DM/64/3

INTERNATIONAL MONETARY FUND

Western Hemisphere Department

The Economy of Central America

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I. Basic Features of the Economy

Although the five countries of Central America (Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua) differ in many respects, the features they have in common are sufficiently important to make it useful to describe and analyze the economic background of the countries as a group. Such treatment also appears appropriate in view of the movement toward economic union that is now in process in the area.

In all of the countries, agriculture is the predominant economic activity, with 30-40 per cent of total output originating in that sector. While manufacturing output has grown rapidly in the region during the past several years, there is no country in the area in which manufacturing accounts for as much as 20 per cent of national production. A large proportion of the agricultural output in Central America enters into foreign trade. Total exports as a ratio of gross national product range from 20 per cent to 25 per cent for the countries of Central America, and in all cases as few as two agricultural products account for more than 50 per cent of total exports. In 1962, three commodities (coffee, cotton, and bananas) provided more than 70 per cent of total export earnings of the area as a whole. A decade earlier the dependence on these commodities was even greater, as they represented in excess of 80 per cent of total export earnings. While coffee is still the single most important export product, it has declined in relative importance. Cotton exports have grown sharply and have become the second most important export of the region.

In all of the Central American countries the ratio of imports to national income is high, and the countries maintain liberal trading and payments systems. Three of the countries in the region (El Salvador, Guatemala, and Honduras) are under Article VIII, and the two countries (Costa Rica and Nicaragua) under Article XIV maintain de facto convertibility. Moreover, the countries in the area have in general maintained stable exchange rates; three countries have not altered their exchange rates since joining the Fund, one (Nicaragua) altered its par value in 1955, and one (Costa Rica) altered its par value in 1961 (by about 15 per cent). Quantitative restrictions on imports, in those countries where they are applied, are generally confined to a narrow range of goods.

Although the tariff rates applied by the Central American countries frequently appear to be high, in most instances the tariff systems are designed to yield revenues for the budget and not for the purpose of protecting import-competing industries. As is indicated by the exchange rate, trade, and payments policies they pursue, the countries of Central America are linked very closely with the world economy. Domestic price movements tend to mirror those in the countries with which Central America trades. During the period of world-wide price inflation, in the years from the end of World War II through 1953, the cost of living in Central America rose sharply. In the past decade, however, no country in the region has experienced domestic price increases averaging more than 2 per cent a year, and for some countries, the price rise has averaged less than 1 per cent a year. These price changes may be compared with the average increase of nearly 1 per cent a year in U.S. export prices during the last decade, inasmuch as the United States is the most important source of Central American imports. In the Central American context, excessive domestic credit expansions result primarily in a worsening in the net foreign reserve position, not in increases in domestic prices. In general, the Central American countries have responded to losses in foreign reserves by adopting policies of restraint designed to preserve the external values of their currencies.

II. Economic Developments

The countries of Central America experienced rapid economic growth in the post World War II years through the mid-1950's. This expansion was sparked by a rapid rise in Central American exports, resulting from an increase in volume and sharp rises in prices. From 1948 through 1957 total exports from Central America nearly doubled, with the rate of increase approaching 8 per cent a year. Growth in exports and income stimulated the expansion of many other sectors of the economy and made available the saving to support an increase in private and public investment. In these years most of the countries enjoyed sound budgetary positions and they were able to reduce their short-term indebtedness and to add to their holdings of short-term assets.

