission and if possible to surpass them. These programs for utilization of foreign funds warrant high priority also because prospects are that internal credit expansion over the next few years will need to be kept within much narrower limits than in the past in order to restrain import growth, particularly in Costa Rica, Guatemala and El Salvador. To the extent that such programs can be increased efficiently, they would both help to relieve balance of payments restraints on domestic credit in the next few years and also benefit the longer-range growth potential of the countries. While an increase in foreign lending for such programs above the levels assumed by the mission would raise the debt service burden above the ratios mentioned in paragraph 152, there is still room for moderate additional debt service provided the countries keep on growing.

172. To sum up, it appears feasible for the countries of Central America to sustain a rise in public investment in the face of lower rates of export growth in the next few years, provided foreign financial assistance for project loans is forthcoming, and is matched by adequate internal savings effort, which will require additional internal fiscal measures in at least three of the countries - El Salvador, Guatemala and Costa Rica. Moreover, looking beyond 1970, additional effort by all the countries will be needed in order to confront their needs for rising investment levels in the future. The measures adopted by any one of them - particularly to control credit, remedy their fiscal or balance of payments imbalances, promote industrial growth - will affect the prospects of the other countries. Hence, harmonization - that is, mutual adjustment of policies to achieve consistent common objectives - will be increasingly important in a variety of fields: taxation, monetary and fiscal policy, tariffs and industrial incentives, educational programs and coordinated programs in infrastructure (particularly transport, power, telecommunications, grain storage and education). Such harmonization could be greatly advanced if the countries strengthened their capacity to take decisions as a group on vital matters of common interest much more rapidly and effectively than in the past. It was suggested above (Chapter III) that a regional tariff and industrial commission be established.

Equally important, the several governments need to make the central body of the integration organization - the Economic Council - more effective by taking the necessary measures internally to enable its members to speak for their governments on all issues which need to come before it rather than being restricted to problems falling within the jurisdiction of the Ministries of Economies.

173. On their side, the external lending agencies will need to look at their lending operations in the area increasingly within the context of regional considerations and emerging issues of regional policy. By and large, external lending agencies have, in the past, regarded the countries of Central America as individual unrelated economic entities, though support has been given to the regional bank and some investment programs of regional significance. Future appraisals of the economic situation and of projects of individual countries will need to take account of what is happening in the rest of the region, particularly to assure that their policies and projects do not run at cross purposes with those of other countries and the development of the region as a whole. In several sectors, external lenders will need to consider projects in terms of their part in a regional program (e.g. highways, grain storage), or in terms of the fact that they cannot be carried out suitably except on a regional basis (e.g. telecommunications, education) or because their role transcends national boundaries (e.g. ports), or because they constitute the best solution to supplying emerging needs (e.g. potentially electric power interconnections), or a combination of these several factors. External lenders will need to be concerned with the improvement of industrial and tariff policies in the Common Market, particularly to centralize the granting of privileges as incentives for industrial development and to better that system, to improve the processes of tariff making and revision so as to secure an efficient and economical industrial establishment and to develop export oriented industries. They will also need to be concerned with the agricultural policies to be followed to diversify out of coffee (including concerted adoption of heavier taxation on that sector) and to provide financing and technical assistance for development of new production and export possibilities - such as livestock and forest products.

174. The bold action of the Central American countries to create a Common Market undoubtedly has broadened the bases for economic growth for all of them. The rapid recent growth of trade within the region should not, however, obscure the fact that the Common Market cannot be an end in itself. But with support from abroad, within the framework of effective national and regional policies, it could become not only a basis for more rapid internal growth but also a more effective means of developing the new exports needed for longer-term growth.

PART II

COUNTRY SUMMARIES

GUATEMALA

175. The economic performance of Guatemala in the last 15 years has been influenced somewhat more by political developments than has been the case in other Central American countries. In the early 50's, at a time when the other economies were growing rapidly as a result of rising coffee prices, Guatemala's economy expanded only slowly because of the uncertainties surrounding the Arbenz Regime and the instability that followed its overthrow. It is only since 1963 that Guatemala has benefitted from rapid economic growth: since then, real income per head has grown by almost 4 percent annually. This rapid growth has been the consequence of an accelerated expansion of cotton production for export, some increase in coffee production accompanied by a recovery in export prices in 1964 and 1965, and a faster expansion of manufacturing, partly as a result of the Central American Common Market. The rapid growth of the economy was not, however, paralleled by any significant increase in public investment. Such investment in recent years has been running at about 2.4 percent of GDP, well below the peak levels reached in 1956-58, at the time the Inter-American Highway and the Atlantic Highway were being built.

Balance of Payments

176. A prospective rise in public investment - discussed below - will be taking place against a background of rather slower economic growth in the next five years than in the recent past. Peak exports in 1966 of $223 million (preliminary data) were attained by (1) exporting half again as much coffee as Guatemala's quota under the International Coffee Agreement envisaged, most of which found its way to traditional markets, (2) by exporting a record cotton crop, and (3) by taking maximum advantage of the Central American market for manufactures. Exports to the Common Market contributed one-third of the increment in total exports from 1962 to 1965, and reached 15 percent of Guatemala's total exports. Medium-term prospects are now dampened by the need to cut back coffee exports to international quotas in the face of declining world prices; by stagnation in cotton output, here as in other Central American countries, due to a squeeze between falling world prices and rising production costs; and by a consequent slowdown in the expansion of the Common Market generally. Estimated merchandise exports are therefore unlikely to exceed US$215 million in 1970, very little above the US$193 million registered in 1965 and expected once more to obtain in 1967. Some additions to earnings from rising tourism may take place over the period, but are unlikely to materially change the order of magnitude of total exchange earnings. The slower growth of export earnings for the next four years or so will be reflected in a substantially slower growth of income than in recent years. Guatemala may not be able to keep the annual growth of income from falling below the rate of population growth.

177. The slower growth of exports is likely to limit substantially the growth of import capacity, after taking into account the foreign exchange availabilities from the projected increase in drawing on existing and potential new foreign loans for the public investment estimated by the mission (discussed later) and other receipts from abroad, as shown in the following tabulation.

	(Million CA pesos)
1970	
Export earnings	257
Public capital receipts (net)	28
Private capital receipts (net)	10
Total exchange availabilities 1970	295
1965	
Imports	249
Permissible annual growth rate 1965-1970	3-4%

This limitation will require a much more restrictive monetary policy than in the last few years, unless Guatemala is rapidly to reduce its modest foreign exchange reserves. On the basis of the mission's projections, the annual growth of imports of goods and services to 1970 will need to be limited by exchange availabilities to about 3-4 percent; this compares with an annual growth of imports of almost 12 percent annually in the boom period 1961-1965. Even with a fairly normal growth in foreign bank loans to the banking system, the permissible annual rate of growth of domestic credit over the next few years within the context of such import limits is unlikely to be much above approximately 2 percent. In the light of experience in the period of export stagnation from 1958-1961, during which imports and domestic credit were stagnant also, these limitations should be manageable for the Guatemalan authorities. They will, however, require:

(1) a balancing of the Government budget, after taking account of disbursements on foreign development loans, if the growth of credit to the private sector is not to be arrested altogether; and

(2) an effective policy to control coffee production in order to avoid diverting scarce bank credit for storage of surpluses in excess of coffee quotas.

178. Economic boom conditions over the period 1961-1965 attracted increasing proportions of bank credit into agriculture, livestock and industry. Though this trend reflected primarily the pull of market forces, it was actively encouraged by the monetary authorities. A slowdown in credit expansion in coming years would therefore be likely to be felt most acutely in these directly productive sectors also. Precisely this factor makes credit restraint effective as a policy to restrict imports: the rapid increase in imports on the upswing was largely concentrated in capital goods and a decline in business activity can therefore be expected to have an immediate impact in the same category as well. Reluctant to go too far in this direction, however, the Guatemalan authorities in early 1967 signed a stand-by agreement with the International Monetary Fund for $13.4 million, reserving the right (1) to introduce selective import controls on a temporary basis should the need arise in the course of the year, and (2) to borrow abroad up to US$3 million on terms of no more than 3 years (all other borrowing to be on terms of no less than 5 years). In addition, they are seeking a substantial program loan from abroad, to underwrite an acceleration of public investment.

Public Investment

179. Public investment in the last eight years has on the whole failed to meet the requirements for growth in the Guatemalan economy. In addition, the composition of actual investment expenditures left something to be desired from the viewpoint of their development impact. Investments in education and electric power have been unduly low. Some of the "social" investment has been on low-priority public buildings, such as the lavish buildings for the Social Security headquarters, the municipality and the headquarters of some state banks. In contrast, however, some of the road construction projects have represented high-priority expenditures and the land settlement projects have had a worthwhile aim, although implementation has fallen short of expectations.

180. The Government's public investment program for the period 1966-1969 calls for a very substantial increase in public investment to an annual average of CA$100 million in 1966-1969, three times the level of recent years. A level of CA$100 million in 1968 or 1969 would represent about 6-7 percent of prospective GDP and would not be unreasonable in an economy in which, because of the backlog of social and economic problems, including a large Indian population outside the mainstream of economic life, the public sector is necessarily called on to play an important role. Guatemala faces major problems to attain these objectives, however, since it is unlikely that the public sector will be able to prepare enough suitable projects to be implemented during the plan period, and also since the domestic public savings necessary to carry out a program of this magnitude, even with considerable foreign assistance, are not likely to be attainable without important fiscal reforms.

181. The new government that took office in July 1966 rapidly embarked on the preparation of major projects in high-priority sectors. Among the larger of these projects are two power projects (for one of which loan documents have been signed), a highway program for the eastern part of the country (which will open up promising areas for agriculture, livestock and lumbering), and a program for primary, secondary and technical education. Late in 1966, loans for agricultural and industrial credit, totalling $6.0 million were obtained abroad by the Central Bank to be channeled to the private sector, and a loan of $4.2 million from CABEI for highways was signed. Even with such and additional efforts, however, the level of public investment that is likely to be realizable will be in the order of an annual average of CA$45 million, a level which is still too low for Guatemala's development needs.

182. The main items in a realizable investment program, over the next 3-4 years will be for transportation. The most important of these will be the reconstruction and improvement of roads: the main road to the Coban area, an eastward link to the Lake Izabal area and back again to the main Atlantic Highway, and an expansion of feeder roads. These projects, for which feasibility studies are yet to be completed, merit priority because of the agricultural potential of the Polochic Valley they will serve, and also because they will permit access to forest resources, including the southern Peten. Total investment for road construction may amount to some $48 million over the next four years. This is about half of what the official plan projected, but about 50 percent more than the levels achieved in recent years. Even this amount of projected road investment, given the variety of roads included, would strain Guatemala's present capacity to plan and administer road building programs.

183. Port investment would include two main projects: the expansion of the Atlantic port of Matias de Galvez, which is being financed by an Export-Import Bank loan, and the proposed construction of a modern port on the Pacific coast. The studies for the latter port have not yet been completed, and it is still uncertain whether the high cost of construction of the port (about US$15 million) in relation to its projected traffic volume (from 250,000 to 500,000 tons) would yield a sufficient rate of return to justify the investment. Despite this uncertainty, for the sake of financial planning, some allowance for expenditures on such a port has been included in the mission's estimates of projected investment.

184. In the case of electric power, the authorities are about to embark upon a major expansion program, to be carried out by the Government's electrical Institute (INDE), whose staff has been strengthened in recent months. INDE completed in 1966 a 13 MW hydroelectric project financed by the Inter-American Bank and, with the assistance of a US$15 million IBRD loan, will begin construction of a 60 MW hydroelectric project in 1967. The new capacity is unlikely to be available before 1970, and the central region of Guatemala may well face a power shortage in 1968-1969 if the load continues to grow at the recent rate of 12 percent annually. The authorities are therefore considering the installation of additional

thermal capacity to provide some reserve. The cost of these projects in this second stage of INDE's program is tentatively estimated at about CA$27 million, including foreign exchange costs of about US$20 million.

185. The Government had planned to increase the number of telephones in the country by about 37,000 over the period 1965-1970 at a cost of about CA$12.5 million; such an increase is justified since at present there are only 24,000 telephones, or 0.55 phones per capita, a low proportion. The program began in 1965, but the financing from the supplier only covers equipment for the first year of the program. This plan is being reviewed by the Government and preliminary studies are being made for a project which would cost about CA$10 million, which might prove suitable for external financing of $7.0 million to cover the foreign exchange costs; this might be ready in 1968. An autonomous telephone agency is to be established to plan, finance and expand adequate facilities, and to operate them efficiently.

186. In the social sector, heavy investment in education at all levels is needed if Guatemala is not to be faced within a decade or less by a growing obstacle to its development in the form of unprepared manpower. The authorities are accelerating preparation of a project including primary school, secondary schools and technical and teacher training at the middle and university levels: they plan to present a project for external financial assistance early in 1967. Investment in education, not only in facilities but also in training and improving the efficiency and quality of education, undoubtedly deserves very high priority in Guatemala's public investment and current expenditures. In housing, the Government housing institute has for several years carried on a modest program of construction of lower middle-income housing; the program is now to be expanded over the period 1967-69, to build 5,700 houses at a total cost of US$9.7 million, of which US$5.3 million will be financed by an existing IDB loan and the remainder by Central Government transfers. But the housing authority expects to enter the low-cost housing field on a larger scale to a total of CA$16 million over the period; this would require more transfers from the Central Government and additional foreign funds of some $3 million. In the last four years, the housing institute has spent about a third of its funds for houses for teachers and military officers: all this construction has been in Guatemala City, and was in part for buyers selected many years ago; these activities should be phased out.

187. There is ample need for expansion of facilities in the field of water supply and sewerage, especially outside Guatemala City, where the municipality has been using its savings to improve the water and sewerage system. With the assistance of IDB loans, various municipalities are expanding their waterworks, although the levels of investment envisaged in the plan will not be achieved in the period. Water facilities could be more effectively developed by having one central agency responsible for coordination, supervision and planning rather than through the various separate Government agencies that now administer and construct water

systems. In public health, the program envisages building enough hospitals to have three hospital beds per 1,000 inhabitants instead of the present ratio of 2.6. The program rightly places more emphasis on areas outside Guatemala City, where the bulk of facilities and doctors have so far been concentrated. However, plans for building the facilities and for staffing them are still uncertain. Altogether, it seems likely that realizable investment expenditures in the entire social sector in 1966-69 may constitute a little less than a third of direct public investment, not an unduly high proportion.

188. In agriculture, the Government's public investments program proposes large expenditures, mostly in colonization and land settlement, but there are delays in the formulation of the specific projects. Expenditures are also proposed for cadastral surveys and for grain storage, markets and some small irrigation projects, for which studies are under way. No direct investments are proposed in industry. For both agriculture and industry the public sector has been an important channel for foreign loans and some local resources to the private sector. These credit programs have been left largely to the initiative of the Bank of Guatemala. Thus, in recent years, the Bank of Guatemala has acted as a channel for loan funds from foreign official agencies and U.S.$5 to $7 million annually in 1962-65. In consequence, the banking system has been able to raise the proportion of its longer-term lending to agriculture (Volume III, Agriculture, Table 14a).

189. The mission considers that the flow of these funds ought to be stepped up considerably in the next few years. The authorities will need to speed up the preparation of sufficient projects for submittal to official external agencies to increase the flow of this lending in the immediate future, particularly if the availability of medium-term funds from U.S. banks on which they have relied to a substantial degree, should diminish. A US$6 million loan from the IDB was approved in October 1966 for agricultural and industrial lending: a major part of the loan will be devoted to small and medium livestock producers (i.e. those with under 200 animals or so). There is need for a similar project for larger ranchers, some of whom have sought loan funds abroad on their own account, and the authorities ought to prepare a credit program for this sector of agriculture. Loans to these farmers on sufficiently long repayment terms are needed to permit a much needed build-up of herds.

190. In sum, the present outlook is that delays in project preparation together with the administrative problems of trying to increase rapidly the levels of investment from those of recent years, make it unlikely that the Guatemalan public sector will be in a position to spend effectively much more than an average of $45 million annually during 1967-70[1] for direct

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1/ The mission has projected the investment estimates for another year beyond the 1965-69 plan.

public investment; another $8.5 million average annually would probably be added through indirect public investment by special credit programs to the private sector. These levels represent a moderate increase over those achieved in 1962-65 when direct investment averaged some $30 million annually and credit programs to the private sector about some $5-7 million. Nevertheless, to carry out the projected levels of investment, the authorities will need to make increased efforts in speeding up and improving preparation of projects particularly those to be financed abroad and their execution once they are financed.

Financing the Investment Program

191. Along with such efforts, increased endeavours in internal mobilization of savings will be required to finance the program. Since 1962 the authorities have moved to strengthen the fiscal position of the Government, and have succeeded in almost doubling the savings of the Central Government. Public savings, after amortization of external debt, have been sufficient to finance about 40 percent of admittedly low levels of public investment and the budget deficit has been limited to manageable proportions. While the Government has borrowed abroad on short-term to help manage its budget, most of this borrowing has been for temporary needs and has been repaid within a year of being incurred, without leading to an accumulation of short and medium-term Central Government external debt. In 1962-63, the Government, faced with the prospect of rapidly rising expenditures, especially for education, put into effect a number of tax reforms, chiefly the introduction of a personal income tax and a doubling of the rates on the stamp tax. These reforms, together with a much improved collection of direct taxes, during a period of rapidly rising incomes, increased Central Government current revenues substantially. But the revenue effort is still very low; even in 1965 Central Government current revenues were equivalent to only 8.5 percent of GDP, while public savings were only 1.6 percent of GDP.

192. The new Government, inaugurated in mid-1966, has been aware from the beginning that in order to move forward with the needed higher level of public investment, it will have to increase the saving capacity of the public sector. Gross disbursements on existing and potential new foreign borrowing on the basis of the present lending practices of external agencies, might cover some 55 percent of projected feasible direct investment estimated by the mission for the period 1967-1970. While such a proportion of external financing of direct investment is not low, it is supported by the need to increase the investment effort, including major projects with a high foreign exchange component and by Guatemala's efforts to improve economic and financial performance. But local resources would need to be increased even with this pattern of foreign financing, as indicated in the tabulation below:

Guatemala: Public Investment and Financing for Period 1967 - 1970
(Million CA pesos)

Public Investment		214
Direct investment		180
Credit programs		34
Financing		185
Public Savings		83
External credit (net)		98
gross receipts	125	
amortization	27	
Net internal bonds		4
Gap		29

193. Hence, measures to cover the gap will be necessary. The public savings estimate shown above is based on the assumption that the growth of current expenditures will be held to a minimum consistent with feasible development programs and with the continued provision of social services on a constant per capita basis; if the authorities exceed these levels, there will be a shortfall in the estimated savings. Estimated revenues already take account of emergency legislation passed by the Assembly in November 1966 and expected to yield about CA$6 million, before it lapses at the end of 1967. Even should this legislation be renewed, therefore, the authorities will still be faced with a gap of about CA$7 million annually, on the basis of the financing pattern outlined above. Anticipating such problems, the Government of Guatemala at the end of 1966 set up a commission to propose permanent tax reforms: its report is expected in June 1967, with legislation scheduled to become effective in 1968. For the interim, it has been seeking a program loan abroad to help bridge the gap.

194. From the point of view both of budgetary balance, and to discourage coffee production in excess of international quotas, increased taxation of the coffee sector commands a high priority. Three specific taxes should be considered in this context. (1) Export taxes: from 1960 to 1965 proceeds failed to increase in spite of the export boom, as the tax base for coffee was shifted from identifiable price quotations in New York to local contract prices. In 1965, consequently, while the theoretical yield of coffee export taxes should have been 14 percent ad valorem, the CA$8.4 million actually collected came to less than 10 percent of export value. (2) Income taxes: the basic exemption for agricultural incomes of less than CA$15,000 exempts the majority of coffee growers from income tax liability. (3) Property taxes: These are now a virtually untapped source of revenue in Guatemala. Property is now taxed at a rate of only 0.3 percent of assessed value and yielded only CA$2.6 million in 1965, accounting for a little over 2 percent of

Central Government current revenues. If the foregoing sources are not sufficient, increases in sales and excise taxes, particularly on non-essential items, would not only yield revenue but also immediately affect import demand.

195. Even with measures adequate to close the prospective budgetary gap in 1968-1970, Guatemala's public savings effort would be relatively low - less than 2 percent of GDP, probably the smallest relative saving effort among the Central American countries. Guatemala needs to increase public investment in priority fields, if possible above the levels projected in 1968-1970, and certainly in following years. She should also endeavor to reduce her heavy reliance on foreign financing for such investment; consequently she should begin now to take tax measures providing a basis for an even higher relative level of public savings with late 60's and 1970's.

