

**THE DYNAMICS OF SECTORAL GROWTH IN THE CENTRAL AMERICAN
COUNTRIES: RECENT TRENDS AND PROSPECTS FOR 2020**

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I. INTRODUCTION

Even after two decades of import-substituting industrialization, the five countries of the Central American Common Market (CACM) remained in 1980 more agricultural than industrial.¹ The same structure was evident in Belize,² while Panama differed from the rest of

¹ Victor Bulmer-Thomas (1987:185) has argued persuasively that the CACM was not intended to replace the traditional export-led development model based on primary products (overwhelmingly agricultural), and did not do so; it was simply grafted onto the traditional model to form a "hybrid" model of industrialization. Agriculture's share of GDP in 1980 exceeded that of manufacturing in all five CACM countries (percent of aggregate value added in

the region in that both agriculture and manufacturing were dwarfed by the services sectors.³

In the last two decades, the structure of production has changed significantly in some Central American countries but not in others. The next section of this paper, which reviews these patterns, notes that the relative importance of any sector (and in particular agriculture) is sensitive to the base year in which the national accounts data are expressed in constant prices. Especially where base years are several decades old, differences between constant-price and current-price shares can be large.

The third section of this paper discusses likely trends in the regional, hemispheric, and world economies during the first two decades of the 21st century, and their potential effects on the structure of production in Central America. In the fourth section, the focus is on economy-wide and sectoral reforms needed for the Central American countries to strengthen their domestic and regional economies and to participate more effectively in the global economy. A fifth section presents alternative visions of the structure of the Central American economies in 2020, with and without major additional policy reforms [and possibly using the two alternative scenarios for the world economy presented in OECD (1997)]. The final section provides policy recommendations for development assistance that would more effectively assist the countries of the region to achieve their aggregate and sectoral growth potential.

II. CHANGES IN THE STRUCTURE OF PRODUCTION SINCE 1978

A. Data Sources and Issues

This section reviews changes in the structure of production in each of the seven countries between 1978-80 and 1995-97; data are also provided for an intermediate period,

1970 prices at factor cost):

	Costa Rica	El Sal- vador	Guate- mala	Hon- duras	Nicar- agua
Agriculture	19.2	30.2	27.7	25.1	25.7
Manufacturing	16.9	17.1	15.6	15.1	23.1

(Bulmer-Thomas 1987: Appendix Tables A.1, A.4, and A.8, pp. 309, 315, and 323). Agriculture's share of employment exceeded that of manufacturing by much wider margins, reflecting the large average productivity differentials between the two sectors.

² [Add Belize data.]

³ Agriculture's share of Panamanian GDP in 1980 (in 1988 dollars) was 9.9%, and that of manufacturing, 10.4% (IDB 1989: Appendix Tables B.1, B.7, and B.9, pp. 463, 467, and 468).

1987-89. Sectoral shares of GDP are calculated on the basis of three-year averages to reduce distortions caused by sharp annual fluctuations in sectors such as agriculture and construction. The initial period, for the most part, excludes the "debt-crisis" effects of the 1980s. Earlier base years were chosen for El Salvador (1976-78) and Nicaragua [(19xx-xx)] to minimize the effects of those countries' civil wars. The final period is 1995-97 rather than 1996-98 to avoid the distorting effects of Hurricane Mitch, which had unusually severe effects in some countries, particularly on agricultural production.

Sectoral shares of GDP are presented in the Appendix tables in both current and constant prices, although most of the discussion in the text is based on constant-price trends. The quality of the national accounts data varies among countries. Also, the base year is sometimes quite old (1958 in the extreme case of Guatemala), a situation that over time increasingly distorts reported trends in overall real GDP growth, as sectoral weights become increasingly outdated. In Central America, the use of old base years tends principally to exaggerate the relative importance of agriculture.

It is important also to examine two "sectors" not identified as such in the national accounts, but which for Central America as a whole recently have shown considerable dynamism: *maquila* (assembly) operations (mainly for apparel) and tourism. Data for these activities come principally from balance-of-payments statistics, although in some cases *maquila* operations are identified as a branch of manufacturing. Both *maquila* operations and tourism have good prospects for continued rapid growth.