The situation changed after 1957. In 1958 and 1959 total exports of the Central American countries fell as the prices of coffee and cotton declined. There was a modest recovery in exports in 1960 and 1961, but they remained below the peak registered in 1957. In the years 1958-61 export volumes continued to expand in most of the countries, but prices decreased at an even faster rate. During this period of export stagnation, per capita income and output declined, budgetary gaps emerged, and foreign reserve positions weakened. Growth in exports resumed again in 1962, and in the two years 1962 and 1963 they appear to have risen at the rate of about 12 per cent per annum. The increases have stemmed from larger volume inasmuch as export prices remained fairly stable or trended downward slightly for the countries of the area. Viewing the past 15 years as a whole, the exports of the Central American countries taken together

have increased on average at a rate of nearly 6 per cent a year. The 15-year period included a sharp rise and then a steep decline in export prices. Contrary to popular belief, the average export prices of the Central American countries increased during the period 1948-63. In the case of two countries, the rises in export prices exceeded the increases in import prices, thereby leading to a small improvement in the terms of trade. For two other countries, the terms of trade deteriorated by a small amount; for the fifth country, export and import price indices back to 1948 are not available. The evidence indicates that the performance of the export sector was on average adequate to ensure a favorable rate of economic development for Central America.

The growth of the Central American economy is reflected in the monetary data of the countries. The average annual rate of increase in the real stock of money and quasi-money ranged from 4 per cent to 6.5 per cent in the period 1948-62. The pause in over-all economic growth in the period 1958-61 is also evidenced in the monetary data, as the real stock of money and quasi-money increased at an average annual rate less than one half as large as in the period 1948-57. With the resumption of a higher rate of economic expansion in 1962, the rate of increase in the public's liquid asset holdings has gone up sharply. Increases in money and quasi-money in real terms, ranging upward from 8 per cent, were registered in 1962, and it is estimated that similar increases took place in 1963.

In the period 1948-62 taken as a whole, and again contrary to popular belief, there has been no starvation for credit in the Central American countries. Credit to the private sector rose at a rapid pace, increasing at average annual rates ranging from 7 per cent to 10 per cent in real terms. In all of the countries, credit to the private sector has risen more rapidly than the money and quasi-money liabilities of the banking system. These disparities in the growth of credit and liquid liabilities reflected in part the utilization of credits from abroad that have been channeled through the banking system and, more important, the weakening in the net foreign reserve positions of most of the countries in the sense that their net foreign reserves now represent a smaller proportion of their banking systems' liquid liabilities than 15 years earlier. Net foreign reserves of the Central American countries increased less than 15 per cent in the period 1948-62, and a substantial proportion of their current gross foreign exchange reserves, about 20-25 per cent, is due to drawings against the Fund and other short-term foreign borrowing. Drawings against the Fund became important after 1958, as the foreign reserve positions of the Central American countries weakened with the stagnation in exports. During the years 1958-61, the net foreign exchange reserves of the five countries taken together declined from more than $150 million to less than $100 million. The decline in the gross foreign reserves was smaller, however, as outstanding drawings from the Fund rose nearly $20 million in this period. The availability of this assistance made it possible to maintain rates of expansion in credit to the private sector well in excess of those that could be supported solely by the growth in domestic resources during the years 1958-61.

With the upsurge in exports and economic activity in 1962 and 1963, some of the Central American countries registered sharp gains in their net foreign reserves. Taken together, the net foreign reserves of the countries in the region rose to an estimated $130 million by the end of 1963. This reserve level was still considerably below those prevailing in the years 1954-57, and represented a considerable deterioration from the earlier years, inasmuch as foreign payments are now one third higher and domestic liquid liabilities have risen more than 50 per cent. In the period 1948-63, only a small portion, probably less than one fifth of 1 per cent, of the national income of the Central American countries has been devoted to saving in the form of foreign exchange reserves. In view of the urgent demands for development, it is unlikely that the accumulation of foreign reserves in Central America will proceed at a pace sufficient to reduce the area's dependence on external assistance for coping with adverse swings in the balance of payments.

