UNCTAD/UNDP

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
UNITED NATIONS DEVELOPMENT PROGRAMME

OCCASIONAL PAPER

GLOBALIZATION, LIBERALIZATION AND SUSTAINABLE HUMAN DEVELOPMENT: PROGRESS AND CHALLENGES IN CENTRAL AMERICAN COUNTRIES (EL SALVADOR, GUATEMALA, HONDURAS AND NICARAGUA)

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UNCTAD/EDM/Misc.126

This report was prepared for, and presented at, five National Workshops in Guatemala City (April 12), San Pedro Sula (May 4), Tegucigalpa (May 5), San Salvador (May 8), and Managua (May 11, 2000), on the challenges facing these countries in the context of managing their integration into the global economy in pursuit of sustainable human development. These workshops were organized under the aegis of the UNCTAD/UNDP Global Programme. Participants at the workshops included senior policy makers from various ministries in the government, representatives of business community, academics, and other members of civil society.

Acknowledgements

This study was prepared by Manuel R. Agosin, David E. Bloom, and Eduardo Gitli. The authors are, respectively, Professor, Department of Economics, University of Chile; Professor of Economics and Demography, School of Public Health, Harvard University; and Professor, Centro Internacional de Política Económica, Universidad Nacional de Costa Rica. The study is heavily indebted to national studies prepared by consultants in the four countries covered. The national consultants were:

- El Salvador: Francisco Molina, Francisco Sorto, and Alvaro Trigueros
- Guatemala: Alvaro Colom, Jorge Lavarrada, and Carmen Urízar
- Honduras: María Bennaton, Ana Cristina Mejía de Pereira, and Miguel Ramos Lobo
- Nicaragua: Irene Agudelo, Miguel Ruiz, and Orlando Solórzano

The focal points of the project in national UNDP offices were essential to its success. They were Rebeca Arias in El Salvador; María Noël Vaeya-Ogilvie in Guatemala, Ximena Ibáñez and Sergio Membreño in Honduras; and María Rosa Renzi in Nicaragua.

The study benefited greatly from comments received from H. E. Rubén Calderón (Secretary for Peace, Guatemala), Ambassador René León (El Salvador), Ambassador Luis Alberto Padilla (Guatemala), Bruno Moro, Georges Chapelier, and Jagdish Saigal.

A summary of the study was presented at UNCTAD X in Bangkok, February, 2000.

Table of Contents

INTRODUCTION

1. While sustainable human development (SHD) is a core objective of the process of economic growth and development, it is also a powerful instrument for *promoting* economic growth, especially when investments in human development are made in a liberal and open economic environment.

2. There are complex interrelationships between three complementary policy spheres: integration into the global economy and the liberalization of markets; the promotion of fast economic growth; and SHD. In a balanced policy environment, positive interactions create "virtuous spirals" of development, leading to rapid, self-reinforcing development gains.[1]

3. The present paper applies this perspective to data derived from a group of four Central American countries – El Salvador, Guatemala, Honduras, and Nicaragua. While each has made (often dramatic) progress across several economic indices in recent years, both human development gains and economic growth have continued to prove disappointing.

4. This paper sets out to provide an informed overview of the key economic aspects relevant to the region's growth, to identify those economic components on which policymakers should concentrate their energies, and to detail the important ways in which a renewed focus on SHD interacts with economic growth.

5. We hope that policymakers specializing in development will find the exploration of how economic factors relate to developmental ones illuminating, while those who specialize in economic growth will come away better informed about the important ways in which a focus on SHD can deepen and strengthen their work.

[1] This paper is a companion piece to Agosin, Bloom, and Gitli 2000, which provides further detail on the philosophical, policy and economic arguments that provide a substantive context to the present paper.

OVERVIEW

6. The notion of integrating into the global economy is often understood exclusively in terms of liberalization of international economic transactions. Our view of global integration is broader and includes not only liberalization of trade and foreign direct investment (FDI) but also success in building new patterns of comparative advantage and in lessening dependence on traditional commodity exports. Long-term economic growth requires the creation of new skills and capabilities in people and in firms. And it is here that more sophisticated trade and investment policies and investments in people become essential.

7. The liberalization of trade and FDI are necessary (albeit insufficient) components of this process, particularly in low-income and small developing economies. There is a growing body of literature that suggests that integration to the global economy may have a positive effect on economic growth (see, for example, Sachs and Warner, 1997). The reasons for this positive association are not hard to find. In the first place, export diversification involves learning to produce new things and acquiring new skills, both of which imply higher productivity. Second, for countries that diversify away from their major primary commodity exports, the world economy represents an unlimited market. Third, through exporting developing countries can earn the foreign exchange they need to import capital goods and new technology unavailable domestically. FDI can make an important contribution by opening up new markets and providing new technologies.[2]

8. SHD is more than economic growth and involves the broad-based improvement in living conditions and in the capabilities of the entire population (Agosin, 1999a). The acceleration of economic growth is undoubtedly a dimension of SHD, since growth makes it easier to achieve the multidimensional objectives of SHD. But, above all, SHD involves the broadening of peoples' capabilities to earn income and – using Sen's felicitous phrase – lead the lives they have reason to value. This encompasses, at a minimum, increasing the basic substantive freedoms of people: freedom from premature death, freedom from avoidable illness, freedom from ignorance through the attainment of basic literacy and numeracy, freedom from arbitrary discrimination, participatory democracy, and free speech (Sen, 1999, p. 36).

[2] We deliberately exclude from the notion of global integration the full liberalization of the capital acount of the balance of payments. The recent Asian financial crisis demonstrated that some international financial flows can be quite fickle and, by rendering the exchange rate very volatile, they can conspire against global integration through trade. The Central American countries, however, are not fully integrated into international financial markets, so that controlling unwanted capital inflows is not really a problem for them. For an excellent analysis of the causes of the Asian financial crisis and its adverse consequences for development, see Radelet and Sachs (1998).

9. Other fundamental components of SHD are the achievement of gender equality, ensuring that growth is environmentally friendly, and the provision of social safety nets to protect people from unexpected adverse shocks. The latter include natural disasters (such as Hurricane Mitch, in the case of Central America) and economic events caused by factors that are exogenous to the people affected by them (e.g., the Asian financial crisis).

10. Economic reform and SHD are two sides of the same coin. To achieve either, policy makers must address both. Human development cannot be achieved without significant investments. Economic growth is essential to ensure human development is *sustainable*. In turn, economic growth cannot be sustained without the fuel of health, education, entrepreneurial energy, capital and so forth.

11. The dynamic relationship between economic growth and human development increasingly occurs within a much larger context, of course, in which the processes of globalization and liberalization are among the most influential factors. Both processes offer great opportunities for both economic growth and human development, but only if their impacts are carefully and intelligently managed.

12. In spite of significant progress during the 1990s, strong and sustained economic growth in El Salvador, Guatemala, Honduras, and Nicaragua requires much greater emphasis on human development in economic development strategies.

Macroeconomics, trade, and investment

13. Macroeconomic adjustment in the region has, to date, wrought mixed impacts on SHD. The 'peace dividend' is obviously welcome in a region characterized for decades by war and the enormous personal, social and economic costs it brings.[3] Likewise, macroeconomic adjustment has helped deliver dramatic reductions in inflation and, in some cases, in the public sector's deficit. However, the costs to SHD – and in turn the economy – remain high. For example, levels of malnutrition among children under five – a key human development indicator, with important implications for individuals' future health – remain high.

14. All four governments have made considerable progress in liberalizing and opening up their economies. Foreign direct investment (FDI) is starting to flow in, and new exports are emerging. However, the toughest challenge lies ahead: creating new production patterns and consolidating recently acquired comparative advantages.

15. The Central American Common Market (CACM) can be utilized as a powerful development tool. In addition to adopting a true common external tariff (CET), a viable common market needs agreement on common rules and taxation for export-oriented investments, be it in Export Processing Zones or elsewhere. The basic objective ought to

[3] Significant costs are also borne by *neighbor* countries, for example, through growing numbers of refugees and disruptions to trade. For a wider discussion of such costs, see Kaldor (1999).

be encouraging the emergence of direct and indirect regional exporters in an increasingly diversified range of products.[4]

16. The physical integration of the region's infrastructure also requires emphasis to facilitate trade and the growth of strong, internationally competitive regional industries. Both Honduras and Nicaragua have pressing debt problems, which will require concerted efforts by both debtors and creditors to resolve. Exchange rates will continue to require careful management, and greater exchange rate co-ordination across all will CACM members (including Costa Rica) will undoubtedly facilitate regional integration.

17. The *maquiladora* industry constitutes a new 'growth pole'. It is currently generating significant employment in all four countries, although its full potential as a 'development pole' has yet to be explored, as it has focused to date almost exclusively on processing of imported clothing components for the United States market.

Sustainable Human Development (SHD)

18. Low levels of human development in all four countries are conspiring against faster progress towards self-sustaining growth. In general, a much more rigorous and consistent approach to promoting SHD among all policymakers will be needed.

19. Policymakers need, in essence, to widen their focus to take on board the key components of SHD, the role of rural and indigenous populations, and the situation of women and girls. In a more competitive global economy, no country can afford to overlook a significant proportion of its most vital asset – people.

20. Exclusionary attitudes to women, and to rural or indigenous people, will prove difficult to remove, but without a sustained attempt to do so, countries cannot expect the pace of human development and of economic growth to achieve their potential. Indeed, they face the opposite of a "virtuous spiral", the "vicious spiral", in which reductions in progress across key policy areas reinforce each other to create a pattern of decline and desuetude.

21. The changing demands of modern economies will require policymakers to prioritize health and educational improvements across the population, and serious fiscal reform will be necessary to fund increased investment in human development.

22. Demography is a powerful way to predict the challenge of future population pressures. The four countries examined have yet to take full advantage of the demographic changes enjoyed by other regions, and policymakers are urged to examine how they can develop and apply approaches to deliver a 'demographic dividend'.

23. This demographic dividend emerges when the lag between a decline in mortality (delivered by basic health care improvements) and a consequent fall in birth rates creates a 'baby boom' generation. As this cohort ages, and is educated and provided with work opportunities, the ratio of workers to dependents becomes particularly favorable, and

[4] Indirect exporters are producers providing inputs to direct exporters.

significant additional growth occurs. Initial attention to health indicators, including contraception prevalence, is thus needed, followed by careful planning for this cohort.

24. Health is vital for both education and productivity. It confers security and is one of the twin pillars of development essential to create a 'virtuous spiral' in dynamic relation to economic growth. Health indicators in all four countries remain very poor. For example, while progress on immunization has been made, over one in ten Honduran children are still not immunized against measles, while about a quarter of Guatemalan children have not had jabs for either measles or DTP.[5] Malnutrition is rife and health expenditures low. Urgent and sustained attention is needed in this area, for poor health in children translates into a lifelong cost borne by the entire economy.

25. The micro enterprise and small entrepreneur sectors are also vital sources of economic growth in need of urgent attention. Both training programs and the rationalization of micro finance are needed to make best use of the significant resources already being devoted to this sector.

26. Given appropriate opportunities, women can make significant contributions to both economic growth and SHD; yet indicators suggest that insufficient attention is being paid to providing these opportunities.

27. Like health, the importance of education cannot be underestimated. The growth of the knowledge economy requires increasingly skilled, entrepreneurial and resourceful people. Educated workers are more likely to have these skills – and in turn act as a magnet for FDI.

28. Unfortunately, the four countries studied have made even less progress in education than in health. For example, a Zimbabwean teenager is four times more likely to have received at least five years of education than her peer in Guatemala – even though Zimbabwe is a significantly poorer country (Bloom and Craig, 1998). Quality of educational provision is crucial, as is attention to providing better access to educational opportunities for women and girls.

29. While progress in primary enrolment has been made, a significant gap between poorer and richer countries remains at the secondary level, and this gap widens alarmingly at tertiary level – and it is higher education which delivers the most sustained benefits to any population. To migrate students as far along the educational axis as possible will require imaginative efforts to increase the quality and value of the educational experience.

30. Poor living conditions, such as the absence of sanitation or a decent dwelling, breeds disease, is demoralizing and an affront to human dignity. All four countries made significant gains on this dimension in the 1990s, although by 1995 a significant share of households was still without access to safe drinking water or plumbing. This problem is particularly severe in Nicaragua and in the rural areas of all four countries.

[5] Diphtheria, tetanus and pertussis (or whooping cough).

STRUCTURE

31. In this paper, we concentrate on recent developments and prospects for the four Central American countries in the various dimensions of global integration, sustainable human development, and economic growth.

32. There are six sections:

- Given its overwhelming importance in the region, the paper starts with a section on *Peace and democracy*, which are essential components of SHD.

- *Progress in opening up to trade and investment* is then discussed in the context of recent advances in global integration. The potential for regional integration is also explored, and exchange rate policies and régimes are considered. Policies toward FDI are documented.

- Next, we evaluate recent trends in *Economic growth in Central America*, looking at overall economic performance, the role of exports, the growth of FDI, and the debt issue.

- The economic context outlined in sections I-III is pulled together when we consider *Progress in human development* and several of the urgent tasks in this area. These include the demographic transition, health, education, poverty, and living conditions. Issues that cut across all of these dimensions include the roles of women and girls as well as those of indigenous and rural populations.