External Debt

196. Effective new tax measures yielding at least CA$13 million per annum are required to finance even the scaled-down investment program considered technically feasible by the mission, provided external loan funds to finance some 55 percent of direct public investment would become available. This ratio would be about the same in the mission's projections if public borrowing for credit programs to the private sector is included and account is taken of private investor's contribution to the projects financed under the credit programs. Based on lending procedures of various external agencies, foreign loans for the major public investment projects which appear to be suitable for foreign financing would, on the average, cover about 70 percent of the total project costs. This percentage would be mainly influenced by the high foreign exchange cost component of the major projects in electric power and transporation and, in some instances, 100 percent financing of roads by CABEI.

197. At the end of 1965, Guatemala had only US$25 million in undisbursed foreign loans available to finance public investment and programs of credit channeled by public institutions to the private sector. The new potential foreign loan commitments implied in the mission's projection total about US$140 million over the next four years or so. About one-third of the borrowing for 1967-68 is covered by completed studies, and one-half by studies yet to be completed. Projects for commitments in the 1969-70 period are almost entirely still to be prepared. It is clear that the timely execution of the levels of public investment projected by the mission will require an intensified project preparation effort. The service on Guatemala's external public debt service is still low, falling from 3.5 percent of export earnings in 1966 to 2.7 percent of projected export earnings in 1970. The additional borrowing over the period 1966-1970 of about $140 million would raise debt service to about 5.5 percent of projected export earnings in 1970 and to 5 percent in 1975.

198. Such a debt service burden is not heavy and suggests that Guatemala could further increase its external debt to finance additional projects if they can be formulated and also to tide the country over the coming period of financial stringency. The authorities have been exploring the possibility of a foreign program loan. For the relatively brief period until adequate tax measures can be introduced, some program lending may be justified. With adequate tax measures, balance of payments equilibrium would be attainable, on the assumption of tight credit restrictions, though per capita GDP would be declining. Further increments in foreign borrowing for the purpose of ameliorating the slowdown in economic growth might best be channeled through the Central Bank, however, in support of credit programs to agriculture and industry if it is possible to expand them efficiently, on condition that firm ceilings are established on access to bank credit by the coffee sector. Increased foreign assistance can in this way be tied most directly to an attack on the underlying longer range problems of export expansion and diversification.

Creditworthiness

199. Guatemala's medium-term prospects are much less bright than they have been in the recent past: Guatemala is committed to reduce its exports of coffee to within its quota for 1967, its cotton acreage has shrunk by 18 percent in consequence of rising costs and declining world prices, and its export earnings for 1967 are therefore expected to drop by about 13 percent below those in the record year of 1966. The Government has responded to these impending difficulties by (1) arranging a stand-by with the International Monetary Fund for $13.4 million, (2) exploring with a foreign Government the possibility of a program loan pending fundamental tax reforms later in the year, and (3) accelerating the signing and disbursement of foreign development loans. These measures, together with the possibility of imposing temporary import controls and of borrowing up to US$3 million on short-term from foreign commercial banks under the stand-by arrangement, are likely to hold the loss of net external reserves of the Central Bank to small amounts.

200. In the longer term, beyond 1970, Guatemala's economic outlook is more encouraging. Guatemala still has fairly large unoccupied areas on the productive Pacific coast suitable for cotton production. Even at prospective lower prices of the 1970's, Guatemala should be able to resume a large scale expansion of cotton output after cotton producers have had time to adjust to lower prices (an adjustment which should be feasible in view of the very high yields already obtained and of possible improvement in production practices). The proposed highway investment on the Atlantic coastal plains should, in the early 1970's, facilitate the development of Guatemala's excellent potential for forest products and cattle. A resumption of economic expansion in neighboring countries of the Common Market is likely to stimulate a recovery of manufacturing. Guatemala's leading position in producing fruits and vegetables, as compared to the other Central American countries, should furthermore enable

it to industrialize some of its agricultural products for export on a larger scale than at present. There are also favorable prospects for exploitation of substantial nickel ore deposits. The slowdown of economic growth over the next few years is likely to be temporary; however, the realization of Guatemala's encouraging long-term potential depends, perhaps more than in the other Central American countries, on substantial investments to take advantage of its resources. While resulting external borrowing is large and will require additional complementary measures to generate public savings, the debt burden should be manageable in view of Guatemala's favorable longer term prospects, its low service on the existing external public debt, and its general tradition of prudent monetary management.

EL SALVADOR

201. El Salvador's economic activity in the last 15 years has continued to be principally dependent on agriculture, particularly agriculture for export. This narrow base has nevertheless, in most years, permitted a substantial rate of growth in GDP, averaging over 7 percent annually from 1956 to 1965, while population increased at a rate of 3.5 percent annually. In the early and mid-fifties, economic growth was in large part the result of high and rising world prices for coffee. With the sharp drop in coffee prices in 1958 economic expansion slowed down considerably. But from 1960 to 1965, export earnings grew at an annual average rate of 13 percent reaching $190 million. Cotton production had risen rapidly, in part stimulated by the construction of a highway on the Pacific coastal lands. This rapid expansion of cotton production was supplemented by the recovery of coffee prices in 1963/64. These two items still accounted for some 70 percent of export earnings in 1965. However, the growth of exports to the Common Market has been a major element in the expansion of export earnings. With the rapid expansion of manufacturing, exports to the Common Market, mainly manufactures, almost tripled from 1961 to 1965, and accounted for 50 percent of the increase in Salvador's total exports in that period. By 1965, Salvadorean exports to the rest of Central America totaled US$46 million, almost one-quarter of her total exports; and her imports from the Common Market were some $42 million, or about one-fifth of her total imports.

202. During the rapid economic growth of the last 15 years, the lower economic levels of society have been modernizing gradually, as a result of industrialization, the spread of cotton production, and the introduction of a minimum wage, in a manner which would not have resulted from a simple coffee boom. Moreover, the authorities have taken advantage of the prosperoty of the last few years to launch several programs in the social sectors and in credit and technical assistance to small farmers. The authorities have also been strengthening the institutions of the public sector, particularly the Planning Office, so that El Salvador is now much better equipped than ten or five years ago to face the decisions and prepare the projects necessary for its continuing development.

203. El Salvador will probably face stagnation or decline in its export receipts in the next four or five years. Cotton production fell by almost 40 percent in the crop year 1965/66 due to bad weather and disease: the prospect of lower cotton prices in the next few years, combined with a disincentive effect of the last crop and higher costs, will probably lead to a decline of cotton production and exports in the next few years. El Salvador faces a surplus of exportable coffee starting in 1966/67; with prospective quotas under the International Coffee Agreement, however, coffee export earnings cannot be expected to grow by much in the next few years. It is likely that manufacturing plants already under construction or projected will lead to some increase in the exports of manufactures to the Central American Common Market, which would largely account for the modest overall increase in exports projected for 1970, representing an average annual increase in export receipts of about 0.6 percent over the period 1965-1970. In the long run, El Salvador has, apart from its dynamic entre-

preneurial class, no special natural resource advantages compared to the other Central American countries. With its limited land area, El Salvador does not have the potential for livestock and forest products of the other Central American countries or any further substantial extension of the margins of cultivation. While, therefore, the setback to export earnings may be of a temporary nature, and exports from 1970 to 1975 may rise at a more rapid rate, at about 4-5 percent per annum, the future growth of Salvadorean production and exports in the seventies is uncertain, depending on recovery in cotton and development of markets for manufactures in Central America.

204. Such low rates of export growth in the next few years will adversely affect the growth of domestic production. Based on recent relationships of export and population growth to changes in GDP, and taking account of the need to restrain import within the limits of estimated resources, growth rates in 1967-1970 are likely to be about one percent annually, far less than the population growth rate of 3.5 percent. Such rates of growth will pose serious problems regarding the balance of payments and credit restraints. To illustrate, the following data summarize estimates of El Salvador's prospective exchange availabilities in 1970 in comparison with imports in 1965, and the annual growth in imports to 1970 which would need to be observed in order to avoid balance of payments difficulties or an excessive drawdown of reserves. Public capital flows, net of amortization and interest payments, are derived from disbursements proposed by the mission from foreign financing of the finance investment program. Private capital flows, (net of amortization and direct investment income) have varied considerably between CA$7.5 million to CA$16.3 million in the period 1961-1965, but averaged about $5 million. There will still be opportunities for private investment in El Salvador and, while any estimate on net capital flow is subject to wide error, it seems reasonable to assume that net inflow in 1970 would be some CA$5 million, about the same as the annual average of 1961-1965. On this basis estimated exchange availabilities in 1970 would be as follows:

	CA$ million
Export Earnings	220
Net Private Capital	5
Net Public Capital	20
Total	245

In comparison, imports of goods and services in 1965 (net of income payments), were CA$232 million. Thus, if such imports were not to exceed the exchange availabilities in 1970, they could grow no more than an average rate of one percent annually. In previous years, imports had been growing at a much more rapid rate, consistent with rapid export and GDP growth while rising deficits in the current account balance were covered by heavy private and public capital inflows.

205. A direct implication of the foregoing is that internal credit restraint in the next few years will need to be geared to the lower rate of internal growth and permissible import growth. A drawing down of exchange

resources does not appear to offer much room for deliberately raising the rate of import growth, since even though banking system net international reserves doubled from 1962 to 1965, they amounted to about two and one-half months' imports. Assuming that the relationships between growth of output and demand for credit in recent years remains unchanged, the growth of internal credit would need to be left at slightly less than one percent annually. In recent years (e.g. 1965), only about one-fifth of total bank credit was extended to the Central Government. However, public demands on the credit system to help finance the investment program in the next few years will need to be severely limited to permit a maximum leeway for the private sector. One source of credit expansion for productive purposes which should be expanded consists of foreign long-term loans for agriculture and industry. The authorities are at present elaborating a program of credit to commercial farmers to expand production for export; such studies should be given a high priority. Among some of the promising possibilities in this field are fruits and vegetables, and intensive livestock fattening to substitute the imports taking place at present. To the extent that such possibilities can be developed beyond the levels included in the 1967-1970 public investment program, it would help alleviate the prospective tightness in imports and credit. Nevertheless, the outlook for the growth of the Salvadorean economy in the next few years is uncertain, and it will be a major achievement if the economy can avoid a reduction in the per capita income of its inhabitants.

The Public Investment Program

206. Direct public investment in El Salvador reached a peak of about CA$27 million annually, or about 5 percent of GDP, in 1956-1958, when major road construction projects were underway. After 1956-1958, peak public investment declined but since 1962, as a result of project preparation efforts in recent years, direct investment rose from CA$14 million in 1962 to almost CA$30 million in 1965. Public investment on the Pacific Highway was crucial in making possible the cotton boom which began in 1962. Similarly, the fact that El Salvador was equipped with a sufficient supply of electric power, and adequate transportation facilities, undoubtedly facilitated the industrial expansion of the sixties.

207. In the last three or four years, the authorities, partly through the Planning Council created in 1963, have made a special effort to improve project preparation in the major sectors, particularly in the sectors which had been relatively neglected in the past, such as education and irrigation. This improvement, together with financially solid and technically competent public institutions in electricity and telephones and with noticeable administrative improvements in the port and housing authorities, means that the Government of El Salvador is technically and administratively much better equipped now than it was some years ago to undertake a major increase in public investment. Such an increase in the level of investment expenditures is particularly timely in view of the likely loss of dynamism in the next few years of other sources of economic growth, especially exports. The Government is thus justified in proposing a major increase in public investment in its plan for 1965-1969, although the average annual level of expenditures proposed (about CA$60 million) - representing an annual average

increase of some 24 percent over the levels of 1962-1965 - is most likely unattainable in the period. The strategy of the program is to concentrate much more heavily than in the past on the social sectors, and on irrigation for high-value crops in view of El Salvador's limited land availability. While these aims in general appear to be consistent with the country's long-term requirements, the very heavy emphasis upon public housing (slightly over one-fifth of proposed public investment) is exaggerated even though some is intended to replace housing destroyed by the earthquake of 1965; it moreover does not take sufficient account of the administrative capacity to execute such a program or of the possibility that the private sector might supply, if given sufficient financial incentives, some of the housing for the upper levels of the low-income brackets.

208. The investment proposed in roads includes the reconstruction of major sections of the Inter-American Highway, the construction of connections along El Salvador's northern border with Guatemala and Honduras, the completion of the National Road program (including improvements in the main roads to the ports of Acajutla and La Libertad, and the Salvadorean connection to the Western Highway in Honduras) and a small but well-conceived program of feeder roads. About half of the road program is devoted to "integration" roads, since El Salvador's main roads are thoroughfares for Central American commerce. The authorities should endeavor to speed completion of the program of construction or improvement now underway before embarking on major new projects. Indeed beyond 1969-1970, there are no clearly recognizable priority areas for road construction in El Salvador. By that time the country will be endowed with a reasonably modern main road network and well-built feeder roads will reach most areas of the economy. However, there will still be room for construction of feeder roads to a few areas which may in time have some, albeit limited, agricultural potential, especially in the area towards Honduras. The port program consists of the expansion of the port of Acajutla now under way, with the assistance of an IDB loan.

209. The public electric power authority (CEL[1/]) has over the years developed into an organization capable of planning its expansion program and financing the bulk of it. Consumption in CEL's system has grown very rapidly, at an average annual rate of 13 percent from 1960-1965; (in 1965 alone by 16.5 percent). CEL has prepared a ten-year (1965-1975) power development program, which is reflected in the Government's public investment program and is progressing on time. The program assumes a growth of demand of 13.5 percent starting in 1967: while it is unlikely that demand will grow any faster in a period of economic slackening, El Salvador's present installed capacity would not be sufficient to cover demand if any one of the major generating units were to fail. A second thermal unit of 33 MW at Acajutla, is under construction and will be completed in 1969, at a cost of about CA$6 million, financed from CEL's own resources. CEL has been planning to start construction in 1967 of a hydro plant with a final capacity of 126 MW at Cerron Grande; however, strong resistance from landowners in the projected reservoir areas has caused a delay. Under the

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1/ Comision Ejecutiva Hidroelectrica del Rio Lempa.

circumstances CEL may choose to add a third 33 MW unit to the Acajutla thermal plant and only start the construction of the hydro project in 1969; the cost of the hydro project is now estimated at $40 million including some $24 million of foreign exchange costs. For the future, there are other possible hydroelectric sites for El Salvador to develop for expansion of its power supply into the 1980's; the major such project (at El Tigre, with an initial capacity of 135 MW) is already being studied. However, the authorities are aware that in the long-term El Salvador's hydro power resources are limited. Interconnection with Honduras is being considered as a possible variation in the present program, although no agreement has so far been reached with Honduras. Also, a study of geo-thermal resources has been started. Since the early 1960's, CEL has carried out a continuous program of extending supply of electric power to rural areas. This program is being facilitated by the country's small size and it is presently being financed out of CEL's earnings.

210. The autonomous public telephone agency (ANTEL), established in 1963, has efficiently embarked upon a CA$14 million program (assisted by an IBRD loan of US$9.5 million) to expand and modernize El Salvador's inadequate telephone system. Once the program is completed by the middle of 1968, the principal cities of El Salvador will have 40,600 modern automatic telephones, instead of the 20,000 mostly manual telephones in 1963. ANTEL plans to continue its expansion program in 1968-1970, at a cost of about CA$5 million, to be financed largely out of its rapidly growing earnings.

211. Education is probably the highest priority investment in the social fields and has a high priority in the overall investment program. The authorities have already improved the facilities for primary education: under a CA$4.4 million program (assisted by a USAID loan of US$2.4 million) 1,600 primary school classrooms were built in 1964-1966. They plan to add 1,800 classrooms more with the help of a further proposed USAID loan toward the target of 4,000 additional classrooms proposed in the 1965-1969 investment program. But to enable both old and new school facilities to be used efficiently, it will be necessary to make basic reforms in curricula and in pupil promotion systems, and to provide incentives for teachers to go to rural areas, which lack teachers even though there are unemployed teachers in the capital city. El Salvador particularly needs to make up for its limited land resources by improvements in manpower; this means that teacher training, technical and secondary education must be given high priority. The authorities recently prepared a CA$12 million investment program for this purpose which is to begin in 1967. If accompanied by the necessary improvements in teaching and curricula, this program should set the basis for a longer-term improvement in El Salvador's educational system.

212. The Public Housing Institute (IVU), in operation since 1935, has since 1962 entered the low-cost housing field (units of about US$2,000 equivalent each) and has since 1963 completed an average of 1,500 units annually. The public investment program proposes construction of about 22,000 urban dwellings in 1966-1969 (an annual average of 5,500 units) at a total cost, including a small amount for rural dwellings, of CA$50 million. Even though the capacity of the housing institute has improved, at best only about 60 percent of such a volume of construction is probably attainable in

the period, partly because the institute (which had a small operating loss in 1965) does not yet have the internal cash generation necessary to face up to such a program. Moreover, some of the construction for upper levels of the low-income groups could be financed by the public National Housing Bank (FNV)1/ if the various savings and loan associations which it has established succeed in mobilizing more domestic funds through higher interest rates.

213. In order to pursue an effective program in water supply and sewerage, El Salvador established a national authority (ANDA)2/ for that purpose in 1961. ANDA has gradually taken over municipal systems, embarked on modest investments and is due to put into effect early in 1967 a tariff schedule designed to produce modest surpluses to help finance the investment program of CA$11 million for 1966-1969. It will probably expand the program to include a major water distribution project for metropolitan San Salvador, the first phase of which could be ready for construction in 1968. In public health, the public investment program is not likely to be fully realized. However, the authorities will probably be able to invest about CA$8 million in 1966-1969, largely on hospitals and health centers outside the capital city, a correct reflection of the country's needs, with the help of a US$2.5 million low-interest 40 year loan from the Federal German Government. Staffing of existing and new facilities presents problems which will need to be resolved by the authorities before new construction is completed.

214. The Government program proposes substantial investment in irrigation. After some delay in feasibility and engineering studies of the two major projects, they are expected to be completed in 1967. These are: Zapotitan Valley, covering about 5,000 hectares, with a total cost of US$4.6 million; and the first stage of Rio San Miguel to irrigate 11,500 hectares, costing about US$10.8 million. An irrigation law has yet to be approved by the Assembly: such a law is important since El Salvador has no experience with large irrigation projects. The lands to be irrigated will have to be used for high-value products if the investments are to be justified in view of the relatively high capital costs involved (almost US$1,000 equivalent per hectare). Nevertheless, the projects deserve high priority if they are used to permit El Salvador to begin production and export of high-value fruits and vegetables.

215. In addition to direct public investment, the public sector in El Salvador acts as an important channel for lending to private industry and agriculture. In 1964, about US$4.0 million was drawn from foreign loans for re-lending to agriculture, and about US$2.0 million for industry;

1/ Financiera Nacional de la Vivienda
2/ Administracion Nacional de Acueductos y Alcantarillados.

in 1965, the amounts drawn were respectively US$6 and 4 million (see Table 19b).1/ Most of the drawings from foreign loans for agriculture have been channelled through ABC, 2/ the semi-autonomous peasant credit agency. The availability of long-term credit for the larger farmers has probably increased only slowly (Table 14b, Volume III - Agriculture). The Central Bank, aware of this deficiency, has prepared an agricultural credit project of about CA$10 million for large and medium-sized farmers; a portion is under consideration by IDB and the rest could be financed by a fund built up from past accumulated profits of the Central Bank. Although the products or activities to be financed have not yet been determined, a project of this kind deserves high priority in principle. If a first tranche is successful, the project should be expanded to a larger size. In industry, INSAFI (the autonomous government industrial bank), which had available at the end of 1965 undisbursed balances of $6-8 million from AID and IDB loans, is still defining its program. In addition funds for industrial lending are available from FISA (the private industrial finance corporation) which received a loan of $5.0 million from AID in 1965. Altogether, the public sector is likely to be able to channel annually about US$6-8 million from foreign loan funds to agriculture and industry in the next few years, which will have to be matched in the case of ABC and INSAFI by Central Government contributions of CA$2-3 million annually.

216. El Salvador's direct public investment reached almost CA$30 million in 1965 and was slightly above this level in 1966. The mission estimates that it would average about CA$50 million for 1967-1970, about 6 percent of GDP. In addition, an average of about CA$10 million annually might be channelled by the public sector in special credit programs to the private sector. From the point of view of the country's growth requirements, such overall levels of investment do not appear exaggerated. The annual level of direct investment outlays projected by the mission is some 10 percent less than that in the Government's plan. Even so, however, the 1967-1970 levels would represent a substantial increase - 20 percent on the average annually - over the levels in the period 1963-1966. Road investments programmed are a relatively lower proportion in El Salvador's public investment program, than in other countries due to her substantial progress in the past in building her highway system. Hence slightly over 40 percent of 67-70 investment expenditures would be concentrated in transportation, telecommunications and power; about 12 percent on agriculture and the remainder on education, health and sanitation and housing. The authorities, however, are likely to face a domestic financing problem for such a level of expenditures and increased efforts at internal mobilization of savings will be required to carry out the projected program.