B. Trends by Country

[Eventually I will make this section shorter, putting most of the material in an Annex]

1. Belize. [To be added.]

2. Costa Rica. [To be added.]

3. El Salvador. El Salvador updated its national income accounts in the early 1990s, changing the base year from 1962 to 1990. One of the most significant effects of this change was to reduce sharply the relative weight of the agricultural sector in 1978, from [XX]% of GDP to 16.8%. This and other changes have affected overall real GDP growth figures, sometimes significantly.⁴

The new national accounts figures show that agriculture accounted for 16.1% of real

⁴ [See data with 1962 base year.]

GDP in the 1976-78 period. Agriculture's share rose to 17.2% in 1987-89, despite a 13.7% drop in real value added, because war-induced production declines were even greater in the rest of the economy.⁵ And while agriculture grew cumulatively by 14.3% between 1987-89 and 1995-97, the much stronger performance of the rest of the economy⁶ lowered agriculture's share to 14.2%.^{7,8} Per capita agricultural production in 1995-97 was 23.4% below its 1976-78 level. A significant appreciation of the real effective exchange rate during the 1990s has offset the favorable effects since 1989 of initial currency depreciation, price and marketing liberalization, and the end of the civil war in January 1992.⁹

Within the agricultural sector, crop production strongly dominates, although its share of sectoral value added in constant prices fell from 72% in 1976-78 to 64% in 1987-89 and remained at that level in 1995-97. Coffee accounted for 34%, 39%, and 35%, respectively, of value added in the crop sub-sector during the three periods under consideration. Cotton, second in importance at 23% in 1976-78, fell sharply to 4% in 1987-89 and statistically disappeared in 1995-97. The demise of cotton, evident also in the rest of Central America, reflects a combination of factors, including the civil war, depressed world market prices, and environmental problems. Basic grains significantly increased their share of the crop sub-sector from 18% in 1976-78 to 29% in 1987-89 and 31% in 1995-97. Real per capita value added in basic grains in 1995-97 was 19% higher than in 1976-78.

All other agricultural sub-sectors increased in relative importance between 1976-78 and 1995-97: livestock, from 14% to 16%; poultry, from 6% to 10%; forestry, from 5% to 6%; and fishing and hunting, from 3% to 4%.

Manufacturing's share of real GDP fell sharply from 27.0% in 1976-78 to 21.4% in

⁵ Aggregate GDP fell by 19.0% between 1976-78 and 1987-89; the decline in per capita GDP was 29.1%.

⁶ Aggregate GDP grew by 37.8% between 1987-89 and 1995-97, an annual increase of 4.1%.

⁷ In current prices, agriculture's share of GDP fell from 39.8% in 1976-78 to 20.0% in 1987-89 and 13.6% in 1995-97.

⁸ Sectoral GDP shares for the revised national accounts data are not quite comparable for 1970-89, on the one hand, and 1990 onwards, on the other. In the earlier years they are based on GDP at market prices rather than factor cost (for which no data are available). Beginning in 1990, sectoral GDP is based on "gross value added." To arrive at GDP at market prices from gross value added, imputed banking services are subtracted from total gross value added (from all sectors combined), and indirect taxes are added.

⁹ The real effective exchange rate appreciated by 47.4% between 1990 and 1997 (IMF 1998:103).

1987-89, then rose to 22.8% in 1995-97. However, data since 1990 include value added in *maquila* operations. If these are excluded, manufacturing's share of GDP in 1995-97 drops to 21.0%, and its annual real growth rate between 1987-89 and 1995-97 falls from 8.0% to 6.2%. Despite this relatively strong recent performance, real manufacturing value added in 1995-97 (excluding *maquila* operations) was 13% below its 1976-78 level.

Within manufacturing, the share of food products rose from 15% of real value added in 1976-78 to 26% in 1987-89 and 29% in 1995-97. The relative increase over the first period was due more to a sharp decline in other manufacturing activity than to food products' modest real annual growth of 1.2%. In the second period, however, real value added in food products rose by 5.3% annually.