- Given its importance to both economic growth and as a potential locus for SHD, we devote a separate section to the *Problems of micro and small enterprises*.

- The last section brings the paper to a *Conclusion*. It points up the seriousness of the challenge facing policymakers in the four countries. Strengthening Central American integration and building links between the *maquiladora* industry and the rest of the economy – now in a regional context - are offered as examples where policymakers can make gains for both economic growth and SHD.

I. PEACE, DEMOCRACY AND GOVERNANCE

33. Up until this decade, the Central American countries went through prolonged civil conflicts that had enormous personal, social, and economic costs. El Salvador and Guatemala experienced outright civil wars that hampered any serious effort at economic and social transformation. In Nicaragua, the Sandinista forces that overthrew the Somoza Government in 1979 faced permanent armed threats from their opponents. In addition to civil strife, the economic and social fabric was subjected to severe strains, as the main orientation of policy swung first toward a radical state-led model of development and later toward a more market-oriented approach. Since the assumption of the elected government in 1990, the strengthening of the market economy has been a major policy objective. Even countries that were not directly involved in the civil conflicts of the region (Honduras and Costa Rica) suffered the spillover effects in the form of large waves of migration from their neighbors and the use of their territory as sanctuary.

34. The peace process began in 1987 with the Second Presidential Summit of Esquipulas, which established a program to pacify and democratize the region. Although it took almost ten years to achieve its objective, its success demonstrated to Central American Governments that they could work together to solve their urgent problems (ERDSH, 1999, p. 37). In particular, the success of Esquipulas II gave a renewed impetus to regional integration efforts.

35. Today, all Central American countries have democratically elected governments committed to market-oriented reforms, the armed forces are increasingly subordinated to civil authorities, and human rights violations are no longer state policy anywhere in the region. Economically, pacification has yielded a large peace dividend. In all four countries, military spending as a share of GDP has declined remarkably (see table 1). In addition, the disappearance of armed conflict, the establishment of the rule of law, and the replacement of military by civilian governments have had a very positive effect on economic growth.

Table 1

Military expenditure, as a share of GDP, 1989 and 1996

(percentage)

	1989	**1996**
El Salvador	3.5	1.5
Guatemala	2.6	1.4
Honduras	8.4	1.3
Nicaragua	28.3	1.5

Source: *Estado de la Región, 1999*, Proyecto Estado de la Nación, San José, Costa Rica, 1999, p. 197.

36. However, there are still several important problems to be resolved in relation to human rights and personal security. Crime rates are high, and people continue to have a sense of insecurity about life and property. Human rights violations by the police, often with the complicity of the armed forces, have been reported in all four countries, but particularly in Guatemala and El Salvador (ERDHS, p. 204). The judiciary is slow and inefficient. Although governments have made efforts to convert the judiciary into a *bona fide* separate power of the State, progress to date has been slow.

37. In Honduras there are reports of widespread illegal seizures of land by organized groups, and affected parties have scant possibilities of redress in the courts. In Nicaragua, protection of property rights is still inadequate. There still exist a large number of unresolved disputes surrounding expropriations of real estate and commercial property carried out during the 1980s (ERDHS, p. 210). Uncertainties surrounding the validity of claims to property rights are acting as a serious deterrent to foreign and domestic investment.

38. In 1997, Congress passed a new property law with a view to putting an end to these conflicts. However, Nicaragua still suffers from a general weakness in its institutions and in the enforcement of laws and contracts that discourages domestic and foreign investment.

39. Distribution of basic services is patchy. In Guatemala, for example, one half of the population is indigenous. Although enshrined in the law, equality of opportunity is in practice denied to what constitutes the majority of the people. Indigenous people, heavily rural, have inadequate access to education, health, drinking water, and plumbing. They remain poorly integrated into modern society. Women, particularly in the rural sector, have even less adequate access to health and education than men.

40. All countries have serious problems of governance. The capacity of governments to design and execute policy is low, owing to the low quality of human resources available to them. The low level of remuneration of government officials perpetuates corruption, a culture that needs to be eradicated and replaced by much higher standards of probity in high government officials.

41. An encouraging sign with regard to the strengthening of peaceful democracies is the emergence of civil society groups committed to democratization, social development, and the protection of human rights and the environment. These groups ought to play an increasingly important role in preserving the gains already made and in moving forward to higher levels of democracy.

II. PROGRESS IN OPENING UP TO TRADE AND INVESTMENT

Impressive macroeconomic adjustment

42. It has become conventional wisdom that it is impossible to bring about structural adjustment without first having achieved effective and lasting stabilization. In turn, this latter objective depends fundamentally on prudent fiscal and monetary policies. Perhaps the single most important reform in this regard is the reduction of the public deficit. If SHD objectives are to be preserved, expenditure cuts must fall on items other than investments in people (basically health, education, and housing). Indeed, in most countries, such expenditures will have to increase. Where the tax burden is low, an important contribution to the needed reductions in the deficit will have to come from tax reform.

43. Three of the four countries have made impressive gains in reducing inflation. Nicaragua's adjustment program brought down the rate of inflation from well over 13,000 per cent *per annum* in 1990 (December-on-December) to between 10 and 20 per cent in the second half of the 1990s. In El Salvador, the rate of inflation declined gradually from 19 per cent in 1990 to between 2 and 5 per cent in recent years. In Guatemala, inflation fell from over 60 per cent in 1990 to 7.5 per cent in 1998 (Urízar, 2000). In Honduras, inflation has come down, but is still in two-digit figures.

44. All four countries, and particularly Nicaragua, have implemented important programs of fiscal adjustment. In Nicaragua, the reductions in public spending have been draconian. Public employment fell from 208,000 in 1990 to 100,000 in 1994. Most of the cuts took the form of reductions in the armed forces, from more than 100,000 soldiers to barely 24,000 over the same period. (Agudelo, 2000).

45. But Nicaragua has also implemented tax reform and has succeeded in raising its tax burden from 15 per cent of GDP in 1990 to over 30 per cent in 1998. As part of the effort to put the fiscal house in order, the Nicaraguan government has made efforts to charge users for public services. The conjunction of spending cuts and revenue increases resulted in a reduction of the public deficit from over 20 per cent in 1990 to 2.2 per cent in 1998 (Solórzano, 2000, annex tables).

46. In spite of the loss of revenue as a result of tariff reductions, El Salvador has been successful in raising tax revenues, from 11 per cent of GDP in 1990 to almost 15 per cent in 1998 (Sorto, 2000). This is the major factor behind the reduction in the fiscal deficit from 6.5 per cent in 1992 to less than 3 per cent in 1990.

47. Tax revenues in Honduras also rose from 12.5 per cent of GDP in 1989 to 17 per cent in 1998. Together with cuts in public expenditures, the increase in the tax burden allowed the Government to cut the fiscal deficit from 7.4 per cent of GDP to 1.6 per cent over the same period (Mejía, 2000).

48. Guatemala has also brought down its budget deficit in an impressive manner, and it now stands at 1 per cent of GDP, compared to close to 5 per cent in the first half of the 1980s (Urízar, 2000). However, Guatemala's tax burden, at less than 10 per cent of GDP, is the lowest in the region.

49. Thus Nicaragua has very little space left to raise taxes and will have to finance increases in indispensable human development spending from debt forgiveness and cutbacks in other less essential expenditures. By contrast, it is difficult to see how the other three countries, and particularly Guatemala, can raise their human development spending without increasing the tax burden. This will involve serious fiscal reform, not just to cut back on expenditure (which has already been done), but to collect the tax revenues that heavy investments in human development will require.

A decisive move toward open regionalism

50. After a long period of protection, in the 1990s the Central American countries adopted an export-oriented model of development. At the beginning of this decade, the bulk of tariffs in the four countries ranged from 5 to 95 per cent, with occasional tariff peaks well over 100 per cent. Countries also resorted to a variety of non-tariff measures to restrict imports. As a result of negotiations to revive the CACM, at the end of 2000 the four countries will have tariffs in the range of 0 to 15 per cent on about 90 per cent of their tariff lines. Most non-tariff barriers have been eliminated.

51. By the end of the 1970s, the CACM had been responsible for the high degree of integration achieved by the Central American economies. About a quarter of the total exports of the five signatories (our four countries plus Costa Rica) had the region as destination, free trade in manufactures had been practically achieved, and a common external tariff (CET) applied to most goods.

52. Buffeted by the disintegrating effects of civil strife and the external debt crisis, the CACM unraveled in the 1980s. With the reestablishment of peace, signatories have been in the process of bringing the CACM back to life. A new CET was agreed, and the principle of free trade among the five member states was reaffirmed. As a result, the share of regional trade in the total foreign trade of member countries has staged a comeback (see table 2).

Table 2

Central America[a]: Intra regional trade, as a share of total trade

(percentage)

	1960	**1968**	**1980**	**1985**	**1990**	**1998**
Exports	6.8	23.5	25.4	13.9	17.0	20.2
Imports	..	21.3	18.5	9.9	9.7	13.3

Source: Authors' calculations, based on data of SIECA and on World Bank, *Trade Liberalization and Economic Integration in Central America*, March 1989, Report No. 7625-CAM, Washington, D.C.

[a] Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua.

53. The Central American Import Tariff is divided into three parts: Part I, encompassing goods to which common tariffs are expected to apply at the latest by December 2000 (about 90 per cent of tariff lines); Part II, covering tariff lines that have not yet been harmonized; and Part III, which includes goods that will retain national tariff treatment, essentially for revenue purposes. The CET pertains, then, to Part I goods and contains only four tariff rates: zero for raw materials, intermediate goods, and capital goods not produced in Central America; 5 per cent for raw material produced in the region; 10 per cent for capital goods produced in the region, and 15 per cent for finished goods. Some examples of goods excluded from the CET are certain agricultural goods, meat, poultry, tobacco, non-alcoholic and alcoholic beverages, petroleum, and automobiles. Tariffs on these goods can be much higher than the maximum of 15 per cent agreed to for the CET. However, these higher rates are often justifiable on government revenue or equity grounds.

54. The CET is, on paper, a reasonable tariff structure. However, there is no agreement among member countries as to where different goods ought to be classified, with the result that individual countries are adopting their own classifications.

55. Efforts to establish a CET have been undermined by other unilateral actions as well. In the first place, individual countries are able to negotiate exceptions to the CET. Nicaragua has obtained agreement from its partners to reduce its top two tariff rates to 5 and 10 per cent respectively. In some cases, tariff surcharges that affect other member countries are imposed without consultation. Nicaragua, for example, is using a schedule of temporary surcharges (*Arancel Temporal de Protección*) that applies to all imports regardless of origin, with rates which, in 1999, ranged from 0 to 20 per cent. These surcharges are due to be reduced gradually over time and to be eliminated by the end of 2001.

56. Second, each country has bound its tariffs in WTO at different rates. Honduras' entire tariff is bound at 35 per cent, El Salvador's and Nicaragua's at 40 per cent, while Guatemala has bound tariffs on agricultural goods at 40 per cent and tariffs on industrial goods at 45 per cent. This means that, faced with balance of payments difficulties, the CET could once again unravel. This is precisely what happened during the debt crisis. Each country attempted to compress foreign exchange use by raising tariffs individually without any concern for its obligations toward its partners in the CACM.

57. Third, countries are pursuing free trade agreements with third parties in an individual manner. For example, Nicaragua has signed a comprehensive free trade agreement with Mexico; El Salvador, Guatemala, and Honduras are still negotiating a joint agreement with that country.

58. Fourth, groups of countries within CACM are pursuing the formation of more exclusive "clubs". Nicaragua has started negotiations with Honduras toward the formation of a complete customs union by 2002. On January 13, 2000, Guatemala and El Salvador signed a Framework Agreement to establish a customs union in their territories.

59. A shared vision of a united Central America with a working common market at its core has yet to emerge. This would require a cession of individual country prerogatives for which there still does not appear to be a political will.

60. There are yet other challenges ahead for the CACM. One of them is agreement on a uniform drawback and export-subsidy scheme for exports outside the region. As will be discussed below, individual countries have gone their own way in this area. The distortive effects of excluding these policies from regional harmonization efforts are bound to grow as integration deepens.

61. A second concern is failure to arrive at a common regional approach toward FDI in general and toward Export Processing Zones in particular. Third, effective integration will require a concerted effort to improve regional infrastructure. Fourth, greater exchange rate and macroeconomic coordination will have to be pursued.

62. In spite of these difficulties and while much remains to be done, the efforts to strengthen regional integration can be judged as very successful. Moreover, regional integration is being pursued in the context of a very significant reduction of tariffs on a Most Favoured Nation (MFN) basis. Thus the Central American countries are faithful adherents to "open regionalism". This is undoubtedly more favourable to development than the protectionist policies of the past.