1/ In addition, direct loans from CABEI to industry were about US$2-3 million and drawings by the private industrial finance corporation in 1965 on a US$5 million loan.

2/ Administracion del Bienestar Campesino.

Financing of Public Investment

217. During the boom years of 1960-1965, despite losses of revenues from substitution of Common Market imports for the dutiable imports from abroad and the tax exemptions for industrial development, the level of government revenues kept roughly in pace with a rapid growth of income as a result of new tax measures and of increased revenues from the coffee tax (due to higher prices together with the sliding scale tax). Thus Central Government revenues kept at about 11-12 percent of GDP during the period. In addition, the government expenditure policies were conservative and thus the fiscal problems which El Salvador suffered at the beginning of the 1960's were eliminated; during 1963-1965 the cash budget had either very low level deficits or some surpluses. The current account savings of the Central Government quadrupled from 1962-1965 (though increased outlays in 1965 reduced the growth on that year) while savings of the autonomous entities almost doubled. Public savings by 1965 reached 2.7 percent of GDP. El Salvador was therefore able to complete the financing of direct public investment by gross external borrowing amounting to about 45 percent of such outlays.

218. For the period 1967-1970, the general outlook for financing of public investment levels projected by the mission could be summarized as follows:

El Salvador: Public Investment and Financing for the Period 1967-1970 1/
(Million CA Pesos)

Public Investment		242
Direct Investment		202
Credit Programs		40
Financing		191
Public Savings		77
External Credit (net)		114
Gross disbursements	132	
Amortization	18	
Gap		51

1/ The mission has projected the investment estimates to 1970.

Even with necessary but moderate growth in Central Government current expenditures, its revenues, under present tax structures, are not expected to grow sufficiently rapidly during the period of slackening economic activities to lead to a rise in the current account surplus. In fact, the

surplus, which in 1965 totalled almost $19 million, is expected to decline to about CA$11 million four or five years hence. This fall is likely to be offset by higher savings from the autonomous enterprises, but these enterprises will use their savings to finance their own programs, and the Central Government will face a lack of local currency as it embarks upon its own major projects, particularly in irrigation and schools. While the gap in 1967 would probably be relatively small, in 1968 it would be in the order of CA$15 million, and somewhat less in the following two years. The projected gap would require additional resources equivalent to some 12 percent of projected annual revenues. This gap is not so large that the authorities would need to cut down the level of public investment if they take additional measures to increase revenues, preferably in the course of 1967 to yield results in 1968.

219. The authorities are aware of the lack of potential growth in revenue under present tax structures and slower rates of economic growth. They have been giving preliminary consideration to tax measures which might be put into effect by the new government entering office in mid-1967. Among them are: a revaluation of properties, introduction of a general sales tax, increases in various consumption and excise taxes, and possibly increases in the effective rates of the lower half of the income tax scale combined with possible application of the income tax to the coffee sector. A cadastral survey is being accelerated but will take another three years to complete. While its results could provide a major source of revenue, other action will be needed in the next two to three years to provide more revenues. While internal bond issues, especially by the autonomous agencies, might be a possibility for appreciable mobilization of resources, the authorities can hardly count on this source if they wish to permit the resources of the banking system to be available, even in the limited amounts possible during a period of slackening export growth, to be available for the needs of the private sector. If El Salvador meets her financing gap by new tax measures, or economies, public savings would rise substantially to about 3.5 percent of GDP in 1970.

External Financing

220. The financing pattern outlined above implies that gross foreign borrowing would cover about 51 percent of projected direct public investment in 1967-1970 (and some 54 percent of the special credit programs). These proportions are somewhat higher than in the recent years, but are not unreasonable in view of the need to increase public investments, particularly during a period of economic slackening. External financing overall would probably be roughly equivalent to the foreign exchange costs of the total investment outlays.

221. In addition to the sums available from undisbursed foreign loans to finance public investment and special credit programs channeled to the private sector, El Salvador would need to obtain new commitments amounting to some $110 million in 1967-1970 to provide the flow of external funds envisaged in the mission's projected investment estimates. The total of such loans would cover approximately 60 percent of the aggregate expenditures on the specific projects to be assisted by such foreign financing.

Studies for almost all the projects for commitments in 1967-1968 have been completed or are well advanced; however, the studies for a major portion of projects for potential commitments in 1969-1970 need to be started or completed to assure that they will be available in time.

222. Due in part to its sound fiscal management, the service on El Salvador's existing external public debt is low, equivalent to about 4.5 percent of export earnings in 1966. Additional external borrowing of $110-125 million during 1967-1970, even if all incurred on conventional terms, would raise the level of external debt service in relation to projected exports slightly in 1970 to about 4.8 percent and to about 6.5 percent in 1975. With the long-term limitations imposed on a predominantly agricultural economy caused by a limited land area together with rapidly rising population, it would be appropriate for El Salvador to seek some part of the new external borrowing on concessional terms.

HONDURAS

223. With a gross domestic product per head of approximately $225, Honduras remains the poorest of the Central American Republics, in spite of the rapid acceleration of economic growth in recent years. For most of the decade of the 1950's, low coffee prices and declining banana output, due to plant disease, blow downs, floods and labor troubles, held the growth of GDP to below 4 percent per year, or to less than one percent per capita. However, from 1960 to 1964 exports increased by 50 percent, more than half the increase was in coffee and cotton exports, but about a third was in other commodities going to the Common Market. In 1965 exports increased by 30 percent mainly in bananas and coffee and cotton; bananas and coffee constituted some 79 percent of total 1965 exports. This remarkable recovery of exports raised the growth rate of GDP to a peak 10 percent in 1965. Correspondingly, the share of exports in GDP increased from 18 percent in 1960 to over 25 percent in 1965. Gross investment, which had long fluctuated at a relatively low level, accelerated to 14 percent of GDP in 1964 as against 11 percent in 1961. The great bulk of the increase in investment took place in the private sector, while public investment was about 20 - 25 percent of total investment.

224. Agricultural development has thus far mainly been induced by the export opportunities of a few crops: mostly bananas and coffee, increasingly complemented in recent years by cotton and staple food crops such as corn and beans, the latter two finding a growing market in densely populated El Salvador. The prospects of only moderate increases of coffee exports and stagnant cotton exports over the next several years and only moderate expansion in bananas (discussed below) emphasize the necessity of diversifying agricultural production. The major focus of diversification would be the opening up of new areas, principally the northeastern and eastern region along the Atlantic coast with its hinterland, where the prospects for forest products and cattle appear very favorable. A large pulp and paper project is already in an advanced planning stage and some important investments in highways and ports would be needed to develop this area.

225. A doubling of exports of manufactures since 1958 has already made an appreciable contribution to export diversification, raising the proportion of industrial products in total exports from 12 percent to 20 percent. By 1965 manufacturing accounted for 14 percent of GDP as against 9 percent in 1955. Nevertheless, exports of Honduras' manufactures to the Central American Common Market have not developed as much as those of most of its neighbors. Between 1961 and 1965 about 25 percent of Honduras' incremental exports (about half of which were manufactures) were directed to the Common Market in comparison with 60 percent, 44 percent and 36 percent in the cases of Costa Rica, El Salvador and Guatemala respectively (consisting largely of manufactures). The major manufacturing center of Honduras - San Pedro Sula - is located near the Atlantic coast in the north and has inadequate inland transport connections to the rest of Central America, while its administrative center near the south coast is easily accessible by paved road from the Pan American Highway. The growth of industrial imports from

neighboring countries has, therefore, been considerably more rapid than that of industrial exports and, despite substantial agricultural exports to her neighbors, the trade balance of Honduras on Central American account has tended to deteriorate. The Common Market partners have recognized the comparative handicap of Honduran industry as a result of the substantially less developed infrastructure. Partly for this reason, and because of Honduras' relatively lower stage of development, they have agreed with Honduras that it might temporarily give more generous tax exemptions and industrial incentive privileges than those applicable to the other four countries under the Central American Agreement for Fiscal Incentives. Also, Honduras has been receiving priority in the allocation of CABEI funds for highways as well as in technical assistance for project preparation and planning from regional and international agencies.

226. The development of the northern and northeastern part of Honduras hold promise not only for Honduras, but for the Common Market as a whole. The exceptional accessibility of the Atlantic coast of Honduras, the proximity of the eastern American markets and hence the lower transportation cost on inputs for import substituting industries, as well as the potentials for developing forest products and cattle, appear to favor the economic expansion of that area.

Balance of Payments

227. The growth of the economy in the next four years is likely to be less rapid than in recent years due to a probable considerable slow down in the growth of exports. Coffee exports, with the quotas likely under the International Coffee Agreement, are not expected to rise much above the present level, while cotton production and export earnings will be suffering from rising production cost and declining world market prices. Medium term export growth prospects largely depend on the plans of the banana companies; these appear likely to continue expanding their plantations, though at the lower rate than recently, at least until 1968. Export diversification from cattle and forest products offers additional possibilities in the long run. The mission estimates that exports up to 1970 will rise at an annual average rate of little over 4 percent, against almost 15 percent annually in the boom period of 1960 - 1965. With a falling off in export growth, growth of GDP is also likely to taper off to some 5 percent per annum or about 1.5 percent per capita.

228. The anticipated growth of Honduran exports, in combination with private capital inflow (expected to at least equal recent levels) and rising disbursements on external public loans, should provide sufficient foreign exchange receipts to finance a growth of imports to 1970 at some 9 percent per annum as shown below:

	(in million CA pesos)
Export earnings, 1970	160
Public capital receipts (net)	19
Private capital receipts (net)	4
Total available exchange, 1970	183
Imports, 1965	115
Import capacity growth rate, 1965-70	9 - 10%

This is a substantial rate even in comparison with the peak import increase of 20 percent in 1965. Consistent with such a rate of imports, bank credit expansion could probably not exceed some 6 percent per annum, all of which for the private sector, as compared with 11 percent in the boom period of 1960-1965. With the slackening in growth of export earnings, such limitations should be readily manageable.

Public Investment

229. The ability of Honduras to take better advantage of its economic potential, particularly with respect to the Common Market, clearly depends on the rapid improvement of its economic infrastructure as well as development of its forest resources. Honduras' public investment reached a peak of $19 million in 1963 or 4.3 percent of GDP, but declined since then to about $14 million in 1965, following the completion in 1964 of the construction of the Western Highway extension, the first stage of the Rio Lindo hydroelectric scheme - both financed with IBRD/IDA participation - and the telecommunications system for the capital. While the road construction program has continued at substantial levels since then, political and administrative problems delayed until very recently the preparation and initiation of major new projects, such as the North Road. The Government's Investment Program proposed a very substantial increase in the level of direct public investment, from a realized average of CA$17 million annually in 1962-1965 to an average of CA$54 million in 1966-1969. Such an increase appears to be administratively and financially unattainable within the time envisaged. However, it is possible that direct public investment may rise to about CA$40 million in 1968, and average about CA$38 million between 1967 and 1970. With an inadequate road connection between the two main cities, no road link at all between the fertile north coast and the rest of the country, the need to improve Honduras' principal Atlantic port - Puerto Cortes - and the tight situation in power supply, the public investment program justifiably continues to place major emphasis upon transport and power investment. Important highway, port and power projects are well advanced in their preparation, or about to begin construction, and they may account for almost two-thirds of direct public investment in the next four years. Projected public investments would represent a substantial rise over the levels reached

in 1963-1966, an increase on average of about 20 percent per annum.

230. The major projects in transportation are the reconstruction of the main North Road from Tegucigalpa (the capital) to San Pedro Sula; the construction of an all weather link from the latter to the north coast banana centers of Tela and La Ceiba, the paving and improvement of the Western Highway, and the construction of modern port facilities at Puerto Cortes on the Caribbean. The completion of the North Road, already started, and the initiation of the other major projects and their execution without delays is likely to strain the capacity of the public authorities to administer and supervise these projects. The Government's investment program also includes construction of a port at San Lorenzo on the Gulf of Fonseca, but this is yet to be studied and it raises questions regarding regional port planning discussed in Chapter IV above.

231. In electric power Honduras is facing the prospect of a possible power shortage by 1968. The proposed 40 MW hydroelectric project on Rio Lindo, downstream of the existing Canaveral plant, was planned originally to allow export of 20 MW to El Salvador. Because the Honduras authorities were unable to reach a decision on the project on this basis, El Salvador has proceeded with alternative plans. The delay has resulted in a difficult situation for ENEE (Empresa Nacional de Energia Electrica), the public power enterprise in Honduras. In order to meet power demand in 1968 and 1969, ENEE is now planning to add 8 MW of diesel plant capacity at an estimated cost of about CA$1.5 million, which it expects to finance with the assistance of a loan of CA$1 million requested from CABEI. While the following stage of expansion is still subject to choice, the mission has assumed for planning purposes that the authorities will decide to go ahead with the Rio Lindo project in 1968. Capital expenditures of about CA$16 million would be incurred over the period 1969-71 with foreign exchange costs of about US$10 million. Honduras has the least developed electric facilities in Central America (with an electric output per head in 1964 of only 53 kwh), and demand can be expected to increase rapidly as new customers are connected In order to deal adequately with these future needs, ENEE will need to substantially improve its planning for future system expansion.

232. The telephone facilities of Honduras are grossly inadequate. In 1964, after the completion of the project, financed by a Japanese supplier, the country's public system (operated by the Ministry of Public Works) had a capacity for 10,600 automatic telephones, and also included about 600 manual telephones. The Government's program envisaged a modest program of expansion for the period 1966-1969, costing about CA$6 million to add about 8,000 automatic telephones to the principal cities outside the capital. So far, no firm arrangements exist for financing the project, although the foreign exchange costs would appear suitable for foreign financing providing the service could be established on a business-like basis.

233. The level of public investment in the social sectors in the Government's public investment program for 1966-1969 is sizeable, though in relation to total investments they constitute only one-fifth - a modest proportion. While expenditures in this sector are needed in view of the backward state of social services in Honduras, the investment targets are unlikely to be realized because of a lack of sufficient projects. In water supply and sewerage, the main agency SANAA (Servicio Autonomo Nacional de Acueductos y Alcantarillados) is carrying out two small projects with financial assistance from AID and IDB, one for improving water systems in 11 towns and the other for rural aqueducts. SANAA has begun to plan for a larger project for water and sewerage in Tegucigalpa. The principal obstacle to the expansion of SANAA facilities is its weak financial condition; the agency has a current account deficit, and no firm plans exist to institute sufficient water and sewerage charges which are needed to help it finance its programs. In public health, the Government's hospital construction program, financed out of the budget, involves expenditures of CA$14 million over the period 1965-1969. While the hospital program is not likely to be completed on time, its general goals appear reasonable: the program aims at raising the number of beds per thousand inhabitants from 1.8 at present to 2.3, including facilities in various provincial centers, and also aims at improving existing facilities rather than emphasizing new construction. Staffing of both new and existing facilities is a problem which needs to be resolved before new construction is undertaken. In public housing, INVA (Instituto de la Vivienda) has so far confined its activities to the Tegucigalpa area, largely through a small IDB-assisted program to construct about 800 low cost dwellings; INVA plans to expand the program with another proposed IDB loan, but, as in the case of SANAA, the lack of any internally generated or recovered resources handicaps the institution in effectively undertaking larger programs. In the case of education, Honduras urgently requires to improve its performance and facilities at all levels. In the past it has carried out some small programs, assisted by loans of $400,000 from IDB and $600,000 from AID. The authorities are considering expanding their program considerably by the construction in the next three years of 1,200 primary school classrooms, and of 175 secondary school classrooms; but no definite plans have yet been drawn up. With the exception of the university, the authorities have so far done little to prepare projects which might be suitable for outside financial assistance, despite the great need in Honduras for providing more education and increasing the efficiency and quality of the system.

234. The Government's investment program also envisages substantial direct investments for agriculture. The largest would be in land settlement and colonization, but the agency responsible, INA (Instituto Nacional Agrario), has not yet completed the preparation of sufficient economically justifiable projects on the large state-owned lands available. The major project is the settlement of the Aguan Valley on the north coast, which was an important banana producing area 30 years ago and could probably become a productive agricultural area again. However, the success of an expensive settlement scheme lacking a major road linking the area to the rest of the economy is likely to be dubious, and major activities on the project may have to wait until the highway now being extended along the

north coast reaches the area in the early 70's. The authorities are also planning to increase the flow of foreign funds channelled to agriculture and industry through BNF, the public National Development Bank. During 1962-1965 BNF used an average of US$1.5 million per year (from two IDB loans), largely for agriculture. The bulk of such BNF lending has been for medium-sized farmers (the average loan to these farmers was about CA$5,400). The BNF obtained in October 1966, a further US$7 million loan from IDB to help carry forward a CA$10.5 million credit program, about evenly divided between medium-sized farmers, small farmers and industry. The volume of lending channelled through the public sector to the private sector could be usefully expanded further if the authorities decide to channel funds towards the independent national banana producers and larger scale cattle farms which are beginning on the north coast. Such lending to creditworthy customers could be undertaken through the commercial banking system, which has hitherto devoted only a small proportion of its resources for credit to agriculture. A project for such a credit program has been under study for some time. Early completion of its preparation, so that it might be considered abroad for financing, would be an important step toward economic expansion in Honduras.

235. In summary, the major increases in public investment expenditures likely to incur in 1967-1970 are in transportation and power, both high priority infrastructure sectors which will broaden the basis of the Honduran development effort. The preparation of an agricultural credit project is a matter of urgency for the development of agricultural resources, including livestock. Even with the public savings effort discussed below, the program necessitates the substantial improvement in project preparation, especially in education and agricultural credit, as well as in project supervision and administration, especially in highways. If these constraints are successfully overcome, Honduras should be able effectively to spend some CA$36 million annually between 1967-1970 for direct public investment plus another CA$4 million annually in indirect public investment through credit programs for the private sector.

Public Finance

236. From 1960 to 1965, revenues of the Central Government grew at an average rate of 8.5 percent annually, along with the upswing of the economy, and more rapidly than its aggregate expenditures (6.2 percent annually). As a result, the fiscal situation improved markedly and persistent deficits changed into surpluses after 1962; these have allowed the government to reduce its domestic debt and to add to reserves with the Central Bank. A partial tax reform in 1962, including the regions first sales tax (3 percent) and increased income tax rates, substantially contributed to the rise in revenues. Consumption taxes alone accounted for 40 percent of the increment in tax revenues during 1961-1965. Although the proportion of tax revenue to GDP steadily increased in the last decade from 9.2 percent to 10.7 percent, the tax effort is still relatively low. While between 1962-1965 public investment declined somewhat, aggregate public savings increased from CA$4.3 million to CA$14 million or 2.7 percent of GDP, 80 percent of

which represented savings by the Central Government. Gross foreign borrowing covered some 58 percent of direct investment (45 percent net of external debt amortization).

237. On the basis of taxes already in force the prospects through 1970 are that Central Government revenues will grow slightly faster than GDP. With restraint in current expenditure, but allowance for necessary growth in development connected current expenditures, Central Government savings could probably reach some CA$17 million by 1970. Autonomous agencies could probably contribute another CA$6 million for a total of CA$23 million of aggregate public savings in 1970, reaching about 4 percent of GDP. On this basis and taking into account possible receipts from external financing, as outlined below, the pattern of financing of future public investment outlays for the period 1967-1970 would be as follows:

Public Investment and Financing for Period 1967-1970
(million CA pesos)

Public Investment		162
Direct	146	
Credit Programs	16	
Financing		162
Public Savings		80
External Credit (net)		82
Gross Credit	90	
Amortization	8	

Gross proceeds from external loans would cover about 55 percent of public investment. Such a proportion of external financing does not appear to be unreasonable taking into account: the need to substantially improve the infrastructure at the time when output and income are likely to rise only moderately; the substantial saving effort contemplated by the Government amounting to almost 10 percent of the incremental gross domestic product; the high foreign exchange component of some major projects (e.g. 70 percent for the Western Highway Paving project); and the low per capita income of the country.

238. However, given the high priority for many years to come of sustaining and possibly increasing the effort to establish an adequate infrastructure which would help Honduras to develop its potential resources and bring about a closer integration of the Honduran economy into the Common Market, the Government should, in coming years, develop measures to step up the internal financing effort. Coffee exports are now taxed at a fixed rate of 10 lempiras per 60 kilo bag: at 1965 coffee prices the ad valorem equivalent should have been 13 percent, although only 10 percent of the value of coffee exports was actually collected. The yield relative to value of coffee exports earning was very close to that in

El Salvador, the highest in the region; however, in El Salvador coffee producers are exempt from income tax as they are not in Honduras. Land area in coffee for some years remained constant, at about 100,000 hectares and, although Honduras' coffee quota under the International Coffee Agreement is currently being negotiated, it seems likely to be at a level that will permit the bulk of prospective increases in output to be exported in the next few years. The property tax in Honduras is, at 0.15 percent of declared values, by far the lowest in Central America: even increases to moderate levels would place Honduras in a position to increase its own contribution to the financing of public investment and to increase public investment itself.