The combined share of the textile and apparel sub-sectors fell from 23% of real sectoral value added in 1976-78 to 16% in 1987-89 and 15% in 1995-97. Wartime disruptions, and the resulting sharp drop in real per capita GDP, explain most of the relative decline in the first period. Below-average growth in the second period may reflect in part the recent appreciation of the real effective exchange rate. Other changes in real sector output between 1976-78 and 1995-97 include relative declines in basic chemicals (from 11% to 9%) and rubber and plastics (from 8% to 2%), and a relative increase in non-metallic minerals (from 3% to 5%).

Elsewhere in the economy, value added in mining increased in relative importance during both periods, but it still represents only 0.5% of GDP. Construction's share of GDP fell slightly from 4.4% in 1976-78 to 4.0% in both later periods. The utilities sector rose from 0.7% of GDP to 1.2%, then fell to 0.6%. However, the reported decline of 24.4% in this sector's value added over the second period seems inconsistent with overall real GDP growth of 37.8%.¹⁰ Moreover, value added in this sector seems generally to be significantly underestimated.¹¹

Among the services sectors, the sharp relative decline in commerce during the first period, from 19.6% to 15.3%, seems broadly consistent with the significant contraction of external trade and overall economic activity at the time; but if some commercial activity shifted to the unrecorded, informal economy, the extent of the decline would be exaggerated. Commerce's rebound to 21.4% in 1995-97 seems consistent with strong economic growth during the 1990s, the recovery of external trade, and the increased inflows of overseas remittances, which are heavily biased toward consumption.¹² In current prices, the commerce

¹⁰ The data problem resides in the electricity sub-sector, where real value added is shown, implausibly, to have declined by 71% between 1990 and 1991, and to have recovered to only 56% of the 1990 level by 1997.

¹¹ [Compare with the relative importance of utilities in other countries.]

¹² For a discussion of external remittances, and proposals for channeling more of these inflows to investment activities, see Siri and Calderón (1996).

sector's share of GDP showed a notable increase, from 9.2% in 1976-78 to 14.2% in 1987-89 and 20.6% in 1995-97.

The other private services sectors unfortunately are not disaggregated prior to 1990 in the new national accounts statistics. Their combined share of real GDP rose from 21.3% in 1976-78 to 25.7% in 1987-89, then fell to 22.4% in 1995-97. For the 1990s, the disaggregated data show the following real annual growth rates between 1990-92 to 1995-97:

Banking, Real Estate & Other Financial Institutions	13.6%
Real Estate and Business Services	4.3%
Housing Rentals	1.6%
Communal, Personal, Social & Domestic Services	4.1%

Of these sectors, only banking, insurance, and other financial institutions grew faster than the overall GDP growth rate of 4.4%.

The share of public administration in real GDP rose sharply from 4.0% in 1976-78 to 7.7% in 1987-89, reflecting expenditures on the war effort, nationalization of banking and marketing operations, and the sharp decline in private economic activity. By 1995-97 the public-administration share was down to 6.1%.

Balance-of-payments data for *maquila* activity show that value added in 1984, the first available year, amounted to \$6 million. By 1990 the figure had reached \$18 million, still a relatively small figure. The expansion of *maquila* activity in the 1990s, however, has been dramatic, with value added reaching \$291 million in 1997. Factors contributing to this growth include the end of the civil war; the devaluation of 1989; sound macroeconomic policies; and declining real wages (Paus 1995), which have offset the recent real appreciation of the *colón*.

National accounts data, showing *maquila* operations as a branch of manufacturing since 1990, reveal that real value added from this activity grew steadily from 0.4% of GDP in 1990 to 2.2% in 1997.¹³

Tourism in El Salvador has been only a modest source of foreign-exchange earnings. From the late 1970s to the early 1990s, the civil war discouraged travel to the country. Foreign-exchange receipts from travel to El Salvador averaged \$75 million in 1990-93 and \$86 million in 1994-97. Factors contributing to the slow growth of tourism, despite the end of the civil war and sound economic policies, include infrastructure shortages, weak public and private promotional and development activities, concerns about personal security, and an appreciating real exchange rate.

4. Guatemala.

¹³ GDP in terms of "gross value added" (see footnote above).

[To be added.]