The weaknesses in the tax structures of the Central American countries became clearly evident during the period 1958-61, when both export prices and exports declined. A large proportion of total government revenues derives from taxes on foreign trade, and as export prices fell, some countries tried to maintain the profitability of production in those sectors by reducing export taxes. In some cases, receipts from export taxes declined because the rate of taxation was linked to the price of the export commodity. Although the growth of exports and over-all economic expansion resumed in 1962 and 1963, there has been a tendency in many of the countries in the area for government revenues to expand at a slower rate than national income. In part, this reflects the reductions in export taxes that took place in the period 1958-61. Also, while imports have grown rapidly in the last two years, collections from import duties have in many cases increased much less rapidly, because incentive provisions under industrial development laws have included exemptions from import duties. The weakening of the tax structures has not been fully offset by new tax measures, whose yields are responsive to changes in economic activity, to replace the reduced import and export taxes.

III. Integration of Central America

The economic and financial integration of Central America appears to be proceeding at a rapid rate. Intra-area trade is growing swiftly, and the countries have developed procedures for consultation and cooperation in confronting the economic problems of the region. Intra-area trade continues, however, to remain a small fraction of total trade, reflecting the fact that the countries of the area are similar in economic structure. While the economic and financial authorities of Central America recognize the obstacles to effective economic integration inherent in their existing economic structures, they feel that national diversification and regional integration may be useful complements to one another.

The major instrument underlying the movement toward union is The General Treaty of Central American Economic Integration, which was signed in Managua, Nicaragua in December 1960 and became operative in June 1961.

The Treaty was intended to accelerate the economic integration of the region and to clarify some of the principles enumerated in preceding regional agreements and in bilateral arrangements existing among the countries. The Treaty provides that by 1966 the five countries of Central America will have eliminated trade barriers among themselves and that they will have set up a common outer tariff on products from third countries. The Treaty provides that the industrial development laws and other legislation of the member states related to investment and business practices are to be made as uniform as possible--particularly with respect to special investment incentives. The Treaty called for the establishment of a Central American bank to finance and promote the economic development of the area, and in May 1961 the Central American Bank for Economic Integration (CABEI) was inaugurated. This Bank was originally capitalized with contributions from the member countries and from the U.S. Agency for International Development. In August 1961 the Central American Clearinghouse was established, with its principal objective being to promote the use of Central American currencies in transactions among the member countries as a means of accelerating their economic integration.