Borrowing Program

239. To supplement the available balances on existing foreign loans, the financing pattern outlined above would imply new external borrowing commitments of roughly $47 million in 1967-1968 and $36 million in 1969-1970, or a total of $83 million for the four years. Projects are in an advanced state of preparation for almost all of the project borrowing in the first two years, but project identification and preparation would have to be immediately and substantially stepped up in order to secure the necessary commitments in 1969-1970. On the basis of the lending policies of various external agencies, the external commitments would approximately cover 70 percent of the total public outlays on the projects financed. This high percentage is mainly a result of the high foreign exchange costs of the bulk of the projects financed abroad, (largely hydroelectric projects and major road construction) and partly the 100 percent financing by CABEI of some road projects.

Creditworthiness and Prospects

240. Honduras' external public debt as of mid-1966 was US$61 million, virtually all medium- and long-term, with debt services amounting to 2.8 percent of 1966 export proceeds. If the average of the new borrowing were incurred on conventional terms, debt service payments would rise to $7.3 million or about 5.0 percent of export earnings in 1970 and $12.4 million or about 6.5 percent in 1975. This would be a substantial increase from the present level of debt burden and relatively high for a poor country such as Honduras. While the debt service burden is still such as to justify substantial borrowing on conventional terms, the Honduran Government may, appropriately, seek to borrow for some of its needs on concessional terms to alleviate the strains on domestic savings that the rapid rise in debt burden would occasion.

241. For the longer run, the economic prospects of Honduras are encouraging. The major public works aimed at integrating the north coast more effectively with the rest of the Honduran economy and with the Common Market will be well under way and some even completed by the early 1970s, enabling it to become an important center for the Atlantic trade of the

region. A substantial beginning is likely to have been made by the end of the decade towards opening up of the northeast. Construction of roads connecting the Olancho region with the Atlantic coast, requiring some new port development, and with the capital to the southeast, would make possible a more extensive exploitation of extensive forest resources there, and the expansion into new areas of cattle raising. The fertile Aguan Valley, abandoned by the banana companies some 20 years ago, may, as a result, be opened up for new settlement also. The authorities have been preparing a new credit program for agricultural development, principally for livestock; this should be given high priority. To realize her possibilities for economic growth, however, will strain the administrative capacity of the Honduran Government and, therefore, requires a far more effective effort than has been the case in the past.

NICARAGUA

242. The economy of Nicaragua recovered sharply over the last five years from the stagnation of the late 1950's, during which per capita GDP fell slightly, mainly because of falling prices and export receipts from cotton and coffee. Exports more than doubled from 1960 to 1965 due to recovery in coffee and cotton; cotton alone accounted for 60 percent of the increment of export earnings. With booming exports, GDP (at constant prices) grew at over 8 percent annually to 1965, reaching $325 per capita in 1965. Gross investment was relatively low in proportion to GDP, rising to some 18 percent in 1964. Public investment, which has varied between 3 percent and 5 percent of GDP between 1960 and 1965, was concentrated mainly on highways, port works, and electric power construction while education investment was neglected.

243. Manufacturing began to expand vigorously; value-added in manufacturing rose at an average annual rate of about 10 percent between 1960 and 1965, although it still did not exceed 13 percent of GDP in 1965. The major stimulus to the industrial expansion - largely in traditional lines - was the buoyancy of the domestic market resulting from the cotton boom. However, new enterprises have been developing, particularly in metals and chemicals, strongly oriented towards the Common Market. Exports to common market countries, two-thirds of which are manufactured products, increased fivefold from 1961 to 1965 reaching CA$10 million or from 2.8 percent of total exports to 6.7 percent. However, compared to the intra-regional export performance of the more advanced industrial sector in El Salvador and Guatemala, Nicaragua - starting from a low level - has only gotten a small share of the growing market resulting from the elimination of trade barriers. Moreover, imports from the Common Market have been rising substantially faster than exports with the result that Nicaragua's trade deficit on Central American account has widened from $1.1 million in 1961 to $11.7 million in 1965. One reaction of the authorities to this development was a competitive and somewhat indiscriminate granting of fiscal and tariff exemptions to particular enterprises. The development of metallurgical and inter-related sodium chloride and insecticide plants, together with modernization of traditional plants (primarily textiles) should enable Nicaragua to obtain more benefits from trade in the Common Market in the future.

Balance of Payments and Growth Prospects

244. In the past, growth of exports of a few agricultural crops has been instrumental in pushing the growth of income. Between 1955 and 1960, coffee and cotton were equally important foreign-exchange earners (each accounting for 33 percent of total exports). However, with falling coffee prices, cotton production became more attractive and was heavily increased along the Pacific slopes; it became by far the most important export crop accounting for almost half of total exports in 1965.

Such an export structure will in all likelihood seriously affect the medium-term possibilities of overall export growth, since cotton in the next few years may be squeezed between lower world market prices and increases in production costs. Most of the land suitable for cotton is in any case already under cultivation, and further increase in yields requires a heavy step-up in the use of fertilizer. Coffee can at best be expected to increase only slowly within the limits of Nicaragua's probable quota in the International Coffee Agreement. Hence, the authorities recognize the need to push diversification of production and exports.

245. Efforts through special credit programs have already been made to increase the production of rice. Programs for development of tobacco, bananas, cattle, fruits and forest products, all of which appear to have considerable potential in the middle and longer run, are being pushed forward by the public development and banking authorities under a three-year plan of immediate action including promotional efforts, technical assistance, special credit programs and public investment. With the completion of the newer and modernized industries in chemicals, metals and other lines, the industrial sector is also expected to contribute to an increasing extent to the diversification of exports.

246. While the efforts of the Nicaraguan authorities to develop exports may reveal new possibilities, it is likely to take some time before large results from present efforts can be fully realized. The mission has estimated that exports of goods and services would increase from about $175 million in 1965 to about $210 million by 1970; this would mean an average annual growth rate of exchange earnings of 3.5 percent as against the 16 percent achieved during the boom in the first part of the 1960's. On the basis of past relationships of exports and population growth to changes in GDP, such a modest rate of export growth is likely to limit the expansion of GDP to about 4 percent per annum to 1970, or slightly higher than one percent per capita.

247. The import capacity of Nicaragua, even taking account of future net foreign loans to the private sector which may slightly exceed recent levels and receipts (net of amortization and interest) from external public loans on a rising scale, consistent with her increasing public investment program, would grow at a rate of 6-7 percent annually; this would be much more modest than the 15 percent rate of increase in imports in 1960-1965. The tabulation below summarizes the main elements as they may appear in 1970, in comparison with 1965.

	(million CA pesos)	
1970		
Export earnings	208	
Public capital receipts, net	19	
Private capital receipts, net	4	
Total exchange availabilities, 1970	231	
1965		
Imports	169	
Annual growth in import capacity, 1965-70		6.5 percent

Under such conditions in the future, monetary policy will need to be geared to a growth of imports compatible with avoidance of balance of payments pressures. While internal credit could not prudently increase at an annual rate of more than about 5 percent, such a rate would provide enough room for a cautious policy of selective credit expansion. In fact, acting with foresight, the Nicaraguan authorities in 1966 did not permit an overall expansion of bank credit and required excess reserves to be invested in Central Bank bonds whose proceeds are being channeled back to the economy only for approved credit programs aimed primarily at export diversification and expansion.

Public Investment

248. Public investment in Nicaragua which had reached CA$18 million in 1957 (about 4.5 percent of GDP) with the construction of major highway projects, especially the Inter-American Highway, declined considerably thereafter. But the authorities renewed their efforts to increase public investment, and since 1960, it has risen from CA$11 million to about CA$24-25 million in 1964 and 1965, or about 5 percent of GDP. Most of the increase has been in the traditional sectors of roads and power, where the organizations for preparing and carrying out projects are best prepared and organized. Despite the relative affluence of the Central Government, the major source of the rising public savings, little was achieved in the field of education and social services, except for the construction of the first stage of a modern water system for the capital city. The Government's public investment program for the period 1965-69 aims at levels almost twice those in 1962-65. It correctly places much more emphasis on investment in education, health and housing which would take somewhat over 30 percent of the planned public investment. However, the lack of sufficient projects ready for financing casts doubt on whether these overall targets will be achieved within the period.

249. The Government's investment plan for roads envisages very heavy expenditures until 1968, but due to administrative and operational delays, expenditures are likely to stretch to 1970 at a somewhat lower level. Nicaragua already has a well-constructed and maintained stretch of the Inter-American Highway and the authorities are correctly placing heavy emphasis on penetration and feeder roads, and on two additional connections to Honduras. The latter would substantially shorten the distance between the main economic centers of the two countries (Tegucigalpa and Nicaragua's Pacific coast ports) and between Nicaragua and Puerto Cortes on the Caribbean coast of Honduras. The largest part of the feeder roads are in the Matagalpa area, to provide a network for development of milk production. All or part of such output might feed into a large powdered milk plant that has been under discussion for establishment in the area. While the establishment of such a powdered milk plant may be open for doubt (see Volume III-Agriculture), the roads could also serve for the expansion of the cattle industry, for which the banking system has substantial loan funds available as indicated below. The road plans also

contemplate beginning construction in 1969 of major 400 km. penetration road to the northeast from Matiguas to El Cabo; the mission considers that much more ought to be known about the soils and potential development of the area before decisions are taken to start such an undertaking.

250. For ports, the transport program envisages the substantial expansion of Corinto, Nicaragua's major port which is already handling more traffic than it was designed to accommodate. The final stages of feasibility studies of this expansion are to be started soon, with IBRD assistance. With financial assistance from the UNDP and the IBRD as executing agency, the authorities in mid-1966 began a regional development study for the mid-Atlantic area, including the feasibility of a modern port and possible connecting highway in the area of Bluefields. The study, which includes also the possibilities for a coastal shipping canal, river navigation and agricultural development, is scheduled to be completed in mid-1968. Major investment projects which might emerge from this important study cannot as yet be defined; they would probably, if justifiable, be scheduled to begin about late 1969 or 1970.

251. The public electric power agency (ENALUF [1/]) has a two-stage investment program for the period 1966-72. The proposed investments should be sufficient to meet the increase in demand, which is expected to average 11 percent annually over the period, compared with an annual average of 25 percent over the period 1958-65, during which several previously isolated areas were connected to the main network. The first stage of the proposed expansion would cost CA$7.3 million, and would include a small (15mw) gas turbine peaking unit and CA$3.2 million of transmission and distribution facilities. A loan of US$5.0 million has been made by the Bank for this project. Studies are now underway for the second stage of expansion; this would include a 40mw thermal unit to be in operation in 1970 and a new hydro station with 50mw to be in operation in 1972. The cost of the expansion program, including transmission and distribution investment, is expected to be of the order of CA$30 to 32 million. Major work would begin in 1968. The telecommunications system, which is administered by a Department of the Ministry of War, was expanded in recent years with the help of credits from a German supplier. By 1965, Nicaragua had 11,300 telephone lines, of which 8,200 were automatic. Under a contract with the same supplier, 2,600 new lines are being added to two provincial centers and another 6,600 are to be added beginning about 1968. The total cost of the program is about CA$6 million. It is likely to be completed by 1970.

252. Public investments in the social sectors are likely to be modest if the present speed of project preparation is not materially increased. A failure to undertake these high priority investments would be particularly regretable as the public sector is expected to generate sufficient savings to provide the financing. In the housing field, a new public housing bank was established in 1966, with departments

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1/ Empresa Nacional de Luz y Fuerza.

for savings and loan operations, mortgage insurance and low-cost housing. The low-cost housing department of this bank succeeds INVI 1/, which in recent years has built an average of about 1,000 low-cost houses per year. The new plans for housing construction in the next three years total about CA$10 million, a major portion of which is in fact designed for middle-income housing with the help of a USAID loan. If the authorities wish to make an effective impact in the housing sector, more emphasis will need to be given to low-cost housing (units of CA$1,500-3,000 each) including the main provincial centers outside Managua. In the field of public health and sanitation, the status of the major projects which could be built in the next few years is still uncertain. The city of Managua, with the help of foreign consultants, has prepared a major sewerage project for the city; the project would supplement the water supply project completed in 1965 by the Managua Water Authority with the help of an IDA credit. However, the water and sewerage system in Managua are administered by two different entities, and a single organization would be desirable to administer and operate the proposed project. The project deserves serious consideration, however, as a necessity to a growing city and as the continuation of the water program. In education, the Nicaraguan authorities have made a special effort to prepare a project including the construction, extension and equipment of 18 secondary schools and the improvement of primary teacher-training: the total preliminary cost of the project is CA$14.7 million, partly to be financed from external sources. The small program to construct primary schools is to be continued in 1967 with the assistance of USAID. A project is being developed for expansion of the National University, including the School of Education which trains secondary school teachers. This might be ready sometime in 1968. While education is moving ahead, other sectors, such as housing and health, ought to receive greater attention than recently in order that more adequate progress could be made in these fields.

253. The public sector has been active in investment in agriculture, largely by credit and promotion through INFONAC, 2/ the public development institution, and the major commercial bank, the Banco Nacional, which is state-owned. INFONAC has in the last three years developed pilot projects, managed by itself, for havana-leaf tobacco and bananas. The tobacco project is leading to the establishment of growing by private planters, but the banana program has been affected by blow-downs in some areas on the Pacific coast. The Banco Nacional in 1965 substantially increased its medium-term lending for livestock with the help of a

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1/ Instituto Nicaraguense de la Vivienda
2/ Instituto de Fomento Nacional

US$9.1 million IDB loan. The Banco in 1966 obtained another credit for general agriculture, a major part of which is to be used to finance a proposed increase in rice production. Together with INFONAC credits for industry, public sector institutions should be able to channel about CA$7-9 million annually of foreign loans, most of which have already been obtained, to the private sector, largely for agriculture and livestock. This lending will have to be matched by about CA$5 million annually in resources from the banking system. The large-scale expansion of lending for investment in agriculture which is thus likely to take place is the result of the authorities' advance planning, and undoubtedly represents a high-priority allocation of resources. In addition, preliminary studies are being carried out by ENALUF for the development, including irrigation, of the Tuma and Viejo Rivers; an initial project might include 15,000 hectares of land so far largely not farmed. The construction of the Rivas irrigation project, begun in 1963 with the aid of an IBRD loan, was interrupted in 1966; the costs of construction proved to be considerably higher than expected and, consequently, experiments are now underway to determine whether high-value crops, especially bananas, could be grown in the Rivas areas and thus justify the project at its higher cost.

254. Provided that efforts are taken to improve project preparation and administration, the public sector should be in a position to effectively spend between 1967 and 1970, an average of CA$40 million annually in direct investment and an additional CA$10-12 million in credit programs to the private sector or a total of some CA$52 million average annually, slightly less than the Plan envisaged. Direct public investment estimated by the mission for the period 1967-1970, would represent an annual average increase of about 12.5 percent over that in the period 1963-1966. The public investment effort will materially strengthen the efforts of the country to diversify its production and its exports to counter the anticipated slackening of cotton and coffee exports. Part of such a diversification effort will consist of the further strengthening of the industrial sector by providing adequate infrastructure and credit facilities. While a beginning is being made toward development of educational facilities, further efforts are needed for the development of an education system which will meet the long-range manpower requirements of the economy. As noted below, Nicaragua is likely to generate resources sufficient to finance a somewhat higher level of investment. It should therefore prepare additional projects in the above mentioned priority sectors; these might allow an acceleration of public investment expenditures towards the end of the decade.

Public Finance

255. Central Government revenues stagnated during the middle and late fifties and the ratio of revenues to GDP fell from 10.8 percent to 9.8 percent. However, there was a vigorous upsurge in revenues in recent years, partly in response to the export induced income boom, and partly because of the tax reform of 1961. This reform introduced retentions from export proceeds on major commodities as a method of collecting income tax and modified the property tax. As a result, the Nicaraguan

ratio of current revenues to GDP rose to 12 percent in 1965, which with that in Costa Rica, was the highest in the region. Though total expenditures also increased rapidly (by more than 12 percent per year), the serious budget deficits of earlier years have since been succeeded by comfortable surpluses. Aggregate public sector savings more than doubled between 1960 and 1965 to almost $30 million with the Central Government generating 70 percent of the total. With gross receipts from foreign loans covering 36 percent of direct public investment in 1962-1965, there were sizeable accumulations of public deposits.

256. The fiscal situation of the Central Government should continue to be good in the coming years. Current expenditures, on the basis of hitherto prevailing policies, are likely to rise somewhat in line with GDP; current revenues, on the basis of existing taxes, are likely to grow slightly faster than GDP. Thus, Central Government savings would reach CA$29 million by 1970, which, together with about CA$8 million of current surpluses of autonomous agencies, would raise aggregate public sector savings to 6 percent of GDP by 1970, which would probably be the highest ratio in the region. With estimated receipts from existing and potential external loans to the public sector during 1967-1970, and the foregoing generation of internal public savings, the financing pattern of the public investment estimated by the mission for 1967-1970 would be about as follows:

Nicaragua: Public Investment and Financing for the period 1967-1970 1/

		(million CA pesos)
Public Investment		207
Direct		161
Credit Programs		46
Financing		234
Public Savings		137
External Credit (net)		97
Gross receipts	118	
Amortization	21	
Balance		27

1/ The mission has projected investment outlays through 1970.

257. Considering the low income level in Nicaragua and the urgent need to improve infrastructure, expand special credit programs and to improve education, health facilities and housing, Nicaragua should, as noted above, increase the investment program in these sectors; such efforts would also be likely to increase the current developmental expenditures and reduce the forecasted surpluses. (Though the proportion of the primary school age population enrolled in Nicaragua came to only 42 percent, the lowest in the region, the proportion of Central Government expenditures devoted to education in Nicaragua was still in 1965 the lowest in the region also). Such an increase in investment expenditures would necessitate a substantial acceleration of project preparation over and above of what is already necessary to carry out the investment expenditures estimated by the mission on the basis of previous programs, such efforts have already started. Otherwise, Nicaragua could mobilize such surpluses as arise to increase its contribution to the financing of projected public investment since gross external financing, as shown in the tabulation above, would be about 53 percent of direct public investment expenditures.

External Debt and Creditworthiness

258. The financing pattern outlined above envisages an annual average disbursement level from foreign loans of about $29 million. To provide these amounts, in addition to existing credits, new external borrowing commitments of roughly $55 million would be needed in 1967-68 and an additional $73 million in 1969-70, or a total of approximately $130 million for the period would be needed. While projects are well advanced in preparation in order to allow commitments during 1967-68 of the above order, almost no studies of projects for commitment in 1969-70 are yet available. Hence the need to considerably speed up project preparation. On the bases of the lending practices of the external agencies, it is estimated that the borrowing program mentioned above would approximately cover an average of 60 percent of the total costs of the projects financed by such loans. A large portion of the potential new borrowing - at least 60 percent - would be concentrated in transportation and electric power projects, having a high foreign exchange component, and in some cases receiving 100 percent financing from CABEI.

Creditworthiness and Prospects

259. In mid-1966 Nicaragua's outstanding external debt, including the undisbursed portion, amounted to about $77 million. Debt service payments on this debt in 1966 represented 5 percent of export earnings and would fall to 3.5 percent and 2.2 percent in 1970 and 1975 respectively. External borrowing program on the order of $130 million for the financing plan of 1967-1970, would raise debt service payments, even if all were incurred on conventional terms, to 6.0 percent and 7.7 percent of export earnings in 1970 and 1975 respectively. This should be well within manageable limits in terms of foreign exchange availabilities, though it would impose additional burdens on the budget.

260. Beyond 1970, the economic prospects of Nicaragua promise to improve substantially. The present efforts of the Nicaraguan authorities to develop new production and new export lines should begin to bear fruit. Conditions in world markets for its major exports commodities are likely to improve. However, while the cotton industry is likely to resume expansion in time, its major potential evidently has already been exploited. Future development will therefore have to be more broadly based: in agriculture, on meat, tobacco, and rice in particular, for which investments in feeder roads and possibly in irrigation works are being considered; in private industry, notably in chemicals, metal manufactures, wood products and possibly textiles, whose growth will require the timely expansion of power facilities and of additional connecting roads through Honduras to the rest of the Common Market. However, a major bottleneck to the continued long-term expansion of the Nicaraguan economy is likely to be a scarcity of skills. Hence, Nicaragua needs especially to increase its efforts in the education sector.