The exchange rate régime: an unresolved problem

63. If the Central American countries are to succeed in changing their production and export patterns, it is essential that they avoid premature real exchange rate appreciation, which discourages investment in new export sectors.[6] Unfortunately, three of the four countries – El Salvador, Guatemala, and Nicaragua – already have a serious problem in this respect. Regardless of how real exchange rates are measured, over the 1990s, El Salvador and Guatemala have experienced severe exchange rate appreciation (table 3). The major cause has been large wage remittances by workers in the United States – a manifestation of the political, social, and economic difficulties of the region. In the case of Guatemala, unrecorded capital inflows also appear to have played a role. Remittances have been particularly large in El Salvador and now account for almost one half of all foreign exchange earnings (Sorto, 2000). In Guatemala, their share in foreign exchange receipts is between 15 and 20 per cent (Urízar 2000).

Table 3
Real exchange rates[a], 1990-98
(1990=100)

	El Salvador	***Guatemala***	***Honduras***	***Nicaragua***
1991	96.1	87.6	100.9	91.3
1992	92.9	84.4	98.9	89.1
1993	83.7	84.7	108.1	93.3
1994	78.3	79.9	118.4	98.4
1995	73.2	76.6	105.9	102.5
1996	68.6	74.4	108.8	105.6
1997	67.2	69.5	103.0	112.9
1998	66.6	69.5	94.7	108.3

Source: Authors' calculations, based on data from International Monetary Fund, *International Financial Statistics*, various issues.

[a] Price for the US dollar in local currency, deflated by the consumer price index and multiplied by the wholesale price index in the United States.

64. El Salvador has in effect maintained a pegged nominal exchange rate since 1992. However, until 1997, sterilization of the monetary effects of remittances was incomplete,

[6] See Agosin (1999a) for a more complete analysis of this issue.

domestic inflation exceeded international inflation, and the real exchange rate appreciated substantially. Since 1997, the Central Bank has been pursuing complete sterilization of reserve accumulation, resulting in very high interest rates which attract even larger remittances.

65. El Salvador's Central Bank could consider a policy of sterilizing remittance inflows by issuing bonds denominated in dollars and backed by the accumulation of Central Bank reserves. This would allow firms with liabilities in dollars, in effect, to purchase foreign exchange cover. Stronger incentives to save a larger proportion of the increase in family incomes associated with remittances would assist in preventing further currency appreciation. To this effect, banks and other authorized financial intermediaries could be encouraged to offer instruments in dollars backed by the dollar-denominated sterilization bonds.

66. In the longer run, it would seem wise for the Central Bank to stop guaranteeing the maintenance of a fixed price for the dollar. Once domestic firms have covered their net debtor positions in foreign exchange, this could be accomplished without inducing a run on the colón.

67. The other three countries have pursued more active nominal exchange rate policies. Honduras' crawling peg has been quite successful in preventing large real exchange rate fluctuations. Guatemala practices a dirty float, and Nicaragua has been following the policy of pre announcing nominal currency devaluations. However, Nicaragua appears to have a serious currency overvaluation problem, mainly as a result of wage remittances and large volumes of foreign assistance. Wage remittances are estimated at US$ 400 million to US$ 600 million, compared to about US$ 700 million in goods exports. On the other hand, ODA amounts to some 20 per cent of GDP. In the absence of such aid, the currency would have to depreciate substantially.

68. Thus Nicaragua must be gradually weaned of its dependence on unhealthy levels of foreign assistance. The process must be gradual in order to avoid dislocation and to allow enough time for the emergence of strong supply responses to a more depreciated currency. These supply responses should be promoted with investments in human development, particularly through policies targeted at making micro and small enterprises more competitive. As in El Salvador, rapid growth of non-traditional exports from Nicaragua will also depend on the skill with which the monetary authorities can prevent wage remittances from continuing to appreciate the currency.

69. As the Central American countries advance toward higher stages of integration, they will undoubtedly have to co-ordinate exchange rate policies much more closely. Current exchange rate régimes are clearly incompatible with one another. Higher levels of trade integration will require stable exchange rates within the integration area. A gradual move toward a common exchange rate régime is thus essential. This régime ought to have two basic characteristics: a high degree of stability in bilateral exchange rates and a joint approach toward exchange rates for major currencies (in practice, the United States dollar). Recent advances in macroeconomic stabilization facilitate the task of devising such a system.

70. Some observers have advocated dollarization as a solution to the recurrent foreign exchange crises of these countries. Arguments in favor of dollarization have been advanced most insistently in El Salvador, where it almost became policy in the late 1990s. Besides eliminating the possibility of monetary mismanagement (by doing away with national money), it is hard to see what the benefits of a currency union with the United States would be. The economies of the Central American countries are continuously subjected to large idiosyncratic external shocks (e.g., sharp temporary movements in their terms of trade), which can be dealt with at reasonable cost only if the authorities are able to modify the nominal exchange rate. This tool of economic policy would be lost with dollarization. In fact, a softer version of dollarization (a currency peg to the dollar) has been in force in El Salvador for several years, with ill effects on competitiveness and growth.

71. Labor mobility between partners in a currency union is one of the fundamental prerequisites for a successful and stable arrangement of this type.[7] However, faced with declines in real incomes, people in Central America are certainly not free to move to the United States. Without nominal exchange rate adjustment and without labor mobility to its partner, a country facing deteriorating terms of trade would simply be condemned to shrinking real incomes without any possibility of redress.

72. As for the alleged benefits of dollarization in preventing monetary mismanagement, it should be noted that Central American countries have already traveled a long stretch of the road toward greater monetary responsibility. Now they have to go the distance.

Export incentives and Export Processing Zones

73. A strong push into export markets and a decisive change in the pattern of comparative advantages require a package of measures that includes appropriate and well-designed export incentives. At the very least, a system of drawbacks of duties on imported inputs paid by exporters needs to be in place. Ideally, drawback schemes ought to apply to direct exporters and to producers of inputs for exporters (so-called “indirect exporters”). Moderate and temporary export subsidies have proven to be quite useful in other parts of the world. In the case of Central America, these facilities ought to be available, of course, only to exports outside the integration area. In order to avoid an artificial allocation of investment between countries, regional integration arrangements must include the adoption of uniform drawback and export support schemes.

74. The four Central American countries have used duty drawbacks only sporadically. In lieu of a drawback, some countries give exporters a subsidy that is tied to the value of exports. In El Salvador, exporters of non-traditional goods (and even traditional exports with a national value added exceeding 30 per cent of the value of exports) are entitled to an export subsidy of 6 per cent, down from an original 8 per cent (Sorto, 2000). In Nicaragua,

[7] There is an ample literature on optimum currency areas. The classic reference is Mundell (1961), for which the author won the 1999 Nobel Prize in Economic Science. It is an irony that, at the same time as that prize was being awarded, some influential observers were advocating currency unions with the United States for countries that were very far from meeting the conditions set down by Mundell and widely accepted by the profession.

exporters of non-traditional goods simply do not have to pay duties or sales taxes on imported capital goods or raw materials. In addition, all exporters receive a subsidy of 1.5 per cent of the value of exports, in order to compensate for existing tax distortions (Solórzano, 2000). As the economy becomes more complex, it will be increasingly difficult to distinguish between producers oriented to export and domestic markets, and a genuine drawback scheme will be required.

75. The design and implementation of a moderate and temporary subsidy for exports outside of Central America (and excluding firms operating in Export Processing Zones) is a pending challenge in all four countries. In Nicaragua, until the beginning of 1998, non-traditional exporters were granted income tax exemptions and received Tax Benefit Certificates equivalent to a certain percentage of the value exported. These incentives were eliminated at the beginning of 1998. Allegedly, beneficiaries were not complying with requirements as regards domestic value added and percentage of exports in the value of output. Some blame the decline of non-traditional exports from US$ 385 million in 1997 to US$ 210 in 1998 on the elimination of the incentive scheme.[8]

76. The Central American countries have been much more successful in setting up Export Processing Zones for the assembly of goods with components imported from the United States (under so-called *maquila* régimes). Firms establishing themselves in these zones have benefited from duty-free imports of capital goods and intermediate inputs. They have also been granted income tax exemptions, which vary in length from country to country. As will be discussed below, one of the great successes of the four countries, and particularly of Honduras, has been to expand exports from these zones very vigorously since the early 1990s. It is fully expected that this process will continue in the coming years.

Stimulating FDI

77. The liberalization of FDI régimes is part and parcel of global integration, and the Central American countries have understood this well. Accordingly, all four countries have liberalized very considerably their foreign direct investment regimes. National treatment is guaranteed to foreign investors. In addition, they have complete freedom to invest in any sector of the economy (except those related to defense) and to remit earnings or repatriate their capital abroad. Performance requirements are generally not applied. All four countries have signed the Multilateral Investment Guarantee Agreement (MIGA).

[8] Information based on interviews conducted by the authors in Managua in July 1999.

78. In Nicaragua, foreign investors who register with the Foreign Investment Committee enjoy additional assurances from the Government and can benefit from specific sectoral incentives that are available to national investors. However, such registration is not a legal requirement, and most investors do not register. Foreign investment legislation is in the process of being simplified.

III. ECONOMIC GROWTH IN CENTRAL AMERICA

79. A bird's eye view of Central American development over the last ten years cannot fail to notice signs of promise alongside signs of foreboding. Positive economic growth has resumed, after two decades of shrinking incomes, massive dislocation, emigration, and dismal economic performance. Exports are booming, and new export sectors are emerging. While much remains to be done to endow the Central American Common Market (CACM) with the strategic importance it once had, intra-regional trade is once again growing, and governments have made renewed commitments to regional integration, now as part of a strategy of "open regionalism". But growth rates remain low, the long-awaited upturn in domestic and foreign investment is still in its early stages, and poverty remains widespread.

Overall economic performance

80. The Central American economies are all small and low-income (see table 4). They rank among the poorest in Latin America and the Caribbean: after Haiti, Nicaragua and Honduras have the lowest *per capita* GDPs (in equivalent purchasing power) in the region; and El Salvador matches the *per capita* GDP of the poorest country in South America (Bolivia). While Guatemala's *per capita* GDP is higher than that of the other three countries, income distribution is considerably more unequal, and many of its human development indicators are worse.

Table 4

Central American countries: GDP per capita and population, 1997

(GDP in US$, PPP; population in million inhabitants)

	Per capita GDP	**Population**
El Salvador	2,880	5.93
Guatemala	4,100	10.52
Honduras	2,220	5.99
Nicaragua	1,950[a]	4.68

Source: World Bank, *World Development Indicators, 1999.*

[a] 1996.

81. The smallness of these economies means that they are heavily dependent on foreign trade. With the exception of Guatemala, in all four countries exports account for between one quarter and one half of GDP (table 5). Guatemala is the exception. The relatively low share of foreign trade in Guatemala's GDP is explained by its large subsistence sector.

Table 5
Exports of goods and services, as a share of GDP
(percentage)

	El Salvador	Honduras	Guatemala	Nicaragua
1980 – 1982	28.2	31.3	17.7	21.2
1990 – 1992	17.7	32.4	18.7	22.6
1993 – 1995	19.4	38.6	18.2	27.0
1996	21.3	47.1	17.8	40.8
1997	24.0	46.6	17.9	42.9

Source: World Bank, *World Development Indicators, 1999.*

82. As a direct result of the advent of peace, in the 1990s, *per capita* incomes began to grow again, after having declined during the 1980s (table 6). In the case of the countries most severely affected by civil strife (El Salvador and Nicaragua), absolute declines in *per capita* incomes and standards of living had taken place for two decades. In this context, even the modest rates of growth achieved in the 1990s must be considered a great success. However, in spite of liberalization and integration into the world economy, during the 1990s *per capita* incomes rose very slowly: annual growth rates were in the 0-2 per cent range.

Table 6

Rates of growth of GDP and GDP per capita, 1970-99
(percentage)

	El Salvador	**Guatemala**	**Honduras**	**Nicaragua**
GDP				
1971-80	2.3	5.7	5.4	0.0
1981-90	-0.4	0.9	2.4	-1.5
1991-99	4.4	4.2	3.1	3.2
1991-95	5.7	4.3	3.4	1.7
1996-99	2.9	3.9	2.6	5.2
Per capita GDP				
1971-80	-0.2	3.0	2.1	-3.2
1981-90	-1.5	-1.6	-0.8	-4.1
1991-99	2.3	1.5	0.2	0.3
1991-95	3.6	1.6	0.4	-1.2
1996-99	0.7	1.3	--	2.3

Source: World Bank, *World Development Indicators, 1999*; and CEPAL, *Balance Preliminar de las Economías de América Latina y el Caribe, 1999,* Santiago.

83. The relative dynamics of growth differed from country to country. On the one hand, the Nicaraguan economy spent much of the first half of the decade in severe adjustment and transition to a market economy. Beginning in 1996, there have been signs that growth is accelerating. By contrast, as the economy recovered from the ravages of civil war, El Salvador experienced positive economic growth in the period 1991-95. Subsequently, there has been a marked retardation in growth momentum. In Guatemala and Honduras, growth was sluggish throughout the 1990s.

84. As a result of slow growth, the gap that separates these countries from the developed world continued to widen (table 7). Again, El Salvador and Nicaragua were the countries whose *per capita* GDPs (in comparable purchasing power) fell most relative to that of the United States. In 1995, the *per capita* GDP of Nicaragua was less than 7 per cent that of the United States, compared to over 20 per cent in 1975. El Salvador's *per capita* GDP fell from 15 per cent the United States' in 1975 to less than 10 per cent in 1997.