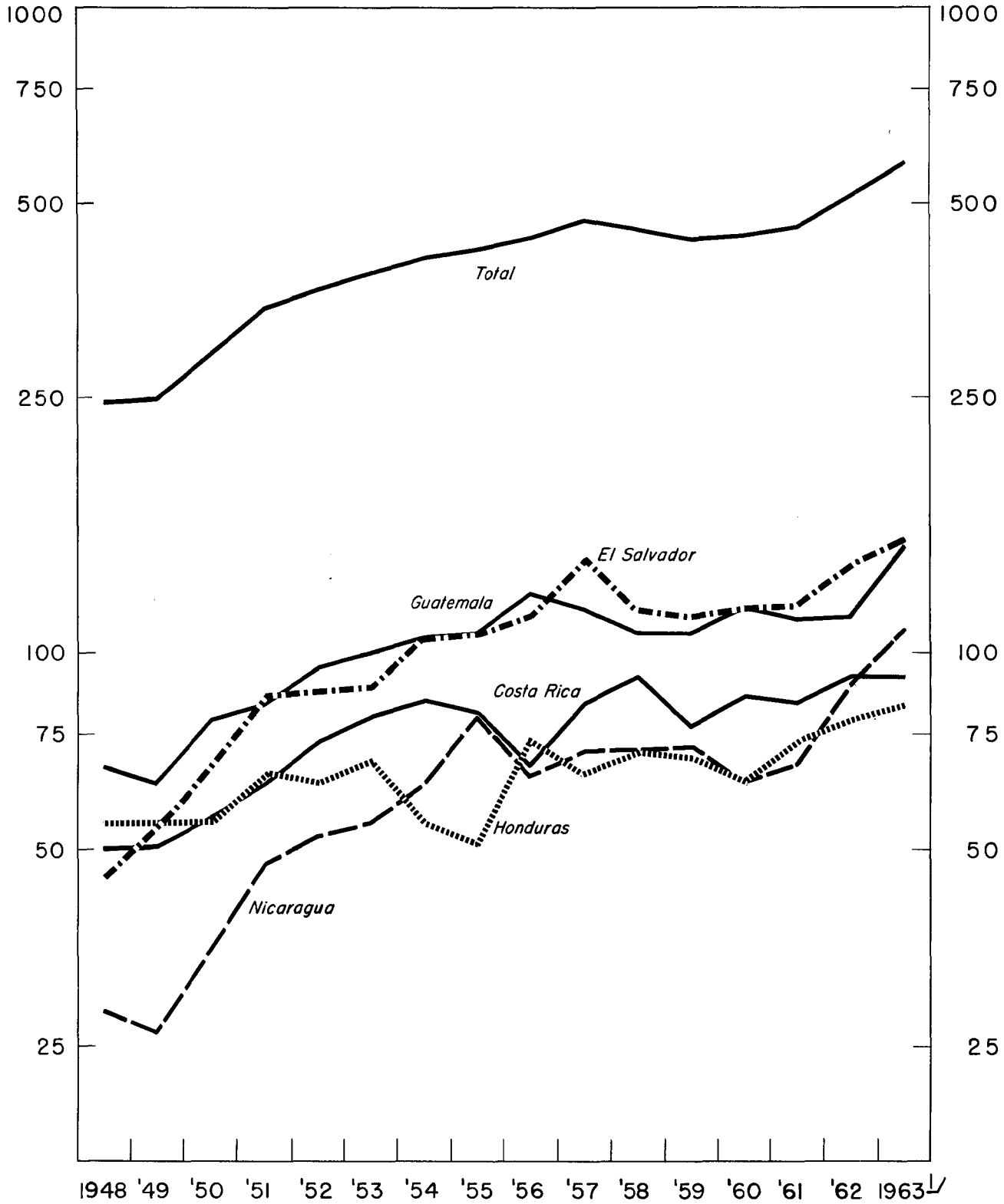
Considerable progress has been made toward attaining the trade objectives of the General Treaty. Except for the special treatment of certain commodities, the members have granted one another immediate free trade for products originating in their respective territories. Most of the products that are accorded special treatment involve situations in which some existing producers would suffer severe injury if they were immediately made subject to regional free trade. On the common outer tariff, the member countries have reached agreement on tariffs for about 95 per cent of the tariff categories. These categories encompass, for most countries, 70-80 per cent of imports from outside the region.

The Central American Bank for Economic Integration has to date granted loans amounting to about one third of its total resources, which are now equivalent to nearly $39 million. The Central American Clearinghouse has been successful in channeling an ever-increasing proportion of intra-area payments through its facilities. Multilateral clearings more than doubled in 1963, and it is estimated that 90 per cent of the region's visible trade was settled through the Clearinghouse. In view of the sharp increase in the operations of the Clearinghouse, the members increased the amount of automatic credit granted by each central bank to the Clearinghouse from the equivalent of $225,000 to $500,000. The scope of the Clearinghouse's operations was broadened in 1963 with the establishment of clearing arrangements between the central banks of Central America and the Bank of Mexico.

It is recognized that the economic development of Central America will depend to a large degree on the construction of basic service and communication networks to bind the area into one single economic unit. In this connection, plans are being developed for a Central American road network, a coordinated electric power grid, and for a telecommunications network.