COSTA RICA

261. Costa Rica has the highest income per head of the five Central American countries. At the same time, it has good endowments for future development and in terms of educational achievement its human resources are above average for most less developed countries. Since the early 1950's the rate of population growth has accelerated, however, to reach 4 percent per year, or more, due both to a rising birth rate and declining mortality. As a result, very substantial increases in the GDP are needed for continued growth of per capita income, at a time when the income-earning population is not rising as fast as the number of dependents. The technical and administrative resources to step up public investment substantially exist in Costa Rica, but the continued deterioration since 1961 of the fiscal position of the Central Government gives cause for serious concern. While revenues have kept up with the growth of the GDP, in recent years the authorities have permitted expenditures to accelerate even more rapidly - mostly for current outlays - relying heavily on short and medium-term borrowing to cover their deficits. The deterioration in the public finances has been paralleled by increasing disequilibrium in the balance of payments and a sharp reduction in the international reserves of the banking system. By the end of December 1966 the authorities had barely four weeks gross reserves available. Faced with this situation, the authorities imposed a new exchange system on January 2, 1967, with sales of exchange at the official rate limited to a number of essential imports and payments, and a free rate for other payments; however, imports of Common Market origin are now treated as "essential".

Balance of Payments

262. Costa Rica's pattern of development is based largely on exports of coffee and bananas. In the mid-fifties the Government countered a substantial drop in the price of both by a well-conceived program of credit and price incentives to increase domestic agricultural and livestock production. This program was largely successful and has enabled Costa Rica to begin exporting meat. Nevertheless, the ensuing increase in agricultural output was not sufficient to maintain a continued rise in income. But in 1962, after several years of stagnating or falling per capita incomes, economic growth resumed, reaching a rate of about 8 percent annually. The main source of this acceleration has been an increase in export earnings by 30 percent over the period 1962-65. Exports of principal crops outside the region failed to rise, and meat and sugar increased only slightly. Exports to the Common Market, largely in manufactures, increased rapidly, accounting for almost the whole of the increment in total exports during this period. The expansion in manufacturing exports compensated to some extent for the eruption of the volcano Irazu in March 1963-December 1964, which seriously affected the most productive agricultural area of the Central Plateau. The eruption substantially reduced the 1964/65 coffee crop, so that Costa Rica's export earnings in 1965 were about US$10 to US$12 million lower than they would otherwise have been.

263. Export expansion at 9 percent yearly over the period 1960-65 was nevertheless lower in Costa Rica than elsewhere in Central America. The rate of increase is expected to fall off still further in response to adverse price movements in world markets and to the consequent economic slowdown in the Common Market generally, to about 7 percent per year through 1970. This rate remains substantially higher than her neighbors can expect, however; coffee exports in 1965 were still well below the basic quota of 851,000 bags set by international agreement, and the banana companies are implementing major expansion programs. However, Costa Rica may well face continuing balance of payments constraints, since imports have risen to very high levels - owing mainly to the failure of the Costa Rican authorities to bring the Central Government budget under control.

264. Early in 1966, the outgoing administration entered into a stand-by agreement with the International Monetary Fund. Under this agreement, limits were placed on the permissible budget deficit, on the assumption that increases in consumption taxes and substantial economies in expenditures could be implemented. Although the new administration which took office in May 1966 did implement a few increases in consumption taxes, these were not sufficient to meet the fiscal targets set under the stand-by agreement. Until 1965, the monetary authorities had severely limited the expansion of Central Bank credit to the public sector; the Government borrowed abroad from banks at short and medium-term to finance its deficits. Since then, however, the Central Bank has contributed the major portion to the financing of government deficits, thereby feeding the rapid credit expansion, which in 1964 and 1965 reached rates of 12-13 percent per year, and the growth in import demand, which accelerated to an annual rate of more than 18 percent.

265. For the future, foreign exchange availabilities from export earnings and from the projected increase in drawings on foreign loans for public investment (including those from new loans for suitable projects which may be made by external lending agencies on the basis of their lending policies, plus estimated disbursements from existing loans, less debt service payments during the period) as well as from other exchange receipts are likely to limit the permissible rate of growth of imports to no more than 1-2 percent per year from the disproportionately high 1965 level, if the present balance of payments disequilibrium is to be eliminated by 1970, as shown in the tabulation below.

	Million CA Pesos
Export earnings 1970	196
Public capital receipts (net)	8
Private capital receipts (net)	5
Total available 1970	209
Imports in 1965	196
Permissible annual growth rate 1965-70	1-2 percent

Even with a normal expansion of capital imports, therefore, a rate of growth of domestic credit that is consistent with import ceilings is unlikely to exceed 2 percent per year over the next few years, implying an annual rate of growth of GDP of hardly more than one percent annually in spite of a 7 percent annual growth of exports. Even this estimate assumes that the necessary fiscal stabilization measures will be taken. Otherwise the prospects for new foreign lending to the public sector, which was interrupted in the financial crisis of early 1967 will be highly uncertain. In such case, external amortization payments will be likely to exceed inflows of public capital. Without an early solution to the fiscal problem, therefore, the Costa Rican authorities may have difficulty in finding the foreign exchange to meet their external debt obligations.

Public Investment

266. The Costa Rican public sector has for several years shown a high degree of skill in the preparation of investment projects. As a result, the authorities were in recent years able to increase the level of direct expenditures for public investment on high priority projects, from CA$20 million in 1962 to CA$31 million in 1965, the major increase being in power and telecommunications. The public investment program prepared by the Planning Office for the period 1965 to 1968 has a high project content, although some of the principal projects are delayed in their execution. Most of the proposed projects are of high priority, including the opening up of new agricultural areas, the construction of badly needed port facilities, and the continued development of electric power and communications. However, it is unlikely that the program will be realized, not only because of insufficient administrative capacity, but also because of the severe shortage of domestic public savings. In projecting investment levels for the next 4-5 years (see Table 20e) the mission has assumed that appropriate tax measures will be approved at an early date, and that the authorities will without delay also take measures to curb the very rapid growth of current expenditures, particularly for education, that is likely to take place on the basis of present trends.

267. The Government's investment program for highways, as revised for the period 1966-69, is ambitious, totalling some CA$68 million. Even without financial constraints it is unlikely to be realized within the period. The major project presently underway is the "Plan Vial" (national highway program), which is being assisted by a joint IBRD/IDA loan of US$11 million. Progress on the project, which includes the improvement of main highways in the Central Plateau and the construction of penetration roads in important agricultural areas, has lagged far behind schedule. Delays have been due to lack of local currency funds, in part the result of starting up other highway projects, and of the slow gearing-up of the local construction industry to handle the large number of small contracts involved, in which international contractors have had little interest. There has been substantial progress on the latter point, and in fact the creation of a local road construction industry has been an important by-product of the project. The mission

strongly recommends that the authorities speed completion of the project in 1967-68 before embarking on major work on some of the other large projects contemplated.

268. Future projects include: (1) the paving and improvement of major sections of the Inter-American Highway (with 100 percent financing from U.S. Bureau of Public Roads' grants and an Export-Import Bank loan); (2) the completion of a main trunk road by constructing the link from El Coco to San Ramon; (3) the construction of the remaining link from Siquirres to give road access to the Atlantic coast; and with this, although the Government is still undecided, (4) the second stage of the "Plan Vial" beginning probably in 1969, which includes the construction of important penetration roads. Financing is assured for the first project and part of the second (with a loan from CABEI), and the Government is therefore giving priority to them. The construction of the latter two projects (which might eventually be combined into one project) has high priority in terms of the development of the connection to the Atlantic and the opening up of new areas for the country's future economic growth; in this respect, the road to the Atlantic, on which some work has begun, is probably most urgent. However, given the existing commitments, together with limitations of funds and in view of the difficulties the Government has had in meeting its construction schedules, it seems likely that major work on this road will have to be postponed until 1969.

269. In the case of ports, the major investment proposed is the construction of a new port on the Atlantic coast. While a major part of the increased traffic will come from banana exports, which can probably be handled with less complicated facilities, the present port is already overcrowded to handle general cargo and larger modern facilities are required. A final engineering study is due to begin shortly. A lesser, though important port improvement, is planned at Puntarenas on the Pacific coast on which feasibility studies are about to begin. Costs of these two projects are still very tentative, but together they might amount to some CA$20 million. In view of the uncertainties on these and various road projects, and on the fiscal prospects of the Government, the likely investment in transportation is still highly tentative, but is in any case likely to account for the single largest share of the public investment in the next four years.

270. Electric power consumption in Costa Rica has been growing at an average annual rate of 10.4 percent in the period 1958-65. The major source of growth has been industry, but very high per customer residential consumption in 1965 still accounted for 62 percent of total consumption. To meet this demand, the Government electric institute (ICE) 1/ in 1961 embarked on a major construction program, of which the main project, a 64 MW hydro station, was completed in 1966. The outlook for the future growth in demand is uncertain, because ICE's sales showed no increase in 1965 following a 12 percent increase in the wholesale tariff.

1/ Instituto Costarricense de Electricidad

ICE estimates that the annual growth in demand during the period 1966-75 will not exceed 9-10 percent and might even be less. On this basis ICE now plans to start construction of its next generating plant in 1968. Studies are now being completed to establish whether this expansion should be thermal or hydro capacity. On the assumption that the hydro alternative would prove more advantageous the cost is estimated at about CA$23 million including foreign exchange costs of about $13.5 million. In any event, further rate increases will be needed to increase ICE's internal cash generation which has been too low in relation to investment so that it may avoid recourse to medium-term private external loans and adjust itself to a planned stoppage of transfers from the Central Government budget.

271. ICE is also responsible for the operation and development of the telephone system. Under a project assisted with IBRD financing, Costa Rica will in 1967 have a system with a capacity for 32,500 lines with automatic exchanges, compared with the 9,100 badly overloaded, manually-operated (with 18,000 telephones connected to them) lines in existence when the project was begun in 1963. ICE is now completing studies on further expansion of the system by an additional 30,000 lines in the period 1968-72. Such a project could cost as much as CA$15 million, with a foreign exchange component of some $8.5 million.

272. The Government development plan of 1966-1968 envisaged large investments in the social sectors (particularly in health and sanitary services), representing almost 40 percent of total direct public investment. A large part of the proposed investment in health is the construction of major hospitals by the Social Security Institute. The Institute has annual savings (1965) of about CA$8 million: whereas in the past these funds were largely used for mortgage loans and credits to other autonomous agencies, in 1964 the Institute started a major three-year program (at a total cost of about CA$15 million) of hospital construction, now nearing completion. While the Social Security Institute (which covers about one-third of the population) is justified in using its funds for improved health facilities, the construction of large hospitals did not represent the highest priority use of these funds in this field. Costa Rica already has a fairly high number of hospital beds (4.4 per 1,000 inhabitants), and needs, rather than additional large facilities, smaller units and staff for preventive medicine. At present the health services of the Central Government, the Social Security Institute, and local bodies, are not coordinated and lead to duplication of investments and high current operating expenditures. For the future, the funds of the Social Security Institute might be harnessed to contribute to the large investments planned by the water supply and housing authorities. The programs of both these bodies have been hampered by the lack of any internal cash generation; in fact, part of the Government contributions which they receive has been used to pay for their current deficits. While the housing authority began to tighten up on its collections in 1965, the water authority has yet to put into effect a rate schedule capable of generating the surplus it needs to help carry out its investment programs. The investment program of the water authority correctly aims at coping with existing shortages and deficiencies in San Jose and provincial centers, but will inevitably be stretched out as a result of financial and administrative limitations.

273. While education (including teachers' pensions and other expenditures related to education) has accounted for about 30 percent of Central Government expenditures, over nine-tenths of these expenditures on education have been for current needs and the bulk of the remainder has been spent on investments in the university. The construction of more and better school facilities, particularly in secondary education, is necessary to meet the rapid enrollment and also to make a more efficient use of the teaching force. The authorities have begun the preparation of a possible project; any substantial investment in the education field, however, needs to be accompanied by basic reforms, particularly in primary education, to prevent the continuation of the very rapid rise of current expenditures of recent years (as indicated in Volume VII - Education). 1/

274. In the last four years, the State-owned banking system of Costa Rica has channelled an average of CA$3 million annually in foreign loans to agriculture, and CA$1.5 million to private industry. Over two-thirds of the lending for agriculture has been for small farmers. In view of the need to expand exports as quickly as possible the authorities have now correctly decided to place more emphasis on lending to larger farmers, particularly for livestock and banana production. An agricultural credit project of this kind is now under consideration by the IBRD: the total amount of credit under the project would be CA$10 million over a three-year period, of which half would be provided under a proposed IBRD loan. If the proposed loan were disbursed in a shorter time as a result of the rapid growth of the livestock and banana industries, a further program could readily follow. In 1965, the banking system already used part of a US$5 million five-year loan from a U.S. bank for these purposes. The Central Bank of Costa Rica has for a decade acted as a channel for a series of four IBRD loans for agriculture and private industry (the last two for industry alone), under which $4.4 million went to agriculture and $7.1 million to industry. Since 1963, the IDB has made similar loans to one of the commercial banks, the most recent in June 1966. In view of the rapid rate of commitment of the existing loans, the Central Bank has prepared another project for industrial re-lending which would envisage a foreign credit of about $5 million. As in three other countries, since 1964 a private industrial development bank has been in operation with the help of a USAID loan; it has been seeking a further loan abroad to expand its resources.

275. The mission estimates that direct public investment feasible from an administrative and project viewpoint could amount to some CA$30 million in 1967 (substantially the same as in the last two years), rising to about CA$40-42 million in 1969 and 1970 as compared with the annual average of CA$52 million in the Government's 1966-68 plan. These levels of investment are not excessive in terms of Costa Rica's ability to carry out the program, or in relation to its needs or the size of the economy; they would amount to about 5-6 percent of GDP in 1967-70 as compared with

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1/ See also The Financing of Costa Rica's Public Investment Program, 1965-68, (WH-156a, February 15, 1966), Volume II - The Educational System of Costa Rica and its Finances.

5.1 percent in 1965. However, even the investment levels as estimated by the mission will require major fiscal reforms for providing the internal funds needed. Without them, the execution of public investment will inevitably be slowed down below the levels which the Costa Rican authorities, in a more normal financial situation, have the administrative and technical capacity to achieve.

Public Finance

276. Large and increasing fiscal deficits have been incurred in Costa Rica especially since 1961, averaging about 11 percent of Government expenditures through 1965. More than three-quarters of the cumulative deficit has been financed internally or from short and medium-term foreign credits: the Central Bank has absorbed four-fifths of the Central Government's domestic issue of bonds and Treasury bills. These deficits were incurred in spite of the fact that current revenues increased in step with GDP, at average rates of 6-7 percent per year over the past decade or so. At 12 percent of gross product, the tax burden is already the highest in Central America. Total expenditures, however, have increased faster than GDP in the period 1960 to 1965, and current expenditures alone now absorb fully 11 percent of gross product, also a record for the region. As the report of a previous IBRD mission to Costa Rica has already suggested, (WH-156a, February 15, 1966) significant economies should be introduced by a revision of contributions to various pension systems so as to reduce their burden on general revenue, by a tightening of the finances of autonomous public agencies to permit a reduction in net subsidies, by a reform of the functioning and content of education, particularly of primary education, and by a centralized control of new hiring.

277. The Costa Rican authorities are aware that, without improved budget control, yields from new taxes are likely to be absorbed in current outlays as quickly in future as they have been in the past. Of a budgeted deficit of about CA$16 million for 1967, the Central Government never expected to be able to cover more than CA$10 million from new taxes yet to be introduced; the remaining CA$6 million were to be saved by cuts in planned expenditures. In estimating financial prospects to 1970, the mission assumed that the growth of current expenditures could from 1966 onward be held to a minimum consistent with feasible development programs and with the continued provision of social services on a constant per capita basis. Even with such restraint, and assuming that the tax measures under discussion since early 1966 are introduced to yield an additional CA$12 million annually, a financing gap for the public sector as a whole of at least CA$17 million per year on the average would still remain for the four years 1967-70, as shown in the tabulation below.

Public Investment and Financing for Period 1967-1970

(million CA pesos)

Public Investment		175
Direct investment		149
Credit programs		26
Financing		107
Public savings		75
External credit		28
Gross	97	
Amortization	-69	
Net internal bonds		4
Gap		68

278. The level of total public investment projected in itself is not excessive: it would amount to about 6-7 percent of GDP by 1970 if all projects which might be financed abroad are carried out. Some 55 percent of total investment outlays in 1967-70 would come from external sources, and it is difficult to conceive that these levels of project financing could be increased. The financing gap arises because of insufficient Central Government savings in the face of large amortization payments on the external debt averaging about $17 million annually as compared with about $4 million in 1962-64, as a result of heavy short and medium-term foreign borrowing to finance budget deficits in the last four years. Even if the authorities were successful in rolling over some of these payments from 1966-68 to 1969 and 1970, amortization payments in the next few years would offset a large share of new disbursements from abroad. Even should tax measures now under discussion be implemented without further delay, as is assumed in the above calculations, the bulk of public savings would be absorbed by amortization payments alone. Unless the authorities are willing to face a very sharp drop in public investment, therefore, it will be necessary to restrain the rate of increase in current expenditures and in addition introduce new tax measures as indicated in the previous paragraph. If the Costa Rican authorities should succeed in their endeavors to reschedule their short and medium-term debt, the burdens of raising such large amounts of revenues would be eased correspondingly.

279. The present tax burden in Costa Rica, about 12 percent of GDP, while high in Central America is, in itself, not excessive. New sources of revenue can still be identified. Coffee export taxes at about 7 percent of export earnings are lower than elsewhere in Central America,- although coffee growers do not receive special exemptions under the

income tax as they do elsewhere - the collection of which has improved considerably in the period 1960-65. Property taxes at 1.05 percent of assessed values are still low although substantially higher than in most neighboring countries; nevertheless, the substitution of a flat 2 percent tax on immovable property for the present system combined with adequate assessment, could yield about CA$12 million more by 1970. In addition, a flat 5 percent retail sales tax as proposed in the course of 1966, was thought capable of yielding a fresh CA$10 million. Together these two measures would leave about CA$6 million annually to be saved by other measures including further reductions in current outlays or increased income tax rates or heavier taxation of exports. Measures of the severity here indicated are inescapable because (1) current government expenditures already disproportionately high in 1965 are difficult to reduce, and (2) because the financing of past deficits by short and medium-term foreign credits has increased debt service requirements unduly, at least for the immediate years ahead.

External Debt and Creditworthiness

280. The pattern of financing for public investment, assuming adequate fiscal measures to cover the financing gap, envisages substantial flows of external funds. In almost all investment sectors important projects which would be suitable for external financing are well advanced or completed in their preparation. As of mid-1966 Costa Rica had available about US$40 million in undisbursed external loans or credits to apply to her public investment programs. The new external loan commitments implied in the mission's projections of public investment, including special credit programs for the private sector, are of the order of US$60 million through 1968, with a possible US$40 million in further commitments in 1969 and 1970 (Table 21e). On the basis of the lending practices of external agencies, these loan commitments could cover almost 60 percent of the total cost of the projects financed. Since Costa Rica cannot reasonably expect external finance for a much larger proportion of her investment program, it is imperative for the authorities to raise public savings at least in amounts indicated above so that the public investment program needed to meet Costa Rica's growth requirements would not be jeopardized.

281. Costa Rica's external debt in mid-1966 totalled US$140 million equivalent. Of this amount, US$30 million were at terms of under five years of original maturity. Sixty percent of Costa Rica's outstanding disbursed external debt is due in the period 1966-70. As a result, the service on Costa Rica's external debt is now high and represents 18 percent of merchandise export earnings in 1966. With heavy repayments in the next few years, service on the existing debt would however fall to about 7 percent of projected export earnings in 1970, if fiscal balance can be achieved in the interim. If new debt incurred during 1967-70 were restricted to the amounts mentioned above, and were contracted on primarily conventional terms, debt service would amount to a little over 9 percent of projected export earnings in 1970, falling somewhat to about 7.5 percent in 1975. Thus the debt burdens for 1970 and late in 1975 would be quite moderate; in the meantime, however, Costa Rica faces an extremely heavy debt service burden, both on the foreign exchange availabilities and the budget.

282. Until adequate fiscal measures are taken, however, it is difficult to envisage any significant external borrowing program for Costa Rica. A sharp deterioration of foreign exchange reserves caused the Board of the Central Bank in December 1966 to propose a three-step emergency program. The first step, already taken and still in effect, restricts the sale of official exchange at the official rate to "essential" transactions only, legalizing a free exchange market for the rest. The second step was to be the introduction early in 1967 of exchange surcharges in place of the dual rate system: for this, legislation was introduced but encountered stiff domestic opposition in the Assembly as well as from other member governments of the Common Market, and has therefore been withdrawn. The third step was to tackle the fiscal deficit directly by introducing new taxes and controlling expenditures. Draft legislation had been submitted to the Assembly even before the December crisis, but of a nature that left the chances for collecting significant amounts in doubt. This draft legislation has also been withdrawn since, and the prospects for new legislation remain uncertain.

