

# CEPAL

## Review

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- Three dots (...) indicate that data are not available or are not separately reported.
- A dash (—) indicates that the amount is nil or negligible.
- A blank space in a table means that the item in question is not applicable.
- A minus sign (-) indicates a deficit or decrease, unless otherwise specified.
- A point (.) is used to indicate decimals.
- A slash (/) indicates a crop year or fiscal year, e.g., 1970/1971.
- Use of a hyphen (-) between years, e.g., 1971-1973, indicates reference to the complete number of calendar years involved, including the beginning and end years.
- Reference to "tons" mean metric tons, and to "dollars", United States dollars, unless otherwise stated.
- Unless otherwise stated, references to annual rates of growth or variation signify compound annual rates.
- Individual figures and percentages in tables do not necessarily add up to corresponding totals, because of rounding.

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# CEPAL

## Review

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## Present and future integration in Central America

*José Manuel Salazar*

Has the idea of integration in Central America been abandoned for the 1990s, while strategies for economic "openness" and other forms of entry into world markets are adopted? Are there any other ways? According to the author, there are grounds for moderate optimism as regards reinforcing Central American integration in this decade.

One cycle in the history of integration has come to an end but the issues debated in the 1950s on ways of promoting economic integration and on its contribution to development will continue to be the centre of discussion in this decade. For this reason, this article starts with a review of Prebisch's original ideas on these subjects and their development by ECLAC.

In section II, it is proposed that regional economic integration, defined in new terms, is both conducive to and complementary to a strategy for gaining greater access to the world economy, based on achieving international competitiveness. One guideline is to eliminate the anti-Central American bias and to promote intraregional trade, for which there are promising prospects thanks to the plan to reactivate the intraregional trade which is being implemented, as described in section III.

The possibility of exploiting the new global economic conditions to the fullest depends on Central America's ability to make the transition from a static, passive trade policy to an alert and active policy, i.e., to maximize the strategic advantages of joint action in the areas of trade, finance and international cooperation. In section IV, various options are analysed, with special reference to trade strategy.

The cost-benefit ratio, arising from integration, acquires new dimensions in a context of export-oriented strategies. Sections V and VI, analyse several areas for joint action aimed at increasing international competitiveness and stimulating industrial specialization and complementarity at the regional level, which may give integration a positive balance both for the region as a whole and for each individual economy.

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## I

### Theory and practice in the origins of integration

The precariousness of the economic and infrastructural ties of the Central American Isthmus during the colonial period was a factor that contributed to the failure of the project to establish a federal republic, after its independence from Spain in 1821, when the countries opted to form five separate States. Nevertheless, the idea of integration endured as a political ideal, giving rise to various partial projects for regional linkage, one of the latest of which was the creation of the Organization of Central American States (ODECA) in 1951, consisting of the ministers for foreign affairs.

However, it was ECLAC that put forward a totally novel approach for promoting Central American unity in contrast to the usual political approach and the previous inadequate economic initiatives. In fact, as early as 1951, on the occasion of the establishment of ODECA, a decision was taken to move towards regional economic integration, although the framework for achieving that goal was not clear.

From 1951 to 1958, ECLAC spent considerable energy on assisting and steering the Governments of Central America. This activity culminated with the signing of the Multilateral Treaty on Free Trade and Central American Economic Integration, followed by the Agreement on the Régime for Central American Integration Industries and Central American Agreement on the Equalization of Import Charges. However, these commitments were later amended by the Treaty of Economic Association and the General Treaty on Central American Economic Integration, signed in 1960.

There were important differences between the original ECLAC approach and the decisions set forth in the Treaty of Economic Association and the General Treaty on Central American Economic Integration, decisions significantly influenced by the attitude of the United States and that country's preference for rapid progress toward a free-trade zone with a common foreign tariff within which the free-market forces would prevail, thus eliminating the elements proposed by ECLAC for the purpose of providing a rationale for the process, namely, planning, reciprocity, the "integration industries"

system and the negotiation procedure for eliminating tariffs.