Table 7
Per capita GDP in PPP dollars
(as a percentage of United States per capita GDP)

	1975	**1985**	**1995**	**1997**
El Salvador	15.2	9.5	10.4	9.9
Guatemala	18.8	15.3	14.6	14.1
Honduras	10.1	9.4	8.0	7.7
Nicaragua	20.3	9.3	6.9	..

Source: World Bank, *World Development Indicators, 1999*.

85. Reflecting their low levels of human development, incomes are unevenly distributed in all countries (table 8). The Gini coefficient, which takes values between 0 and 1, is the most widely employed measure of inequality. The closer this ratio is to unity the more unequal is income distribution. In Guatemala and Honduras, the Gini coefficient is not only high but it is significantly higher than expected, once one controls for the impact of income levels.[9] By the same token, the share of income of the lowest quintile is lower than expected, and the share of income of the highest quintile is higher than expected. The deviations with respect to expected values are particularly large in the case of Guatemala. Undoubtedly, differences in incomes between indigenous and white people (each roughly half of the population) account for a good share of the high degree of inequality in that country.

[9] We regressed the Gini ratio for 90 countries against per capita income and found that the latter is negatively associated with the former. In other words, as income *per capita* rises, inequality declines. For a discussion of the relationship between inequality and income levels, see Kuznets (1955), and Anand and Kanbur (1993a and 1993b).

Table 8

Gini coefficients and income shares of highest and lowest quintiles: Actual and predicted values

	El Salvador	Guatemala	Honduras	Nicaragua
Gini coefficient				
Actual	49.9	**59.6**	**53.7**	50.3
Predicted	51.9	51.1	51.9	52.3
Share of lowest quintile				
Actual	3.7	**2.1**	**3.4**	4.2
Predicted	3.8	3.9	3.8	3.7
Share of highest quintile				
Actual	54.4	**63.0**	**58.0**	55.2
Predicted	56.0	55.6	56.0	55.0
Ratio of highest to lowest quintile	14.7	30.0	17.1	13.1

Source: Authors' calculations, and World Bank, *World Development Indicators, 1999.*

Note: Numbers in bold reflect higher than expected levels of inequality. Predicted values are calculated by estimating an equation in which the Gini ratio and the two income shares are made to depend on the square of the log of per capita GDP and dummy variables for Africa and Latin America. Data for per capita GDP are for 1990, and they are expressed in PPP dollars.

86. International experience shows that it is very difficult to achieve a growth rate above 5 per cent on a sustainable, long-term basis without raising the investment rate above 25 per cent of GDP. In Central America, unfortunately, investment rates are, on average, still very low (table 9). The median annual rate remained in the range of 15-20 per cent during 1991-97 in three of the four countries. The only country where the median annual investment rate exceeded 25 per cent was Honduras.[10]

[10] There is some evidence that investment is systematically overestimated in Honduras. It is also possible that GDP may be underestimated (Ramos Lobo, 2000). Therefore, the median investment-GDP rate calculated for the 1991-97 (32 per cent) is likely to exaggerate actual performance. The high rates of investment reported in the national accounts are not credible in light of the modest rate of growth of GDP recorded during the same period (3.7 per cent).

Table 9
Gross investment-to-GDP ratios[a]
(percentage)

	1960-70	1971-80	1981-90	1991-97
El Salvador	12.1	14.5	11.5	17.0
Guatemala	14.9	18.4	13.4	14.9
Honduras	23.5	27.1	21.1	32.4
Nicaragua	19.8	19.0	24.9	19.6

Source: World Bank, *World Development Indicators, 1999.*

[a] Denominator and numerator are both in 1995 prices. Period ratios are medians for individual years.

Exports lead economic growth

87. Since global integration is one of the key objectives of the new development strategies adopted by all Central American governments, particular importance attaches to the evolution of exports in the 1990s. A good sign that change has begun is, indeed, the performance of the export sector. Exports have led economic growth in all four countries in the 1990s, and there is evidence that export growth is accelerating (table 10). In the 1996-98 period, the annual rate of growth of exports of goods and services ranged between 9 and 10 per cent.

Table 10
Growth of exports of goods and services, in constant prices, 1971-98
(average annual rate, percentage)

	El Salvador	Guatemala	Honduras	Nicaragua
1971-80	4.1	6.5	4.6	7.2
1981-90	-3.5	-1.5	0.8	-5.7
1991-98	10.7	6.9	3.1[a]	7.6
1991-95	11.2	5.6	0.9	6.1
1996-98	10.0	9.1	9.0[b]	10.1

Source: World Bank, *World Development Indicators, 1999*; and CEPAL, *Estudio Económico de América Latina, 1999,* Santiago.

[a] 1991-97.
[b] 1996-97.

88. The transformation of the structure of exports since the early 1990s has been remarkable. Indeed, export growth has concentrated on new exports. The share of traditional commodity exports (bananas, coffee, sugar, cotton, and meat) fell dramatically in the 1990s in all countries with the exception of Guatemala (table 11). Since the arrival of peace, new export crops have been developed, especially fruits and vegetables (so-called "dessert products"), ornamental plants, and new agricultural staples. Some light manufactures have also been added to the export basket. Exports to Central America have grown very rapidly, but so have non-traditional exports to destinations outside the region.

Table 11
Traditional and non-traditional exports: shares in total exports and average annual rate of growth, 1990-98
(percentage)

	Share in total, 1990	Share in total, 1998	Growth, 1990-98
El Salvador			
Traditional	50.9	26.8	4.5
Non-traditional	49.1	51.6	13.9
Central America	(30.1)	(37.6)	(16.4)
Rest of the world	(19.1)	(14.0)	(9.0)
Maquila value added	--	21.6	45.1[a]
Total	100.0	100.0	13.2
Total (million US$)	581.5	1,569.2	
Guatemala			
Traditional	47.1	41.4	9.1
Non-traditional	49.7	48.6	10.6
Central America	(23.0)	(26.1)	(12.7)
Rest of the world	(26.7)	(22.5)	(8.6)
Maquila value added	3.1	9.9	28.3
Total	100.0	100.0	10.9
Total (million US$)	1,250.4	2,866.6	
Honduras			
Traditional	82.7	37.0	1.0
Non-traditional	17.3	41.3	24.5
Central America	(4.2)	(11.3)	(26.2)
Rest of the world	(13.0)	(30.0)	(23.9)
Maquila value added	--	21.7	45.2 [a]
Total	100.0	100.0	9.8
Total (million US$)	831.5	2,011.0	
Nicaragua			
Traditional	79.2	56.5	4.2
Non-traditional	20.8	32.7	15.0
Central America	(13.2)	(19.2)	(13.8)
Rest of the world	(7.6)	(13.5)	(16.8)
Maquila value added	--	10.7	96.2 [b]
Total	100.0	100.0	8.7
Total (million US$)	330.5	642.2	

Sources: Authors' calculations, based on data from Banco Central de Guatemala, Banco Central de Reserva de El Salvador, Banco Central de Nicaragua, SIECA, Banco Central de Honduras, Consejo Monetario Centroamericano, and Gitli (1997).
[a] 1991-98.

89. In addition, Central America has emerged as a big assembler of garments (and, marginally, of other manufactured goods, such as plastic goods, metal products, and consumer electronics) for the United States market (Gitli, 1997; Jenkins, Esquivel, and Larraín, 1998). Honduras has taken the lead in this regard, with almost 100,000 jobs generated in Export Processing Zones by foreign firms and their domestic subcontractors. These *maquiladoras* are concentrated in a corridor outside San Pedro Sula, which has become the main industrial center in the country.

90. The heavily globalized garment industry is built around a dozen or so layers of subcontractors. The entrepreneurial structure can be viewed as a pyramid of subcontractors, which has at its upper apex a big production or marketing transnational corporation. When one reaches the Central American layers, one finds a few United States, Korean, and Taiwanese transnational corporations with their own facilities, as well as domestic enterprises working on a subcontracting basis for a transnational corporation. From the point of view of the development of domestic entrepreneurship, this is a favorable characteristic, because it makes for the strengthening of domestic businesses.

91. The growth of the *maquiladora* industry has been phenomenal (table 12). In 1990, national value added by *maquiladoras* constituted barely 3 – 4 per cent of total export earnings from goods, and they employed no more than 50 thousand workers in the four countries. In recent years, national value added is up to 10 – 20 per cent of export earnings from goods. Total employment generated is probably above 200,000 workers. In Honduras, employment in *maquiladoras* represents nearly 25 per cent of total manufacturing sector employment.

Table 12
Importance of the *maquiladora* industry

	1990	1996
El Salvador		
National value added (US$ million)	22.0	213.6
Percentage of exports	3.8	20.9
Employment (thousands)	31.4[a]	38.4
Percentage of industrial employment	30.6 [a]	28.4
Guatemala		
National value added (US$ million)	38.9	183.6
Percentage of exports	3.3	9.0
Employment (thousands)	..	68.0
Percentage of industrial employment	..	..
Honduras		
National value added (US$ million)	31.6	132.6 [b]
Percentage of exports	3.9	12.5 [b]
Employment (thousands)	17.5	76.4
Percentage of industrial employment	22.3	50.0 [c]
Nicaragua		
National value added (US$ million)	-	53.1
Percentage of exports	-	8.0
Employment (thousands)	-	11.0
Percentage of industrial employment	-	30.0 [c]

Source: Gitli (1997), pp. 32-34, 38.

[a] 1992.
[b] 1995.
[c] Estimate.

92. The *maquiladora* industry constitutes, then, a potentially interesting new growth pole for the Central American countries. However, its contribution to development is still weak. Governments have tended to see it mainly as a source of employment, rather than as part and parcel of a development strategy. The industry remains poorly integrated into the domestic economy, domestic value added representing only a quarter to a third of the value of exports (Gitli, 1997, pp. 32-34). In addition, governments are not making efforts to target specific sectors and firms to attract to their Export Processing Zones. Products other than textiles, such as assembly of electronic and plastic goods, have greater potential for developing stronger linkages with the domestic economy, and their producers are less footloose than garment assemblers.

93. Each Central American country has its own Export Processing Zone legislation, with varying provisions regarding tax benefits and the length of income tax exemptions. Besides being an unjustifiable exception to the regulations governing the CACM, the disparities in Export Processing Zone legislation across individual countries lend themselves to incentive wars and to distortions in the allocation of investment. While income tax exemptions for a limited number of years may well be necessary to stimulate the initial development of the sector, they are hard to justify over the long haul, especially when one considers that investors benefit from public expenditures in infrastructure.

94. There is evidence that the further development of clothing exports from Central America have been adversely affected by the North American Free Trade Agreement (NAFTA) coming into effect in 1994, which granted Mexico duty-free access to the United States market. *Maquila* exports from Central America are basically sewn garments from components imported from the United States. Garments that are cut, pre-washed or subjected to perma-pressing in a Central American country, even with United States fabric, lose their favorable tariff treatment under the United States outward processing regime (so-called 807 provisions) and must pay tariff on their total value. In addition, they may become subject to textile quotas. While average tariffs for garments originating in Central America are about 18 per cent, those originating in Mexico benefit from duty-free access to the United States market (Gitli, 1997). Therefore, the United States could assist the Central American countries' efforts to diversify their exports and production base by enacting "NAFTA parity" legislation, something for which the Central American Governments have been rightfully pressing. Otherwise, the Central American countries are being condemned to the category of "stitchers" in the United States division of labor.

95. In order to transform the *maquiladora* industry into a true "development pole", greater attention must be devoted to encouraging the growth of stronger linkages with the rest of the domestic economy.[11] For starters, Export Processing Zone legislation ought to be harmonized across countries. It is important to avoid incentive wars among countries in the region that wind up transferring most of the economic benefits to foreign companies or to their home governments. In the case of Export Processing Zone legislation in Central America, the length of income tax holidays vary considerably from country to country, from six years in Costa Rica to indefinitely in Honduras. A uniform length of 5-10 years ought to be adopted by all countries.

96. Second, countries ought to sign double taxation treaties with the United States, the main home country of foreign investors in Export Processing Zones. As regards foreign investors in the industry, double taxation treaties with the United States (and other countries of origin) are probably just as useful as tax exemptions. Once such a treaty is in place, taxes paid in Central America would simply be credited to their income tax liabilities back home. This is true, of course, only if income tax rates in host Central American countries remain lower than in home countries, which is likely to be the case.

[11] We endorse the recommendations in this respect made by Jenkins, Esquivel, and Larraín (1998).

97. Third, efforts should be made to identify key industries and to attract specific companies from developed countries in those industries. This is exactly what Costa Rica has done in the field of electronics. Its efforts culminated in 1997 when Intel decided to site in Costa Rica an important new semiconductor assembly plant. This investment (worth about US$ 500 million) is eventually expected to deliver interesting backward linkages and to strengthen the information technology industry in the country (CEPAL, 1998, pp. 48-49).

98. So far, in other countries in Central America, backward linkages have been conspicuous by their absence. Thus the third element of a growth-oriented strategy toward the *maquiladora* industry is a deliberate effort to encourage the development of strong regional industries supplying inputs to the *maquiladoras*.