283. Costa Rica's fiscal problem should not obscure Costa Rica's favorable potential for economic growth. Its exports to world markets can be expected to continue increasing substantially in the next few years and its human resources are ample to take advantage of opportunities created by the Central American Common Market also. In view of accelerating population growth, it is urgent that Costa Rica should respond to the fullest of its opportunities. The burden of basic present and potential long-term debt would not be excessive. However, the creditworthiness of the economy for additional external public borrowing is dependent upon a very substantial improvement in the fiscal condition of the Central Government, which would permit not only the generation of sufficient savings to carry out important infrastructure projects but also enable the authorities to maintain monetary and financial policies consistent with an orderly exchange system.

APPENDIX A

THE COMMON MARKET

A. Origins and Development

1. The Central American integration movement has old historical roots reaching back to the unified administration of the five countries under Spanish rule and the attempts to maintain Central America as a federation, which collapsed in 1838. Since then, the countries have evolved as independent political entities but their historical connections and the community of language and culture has been an important factor reinforcing the economic basis of integration and nurturing the persistent determination of the people of Central America to achieve common progress. The present advanced stage of trade liberalization in the area and the common external tariff is the result of a process which began with a series of bilateral agreements freeing trade between certain countries in the early 1950's and the general realization that the size of the national markets inhibited the possibilities of economic growth of the individual countries. At the request of the Governments, the U.N. Committee for Economic Cooperation for the Central American Isthmus was set up in 1951, under the auspices of the U.N. Economic Commission for Latin America (ECLA) to carry on work on economic integration. ECLA has provided continuous technical assistance in studies and preparatory work for several succeeding negotiations, including the development and adoption of a common tariff nomenclature (NAUCA) which was an indispensable basis for the subsequent agreements on trade and tariffs. By 1958 Guatemala, El Salvador and Honduras had reached agreement on a Multilateral Treaty for Free Trade and Economic Integration. This was further amplified and developed into an Agreement of Economic Association between the same countries in 1960. As part of these general arrangements, the countries also adopted an Agreement on the Integration Industries Regime (1958) contemplating special treatment for industries of regional character, and the Agreement on the Equalization of Customs Duties (1959) applied to external tariffs.

2. Both the Agreement on Equalization of Customs Duties and the Treaty of Economic Association (between Guatemala, El Salvador and Honduras) were important steps leading to the General Treaty of Central American Economic Integration of December 13, 1960, now in effect between all five countries. The Equalization Agreement provided that tariffs on imports from outside the area were to be immediately equalized on a specified list of items; successive annual adjustments would be made thereafter, by negotiations, over a five-year transitional period, to result in complete equalization. Moreover, commodities in which tariffs were equalized would be freed of duties between the countries within the same five-year period. However, this general approach was drastically changed shortly thereafter by the Treaty of Economic Association (between Guatemala, El Salvador and Honduras and open to the other two). This took a new emboldened approach; instead of freeing intra-trade on a

limited list of items, it abolished tariffs on all trade between the partners except a limited list of goods subjected to a transitional period because they were important sources of government revenue. Complete freedom of regional trade and a common tariff toward third countries were to be achieved within five years as well as free movement of capital and people among the partners. By opening a large common market amongst the three countries, the Treaty of Economic Association created a strong attraction for other countries to join and later in 1960 the five countries signed the General Treaty. This entered into force for Guatemala, El Salvador and Nicaragua in June 1961, for Honduras in April 1962 and Costa Rica in November 1963.

B. Basic Aspects of the General Treaty of 1960

3. The General Treaty commits the countries to establish a common market within five years of its coming into force; this period expired on June 4, 1966. Provisions of earlier treaties not inconsistent with those of the General Treaty remain in force. The countries also agreed to form a customs union, although the form and method, as well as the objectives are not specified and no date was set for this. Although the Treaty refers to a "common market", its provisions relate to the free trade within the region and a common tariff but not to free movement of capital and persons which the expression "common market" often implies. The General Treaty established immediate free trade on all products, except on specified products between pairs of countries on which tariffs were retained for a transitional period. Other important provisions of the Treaty were: the elimination of consular fees and all other charges on imports; establishment of national treatment as regards internal taxes and regulations; freedom of transit and treatment for construction firms; restrictions on unfair trade practices; and prohibition of dumping as well as direct or indirect export subsidies. The Guatemala protocol of 1963 established a Uniform Customs Code (which sets forth uniform customs procedures and rules for administrative practices). Another protocol (Costa Rica, 1965) added an Agreement on Basic Grains to regulate trade in these commodities. The General Treaty also incorporated the Integration Industries Regime and provided that a Central American Bank for Economic Integration should be established. It committed the countries to adopt a special convention providing for regional legislation on fiscal incentives for industrial development.

4. The Treaty established the Central American Economic Council (Consejo Económico Centroamericano) consisting of the Ministers of Economy of the countries, as a superior body to direct the integration program and to coordinate the economic policy of the member countries, although the extent and means of such coordination is not described. Below the Economic Council there is an Executive Council responsible for the adoption of measures necessary to apply the Treaty and to resolve problems arising under its provisions. A Permanent Secretariat of the Integration Treaty (SIECA) was created to serve as a technical body of the Economic Council and the Executive Councils. SIECA, located in

Guatemala City, has been responsible for studies and preparatory work on negotiations concerning the Common Market. It also conducts the business of both councils as well as the various committees and sub-committees appointed for different sectors (such as transport, power, agriculture and industry) although most of its activity has been concerned with trade matters. It has had close support from the ECLA office in Mexico which serves as the Secretariat of the U.N. Committee on Economic Cooperation for the Central American Isthmus (also composed of the same ministers who comprise the Economic Council). SIECA's responsibilities were widened in 1966 by incorporation of the Central American Joint Planning Commission (JOPLAN). The task of JOPLAN, which consists of a group of technicians supported financially by ECLA, OAS, IDB, the Central American Integration Bank and SIECA itself, is to assist the countries in the preparation of national development plans and to help coordinate them within the regional framework. JOPLAN assisted greatly in the formulation of the national development plans for 1965-69. With these already drawn and the trade measures fairly advanced, SIECA, reinforced by JOPLAN staff, will be in a position to concentrate its efforts increasingly on the urgent task of assisting countries to prepare the specific projects needed to implement their development plans. This activity was recently begun by JOPLAN before its incorporation to SIECA.

Progress of Trade Liberalization

5. The process of tariff equalization and intra-trade liberalization has been almost completed through the adoption of five Protocols to date (Managua, December 1960; San José, July 1962; San Salvador, January 1963; Guatemala, August 1964, San Salvador, November 1965). In late 1966, there remained pending only 32 tariff sub-items, mainly: wheat and wheat flour; crude oil and oil products; radio and television sets, passenger cars, refrigerators, and accessories and parts thereof; and special transactions, such as gold, coins, returned articles and bank notes. Imports of these goods in 1964 represented 17.7 percent of the region's total imports and 6.5 percent of intra-regional imports. Wheat and wheat flour and oil products accounted for approximately one half of the total still pending agreement and assembly goods for the other half. Discussions have been in progress on trade liberalization for these items.

C. The Central American Bank for Economic Integration (CABEI)

6. The basic institutional framework provided for in the General Treaty is operative, except for the Central American Agreement on Fiscal Incentives for Industrial Development which was signed in 1962 and modified in 1966, but which requires further ratification to come into force. The Central American Bank for Economic Integration (CABEI) was created in 1960 and started operations in 1961 with headquarters in Tegucigalpa, Honduras. CABEI's basic general objective is to promote the economic

integration of the region and the balanced growth of the member countries. Accordingly, its principal sectors of activity are defined as infrastructure, industry, agriculture and financing services. In these, its financing is to be directed to projects of "regional character" or contributing to regional commerce, and it may not finance projects of essentially local or national character or scope. CABEI's capital is subscribed in equal amounts by the five member Governments. Authorized capital is CA$40 million of which CA$20 million had been subscribed and of which $17 million had been called and paid in (or was in process of being paid in) as of May 31, 1966. CABEI is empowered to lend (at long and medium term), borrow, act as intermediary, give or obtain guarantees, and provide technical and administrative assistance to applicants for loans. In addition, under its general powers CABEI may make equity investments, although in fact it has not yet done so. The superior authority of the Bank is vested in a Board of Governors formed by two Governors for each country, and management lies with an Executive Board (consisting of a Director for each country) and a President and an Executive Vice President. Apart from its own capital, CABEI's operations have been financed by grants and loans received from external sources, notably the U.S. AID and the IDB. As of May 31, 1966, CABEI's resources, by origin, were as follows:

	(In millions of CA Pesos or US dollar equivalents)
Authorized capital	40.0
of which: Authorized and Subscribed	20.0
Less: Capital subject to call	3.0
Total capital called and paid in (or in process of being paid in)	17.0
Loans obtained:	
Inter-American Development Bank, for industry	14.2
U.S. AID, for industry (two loans)	15.0
U.S. AID, for housing	10.0
U.S. AID, for feasibility studies	2.5
U. S. AID, for Integration Fund	35.0
Mexican Government, for industry	5.0
Mexican Government, for general purposes	1.0
Total borrowings	82.7
Grants received:	
U.S. AID, for credit operations	2.0
U.S. AID, for studies to intensify investment opportunities	1.0
Total resources	102.7

7. During the first five years of operations, the activities of CABEI have been largely concentrated in financing industrial enterprises (and some pre-investment studies) throughout the region, some housing projects, studies necessary for infrastructure projects and more recently (1966), loans for highways from its Integration Fund, as explained below. Although the totals of loans approved for industry and infrastructure are similar, no disbursements on infrastructure loans have yet been made as of May 31, 1966, whereas nearly two thirds of those for industry have been disbursed, as shown in the following tabulation:

	(In million CA pesos)			
	Approved Loan Commitments		Loan Disbursements	
Sector	For Pre-Inv. Studies	For Investment	For Pre-Inv. Studies	For Investment
Industry	1.1	31.9	0.4	19.3
Services	.1	2.0	.06	1.6
Infrastrucutre	2.2	30.3	.3	-
Housing	-	10.0	-	3.8
Total	3.4	74.2	.8	24.7
	77.6		25.5	

The distribution of loans by countries, tabulated below, shows the largest amounts to be with Honduras and Nicaragua, with El Salvador closely following, mainly due to substantial loans to industries in that country.

	(In million CA Pesos)	
	Approved Loans	Disbursements
Guatemala	13.0	6.3
El Salvador	15.9	7.2
Honduras	18.7	5.3
Nicaragua	17.2	2.5
Costa Rica	12.9	4.2
Total	77.7	25.5

8. CABEI's road loans from the Integration Fund cover 100 percent of the loan projects costs, and at present bear a rate of interest of 3 1/2 percent, with 25 years for repayment and seven years of grace. For industrial loans, the rates of interest for investments in fixed assets were raised in June 1966 from 6 1/4 to 7 percent on the foreign exchange costs and from 7 1/4 to 8 percent on national currency costs. All loans

for working capital are at 8 percent and for hotels at 9 percent. CABEI charges also, once only, a commission for processing and supervision of industrial loans ranging from 1 percent for loans up to CA$4,000 as a fixed charge for loans exceeding CA$800,000. CABEI's industrial loans, which may be up to 60 percent of the total cost of a project in the private sector, have been an important factor in long term financing of the recent industrial development in the region.

9. The resources of CABEI were substantially increased in 1965 with the creation of the Central American Integration Fund, amounting to CA$42 million, of which the Central American countries contributed CA$7 million by equal shares and CA$35 million came from a U.S. AID loan. It was agreed that this Fund, at least in its first stages, would be used to finance the improvement or construction of the Central American regional road network. A tranche of $30 million from the Integration Fund has already been committed in road loans to each of the countries and commitment of the remaining $12 million is under discussion. Thus CABEI's loan disbursements, at least in the next few years, are likely to shift to infrastructure projects. As of mid 1966 CABEI had about CA$25 million of funds available for future commitments of which $12 million would be for roads, and some $13 million for industry.

D. Regional Clearing House and Monetary Union

10. The framework of Central American integration includes the Central American Clearing House and an Agreement for Establishment of a Central American Monetary Union. The Clearing House was created in 1961 by agreement of the five Central Banks to facilitate the settlement of inter-country balances arising from trade and other transactions and to reduce use of their foreign exchange reserves for the cash settlements of such balances. Each Central Bank is obliged to grant up to CA$500,000 in regular credits to the other four taken together. Settlement of these regular credits in cash is made every six months. Once the limit of the regular credit is reached, any excess is subject to settlement in cash weekly, although in fact the application of this obligation is flexible, depending on the attitude of the creditor country. Credits earn interest at 3 1/2 percent. Transactions are carried in a unit of account CA$ (Central American peso) equivalent to the US dollar. Despite deficiencies in commercial bank procedures for collection and remittances, the amounts of payments channelled through the Clearing House have grown steadily and, as shown in the tabulation below, the ratio of the clearing operations to the volume of intra-regional trade has increased, except in 1964 when trade expansion was exceptionally rapid.

Year	(1) Values compensated	(2) Value of intra-regional trade (in millions of CA$)	(3) Percentage of (1) to (2)
1962	24.6	50.4	48.8
1963	50.7	66.2	76.6
1964	77.6	105.4	73.6
1965	112.2	136.0	82.4

The operation of the Clearing House not only represents economies in the use of the foreign exchange reserves held abroad by the five Central Banks, but also offers opportunities for the Presidents of the Central Banks to meet and to discuss problems of mutual interest arising in the trade field.

Monetary Union

11. The need for a coordinated monetary and exchange policy in the framework of the integration program was specifically recognized in Article X of the General Treaty which directs "the Central Banks of the Member States to cooperate in avoiding currency speculation that may affect the exchange rates and in maintaining the convertibility of the several currencies on a basis which guarantee, within a normal system, freedom, uniformity and stability of the currencies". Later the Economic Council specifically requested the five Central Banks to prepare studies of the means and machinery to achieve those ends. The result of the first efforts in this field was the Agreement of the Central Banks for the Establishment of a Monetary Union of February, 1964. The Agreement spells out somewhat more precisely the objectives mentioned in the General Treaty and the Council's request, adding the objective of providing financial assistance to meet temporary disequilibria in the balances of payments and uniformity of monetary and credit legislation in the region. It establishes a Central American Monetary Council, consisting of the Presidents of the Central Banks. However, monetary union as such remains an ultimate objective to be reached by stages. The studies needed to carry out the objectives of the Agreement are just beginning. Nevertheless the Council provides a means for closer and continuous consultations among the five Central Banks, and dealing more effectively with common problems. While eventual monetary union of the region is an ultimate goal that will require considerable prior progress in several fields of regional economic policies and cooperation, the Common Market has now a machinery that could contribute to accelerate that progress.

E. Growth of Intra-regional Trade

12. Trade between the Central American countries has risen dramatically as a result of the creation of the Common Market. Between 1961 and 1965 intra-regional trade has grown from CA$37 million to CA$136 million, an increase of 270 percent in five years as shown below. The share of intra-regional imports in total imports has increased from 7.4 to 15.6 percent.

Year	Intra-regional imports		Intra-regional imports as percentage of total imports
	Value (million CA$)	Percentage increase over preceding year	
1961	37	12	7.5
1962	50	37	9.1
1963	66	31	10.2
1964	105	59	13.7
1965	136	29	15.3

For the region as a whole, from 1962 to 1965, the ratio of intra-regional imports to regional GDP has increased relatively less (106 percent) than the growth of intra-regional imports, 172 percent. On the other hand, the ratio of imports from outside to GDP has risen during the period. There has been, therefore, no overall net import substitution for the area as a whole, but an increased dependence on outside imports. Due to the expansion of intra-trade,that increased dependence has been less than otherwise would have been the case. Imports from abroad of finished manufactures for consumption have dropped from 32 to 27 percent of total imports from abroad between 1962 and 1965. The substitution of regionally produced finished manufactures and foodstuffs for imports of these items from third areas, however, has been more than offset by increases in other imports. The high import component of many of the new industrial products developed in the region appear to be a factor in this development.

13. It is still too early to judge whether the slackening in the rate of increase of intra-regional trade registered from 1964 to 1965 indicates the beginning of a trend of lower growth in trade and the passing of the initial and easiest stage of import substitution. Thus far intra-regional trade has been an important element of growth in the region, accounting for about 20 percent of the increase in industrial output, and reinforcing the high level of general economic activity brought about by the export boom that has taken place during the period.

14. The expansion of intra-trade has not been equally shared among countries, but all have probably benefitted from it. Each country's total intra-regional exports in 1961 and 1965 is shown below.

Country	Exports to Common Market (million CA$)		Percentage Increase	Percentage Share of total intra-trade	
	1961	1965	1965/1961	1961	1965
Guatemala	9.3	38.0	309	25.2	27.9
El Salvador	14.4	45.4	285	38.1	33.3
Honduras	8.3	22.1	166	22.6	16.2
Nicaragua	1.8	9.8	444	4.8	7.2
Costa Rica	2.0	18.8	840	5.4	13.8

15. The Common Market has become important for each of the countries, either as an outlet for exports or as a source of imports or both. Intra-regional exports are still very heavily concentrated in the first three countries, which had developed substantial trade among themselves long before the Common Market came into being. Yet the creation of the Common Market has stimulated a shift toward a more balanced pattern of exports among the countries. In 1965 exports to Common Market partners in relation to total exports of the country were 21 percent for Guatemala; 24 percent for El Salvador; 18 percent for Honduras; 7 percent for Nicaragua and 17 percent for Costa Rica. Each country's exports and general level of economic activity has thus become more dependent on the economic activity of its neighbor and of the region as a whole. In terms of imports, the

Common Market has reduced the concentration of regional trade in the three northern countries - Guatemala, El Salvador, Honduras - which had been developing among themselves before the Common Market. From 1961 to 1965 the combined share of these three countries has dropped from 81 to 72 percent of intra-regional imports, while Nicaragua's share has exactly doubled, and Costa Rica's share has remained practically unchanged.

16. Trade of each country with the rest of the region has not developed marked tendencies toward surplus or deficit in their trade balances except in the case of Nicaragua which is experiencing a persistent and increasing deficit. This deficit basically reflects the fact that Nicaragua's impressive export effort in the last several years has been directed mainly outside of the region. The launching of the several important industrial projects, including chemicals, insecticides, metal fabrication and textiles, at present being prepared or already underway, will substantially increase Nicaragua's exports to the rest of the region. In substantial degree, the present trade imbalances are likely to reflect the earlier start of some countries toward industrial development rather than any fixed pattern resulting from substantial comparative advantages, although the period is still too short to form a firm judgement in this respect. Free trade in the areas is stimulating product specialization more than industry specialization among the countries, and the possibility of product specialization thus offers opportunities to each of the countries to develop its exports. In any case, it is the overall trade and balance of payments position of a country which is of primary importance, and its balance or imbalance regionally must be viewed in that context.

Commodity composition of intra-trade

17. Manufactured goods now predominate in the trade among Central American countries, accounting for 59 percent of total intra-regional trade in 1965 compared with 40 percent in 1962. By 1965 trade in finished manufactures was CA$79 millions, an increase of CA$61 million, representing 73 percent of the increase in total intra-regional trade since 1962. Trade in crude materials and crude foodstuffs increased considerably in absolute terms, but their share in regional trade dropped from 33 percent in 1962 to 17 percent in 1965.

18. Another outstanding feature of intra-regional trade is the intensity of trade in the same categories of goods. Most of the intra-trade is very widely distributed among many commodities, with some exceptions, i.e. in 1965, a large proportion of Honduras' regional exports were crude foodstuffs; El Salvador imported a large percentage of the region's exports of semi-manufactures for industry, and Guatemala a high percentage of manufactures for consumption goods. Heavy reciprocal trade in the same commodity groups is thus taking place between many pairs or groups of countries (see Table 41). As this also holds true for much narrower industrial classifications, intra-trade in the Central American Common Market is evidently taking place largely on the basis of product specialization rather than inter-industry specialization.

19. As yet, intra-regional trade is concentrated mainly between Guatemala, El Salvador and Honduras which include about three quarters of the population of the region and somewhat less (70 percent) of regional GDP in 1965. These countries, particularly the first two, account for a large share of total intra-regional exports of manufactures; thus in finished manufactures for consumption they provide 73 percent of the total intra-regional exports of these goods. They import 43 percent of intra-regional imports of that category. However, the market is open to competition and thus Costa Rica has been able to substantially expand its exports of finished manufactures in the two years since it entered the Common Market not only to neighboring Nicaragua but also to the othre three trading partners in important amounts.

F. The Central American Common Tariff

20. Tariff levels and tariff policy in relation to the growth of domestic industrial production, import substitution and industrial development are discussed in the industrial section of this report. They are considered here in relation to the general framework of the common market. No satisfactory method exists for measuring overall changes in tariff levels or for comparing the overall incidence of different tariffs. However a partial comparison between the weighted and unweighted averages of the previous national tariffs and the Common Tariff (See Table 35) gives a rough indication of the general direction and extent of change in tariffs caused by adoption of the Common Tariff. The comparison is based on a list of 83 tariff sub-items covering all economic categories of goods except industrial machinery. In value, it represents 43 percent of total imports from outside the area in 1964 and 75 percent if machinery imports are excluded from total imports. Industrial machinery is not included in the comparison because tariff rates are generally very low or moderate as a matter of policy and a large proportion of such goods are in any case exempted from duties by privileges granted under the national industrial promotion laws. Except in a few isolated cases, differences between the weighted and simple averages of the five previous national tariffs and the Common Tariff are not significant, reflecting the basic similarity among countries with respect to the structure of their previous tariffs and of their imports from third areas.