5. **Honduras.** Honduras's structure of production, measured in constant prices, has changed relatively little since the late 1970s. This is particularly true of agriculture, whose share of GDP at factor cost has remained at about 27%, and manufacturing, which has held steady at 15%. The share of mining fell from 2.0% in 1978-80 to 1.8% in 1995-97, while that of construction declined from 5.4% to 4.2%. The relative importance of the utilities sector more than doubled, from 1.3% to 2.9%. The GDP share of three services sectors increased, while that of three others declined:

	1978-80	1987-89	1995-97
Transportation	6.7	8.3	8.6
Finance	5.8	6.6	9.7
Housing	5.5	6.4	6.6
Commerce	15.2	11.6	10.9
Public Administration	6.9	7.5	4.8
Personal and Other Services	9.1	9.0	7.7

The reported sharp drop in the relative importance of commerce, most of which occurred between 1978-80 and 1987-89, is surprising.¹⁴ It may be due in part to the decline in external trade during the 1980s; but it may also reflect a shift in some commercial activities to the informal economy, where many activities are difficult to measure and therefore are unrecorded.

Since the base year for the national accounts data is 1978, significant differences between constant-price and current-price data in 1995-97 are not surprising. As early as 1987-89, agriculture's current-price share (21.1%) was sharply below its constant-price share (26.8%), reflecting a drop from the relatively high prices of the late 1970s. The respective figures in 1995-97 are 22.5% and 27.5%. In manufacturing, by contrast, the current-price share of GDP in 1995-97 (18.0%) significantly exceeds the constant-price share (15.3%), a phenomenon that was not evident in 1987-89. Other major differences in 1995-97 are in transport, storage, and communications, where the current-price share of GDP (4.6%) is far below the constant-price share (8.6%); and utilities and other services, whose respective current-price shares (5.7% and 10.0%) are well above their constant-price shares (2.9% and 7.7%).

Honduras's agricultural sector grew in real terms at annual rates of 2.5% between 1978-

¹⁴ The level of real commercial activity is reported to have declined by 4.2% between 1978-80 and 1987-89, or by 26.4% per capita. By contrast, real GDP (at factor cost) grew by 25.2% during this period, while real per capita GDP fell by 3.8%.

80 and 1987-89, and by 3.7% between 1987-89 and 1995-97. In per capita terms, value added in agriculture declined in the first period by 0.5% a year, then rose in the second period at an annual rate of 0.8%. In both periods, coffee grew faster than the rest of the sector:

	<u>Annual Growth Rates of Value Added (%)</u>		
	Total Agri- culture	Coffee	Other Agri- culture
1978-80 to 1987-89	2.5	3.6	2.1
1987-89 to 1995-97	3.7	5.5	2.9

The agricultural sector is dominated by crop production, whose relative share of sectoral value added held steady at 65% in constant prices, although varying considerably in current prices.¹⁵ The crop sub-sector was even more dependent on coffee in 1995-97 (48.3% of value added in crop production in 1978 prices) than in 1978-80 (38.1%). Meanwhile, the constant-price share of bananas fell from 24.7% of crop production in 1978-80 to 11.3% in 1995-97, reflecting a considerable loss of the country's world-market share of banana exports in recent years.¹⁶ The relative share of livestock production has declined significantly over the last two decades, but poultry production has shown considerable dynamism. Forestry has also lost considerable relative importance, especially since 1987-89, while the fisheries sub-sector has gained, mainly because of the expansion of shrimp farming.

The major factors limiting sectoral growth between 1978-80 and 1987-89 were the uncertainties created by the armed conflicts in neighboring countries and an increasingly overvalued exchange rate. Agriculture's stronger performance since then is due largely to significant liberalization of agricultural prices and marketing and the 1990 devaluation of the *lempira*. These positive factors have outweighed the negative effects of limited public investment in rural infrastructure and agricultural services, continuing land-tenure insecurity, and real exchange-rate appreciation in recent years. Still, the sector is performing well below its potential.

Manufacturing grew at sluggish real annual rates of 2.6% between 1978-80 and 1987-89 and 3.4% between 1987-89 and 1995-97, closely paralleling the growth of aggregate GDP over these periods (2.5% and 3.3%, respectively). The largest sub-sector—foodstuffs, beverages, and

¹⁵ The current-price shares were 65% in 1978-80, 61% in 1987-89, and 70% in 1995-97.