99. The Export Processing Zones constitute a natural point of contact between the regional economies and the international market place. A multifaceted program to develop regional supply capabilities should be the major component of a new export-oriented strategy.

100. This strategy ought to include:

- A region-wide program of tariff drawbacks for indirect exporters;
- The harmonization of income tax exemptions on a region-wide basis, including agreement on a maximum exemption period;
- Favorable income-tax treatment beyond the exemption period for firms that raise domestic content beyond a certain threshold level (say, 40 per cent of exports);
- Double taxation treaties with the United States;
- Special training and technology upgrading programs oriented to the development of efficient suppliers of intermediate inputs; and
- Training programs for skilled workers at the vocational and secondary school level targeted at the skill requirements of domestic firms producing inputs for exporters.

101. The latter two elements in the strategy are particularly suited for foreign technical and financial assistance. Donors rightly emphasize the need for recipients to give proof that they are making national efforts towards their own development. This objective would be easily met by channeling a share of foreign assistance to a program of the characteristics we are recommending.

Growing FDI inflows

102. FDI has increased considerably in recent years (table 13). In El Salvador, the main recorded investments have been one-off inflows for the purchase of privatized electrical utilities and telecommunications in 1998. However, there is evidence that foreign direct investment is under-reported and could, in effect be quite a bit larger than recorded figures (Sorto, 2000). In Guatemala, privatizations also account for the bulk of the increase in foreign direct investment in 1998 (Urízar, 2000). In Nicaragua, beginning in 1996, there have been important new investments in the energy and mining sectors. Other sectors that have received significant foreign investments are hotels, shrimp farming, and cell phones. Although the amounts are still small, FDI into Honduras has held steady at about 2 per cent of GDP since 1995. Most of it has gone into Export Processing Zones.

Table 13
Foreign direct investment, as a share of GDP
(percentage)

	1990 - 1992	**1993 – 1995**	**1996**	**1997**	**1998**
El Salvador	0.3	0.2	0.0	0.0	7.4
Honduras	1.5	1.5	2.2	2.7	1.9
Guatemala	0.8	0.7	0.5	0.5	3.5
Nicaragua	0.3	2.8	4.9	8.6	10.2

Source: World Bank, *World Development Indicators, 1999*; and Central American Monetary Council.

103. There is thus evidence that FDI is beginning to pick up in the region as a whole. If countries are able to maintain currently favorable conditions for investors, it is likely that the region will see substantial new flows of foreign direct investment in the near future. The destinations are likely to be privatized utilities and export-oriented sectors, mostly in Export Processing Zones.

104. The attractions of Central America to foreign investors have changed dramatically. While in the sixties and seventies most investment into the region sought to benefit from protected markets, in the 1990s, investment is much more export-oriented. In line with this change in orientation, foreign firms are investing in the area attracted by a good port and airport infrastructure, low wages (adjusting for productivity), a favorable geographic position close to United States markets, the absence of what investors view as onerous regulations,[12] and reasonable macroeconomic stability (Gitli, 1998). These locational advantages need to be cultivated and improved.

[12] Of course, a greater degree of regulation (e.g., with regard to labour or environmental standards) may eventually be in the interest of sustainable human development in the host countries themselves.

The pressing debt problem of Honduras and Nicaragua

105. Honduras and Nicaragua are facing a strangling debt problem that requires immediate attention and that is choking off fast growth and improvements in human conditions. Both countries are candidates for inclusion in the Debt Initiative for the Heavily Indebted Poor Countries (HIPC). As in other low-income countries, most of the foreign debt of Nicaragua and Honduras is official. Both countries have been important recipients of bilateral and multilateral overseas development assistance (ODA), and their public finances are heavily dependent on these resources. This is particularly the case with Nicaragua. Efforts to become less dependent on ODA received a rude setback from Hurricane Mitch.

106. Nicaragua was able to negotiate very substantial debt relief in 1996. The decrease in debt stocks from US$ 10.3 billion to US$ 6.1 was due mainly to debt forgiveness granted by Russia and Mexico (Esquivel, Larraín, and Sachs, 1998). The contributions of Paris Club members and other developed countries were very modest. As already noted, Nicaragua has made important and sustained efforts to open its economy and increase export earnings. Owing to the decrease in debt stocks, the rescheduling of some other debt, and the rise in export earnings, the debt service-export ratio declined from 150 per cent in 1991 to 24 per cent in 1998. While much more manageable, devoting one quarter of its export earnings (and 13 per cent of its GDP) to debt service is a very heavy burden to bear. Thus debt service is restricting the Government's capacity to implement sustainable human development-related programs.

107. The debt stock indicators for Honduras look a lot less dramatic. However, its debt service-to-exports ratio (at 21 per cent) is of the same order of magnitude as Nicaragua's (table 14). By comparison, Guatemala and El Salvador both face a ratio less than half these figures. It should be noted that Honduras has also experienced a decline in its debt service-export ratio. However, debt relief has played no role in this favorable development, which is exclusively the result of successful efforts in raising exports.

Table 14

Debt indicators for Honduras and Nicaragua, 1991 and 1998
(percentage)

	1991	**1998**
Honduras		
Debt stock to GNP	118	103[a]
Debt stock to export earnings	307	195[a]
Debt service to GNP	11	11[a]
Debt service to export earnings	28	21[a]
Nicaragua		
Debt stock to GNP	831	295
Debt stock to export earnings	3,136	824
Debt service to GNP	40	13
Debt service to export earnings	152	24

Source: World Bank, *Global Development Finance, 1999*; Esquivel, Larraín, and Sachs (1998).

[a] 1997.

108. An early resolution to this long-lasting problem is up to the governments of creditor developed countries and multilateral financial institutions. Inclusion in the stock-of-debt reduction exercise of the HIPC Initiative (by which a country can obtain up to 80 per cent debt write-off) is essential. Nicaragua will potentially reach the decision point where this is possible under the HIPC Initiative only in the course of 2000. Honduras is still farther behind.

IV. PROGRESS IN HUMAN DEVELOPMENT

109. If one takes a longer-term perspective, it is evident that all four Central American countries have made progress toward improved health, longer life, and longer years of education. However, a cursory inspection of human development indicators in the areas of demographic transition, health, education, and living conditions reveals that there remains much to be done. This is particularly so in Guatemala, Honduras, and Nicaragua. El Salvador appears to have taken significant strides toward raising its levels of human development along several important dimensions. It is also more advanced than its neighbors in its demographic transition, and its health and education indicators are somewhat better.

110. Adjustment programs in the 1990s prevented the Central American countries from increasing the levels of spending on health and education, and in some cases, those levels fell as a share of GDP. It should be noted, however, that countries in the region did make efforts to raise their social spending even in the context of severe government spending cutbacks. Nicaragua benefited from the sharp reduction in military spending and was able to maintain spending on education at between 4.5 and 5 per cent of GDP.

111. The low levels of human development that are still prevalent in the four countries are conspiring against faster progress toward self-sustaining growth. In this section, we compare the evolution of selected human development-related variables in the four countries, and in the tables we use Costa Rica as a regional benchmark. Costa Rica is the country within the Central American region that has achieved the highest level of human development. UNDP's human development index ranks Costa Rica in the 45th place. By contrast, El Salvador is ranked 107th, Honduras 114th, Guatemala 117th, and Nicaragua 121st (UNDP, 1999, pp. 135-136).

112. While the human development issue has many additional dimensions, we concentrate on five that are readily quantifiable: the demographic transition, health, education, poverty, and living conditions.

Demographic transition

113. As a consequence of advances in public health, over the past few decades, many low-income countries have experienced significant reductions in their death rates. Infant mortality in particular has declined – leading to a greater number of living children per woman, and indeed, to a greater number of children.

114. In other countries, most dramatically in East Asia, this has been followed by a decline in birth rates, as women become more certain of the ratio between their pregnancies and their desired family size, and as they have greater access to birth control. There is evidence that this type of demographic is one of the factors responsible for East Asia's economic miracle (Bloom and Williamson, 1998; Bloom, Canning, and Malaney, 2000). The lag between falling mortality and fertility rates means that countries see a rapid growth in population, which then gradually declines. This lag, combined with improving health, causes a baby-boom generation. If countries manage to provide the increasing number of young people with good education, and if the economy is growing, this baby boom generation will enter the work force – and create a window of opportunity for substantial economic growth, as the ratio of workers to dependents grows.

115. To date, in Central America, declines in birth rates and in fertility rates have been slower than could have been predicted. Population growth rates *are* coming down, but they are doing so very gradually, and they still hover close to 3 per cent *per annum* (table 15).[13] Crude death rates are now almost at the same level as Costa Rica's (table 16). Except for El Salvador, however, crude birth rates are substantially higher (table 17). By the same token, fertility rates are still between four and five live births per woman, again with the exception of El Salvador (table 18). Costa Rica's fertility rate is well below 3 births per woman.

Table 15
Population growth
(annual percentage rate)

	El Salvador	Guatemala	Honduras	Nicaragua	Costa Rica
1961	3.0	3.0	3.4	3.2	3.7
1970	3.3	2.8	2.9	3.2	2.8
1980	1.5	2.5	3.3	3.0	3.0
1990	1.8	2.4	3.0	2.7	2.7
1997	2.2	2.7	2.8	2.7	1.3

Source: World Bank, *World Development Indicators, 1999*; Agudelo (2000).

Table 16
Crude death rate
(per 1,000 people**)**

	El Salvador	Guatemala	Honduras	Nicaragua	Costa Rica
1962	15	18	18	17	8
1970	12	15	14	14	7
1980	11	11	10	12	4
1990	7	9	7	8	4
1997	6	7	5	6	4

Source: World Bank, *World Development Indicators, 1999*; Agudelo (2000).

[13] In El Salvador, the low rates of growth of population since the 1970s are due to emigration caused by the civil war, as people of reproductive age migrated, and a rise in male mortality (Molina, 2000).

Table 17
Crude birth rate
(per 1,000 people)

	El Salvador	Guatemala	Honduras	Nicaragua	Costa Rica
1962	48	48	51	50	41
1970	44	45	48	48	33
1980	36	43	43	46	30
1990	30	39	38	39	27
1997	28	34	34	35	23

Source: World Bank, *World Development Indicators, 1999*; Agudelo (2000).

Table 18
Fertility rate
(live births per woman)

	El Salvador	Guatemala	Honduras	Nicaragua	Costa Rica
1962	6.8	6.9	7.4	7.3	6.9
1970	6.3	6.5	7.2	6.9	4.9
1980	4.9	6.3	6.5	6.3	3.7
1990	3.7	5.3	5.2	4.7	3.1
1997	3.2	4.5	4.3	3.9	2.8

Source: World Bank, *World Development Indicators, 1999*; Agudelo (2000).

116. Fertility rates remain high for a variety of reasons. One is that, in traditional societies, children are economically valuable as workers and as social insurance for retirement. In an area where economic stability is not guaranteed, children are a surer way of providing for old age than pensions.

117. Another reason is simply unwanted births. Contraceptive prevalence has not surpassed one half of women in all four Central American countries. In Guatemala, it is around one third (table 19). This compares with rates around 75 per cent in East Asia (Bloom and Sachs, 1998, p. 247).

Table 19
Contraceptive prevalence
(percentage of women aged 15-49)

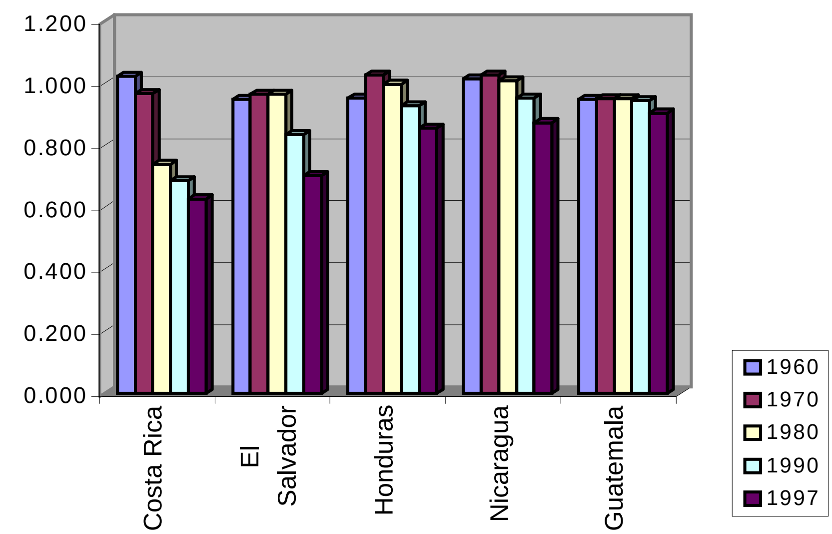
	El Salvador	**Guatemala**	**Honduras**	**Costa Rica**
Late 1970s	34	18	12	64
Late 1980s	47	23	41	68
Mid 1990s	53	32	50	..

Source: World Bank, *World Development Indicators, 1999*.

118. Third, fertility is negatively correlated with the level of education of women. This finding has been verified in El Salvador and Nicaragua (Molina, 2000; and Agudelo, 2000). In Nicaragua, while women with no education had, on average, 6.1 children, women with university education had only 1.5. Thus, progress in providing better access to education to all people can have an important demographic dividend by helping to reduce the birth rate – and the ratio of dependents to workers.