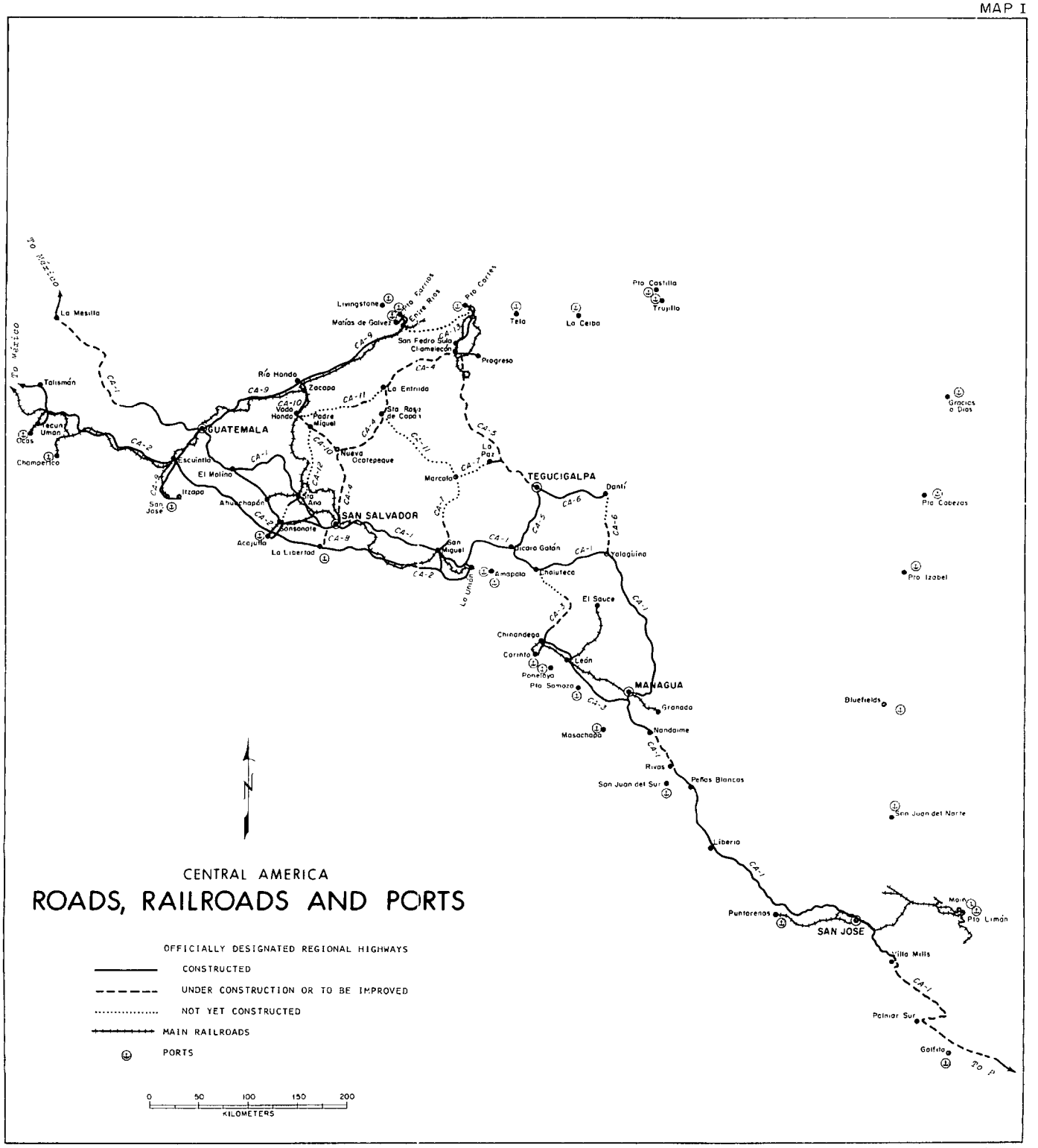
21. A comparison of the frequency distribution of the weighted average rates of the previous national tariffs and the Common Tariff rates for the selected sub-items shows that the Common Tariff represents a shift to distinctly higher rates.

Range (class) of Ad-valorem tariff rates (at 1964 unit import values)	Number of Tariff Sub-items	
	Previous tariffs weighted average	Common Tariff
Less than 10 percent	10	5
10 to 39 percent	29	26
40 to 69 percent	29	18
70 to 99 percent	6	15
100 to 129 percent	5	8
Over 130 percent	4	11
Totals	83	83

Under the previous tariffs, tariff rates of 39 percent or less ad-valorem applied to 47 percent of all sub-items in the list, but under the Common Tariff only 37 percent of the items fell within such rates. Within rates from 40 to 69 percent ad-valorem fell to 35 percent of all items under the weighted average of the previous tariffs but to only 22 percent under the Common Tariff. In contrast, only 18 percent of the items were subject to rates of duty of 70 percent or more under the previous tariffs, but under the Common tariff those items represented 41 percent of the total in the list. The structures of the previous national tariff and the common tariff, in terms of economic categories, are substantially similar, in that both levy low duties on raw materials and machinery and equipment, while levying higher duties on manufactured foodstuffs and finished manufactures for consumption. While increases accorded under the Common Tariff were particularly concentrated in these latter categories, the movement has been to higher rates in all economic categories.

22. As another measure of the upward shift, the median of the list of ad-valorem rates of duty of the previous tariffs was 44 percent but it is significantly higher, 64 percent, under the Common Tariff. Despite the limitations of the sample list, the foregoing comparisons show that the Common Tariff resulted in widespread and often substantial increases in the rates of duties compared to both the simple or the weighted average of the five previous national tariffs. The rates of Common tariff on consumer goods particularly were increased and are now very substantial and often very high by any criteria of evaluation.

MAP I



SEPTEMBER 1966

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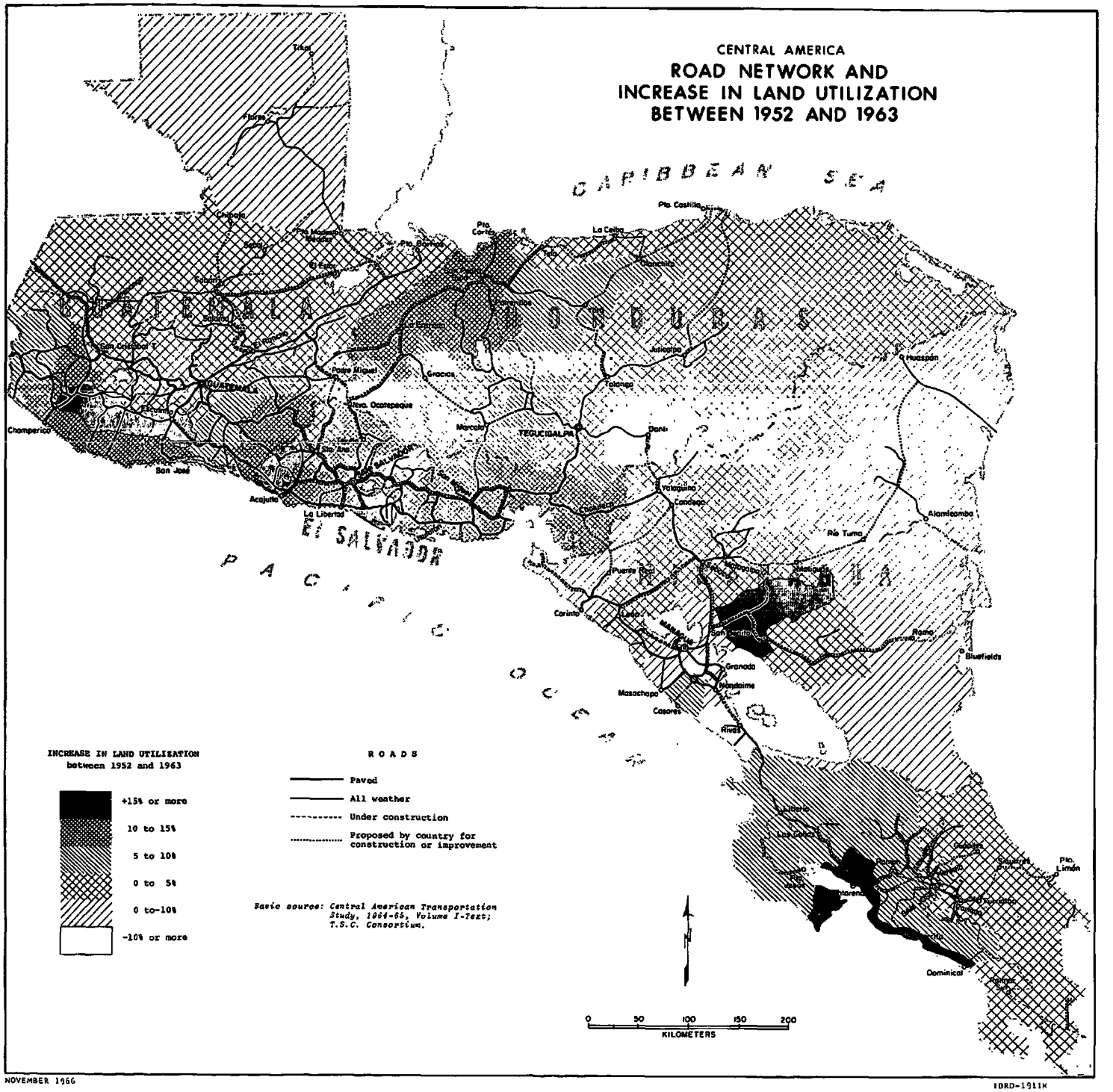

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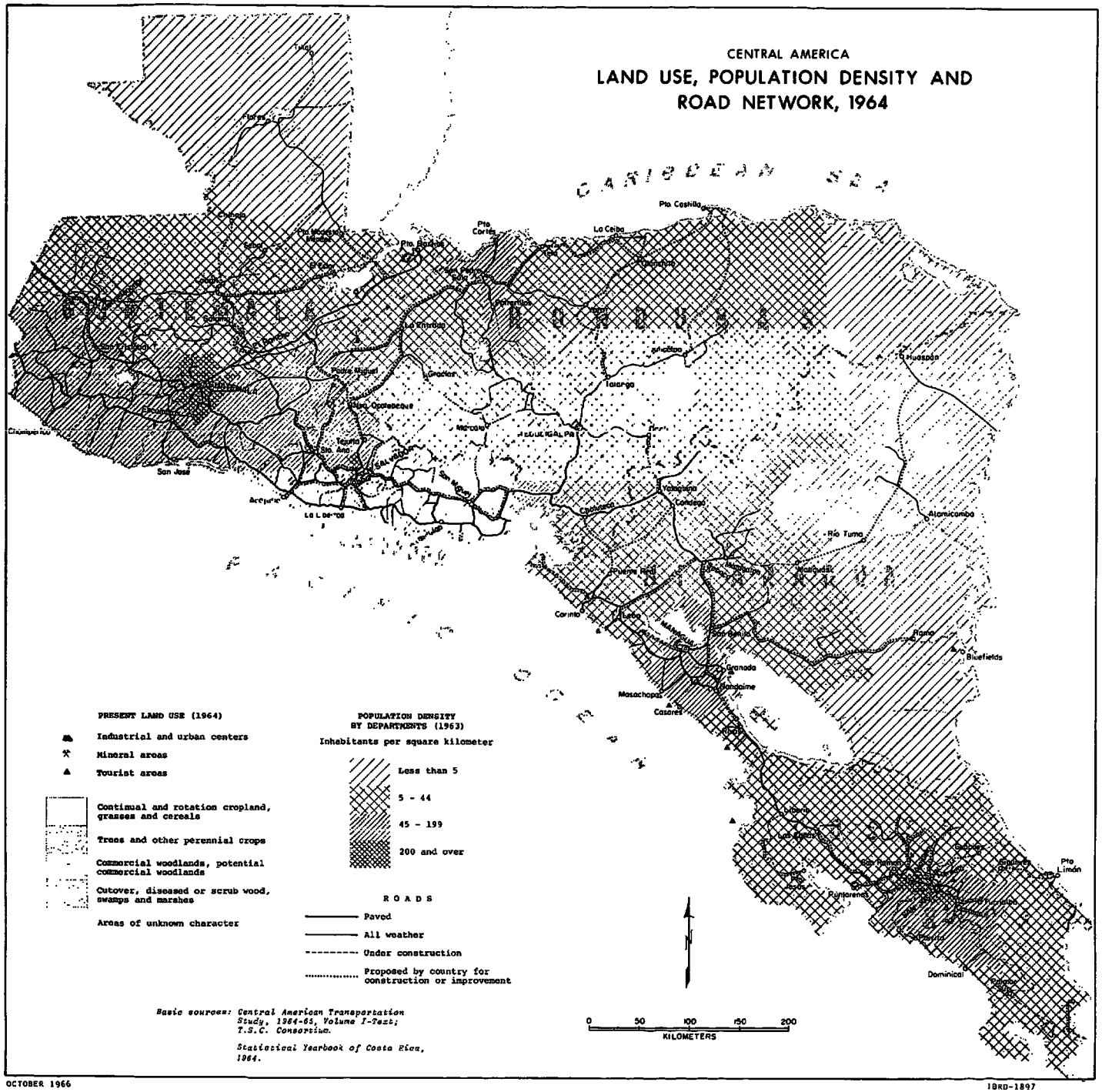
MAP II

CENTRAL AMERICA

LAND USE, POPULATION DENSITY AND ROAD NETWORK, 1964



Basic sources: Central American Transportation Study, 1964-65, Volume I-Text; T.S.C. Consortium.

Statistical Yearbook of Costa Rica, 1964.

OCTOBER 1966

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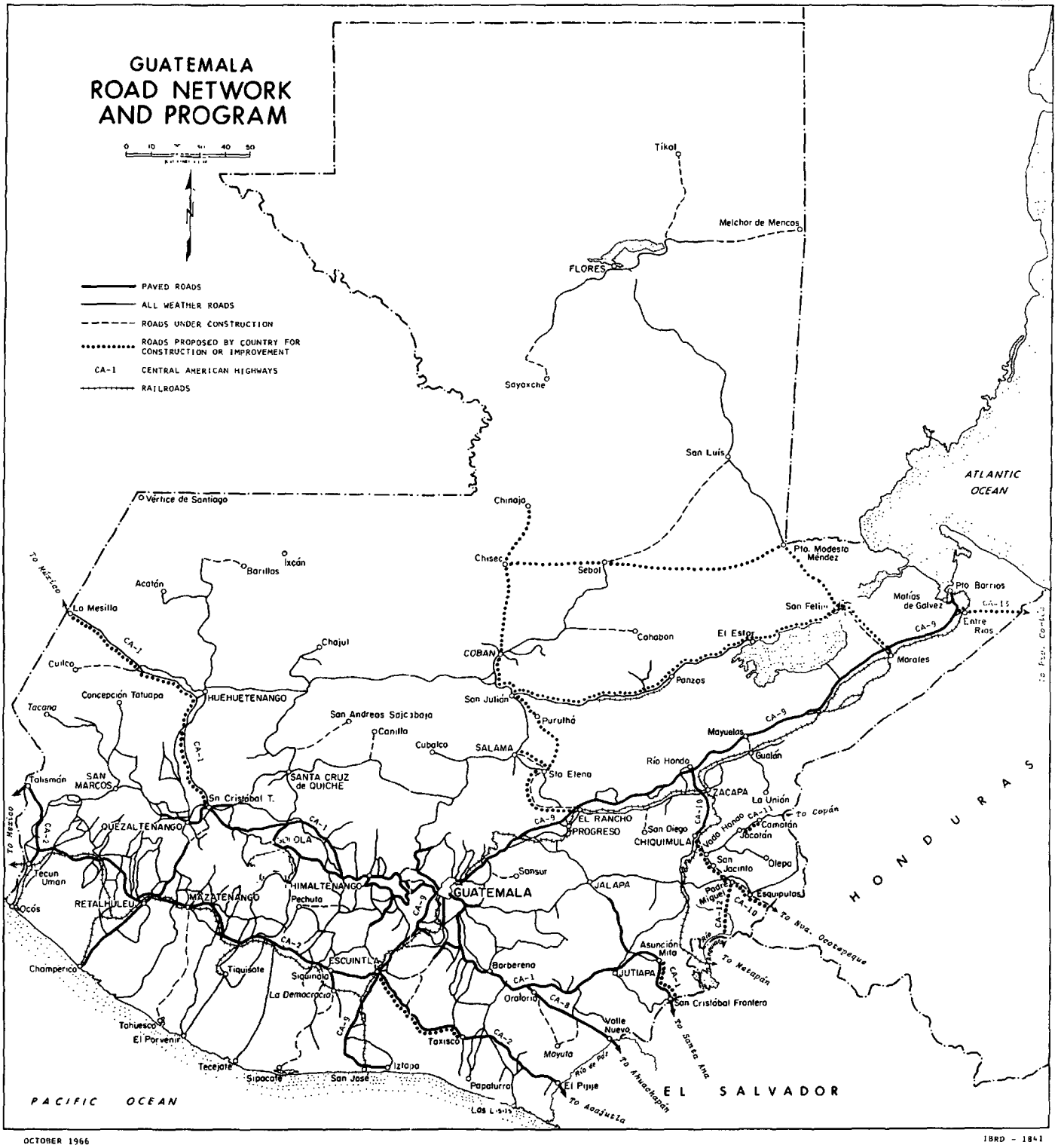
MAP III

MAP IV



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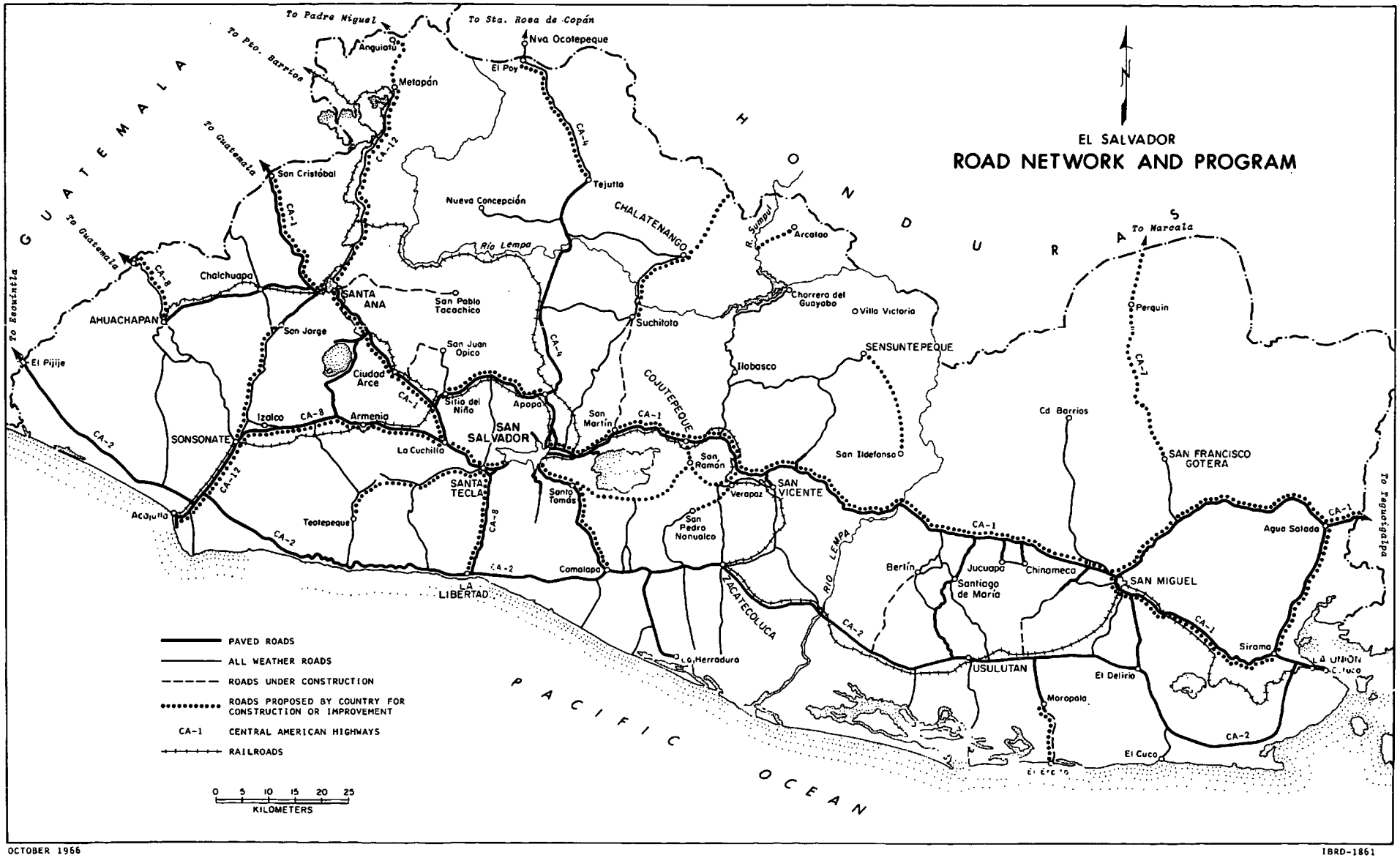