¹⁶ Even before the European Union imposed restrictions on imports of Honduran bananas, the country's market share of Latin American and Caribbean banana exports to world markets fell from 16% in 1988 to 8% in 1993 (Honduras 1994:5). Contributing to this decline were a fall in labor productivity, due in part to work stoppages and other labor-relations problems; increased costs of combating black sigatoka disease; and hurricane damage in 1993.

tobacco—grew at above-average rates (3.9% and 4.1%, respectively), increasing its share of sectoral value added from 36.3% in 1978-80 to 43.1% in 1994-96.¹⁷ Another major sub-sector, apparel, declined at an annual rate of 2.4% in the first period, then grew at a rapid annual rate of 14.9% during the second. Its 12.2% share of sectoral value added in 1994-96 thus exceeded its 9.1% share in 1978-80.¹⁸ Four other sub-sectors saw their share of sectoral value added increase, and four experienced declines:

	1978-80	1994-96
Paper and Paper Products	4.1	5.7
Non-metallic Mineral Products	5.0	7.9
Basic Industrial Metals	0.1	0.7
Other Industries	0.7	1.0
Wood and Wood Products	10.6	3.7
Chemicals and Chemical Products	11.6	7.9
Metal Products, Machinery & Equipment	6.7	6.3
Artisan Products	15.8	11.5

The wood and wood products sub-sector experienced a 46% real decline in value added between 1978-80 and 1994-96, reflecting poor management of the country's extensive forestry resources by the parastatal company, COHDEFOR.

Turning now to the balance-of-payments statistics (Table [x]), the data on *maquila* exports are not consistent over the entire period between 1978 and 1997 because of incomplete coverage in earlier years. Still, as late as 1990 value added by *maquila* firms appears to have been at most about \$20 million, comparable to that of El Salvador and far behind that of Costa Rica and Guatemala. Since 1990 it has risen explosively, to \$305 million in 1997 and \$398 million in 1998.¹⁹ Honduras has become the leading Central American supplier of *maquila* products to the U.S. market. About 95% of these exports are apparel items, although non-apparel assembly operations recently have begun to show some dynamism. Employment in the *maquiladoras* is now close to 100,000, or about 4.5% of the total labor force.

Factors contributing to the rapid expansion of *maquila* operations in Honduras include

¹⁷ Value-added data by sub-sector are available only through 1996.

¹⁸ In current prices, apparel accounted for 21.1% of value added in manufacturing in 1994-96, compared to 9.5% in 1978-78.

¹⁹ Hurricane Mitch did relatively little damage to *maquila* production, in contrast to its extensive damage to the agricultural sector. Losses of value added in *maquila* production have been estimated at \$10 million in 1998 and \$15 million in 1999.

improved macroeconomic policies since 1990, favorable tax and other legislation, relatively low wages in dollar terms after the devaluation of 1990, and the favorable geographic location of the San Pedro Sula-Puerto Cortés area with respect to U.S. markets.

Figures for exports of tourism services, like those for maquila exports, are not consistent over time. Data prior to 1993 are incomplete, excluding information from the Instituto Hondureño de Turismo that have been incorporated since that year. The new data show very rapid growth in tourism receipts during the 1990s, from \$60 million in 1993 to \$164 million in 1998. This expansion has been stimulated by the end of armed hostilities elsewhere in Central America; the 1990 devaluation; economic prosperity in the United States; generally sound economic policies; and expectations that new legislation friendly to foreign investment in tourism would be approved (which occurred in December 1998).

6. Nicaragua. [To be added.]

7. Panama. [To be added.]

III. ANTICIPATED GLOBAL, HEMISPHERIC, AND REGIONAL ECONOMIC TRENDS AND THEIR POTENTIAL EFFECTS ON THE STRUCTURE OF PRODUCTION IN CENTRAL AMERICA

A. Overview

As small, open economies, the countries of the Central American isthmus are highly sensitive to events beyond their borders. Globally, they are affected by volatile prices for their major commodity exports and for one major commodity import, petroleum.²⁰ Moreover, the decline in relative prices of primary products since 1980 is likely to continue well into the 21st century (OECD 1997:78; Reinhart and Wickham 1994).²¹ Within the Western Hemisphere, the Central American countries' high dependence on exports to the U.S. market makes them vulnerable to trends in that large economy. Also, as intra-Central American trade has expanded significantly since plummeting between 1980 and 1986,²² the countries of the region

²⁰ Guatemala is the only Central American country with any domestic petroleum production, and it is dependent on imports for most of its petroleum requirements.