119. High population growth translates into high ratios of dependents (children younger than 15 and people older than 65) to working-age population (15 to 65 year-olds). In countries other than El Salvador, the age dependency ratio is closer to unity than it is to one half (figure 1). This means that, for every working-age adult there is almost one dependent. By contrast, in Costa Rica, this ratio is 0.63, and in the successful economies of East Asia it is well below 0.5 (Bloom and Sachs, 1998, p. 245).

Figure 1
Age dependency ratio, 1960-97



Source: World Bank, *World Development Indicators, 1999*.

120. What implication does this carry? Low dependency ratios are desirable because they allow families to save a larger share of their incomes (providing the economic environment is stable). Private expenditures on education are also likely to be higher in families with fewer children. Longer life expectancy makes that investment more worthwhile.

121. More importantly, the ability of the public sector to provide adequate educational services is challenged by a high dependency ratio. A large proportion of young people to workers places heavy demands on the public sector to provide educational services. At the same time, other things being equal, a high dependency ratio implies a small tax base and, in this way, reduces the potential resources the public sector can raise via taxes.

122. Thus a delayed demographic transition is acting as a brake on economic growth in three of the four countries. El Salvador is the exception: its demographic behavior is well ahead of its level of economic development and is rapidly becoming similar to Costa Rica's.

123. However, it is critical that this does not stop investment in education. Policy-makers must take a long-term view, realizing that the high ratio of young dependents will soon be adults. Central America's young people need to be productively employed. If they are not, they will not only continue to be an economic drain, they will also be socially and politically marginalized, and, in large numbers, will then pose a threat to the stability of society.

124. The young dependents today will be the workers of tomorrow: if they are not educated they will be less able to participate in today's global economy; and if they do not have access to the world's markets they will not be able to compete. To take advantage of the window of opportunity that Central America's demographic transition presents, government must be able to create effective policies – and plan for the changing demographics.

Health

125. Good health, desirable in itself, improves labor productivity – and thus income, which in turn is positively correlated to improved health. Additionally, a highly productive work force is attractive to investors. Good health encourages people to invest in their education and in the education of their children. Good health encourages people to save for their old age. Improving health is therefore one prong of the attack on national poverty.

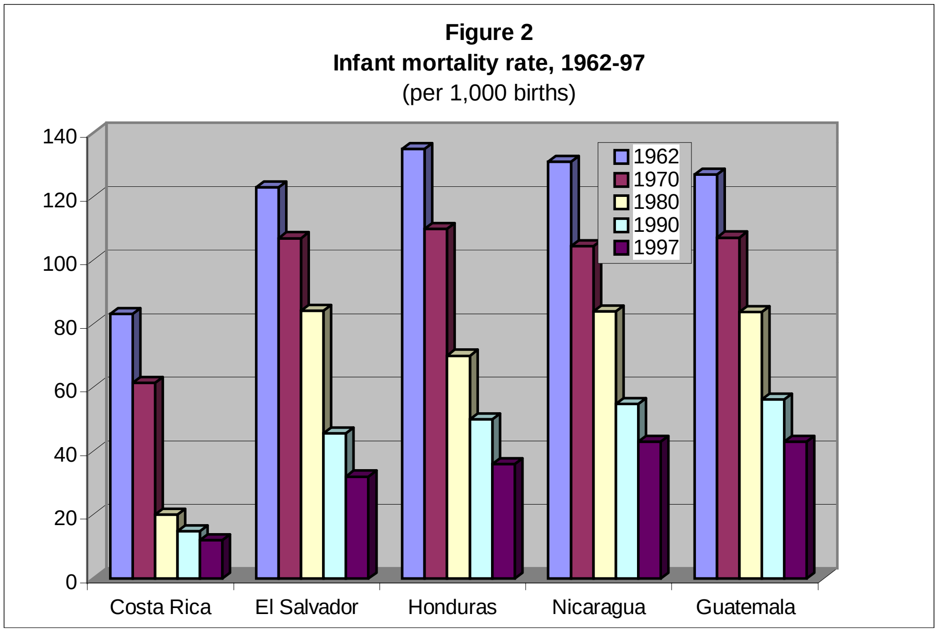
126. There is no one indicator that measures the quality of a country's health. Here we look at a few, some being indicative of outcomes (life expectancy at birth, infant mortality rates, and malnutrition indicators), while others measure effort (physicians per 1,000 inhabitants, health expenditures per person, and immunization ratios).

127. While life expectancy has been rising in Central America (as everywhere in the world), at 64 – 69 years it remains well below the leading countries, which record a figure of around 80 years (table 20). Infant mortality rates have also declined over time. Nonetheless, at 32 – 43 per 1,000 children, they are between 3 and 4 times that of Costa Rica (figure 2).

Table 20
Life expectancy at birth
(years)

	El Salvador	**Guatemala**	**Honduras**	**Nicaragua**	**Costa Rica**
1962	52	47	48	49	63
1970	57	52	53	54	67
1980	57	57	60	59	73
1990	66	61	67	64	75
1997	69	64	69	67	77

Source: World Bank, *World Development Indicators, 1999*; Agudelo (2000).



Source: *The World Bank, World Development Indicators, 1999.*

128. Our three malnutrition indicators (table 21) show that infant and child malnutrition is widespread in all four countries. The large share of low birth weight babies is indicative of maternal malnutrition. The ratios of children under 5 years of age that have low height and low weight for age are extremely high. In Guatemala and Honduras, 40-50 per cent of all children under five years old have lower-than-normal heights. These are indicators of severe child under-nourishment. Malnourished children have serious learning disabilities – which in turn affects their prospects for engaging in the knowledge economy.

Table 21
Indicators of malnutrition

	El Salvador	Guatemala	Honduras	Nicaragua	Costa Rica
Low birth weight babies (% births)					
Early 1980s	9	10	9	15	12
Late 1980s	8	14	..	8	6
Early 1990s	9	14	9	8	7
1995	..	..	..	15	7
Low height for age (% children under 5)					
Early 1980s	..	..	..	22	13
Late 1980s	30	58	37	..	..
Early 1990s	23	..	36	24	9
Mid to late1990s	23	50	40	..	6
Low weight for age (% children under 5)					
Early 1980s	..	..	..	10	6
Late 1980s	15	33	21	..	..
Early 1990s	11	..	18	12	..
Mid to late 1990s	11	27	18	..	5

Source: World Bank, *World Development Indicators, 1999*; Molina (2000).

129. There has been significant progress in immunizing children against contagious diseases. However, about one quarter of children in Guatemala are still not immunized against DTP[14] or measles (table 22). Eleven per cent of Honduran children are not immunized against measles. These figures indicate that dramatic gains in health can be made in Guatemala and Honduras at relatively low cost.

[14] Diphtheria, tetanus and pertussis (or whooping cough)

Table 22
Immunization
(percentage children under 12 months)

	El Salvador	Guatemala	Honduras	Nicaragua	Costa Rica
DPT					
1980	43	43	31	15	86
1990	80	66	84	66	95
1997	97	78	94	94	91
Measles					
1980	45	23	35	15	60
1990	98	68	90	82	90
1997	97	74	89	94	99

Source: World Bank, *World Development Indicators, 1999.*

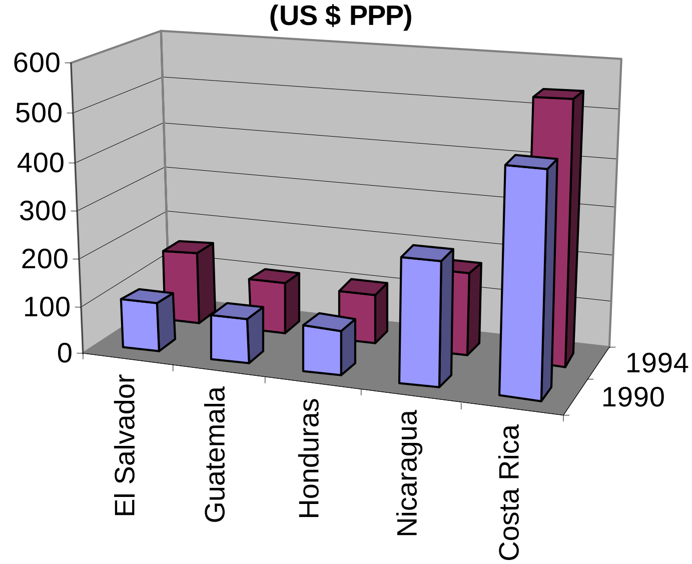
130. Expenditures on health are abysmally low in all four countries. In El Salvador, Guatemala, and Honduras, in 1994, *per capita* dollar expenditures on health (in equivalent purchasing power) were barely US$ 100, compared to over US$ 500 in Costa Rica (figure 3). As already noted, *per capita* spending on health fell in Nicaragua over the first half of the 1990s, a period that coincided with severe macroeconomic adjustment. A reflection of the inadequacy of health expenditures is that the number of physicians per 1,000 inhabitants (table 23) remains extremely low in all countries, but particularly so in Guatemala and Honduras. Little progress has been made over the 1990s towards changing this sorry situation.

Table 23
Physicians
(per 1,000 people)

	El Salvador	Guatemala	Honduras	Nicaragua	Costa Rica
1960	0.2	0.2	0.1	0.3	0.4
1970	0.2	0.3	0.3	0.5	0.6
1980	0.3	..	0.3	0.4	0.7
1990	0.8	0.8	0.7	0.6	1.3
1993	0.7	0.3	0.4	0.6	0.9
1997	..	..	..	0.8	..

Source: World Bank, *World Development Indicators, 1999*; Agudelo (2000).

Figure 3
Health expenditures per capita (PPP)
(US $ PPP)



Source: World Bank, *World Development Indicators, 1999.*

Education

131. The importance of education must not be underestimated. The global economy requires increasingly skilled, entrepreneurial and resourceful people. Educated workers are productive and flexible – able to react quickly to changing market conditions. Educated workers are also more likely to make the most of new technology – and are a magnet for FDI.

132. The reverse side of the coin shows that a poorly educated work force is more likely to suffer from ill health, is less flexible in adapting to market pressures, and is less productive.

133. Improving education is of prime importance to Central America. The examination of a variety of indicators shows that, over the 1990s, there has been even less progress in education than in health.

134. The quality of education is a key concern. At the primary level, all students should acquire at least basic literacy and numeracy. But between 23 and 41 per cent of adult females remained illiterate in 1997 (table 24). The figures for adult males ranged between 22 and 29 per cent. Lack of access to literacy and numeracy is a serious drawback to productive participation in the economy.

Table 24
Illiteracy rates
(percentage of people aged 15 and above)

	El Salvador	**Guatemala**	**Honduras**	**Nicaragua**	**Costa Rica**
Adult females					
1970	47	62	49	46	12
1980	38	54	41	..	9
1990	31	46	34	..	6
1997	27	41	30	23	5
Adult males					
1970	36	46	43	45	11
1980	29	38	37	..	8
1990	24	31	32	..	6
1997	22	26	29	23	5

Source: World Bank, *World Development Indicators, 1999*; Molina (2000); Agudelo (2000).

135. The education of women and girls is a significant factor in improving health and education – and reducing poverty rates. More education encourages women to have fewer (and healthier) children as well as increasing their own earning power, thereby increasing the spending power of a household. Educated women add to the strength and size of the educated work force. There is also evidence that better educated and wealthier women pass on the benefits of their education to their family and their communities in a more direct way than men – especially when diffusing medical knowledge. For example, vaccination rates for children increase with the education level of the mother. The education of women and girls need to be targeted specifically – especially in El Salvador and Guatemala, two countries where illiteracy is significantly higher among women. Discrimination against women thus deprives half the population of the minimum skills needed for responding to potential opportunities opened up by liberalization and global integration.

136. The costs of attaining universal literacy and numeracy ought to be well within the capabilities of Central American governments, since in labor intensive economies, wage rates, even for skilled workers, are low.

137. All four countries have made significant progress in raising their primary enrolment rates (table 25). The deficiencies lie on either side of primary education: despite some progress during the 1990s, school enrolment rates are still inadequate in pre-primary and in secondary education. Pre-primary education is not a luxury: it has been demonstrated that success in primary education requires the socialization and basic skills acquired in pre-primary school.