The contrast between the original ideas and the final decisions has been well documented in the literature on the Central American Common Market (CACM).<sup>1</sup> Less attention has been paid to the dynamic vision of industrialization, formulated by Raúl Prebisch: on the sequence of import substitution, common market, and industrial exports to the rest of

the world; on the role of progressive forms of integration into the world economy; and on his recommendations that trade policy should be managed so as to implement the sequence in a balanced, efficient and rational process of industrialization. Given his current relevance for Central America and on the occasion of this special issue dedicated to him, the ideas of Raúl Prebisch on this matter are examined in the following section.

## II

### The thought of Raúl Prebisch on industrialization and economic integration

#### 1. Industrialization, common market and development

As Prebisch observed: "The urgency of the need for progressive forms of economic integration began to claim attention from the time of the secretariat's very earliest studies, subsequently reasserting itself..." (Prebisch, 1959a: 5). Among those early studies, the *Economic Survey of Latin America, 1949* is outstanding. In it the argument is advanced that the First World War demonstrated the possibilities inherent in industrial development, a lesson later corroborated by the Great Depression and the Second World War, and the "conviction that those possibilities had to be used in order to offset, by means of internal development, the manifest failure of the external incentive which until then had stimulated Latin American economy" (ECLAC, 1951: 4).<sup>2</sup>

The effects of the universal propagation of technology provide the momentum for the centroperephery model which Prebisch used in his analyses. With this model, Prebisch concluded that the deliberate stimulation of industrialization, together

with the development of complementary activities (transport, trade, services), was a policy for the peripheral countries that was necessary for absorbing population growth, while raising productivity and living standards.

Nevertheless, in the analysis he emphasized that the narrowness of regional markets limits efficient industrialization: "[...] as progress is made in this direction, increasingly complex activities, in which the size of the market is a supremely important factor of productivity, will in fact have to be undertaken. Thus, the continued development of production in twenty watertight compartments, as under the present system, will steadily widen the gap between the yield of the new capital investment [...] and the results obtained in the great industrial centres with broader markets at their disposal" (Prebisch, 1959a: 6). For Prebisch "the chief weakness of the industrialization process consists in the fact that it has developed in watertight compartments, within which each country attempts to do the same as the rest, without specialization or reciprocal trade" (Prebisch, 1959a: 18).

From this perspective, he derived the rationale for a common market: a process of efficient industrialization will depend on the continuing and systematic expansion of markets. This, for Prebisch, is precisely the function to be performed by progressive stages of economic integration.<sup>3</sup>

<sup>1</sup> The classic work on the origins of CACM is Cohen (1972). See also Bodenheimer (1974), Guerra-Borges (1988) and Bulmer-Thomas (1989).

<sup>2</sup> Osvaldo Sunkel, for the purpose of refocusing on what, for Prebisch, was a central element in his vision of development (the internal factors of supply and the endogenous industrial and technological dynamic based on the creation and spread of technical progress, overcoming the errors inherent in a definition that would compare "outward" development with "inward" development), has retrieved a concept which manages to break away from traditional confines: a strategy for international access "from within" (Sunkel, 1990).

<sup>3</sup> "In reality, the common market is an expression of the effort to create a new pattern for an inter-regional trade capable of meeting two exacting demands, namely, the requirements of industrialization and the need to lessen the external vulnerability of the Latin American countries" (Prebisch, 1959a: 6).