²¹ Real non-oil commodity prices fell by about 45% between 1980 and 1992. In the late 1980s and early 1990s they were lower than at any other time in the 20th century. These trends are documented by Reinhart and Wickham (1994), who conclude that most of the real price decline since 1980 has been secular in nature.

²² The nominal value of intra-CACM trade fell by 65% between 1980 and 1986, and its real value fell by 69% (Zuvekas 1997:12).

are increasingly affected by each other's economic performance. Thus the heavy damage caused by Hurricane Mitch in Honduras and Nicaragua in October 1998 not only affected their own export capacities but also temporarily reduced the demand for imports from their neighbors. Moreover, the effects of Hurricane Mitch on other Central American countries (although moderate in El Salvador and Guatemala and small in Costa Rica) have lowered somewhat the demand for Honduran and Nicaraguan products.

Despite this vulnerability to external events, the economic depression experienced by the Central American countries in the 1980s led to

[a] remarkable consensus . . . , across most of the . . . political spectrum, on the desirability of export expansion and diversification into new products, based on comparative advantage and liberalized trade. It reflected a recognition that the international economic environment had changed radically since 1980, and that several major sources of foreign exchange, available in the 1960s and 1970s to these import-dependent economies, would be less bountiful in the future (Zuvekas 1997:3).²³

This section seeks to identify some of the major changes likely to occur in the global, hemispheric, and regional economic environments over the next two decades, and to consider how these trends might affect the structure of production in Central America. The region has basically accepted the challenges of globalization; but not all countries are well prepared to meet these challenges.

B. The Global Economy

One can conceive a rosy scenario for the first two decades of the 21st century, based on rapid technological progress (e.g. in telecommunications, biotechnology, environmentally-friendly energy, and transport) and on favorable economic policies in the OECD countries, China, East and South Asia, Latin America, and the transition economies of Europe and Asia.²⁴

²³ This theme is discussed in more detail in Zuvekas (1992:137-142).

²⁴ The performance of sub-Saharan Africa will have little effect on the global economy over the next 20 years, even if the region soon begins to grow rapidly. The Middle East/North Africa region will basically follow global economic trends rather than make an independent contribution to them. The OECD (1997:80, 92), under its high-growth scenario, envisions this region as expanding faster than the world economy, based on a significantly rising share of world petroleum exports. On the other hand, it is projected to underperform the world economy under a low-growth scenario. Middle Eastern and North African economies are highly vulnerable to technological changes that would significantly reduce world demand for petroleum; these changes might well begin to occur before 2020.

Even a few thorns among the roses (e.g. civil wars, localized cross-border conflicts, AIDS, and occasional financial crises) would not prevent a generally positive economic outcome. The OECD's high-growth scenario (1997:92) envisions average annual world economic growth of 5.0% in the first decade of the new century and 4.9% in the second.

On the other hand, one could paint a rather grim picture of the next two decades in which the world is dominated by protectionism; other backsliding on economic policy; major regional and even global financial crises; the reignition of armed conflict in areas where peace has been achieved; and generalized social and political unrest that reflects such factors as increased income inequalities and decreased personal security, and that could reverse the present trend away from authoritarianism toward democracy.

An intermediate position is represented by the OECD's (1997:92) low-growth scenario, which envisions world GDP growing at an average annual rate of 3.1% in 2001-2010 and 2.8% during 2011-2020.

This paper leans toward a favorable outcome for the world economy, reflecting the author's optimistic long-run worldview, however much he might be concerned about short-term events. Still, it is important to bear in mind what is presented below is a series of speculations, not projections.

1. Trade

[-- Prospects for WTO reforms, drawing on Croome (1998); Díaz-Bonilla and Robinson (1999); Lawrence, Rodrik, and Whalley (1996); Preeg (1998); Rodrik (199x); and other studies.]