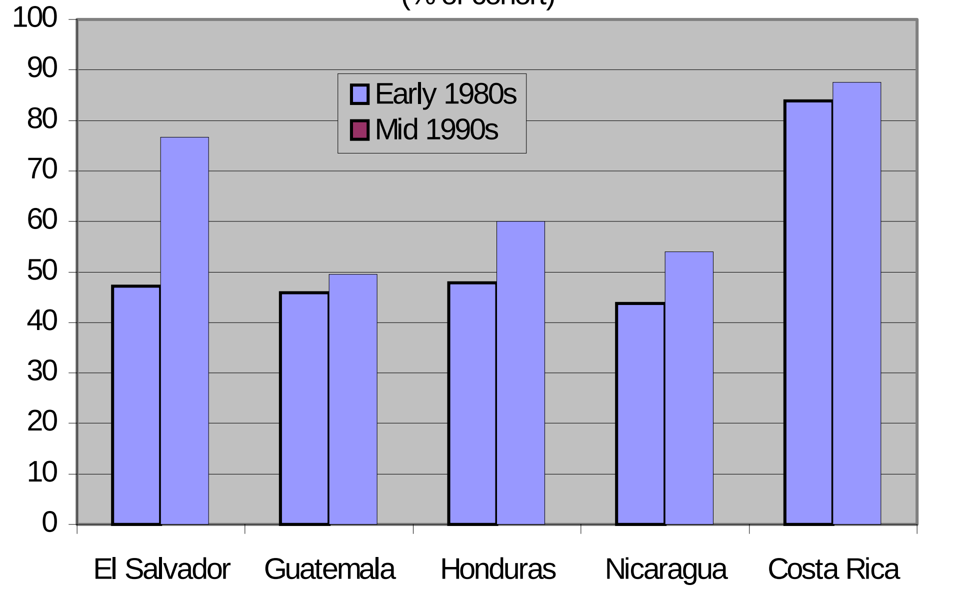
Table 25
Gross school enrolment rates
(percentage of cohort)

	El Salvador	Guatemala	Honduras	Nicaragua	Costa Rica
Pre primary					
1980	11	21	9	8	39
1990	20	25	16	12	61
1996	34	33	31	20	72
1998	..	..	33	33	..
Primary					
1960	80	45	67	66	96
1970	85	57	87	80	110
1980	75	71	98	94	105
1990	81	78	109	98	101
1995	88	88	108	101	103
1998	..	..	..	96	..
Secondary					
1960	13	7	8	7	21
1970	22	8	14	18	28
1980	24	19	30	..	48
1991	25	23	34	31	43
1996	34	26	32	36	47
1998	..	..	34	42	..
Higher					
1977	2	2	1	2	6
1992	13	8	8	13	21
1997	17	8	9	9	22

Source: World Bank, *World Development Indicators, 1999*; Ramos Lobo (2000); Agudelo (2000).

138. It is interesting to note that these countries have a large percentage of dropouts in primary school (figure 4). With the exception of El Salvador, in the other three countries barely 60 per cent of children make it through fifth grade. It has also been reported that it takes children in the four countries an average of over 10 years to complete the six years of primary education (Alvarez, Dassin, Rosenberg, and Bloom, 1999).

Figure 4
Persistence to grade five
(% of cohort)



Source: **World Bank, *World Development Indicators, 1999.***

139. Because comparatively few children finish primary education, few enroll in secondary school. Secondary enrolment rates still range between 26 and 41 per cent of their cohort. This is a serious drawback for participating in a world economy where a premium is increasingly placed on knowledge.

140. Education reformers need to concentrate on improving the quality of the experience people receive whilst in the education system. If the quality improves, children are less likely to drop out. Primary schools must lock people into education, by providing them with the two essential tools to continue: literacy and numeracy. Secondary schools should focus on getting more students into tertiary education – and enriching their learning experience. Better teacher training, both initial and in-service, will improve the educational experience for students.

141. As can be seen in table 26, during the 1990s, public spending on education rose in three of the four countries (all except Honduras). However, in two of them, El Salvador and Guatemala, it is still very inadequate in quantitative terms (around 2 per cent of GDP). The poor quality of education is an acknowledged problem in all four countries (see Alvarez, Dassin, Rosenberg, and Bloom, 1999). While much more than increasing public spending will be needed to overcome the problem, it is inconceivable that educational quality can be tangibly improved with these low levels of spending.

Table 26
Public spending on education
(percentage of GDP)

	El Salvador	Guatemala	Honduras[a]	Nicaragua	Costa Rica
1960	2.1	1.4	2.2	..	4.1
1970	2.6	2.0	3.1	2.3	5.2
1980	3.9	1.8	3.2	3.4	7.8
1990	2.0	1.6	4.2	4.9	4.4
1995	2.2	1.7	3.9	5.1[b]	4.6
1997	2.5	1.8	4.1	5.1	..
1998	..	..	..	4.6	

Source: World Bank, *World Development Indicators, 1999*; Agudelo (2000); Ramos Lobo (2000); Molina (2000); Lavarreda (2000).

[a] As already noted, there is evidence that GDP has been underestimated in the last two decades, which could be overestimating the ratio.

[b] 1994.

142. The gap between rich and poor countries' higher education enrolment is increasing alarmingly. Higher education in the global knowledge economy is essential for long-term success. Not only are highly educated people well placed to become economic and social entrepreneurs, but they also help create, or strengthen, the institutions (including government) and the infrastructure needed to sustain development.

143. The quality of public policy formulation and implementation – an important component of governance – depends to a large extent on the pool of available human resources with higher education. In the case of the Central American countries, in three of the four countries (the exception being El Salvador), enrolment rates in higher education are still below 10 per cent. This compares very unfavourably with a rate of 22 per cent for Costa Rica, our benchmark country.

144. It is imperative that policy-makers in Central American countries acquire a *vision* of why higher education is important to guide their decisions – and they need to promote that vision. The vision must be tempered with what their national higher education system can be expected to achieve. New players, especially from the private sector, must become involved in funding and providing advanced education.

145. One consequence of continuing poor education in these four countries is persistent unemployment and underemployment. The job opportunities that do arise are in the modern sector of the economy. Most people, however, do not possess the skills that would make them employable in the modern sector. Adult training and retraining programs should also be considered to enable workers to acquire the skills they need to adapt to the changing distribution of work opportunities. Strengthening basic education, while essential, has positive impacts on labor productivity after a long lag, whereas retraining programs offer more immediate benefits.

Living conditions

146. As with other dimensions of sustainable human development, improving living conditions for the population is an objective in itself and a means to higher productivity. The absence of drinking water, sanitation, or a decent dwelling is a breeding ground for illness and demoralization as well as being an affront to human dignity. In this dimension of sustainable human development, the four Central American countries made significant gains in the period form the mid-1980s to the mid-1990s. However, by 1995 a significant share of households in all four countries still did not have access to drinking water or plumbing (table 27). This deprivation was particularly severe in Nicaragua and in the rural areas of all four countries.

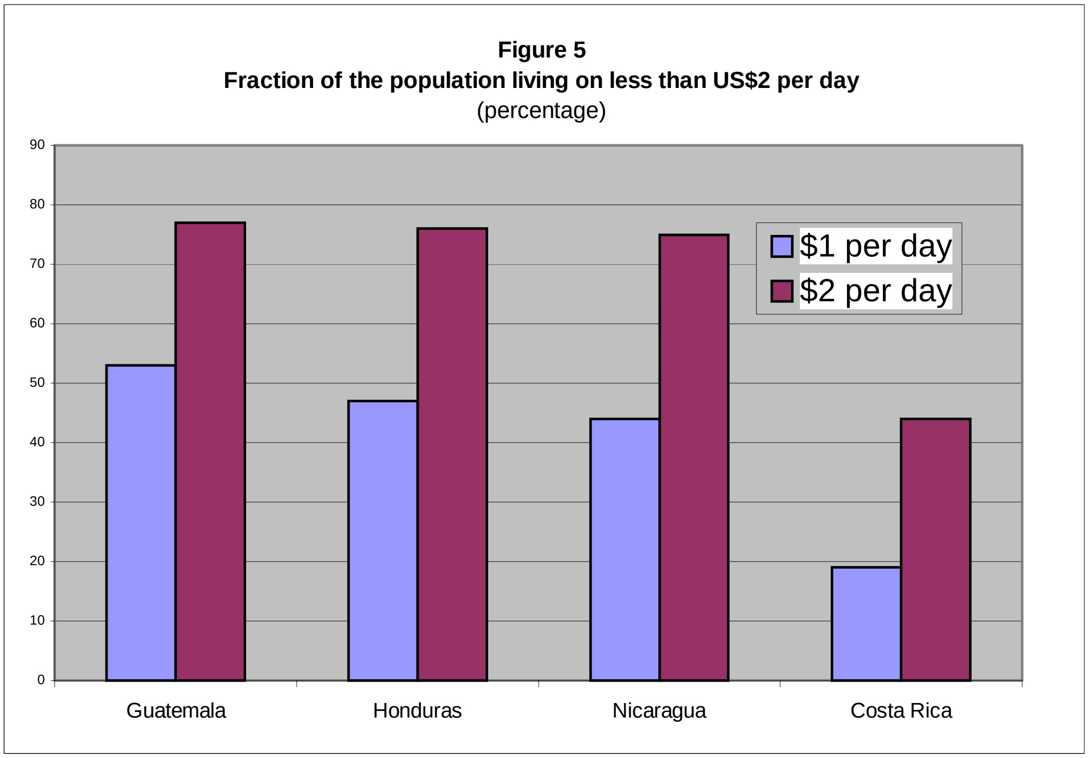
Table 27
Indicators of living conditions
(percentage of the population with access)

	El Salvador	Guatemala	Honduras	Nicaragua	Costa Rica
Safe water, total					
1970	40	38	34	35	79
1985	51	58	50	50	93
1995	53	67	77	62	100
1998	..	..	..	61	..
Safe water, rural					
1970	20	12	10	16	59
1985	47	39	49	13	82
1995	..	48	66	28	99
1998	..	..	..	30	..
Sanitation, total					
1985	62	54	32	27	95
1995	77	67	82	59	97
1998	..	..	..	61	..
Sanitation, rural					
1985	35	42	38	16	88
1995	65	50	71	28	95

Source: World Bank, *World Development Indicators, 1999*; Agudelo (2000).

Poverty

147. The bottom line of the bleak human development picture that we have described in this section of the report is widespread poverty. Poverty measurements tend to be non-comparable across countries, because poverty lines differ from one country to another. The closest one can come to an internationally comparable measure is the fraction of the population living on less than one and two US dollars a day. Unfortunately, this figure is usually available for one year per country. Nonetheless, a comparison for our four countries is quite instructive. No data are available for El Salvador. As can be seen in figure 5, for the other three countries, almost 50 per cent of the population lives on less than one US dollar per day and fully three quarters has incomes of less than two dollars per day. The figures for our benchmark, Costa Rica, are 19 and 44 per cent, respectively.



Putting it all together

148. Can we say something about how much *per capita* GDP would rise if the Central American countries would find the wherewithal to improve their demographics (by diminishing significantly their dependency ratios), health (as measured by life expectancy), and openness (as measured by the degree of openness to trade)?

149. We attempt to do this by using an empirical model to explain differences in growth rates in the world economy developed by Bloom, Canning, Graham, and Sevilla (2000). This model explains growth rates in the period 1965-90 by the following variables:

> (a) the log of per *capita* GDP in 1965 (in 1985 dollars of internationally comparable purchasing power);
>
> (b) the log of the share of the working age population in the total population in 1965;
>
> (c) the percentage of area in the tropics;
>
> (d) the log of the secondary school gross enrollment rate in 1965;
>
> (d) a measure of openness to trade over the period from 1965 to 1990;

(e) a measure of institutional quality in 1980;

(f) life expectancy in 1965;

(g) the difference in the growth rate between the working age and the total population (GDIF); and

(h) the interaction between openness and GDIF.

150. For deriving benchmark estimates of *per capita* GDP in 2015 (in 1985 international dollars), we use the parameters from the growth regression and the 1990 values of the independent variables. The simulations of per capita GDP in 2015 labeled "Improvements in demography", "Improvements in openness", and "Improvements in demography and openness" use, respectively, data values for Chile in 1990 for GDIF only, for openness only, and for GDIF and openness together. The simulations labeled "Improvements in health" measure the effect on *per capita* GDP in 2015 of life expectancies in 1990 that were counterfactually 10 per cent higher than they actually were.

151. The results of the simulations are shown in table 28. Improvements with respect to their values in 1990 in demographic characteristics, health, and openness to trade can raise very significantly the levels of *per capita* GDP in all four countries by 2015 (between 75 and 80 per cent). It is important to stress that the *combination* of the three policy changes is what yields the big gains.

152. A good part of the task of opening up the economy to trade has already been achieved. In fact, as already noted, during the 1990s all four countries implemented policies to open up their economies to trade and investment. The big challenges ahead relate to human development. It should be noted that these simulations do not include the impact of better education. The favourable effects of more and improved education ought to be very considerable and should exceed by a big margin the boost that improved demographics and health alone can be expected to give to incomes per head.

V. THE PROBLEMS OF MICRO AND SMALL ENTERPRISES

153. The micro and small enterprise sector is a hinge between economic growth and human development. A development strategy focusing on sustainable human development ought to pay specific attention to this segment of the enterprise sector. Success in promoting the upgrading of these firms has a double dividend: since poverty is heavily concentrated in this sector, progress can simultaneously foster both economic growth and increased equity.

154. The incapacity of a developing economy to generate output growth that is commensurate with the growth of its labor force shows up in burgeoning open unemployment and a swelling of the ranks of the self-employed.

155. All four countries face problems of unemployment, underemployment, and employment-informality. In all four countries, a large share of employment is in micro enterprises, the majority of which are, in turn, at the subsistence level. These are not really firms in the formal sense of the term. Most of them are precarious, do not carry books, and are unable to generate surpluses leading to reinvestment and growth.