EXPORTS OF CENTRAL AMERICAN COUNTRIES

(In millions of dollars)

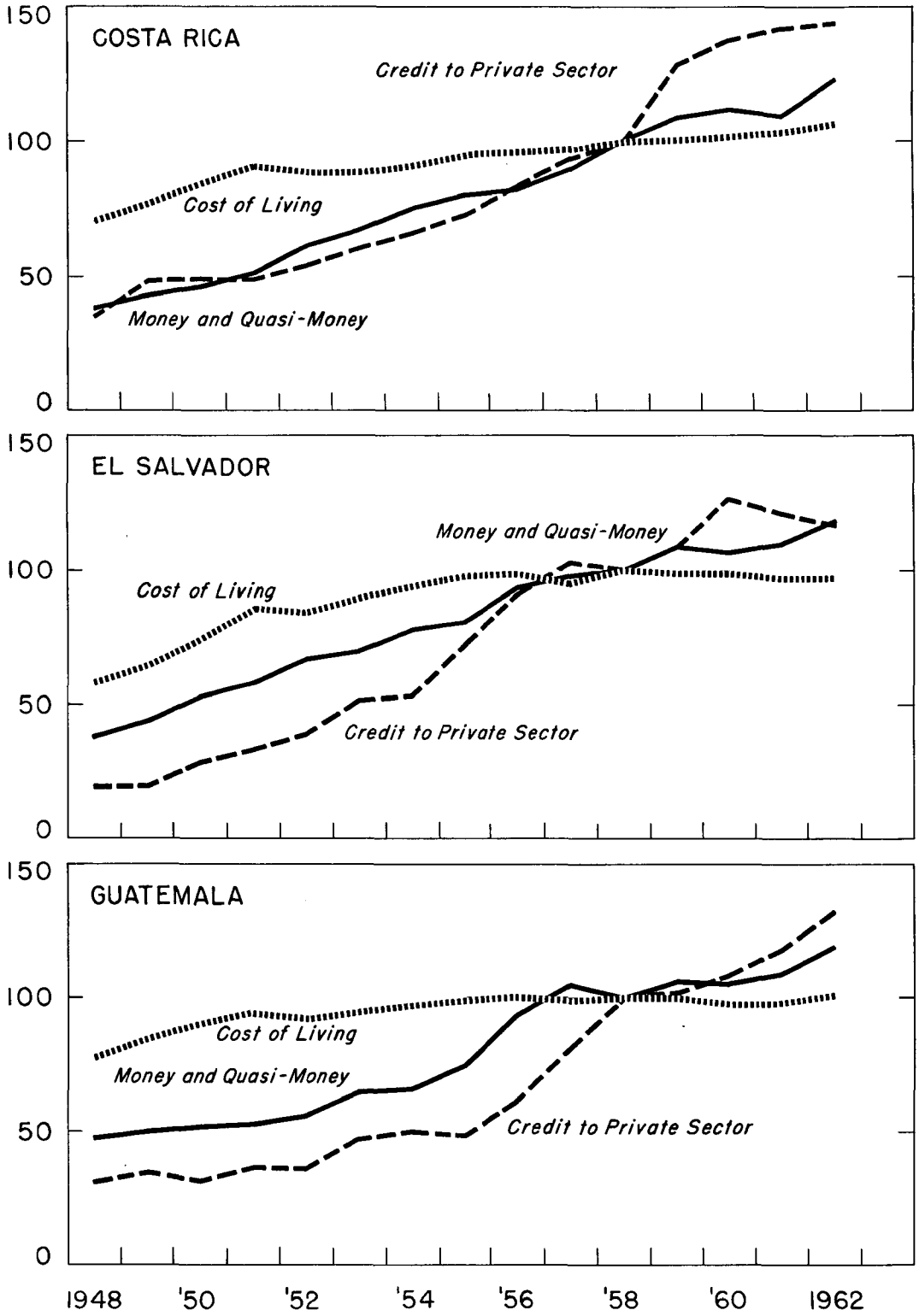


Sources: International Financial Statistics; and staff estimates.

1/ Preliminary estimates.