MAP V

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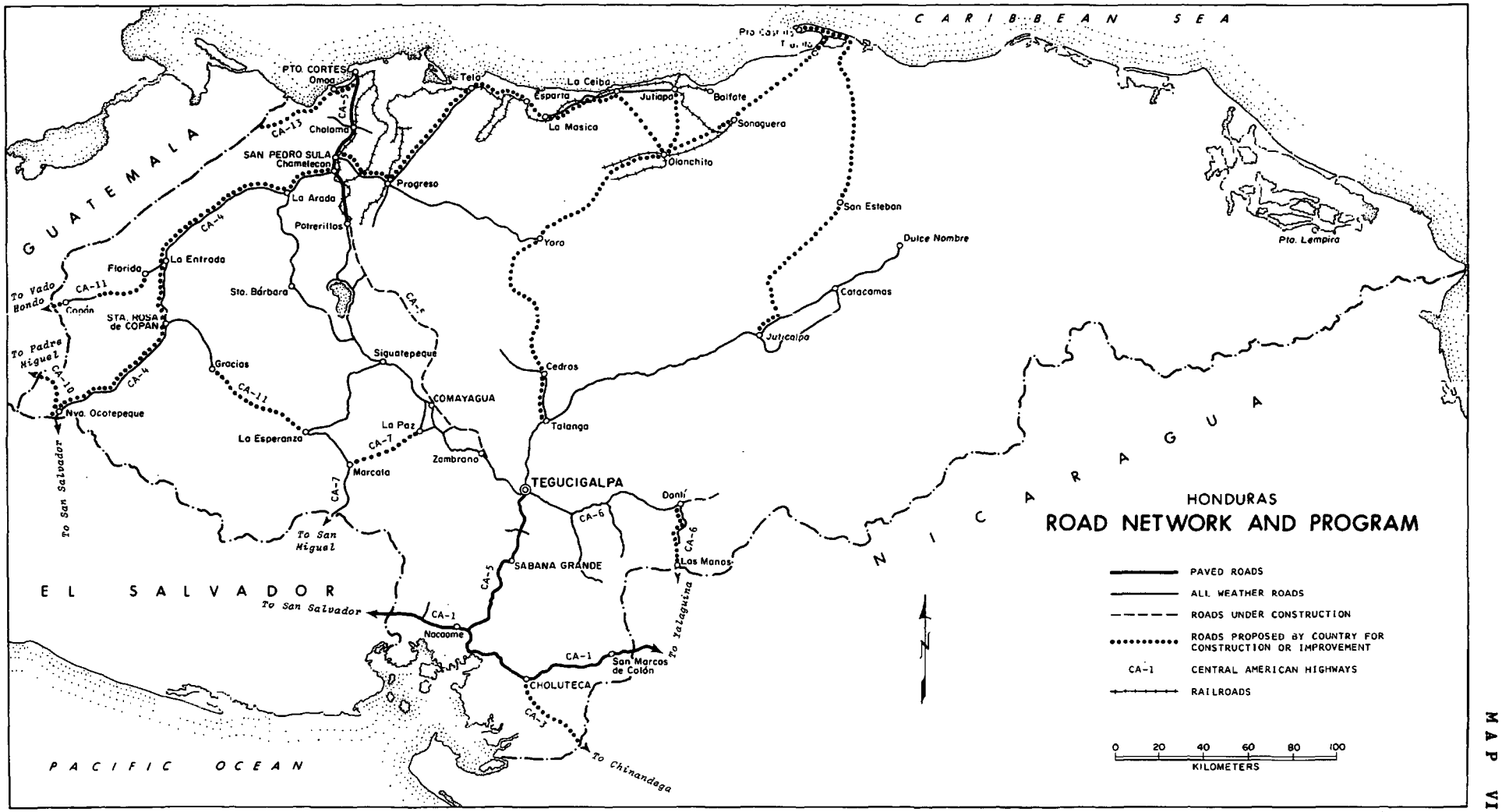

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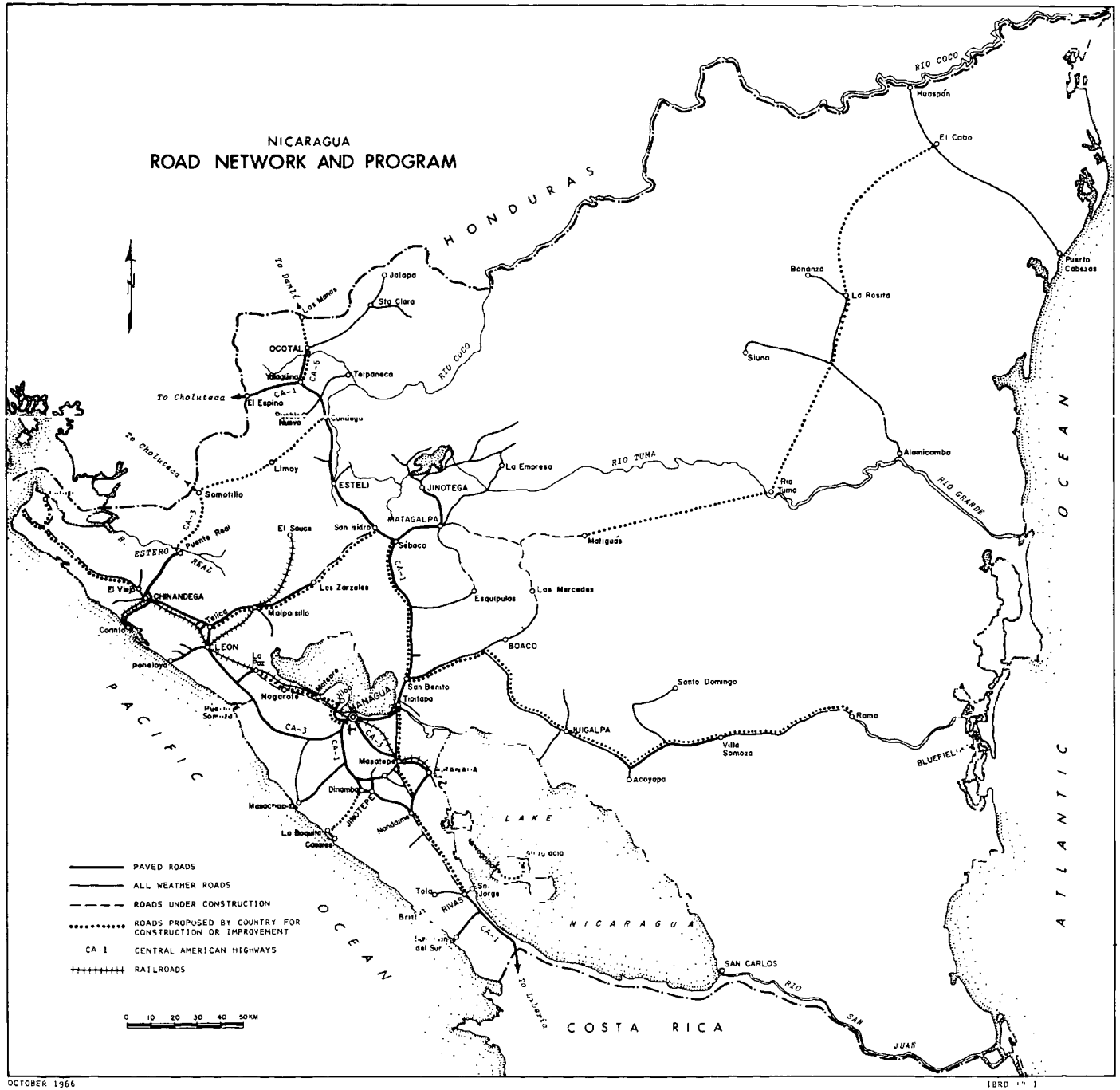
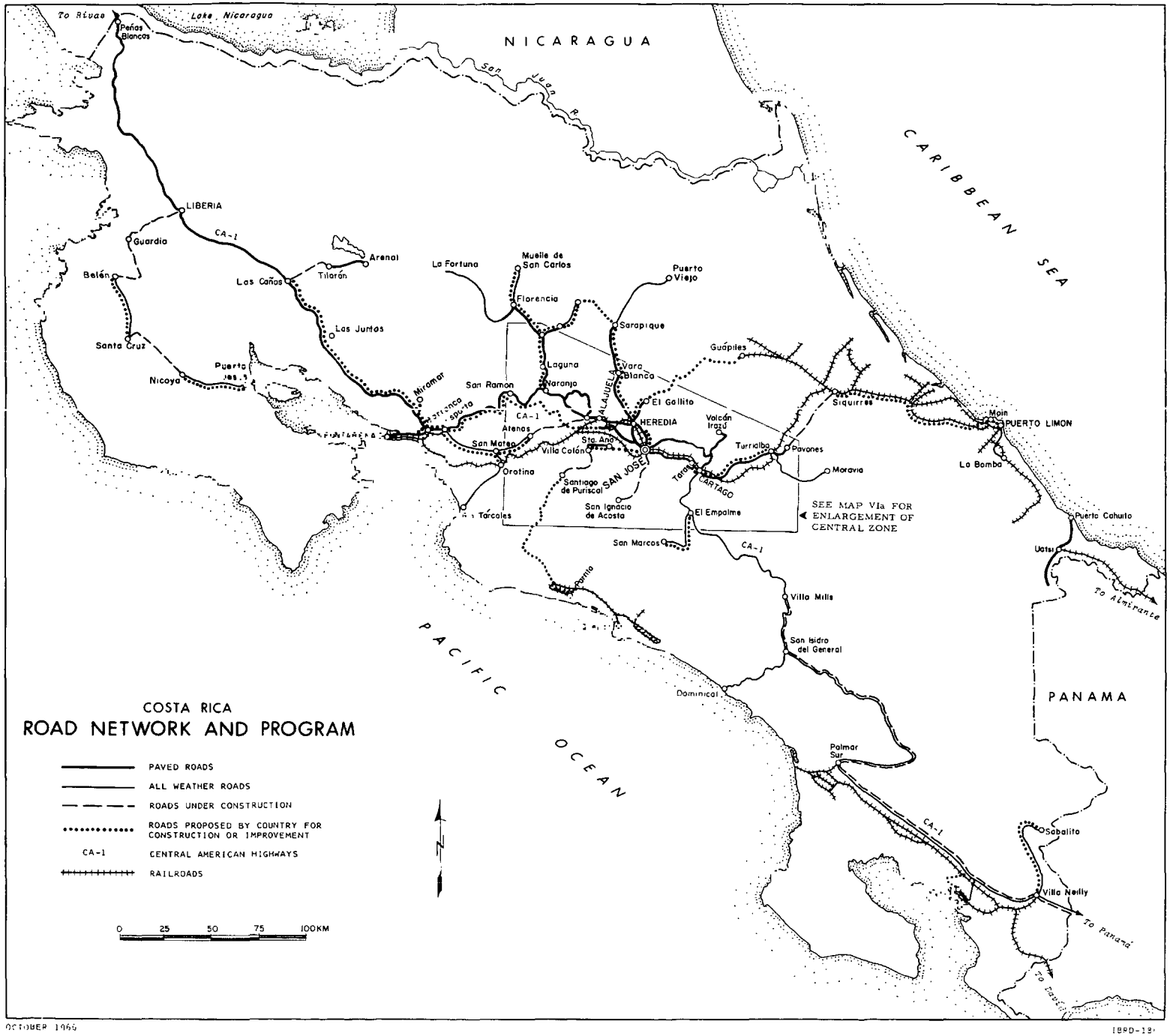
MAP VI



MAP VII

OCTOBER 1966

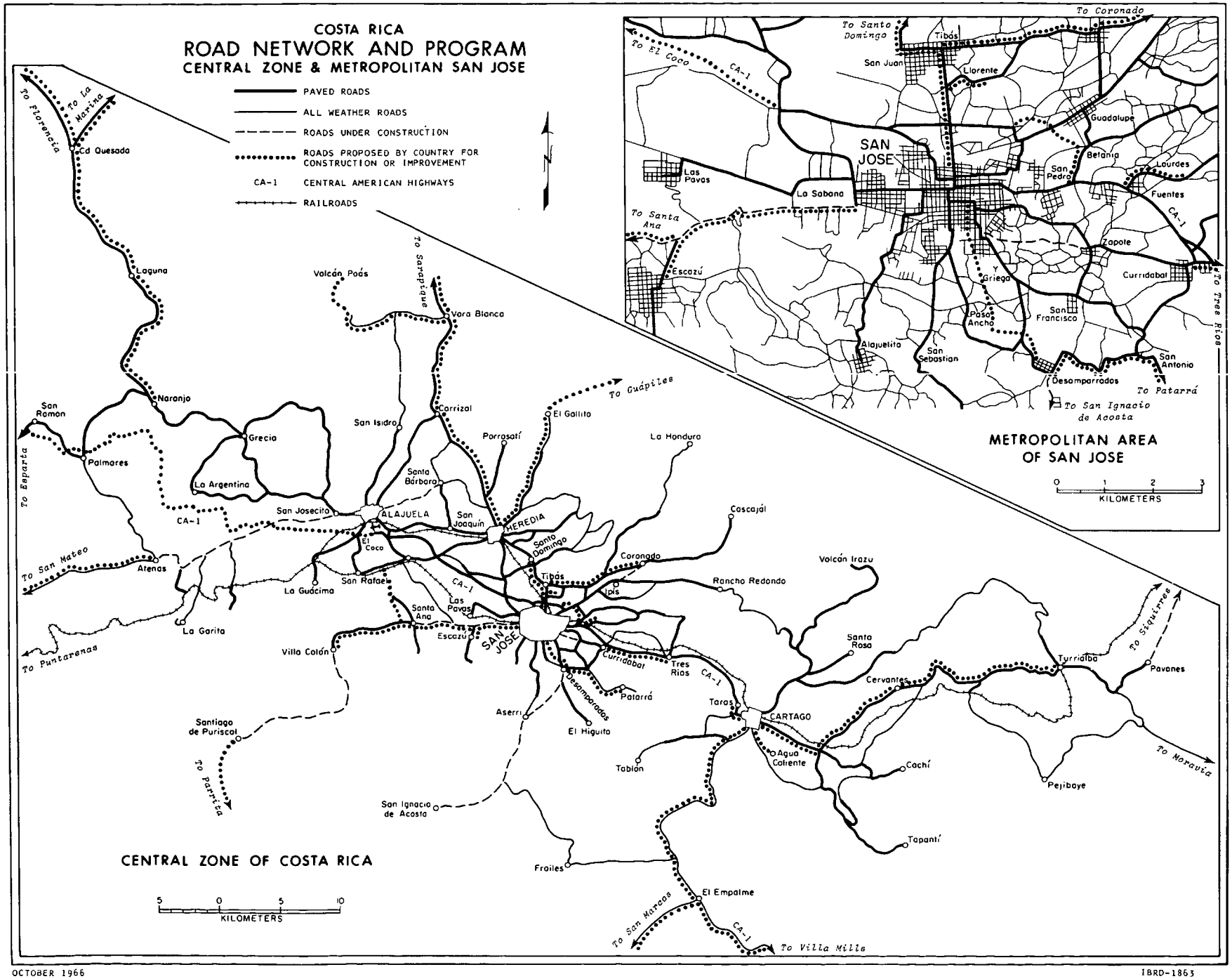
IBRD [illegible] 1



MAP VIII

OCTOBER 1965

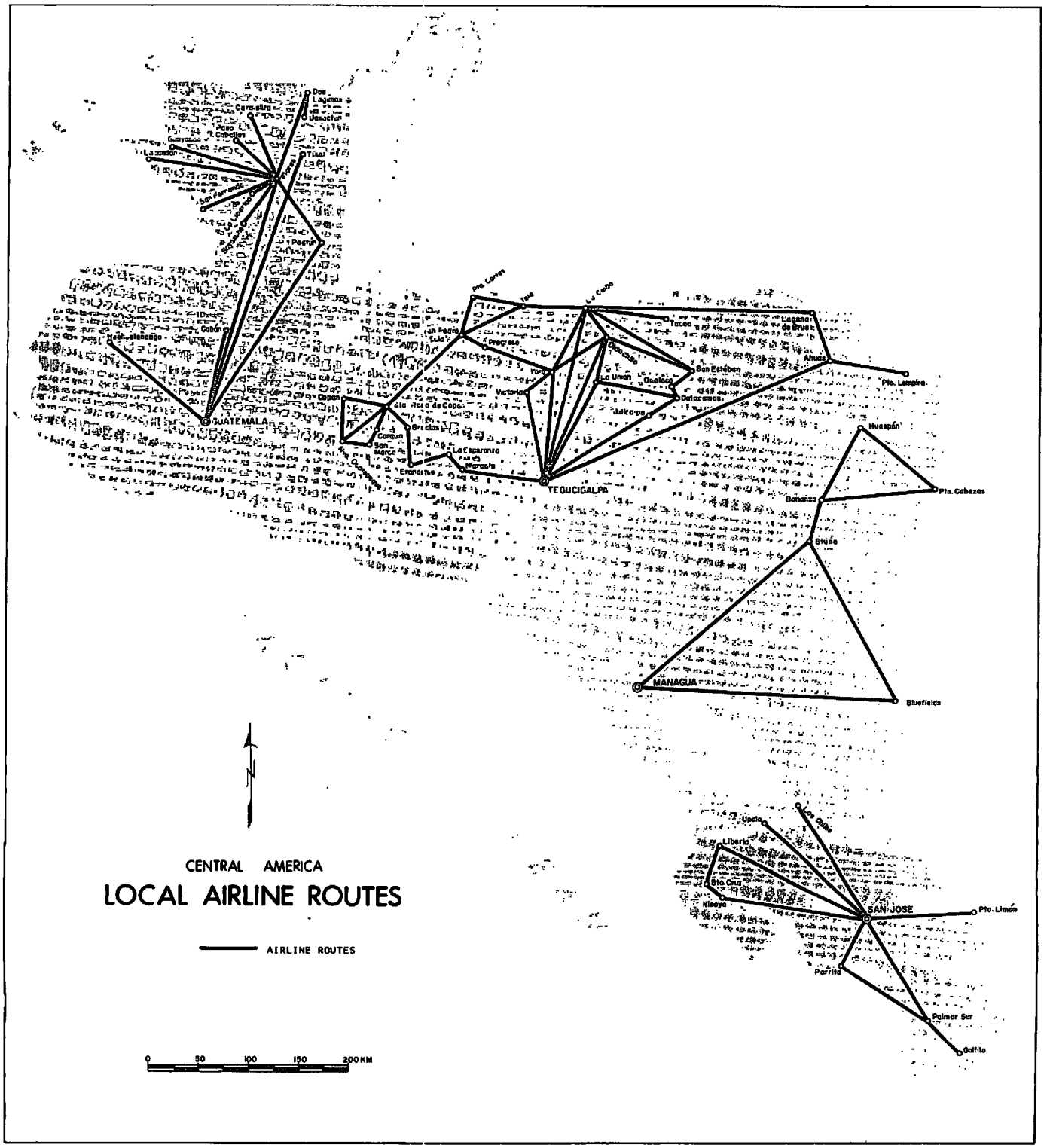
IBRD-18



MAP VIIIa

OCTOBER 1966

IBRD-1863


CENTRAL AMERICA
LOCAL AIRLINE ROUTES
AIRLINE ROUTES
0 50 100 150 200KM
N
GUATEMALA
TEGUCIGALPA
MANAGUA
SAN JOSE
Tocoa
Laguna de Brus
Ahuas
Pto. Lempira
Huspán
Pto. Cabezas
Bonanza
Siuna
Bluefields
San Esteban
La Union
Olancho
Catacamas
Juticalpa
Victoria
Progreso
La Ceiba
Tela
Puerto Cortez
San Pedro Sula
Copán
Sta. Rosa de Copán
Gracias
Corquin
San Marcos
La Esperanza
Marcala
Choluteca
Nueva Ocotepeque
Cobán
Huehuetenango
Quetzaltenango
Coatepeque
Tilar
Pochuta
Puerto Barrios
Los Chiles
Upala
Liberia
Sta. Cruz
Nicoya
Puerto Limón
Perrito
Palmar Sur
Golfito