[-- Includes brief discussion of labor standards, environmental concerns, and competition policy as likely elements of trade agreements.]

2. Financial Flows

[-- See OECD (1997); IDB studies; others]

3. Technological Progress

[-- This section will draw on OECD (1998), among other studies]

[-- telecommunications
 -- biotechnology
 -- energy
 -- transport]

4. World Economic Growth and Patterns of Demand for Central America's

Exports**-- agricultural products**

[-- Based in part on IFPRI documents]

-- manufactured goods

[-- See OECD (1997); other studies]

-- services

World trade in services grew by 8.7% annually between 1980 and 1995, nearly double the 4.5% annual growth rate for merchandise trade (OECD 1997:37).²⁵

The OECD (1997:38) has estimated that, in terms of technical feasibility, some 12%-16% of service jobs in the G7 countries could be shifted abroad. Assuming that it would be economically attractive for about 10% of such jobs to move overseas, "as of 1990 the potential additional exports from developing countries to the G7 was estimated at around \$40 billion (or 6 per cent of non-OECD countries' total exports)."

Within Central America only Costa Rica [and perhaps Panama?] have begun to tap into this potential in any significant way. For example, in June 1999 Proctor and Gamble announced that it would invest \$60 million to build a Global Business Services center in Costa Rica, employing about 1,500 persons in services related to finance and accounting, customer orders, payroll, travel management, purchasing, and information technology.²⁶

C. Toward a Free Trade Area of the Americas

[-- Brief discussion of prospects for the FTAA and implications for Central America]

D. Strengthening Central American Economic Integration

[-- Perhaps 1-2 paragraphs, drawing on other CA2020 papers.]

²⁵ "Trade in services is considerably underestimated by current balance-of-payments statistics which fail to reflect transactions like cross-border intra-firm exchange of technology and financial advice, remote data processing and transmission, and the revenue from services offered in the host country by foreign affiliates of multinationals" (OECD 1997:37).

²⁶ Reported in Honduras This Week (June 19, 1999), p. 4.

IV. DESIRABLE ECONOMY-WIDE AND SECTORAL REFORMS

A. Overview

The process of economic development is too complex for economists to tackle by themselves. The widening inequalities associated with Latin American countries' recovery from the debt crisis of the 1980s (Berry 1997; Bulmer-Thomas 1996) have made clear that blind faith in markets is misplaced. Successful, sustainable responses to the challenges of globalization require national strategies focused, in an integrated manner, on four interrelated goals: (1) economic growth, (2) poverty reduction, (3) environmental protection, and (4) participatory democracy. In addition, deeper and broader regional integration can make the Central American countries' participation in the world economy more effective.

B. Economic Growth

Economic growth is not just an end in itself. It is the most important factor contributing to poverty reduction over the long run; it facilitates (but does not guarantee) the solution of some environmental problems (while aggravating others); and it can create (but again not guarantee) opportunities for more people to participate in democratic processes that encompass far more than free and fair elections.

A key determinant of economic growth is the amount and productivity of investment, and in particular private investment. While governments still have a key role to play in providing basic infrastructure, it is now widely accepted that private investors are generally more efficient than bureaucrats as enterprise managers. Since 1980 Central American governments, to varying degrees, have privatized or dismantled many state enterprises, receiving one-time payments for assets sold and eliminating the annual fiscal burdens of operating (and capital) subsidies.

For some countries, the case for privatization extends beyond directly productive activities to encompass infrastructure. Heavily indebted Honduras and Nicaragua, in particular, have little capacity to provide new basic infrastructure because of insufficient domestic resources and their inability to contract non-concessional external loans.²⁷ In order to achieve more than moderate economic expansion over the next two decades, they will have to both increase public savings rates and permit greater private investment in infrastructure.

²⁷ Honduras and Nicaragua are both seeking external debt relief under the Highly-Indebted Poor Countries (HIPC) initiative and would be ineligible for HIPC if they contracted non-concessional debt.