MONEY AND QUASI-MONEY, BANK CREDIT AND PRICES IN COSTA RICA, EL SALVADOR AND GUATEMALA

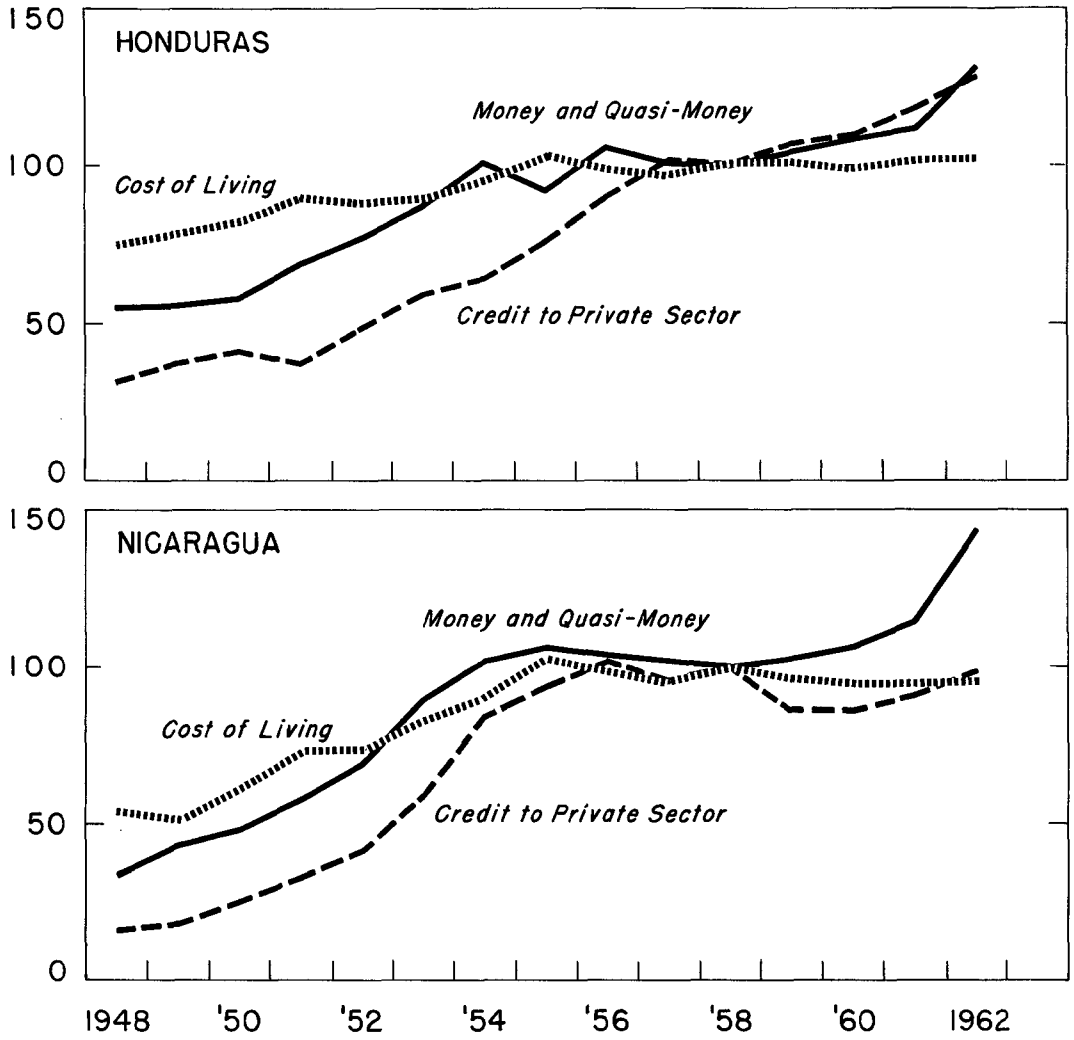
(1958=100)



Source: International Financial Statistics.

MONEY AND QUASI-MONEY, BANK CREDIT AND PRICES IN HONDURAS AND NICARAGUA

(1958=100)



Source: International Financial Statistics.