156. In Nicaragua and El Salvador, efforts have been made to measure underemployment, defined as people who are self-employed because they are unable to find a job in the formal sector of the economy. In both countries, underemployment has been estimated at over 30 per cent of the labor force (Solórzano, 2000; Trigueros, 2000). This figure underestimates the true prevalence of underemployment because it does not include the large number of low-productivity self-employed people. In Nicaragua, for example, the informal sector of the economy absorbs two thirds of the working population. For this segment of the labor force, working conditions are deplorable, incomes insufficient to provide for subsistence, and social security non-existent (Agudelo, 2000).

157. In Guatemala, it is estimated that micro enterprises, mostly informal in nature, account for one quarter of total employment. In the case of women the informal economy accounts for up to 70 per cent of employment. Almost all rural women work in informal micro enterprise settings (Colom, 2000).

158. In Honduras, although unemployment is not a serious problem, wages are too low to allow workers to meet even subsistence needs. In agriculture, economically unviable farms represent over 70 per cent of all production units (Ramos Lobo, 2000). In Guatemala, poverty is also concentrated among rural producers, the vast majority of whom are indigenous. Three quarters of all micro enterprises are indigenous.

159. In El Salvador, in 1996 a comprehensive study was carried out by 14 interested institutions in order to understand better the characteristics and problems of the micro enterprise sector (Trigueros, 2000). This study – entitled *Libro Blanco de la Microempresa* – determined that micro enterprises accounted for between 24 and 30 per cent of GDP and employed 31 per cent of the country's labor force.[15] About three quarters of the enterprises are urban,[16] and about 65 per cent of micro entrepreneurs are women[17]. Most micro enterprises were to be found in commerce (almost one half of the total), about a quarter in manufacturing, and 15 per cent in personal services. At the time of the survey (1996), 23 per cent of all micro entrepreneurs did not have any schooling, and 50 per cent had between one and six years of schooling; 11 per cent were illiterate.

[15] According to the *Libro Blanco*, micro enterprises are production units with up to ten workers and with annual sales of up to 600 thousand colones (about US$ 75 thousand).

[16] This proportion is surely lower in the other countries, and particularly in Guatemala, where the agricultural sector is larger relative to the economy, and rural poverty is a more important problem.

[17] It is interesting to note that the experience of the Grameen Bank, one of the world's foremost micro finance institutions, has led them to discriminate heavily in favour of women clients (see www.grameen.org).

160. The survey classified micro enterprises into three categories: subsistence, primitive-accumulation, and amplified-accumulation. Subsistence enterprises are those with very low productivity and whose incomes do not cover the consumption needs of the entrepreneur. They are concentrated in retail trade and personal services and headed mainly by women – who are also heads of household. Simple-accumulation enterprises are those whose income is sufficient to cover subsistence costs but not high enough to allow for growth. Enterprises with amplified accumulation can save and invest. According to sales, subsistence micro enterprises represent about 70 per cent of the total, with simple-accumulation firms taking up somewhat over a quarter.

161. The potential for growth is concentrated in the last two categories. Policies to enhance the production capacities and competitiveness of these firms are important not only from the point of view of their effects on the incomes of their owners. More viable small firms can be the source of employment for other unemployed or underemployed workers as well. Therefore, they should be the targets for financial and technical assistance aimed at transforming them into productive small enterprises.

162. The needs of these firms are of three different kinds. First, their technologies and forms of organization do not allow them to participate in global integration. In fact, micro and small enterprises in handicrafts and simple manufactures are probably adversely affected by trade liberalization, in that they are ill equipped to compete with cheap imports. Interestingly, in El Salvador, micro enterprises are very active in fishing, and export their produce to other Central American countries. The appreciation of the Salvadoran colón, already referred to above, has affected adversely these exports, since firms are unable to introduce new technologies to increase productivity and remain competitive. Effective programs of technical assistance aimed at raising the ability of micro enterprises to compete could have a very significant impact on both growth and human development.

163. Second, as the results of the Salvadoran survey indicate, the education of the micro entrepreneurs and their employees is very deficient and needs to be improved through effective programs of basic adult education.

164. Third, micro enterprises are often unable to finance investment projects because they do not have access to capital markets. The financial constraints they face originate in the nature of financial markets. The basic trait of financial markets, and the main reason why they do not conform to textbook competitive markets, is the existence of asymmetric information: lenders do not know what borrowers will do with their money.

165. This gives rise to two different kinds of risk. One is risk attached to the borrower herself, who can use the borrowed funds for purposes that are quite different from those for which the money was lent. The other kind of risk is commercial: all projects are uncertain, and some will undoubtedly fail to yield expected returns. In the first case, the borrower may be able to repay but may be unwilling. In the second, she may be unable to do so.

166. These two sources of risk induce creditors to demand collateral from untried borrowers. Since small firms often are unable to put up collateral, financial markets tend to ration them out. In addition, there are important economies of scale in the finance industry, which means that small loans tend to be more costly than large loans. Fortunately, it has been shown that small firms are usually willing to defray higher interest costs and that the main problem they face is not high interest rates but inadequate access to credit.

167. Financial institutions catering to the micro enterprise sector have sprung up all over the world, often with the assistance of donor agencies and NGOs (Agosin, 1999b; Morduch, 1999). Central America is no exception. One of the main problems facing these institutions is how to solve the problem of non-existent collateral. There are several well-known alternative financial technologies, including collective credits (particularly suited to small agricultural concerns),[18] the monitoring of borrower balance sheets and performance, tying initial lending to previous deposits, and testing borrowers' creditworthiness through gradual increases in loan sizes.

168. Experience demonstrates that, when micro finance banks are perceived by their clients to be permanent institutions, the amount of subsidization needed for them to continue to operate declines very considerably. Some in fact outgrow dependence on their original funding sources to become economically viable. In countries that have developed successful micro finance institutions, bad loans are a smaller proportion of total assets in these institutions than in conventional banks.[19]

169. In all four Central American countries, there have been numerous efforts to set up micro finance institutions, with rather mixed results so far. The most successful experience is that of Financiera Calpiá in El Salvador. This institution was born from a 1988 grant by the German aid agency, GTZ, to the Salvadoran Association of Medium and Small Enterprises (AMPES). In 1995, with financial contributions from the Inter-American Development Bank, the Central American Bank for Economic Integration, and domestic institutions, Financiera Calpiá became totally independent. It provides credits and other financial services such as current accounts, time deposits, and savings deposits to micro enterprises and poor people.

170. The institution operates on the same principles as a bank, and its shareholders expect it to be profitable. In its lending operations, it considers that the production and consumption activities of its clients are inseparable; money being fungible, it is not possible to prevent poor families from using credits to finance consumption that were originally intended for production activities. Therefore, its credit technology consists in obtaining detailed knowledge about the repayment capacity of each borrower through visits by loan officers to clients' homes. As collateral, borrowers pledge goods that have a high use value for the family (for example, a bed or consumer durable). The size of loans is

[18] This involves forming groups of debtors who are all guarantors of each other's loans. If one member fails to pay back her loan, all other members of the group are liable, and they all lose their creditworthiness.

[19] Two classic cases of successful micro finance institutions are Grameen Bank in Bangladesh and Banco Sol in Bolivia. Grameen Bank was started with aid money in 1978. Now it is a self-sustaining bank with over US$ 271 million in loans outstanding to micro enterprises and poor people (which it has aided to go beyond the subsistence level). Grameen Bank pioneered the use of collective credits (see Yunus, 1999).

increased gradually over time as the borrower establishes a reputation for repayment. In line with its relatively high costs, Financiera Calpiá charges interest rates that are higher than at conventional banks (Trigueros, 2000).

171. Financiera Calpiá's activities have grown rapidly since it began operations as a full-fledged bank. Total credits rose from 18 thousand in 1996 to almost 29 thousand in 1998. Over the same period, the amounts lent practically doubled, to about US$ 22 million in 1998. It has also been very successful in attracting savings and time deposits.

172. In other countries, experience has been much less favorable, basically because Financiera Calpiá's commercial approach to micro finance has been absent. There have also been surmountable legal problems. In Nicaragua, the main problem is that the banking law does not allow these institutions to receive deposits from the public (Ruiz, 2000), an indispensable precondition for becoming economically viable. This limits existing micro finance institutions to being conveyor belts for what are in effect gifts to underemployed people. Unsurprisingly, the ratio of bad loans to total assets of these "banks" is very high. The many institutions that have been created with the assistance of donor governments and non-profit institutions from developed countries are not economically viable and are still dependent on the good will of donors.

173. As Financiera Calpiá's experience shows, micro entrepreneurs have potential demands for many types of financial services, not just loans. An essential condition for becoming self-sustaining in the financial sector is to be able to offer clients a wide range of services. These include deposits, savings instruments, retirement accounts, and insurance. With the exception of Financiera Calpiá, none of the micro finance institutions in Central America fulfils this condition.

174. Micro finance has a great potential and can play an important role in fostering the transformation of micro enterprises in Central America. If it is to fulfill its promise, however, the sector must be reformed thoroughly. An assessment of resource needs and availability has not yet been undertaken, but it would not be surprising to find out that sufficient resources are already being devoted to the problem. The task is then to put them to good use through organizational reform. A key issue is to allow micro finance institutions to become true banks offering services to people who have potential demands for them.

175. The distinction made in El Salvador's *Libro Blanco* between subsistence and other types of micro enterprises is useful in formulating policy toward micro finance. Subsistence firms basically require working capital to purchase inputs for very simple production processes. Collective credit technologies and those pioneered by Financiera Calpiá are well suited to this segment of the micro enterprise sector. As firms grow in size, they begin to demand longer-term credit to finance investments in fixed capital. For this group of firms, a more effective solution for the problem of inadequate access to credit is the setting up of a public credit guarantee agency. The objective of these institutions is to provide credit insurance (for a fee, of course).

VI. CONCLUSIONS

176. In the years ahead, Central American countries face a number of daunting challenges to sustainable human development and rapid growth:

- a labor force with insufficient basic skills
- micro and small enterprises are unable to contribute to growth because of inadequate access to credit and uncompetitive technologies
- high levels of civil insecurity remain (despite progress towards democracy)
- uncertainty as to the enforcement of laws and contracts (especially Nicaragua)
- a large share of the population is still outside the modern market economy (for example, a significant proportion of the indigenous population of Guatemala)
- a low-productivity informal sector absorbs a disproportionate share of the labor force.

177. Sustained attention to the synergies between SHD and economic growth offer the best prospects for policymakers striving to tackle these problems. In light of this, it is worrying that some countries have either cut back on, or failed to increase in a sustained manner, key human-development expenditures, such as those on education, health, and decent housing.

178. Progress along the many dimensions of SHD should be protected from the vagaries of macroeconomic adjustment. The reduction in military spending, quite impressive so far, is an optimistic sign that it is possible to reach much higher levels of human development. More needs to be done at the national level to achieve a lasting peace, solidify democracy and the rule of law, and put an end to corruption.

179. In Honduras and Nicaragua, an essential component of any strategy to foster human development is early debt relief. Since most of the debt of these countries is official, the objective of debt relief ought to be well within the capacities of donor governments. Debt relief programs can be structured in such a way that, as a *quid pro quo*, the governments of the two recipient countries make measurable progress in reaching quantifiable human development targets.

180. A further difficulty is that individual countries have had problems designing and implementing coherent policies, particularly in the area of trade and the exchange rate. Exchange rate policy needs to be supportive of export diversification by maintaining competitive domestic prices in foreign currency. Unfortunately, sustained currency overvaluation is threatening export-oriented growth.

181. A major challenge ahead refers to the strengthening of the CACM. Central American integration has great potential for fostering SHD and sustained growth. A true common market is yet to emerge. This will involve agreeing on common rules not only for imports but also for export incentives, foreign investment, and the treatment of investment in Export Processing Zones. If the CACM is to become a true "engine of growth", the harmonization of exchange rate policies (and of the macroeconomic policies that underpin the exchange rate) will need to be tackled sooner rather than later. A regional infrastructure policy is also a must.

182. Finally, the *maquiladora* industry has the potential to become a pillar of a new development strategy. In all four countries, this industry is already an important generator of employment. However, up to now, it is oriented almost exclusively to stitching together imported clothing components. It is time for countries to diversify the industry mix in the Export Processing Zones and to develop strong and competitive suppliers for these firms, so that the positive growth impulses emanating from them can reach the broadest segments of the region's population. Regional integration ought to be seen not only in terms of the benefits of a larger internal Central American market but also as the best option for developing *regional* input suppliers to export-oriented firms.

183. Without wishful thinking, one can envisage a *maquiladora* industry that becomes the focal point for an integrated development strategy based on the acquisition of new comparative advantages. Such zones can also make an effective locus for a range of initiatives, such as retraining programs and health service delivery.

184. The tasks ahead, then, involve continuing efforts in the intelligent design and effective implementation of policies in the two areas that are the subject of this assessment: on the one hand, more sophisticated trade and finance policies and, on the other, policies oriented toward the deepening of human development. Ending the scourge of poverty in low-income countries such as those analyzed here, policy makers must learn to constantly consider both of these approaches simultaneously. In order to help the world's poor the two must, in short, become one.

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