Macroeconomic policy. An essential requirement for stimulating private investment--and both private and public savings--is a sound macroeconomic policy that avoids large imbalances, both internally (fiscal accounts) and externally (current account of the balance of payments). The key requirement here is to achieve good performance, not for just a few years, but on a reasonably consistent basis over time. In the words of the OECD's 2020 document (1997:16): "Stable and sustainable macroeconomic policy will be a precondition for taking full advantage of the opportunities provided by globalisation, as well as for successful structural reform."

Macroeconomic stability minimizes domestic inflationary pressures and exchange-rate fluctuations, reducing risks and uncertainties faced by private investors.²⁸ It is also worth noting that controlling inflationary pressures is particularly beneficial for the poor.²⁹

Albert Fishlow (1997:405) has observed that Latin American countries have finally learned the importance of responsible fiscal and monetary policy as a central condition for economic development." In Central America, Costa Rica absorbed this lesson much sooner than its neighbors, initiating in the latter half of 1982 a major program (implemented gradually) of macroeconomic stabilization and structural adjustment. Guatemala followed in 1986, while El Salvador (1989), Honduras (1990), Nicaragua (1991) were late converts. [Identify dates for Panama and Belize.]

Implementation of macroeconomic stabilization programs in Central America has not always proceeded smoothly. Costa Rica has lost macroeconomic discipline on several occasions, and fiscal laxity in Honduras in 1992-93 contributed to a severe recession in 1994. Nevertheless, in nearly all such cases, macroeconomic discipline was restored relatively quickly, and in general fiscal and monetary policy in the 1990s has been much better than in the 1980s. While macroeconomic policy can still be improved, it seems unlikely to be a major obstacle to Central American economic growth in the next two decades.

Financial-sector reforms.

[-- Recent Asian crisis illustrates importance of reforms in this area.]

[-- See Kaminsky and Reinhart re relationship between financial liberalization, banking crises, and currency crises.]

²⁸ The maintenance of relatively sound macroeconomic policies over the course of a number of decades is one reason why Colombia has continued to attract investors and to keep growing in the face of debt and financial crises elsewhere in the region and social and political turmoil at home.

²⁹ [Cite studies on inflation in Brazil.]

[-- Pension reform.]

Reform of the State.

"Privatisation, the legal framework for enterprises, regulatory reform and tax and competition policy are all important areas for reform efforts. In conjunction with strong macroeconomic policies and financial management, reforms in these areas will lay the bases for internationally-competitive domestic enterprises and help attract FDI [foreign direct investment], thus building up the linkages with the global economy" (OECD 1997:20).

[-- Also important: improving the efficiency and efficacy of government programs, especially in the social sectors.]

Sectoral policies.

[-- agriculture]

[-- manufacturing]

[-- *maquila* operations]

[-- Need for a long-run strategy to begin converting *maquila* operations into true manufacturing activities]

[-- tourism]

[-- other services]

C. Equity

[-- investment in human capital]

[-- better-targeted subsidies]

[-- improved access by poor households to the factors of production]

D. Environmental Sustainability

- [-- **green, blue, and brown issues]**
- [-- **disaster preparedness]**
- [-- **importance of attention to this area for access to the FTAA]**

E. Participatory Democracy

- [-- **consolidating electoral reforms]**
- [-- **improved administration of justice]**
 - **including fair administration of legislation regarding property rights**
- [-- **personal security issues]**
- [-- **decentralization of government programs]**
 - **as a practical solution, not one driven by religious zeal**
- [-- **strengthening civil society]**
 - **including social auditing of development programs**
- [-- **equality of opportunity for women and minority groups]**
- [-- **freedom of association (for labor unions, peasant organizations, etc.)]**

F. Regional Economic Integration

- [-- **Incorporation of the agricultural and services sectors]**
- [-- **Access to the FTAA is likely to be more feasible for Central America as a group than for individual countries]**

V. ALTERNATIVE VISIONS OF CENTRAL AMERICA'S ECONOMIC STRUCTURE IN 2020

- [-- **These visions will depend on:**
 - **The performance of the world economy (the OECD's high-growth and low-growth scenarios)**
 - **The extent of policy reform in Central America]**

VI. POLICY RECOMMENDATIONS FOR MORE EFFECTIVE DEVELOPMENT ASSISTANCE

[To be added]

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