## 2. *The importance of planning the economic integration process*

Prebisch and ECLAC conceived the common market as a broad, negotiated and rational effort to achieve industrial specialization and reciprocity aimed at attaining the basic objectives of "improving traditional trade in primary products" and "ensuring the rational industrialization of the Latin American countries" (Prebisch, 1959a: 20). The following sections present Prebisch's main recommendations for promoting the integration process.<sup>4</sup>

### a) *The stages, sequence and speed of the process*

A first stage of 10 years is proposed, during which reciprocal trade will be given a strong impetus by means of the following measures: elimination of all non-tariff trade barriers; reduction of the average level of intraregional trade tariffs, maintaining a certain level of uniform protection against the rest of the world; and the development of an effective system of credit and payments. This first stage is understood to be experimental and exploratory. The goal of achieving a common market—the liberalization of trade—is to be dealt with in a second stage of negotiation among Governments, bearing in mind the experience of the first stage. This gradual approach is justified by what we would call today the costs of adjustment, with respect to which Prebisch emphasized as a basic principle that "no solution entailing persistent unemployment of the factors of production would be acceptable" (Prebisch, 1959a: 5).

### b) *The form commitments would take*

Commitments determining quantitative goals for reducing the average level of customs tariffs are recommended, both among common-market member countries and the rest of the world. With respect to the world market: "The final aim would be the establishment of a single external tariff, in order to ensure that all the contracting parties were in a

position to compete on equal terms [...] All such points would have to be dealt with in a series of negotiations, until, with the passage of time, the common market was established in the form of a customs union" (Prebisch, 1959a: 15). As for the liberalization of intraregional trade, the method of drawing up inclusive lists is recommended, i.e., liberalizing trade in the products included in the lists, as opposed to exclusion lists which take free trade as the norm, except for the products on the exclusion lists. Moreover, for the purpose of defining the pace of tariff reduction, ECLAC distinguished diverse categories of products according to their agricultural or industrial nature, the income-elasticity of demand, the potential for import substitution, and the effects of a sudden outbreak of competition.

### c) *Differential treatment for countries in the early stages of development*

In order to reconcile the demands of a common market—more trade and specialization thanks to the liberalization of intraregional trade—with the need for moderately higher levels of protection for less productive countries in the early stages of development, a regime of special concessions is recommended. This would constitute an exception to the most-favoured-nation principle in the sense that the reduction or elimination of tariffs, which a more advanced nation would concede to a country in the early stages of development, would not be extended to the other members of the common market, but only to those in the early stages of development. This exception would not only benefit the less developed economies but would also allow the more advanced nations to go much further in granting them special concessions, if they are not also extended to other advanced countries. This is precisely the principle adopted in the General Agreement on Tariffs and Trade (GATT) during the Tokyo Round of multilateral trade negotiations and it applies to the Caribbean Basin Initiative.<sup>5</sup>

<sup>4</sup>In 1959, Prebisch published his work *El Mercado Común Latinoamericano*. This book brings together, on the one hand, the ideas developed by ECLAC during the period of intense efforts to advise and guide the process of Central American integration beginning in 1951 and, on the other hand, the recommendations of the Working Group organized by the ECLAC secretariat for the purpose of offering suggestions to Governments for the establishing of a Latin American common market.

<sup>5</sup>Differentiated and most favoured treatment, reciprocity and greater developing country participation. See the Decision of 28 November 1979, in GATT (1986).

#### d) *The principle of reciprocity*

The concept of reciprocity refers to the important fact that member-country imports can be financed by their own *additional industrial exports* from the earning of their primary exports. This concept is fundamental to the Prebisch and ECLAC positions on trade policy and can, naturally, be extended, not only to trade within a Latin American common market, but also to integration in any larger trade bloc. Without this principle, trade liberalization policies would not promote industrialization as such, nor the development of associated services.<sup>6</sup>

Prebisch points out that, in practice, the competitive strength of certain countries, in a context of liberalized trade, would make their exports dominant in the market of less competitive countries, and that it is essential for the trade dynamics of the common market (or trade bloc) to prevent this type of situation from provoking restrictive measures. The principle of reciprocity implies that the more competitive countries must take complementary liberalization steps to step up their own industrial imports from relatively less developed and less competitive countries.

Another dimension of reciprocity has to do with the fact that protection has a different meaning in countries specializing in primary products and in the industrial centres. Given that the income-elasticity of demand for industrial imports in the periphery is greater than the income-elasticity of demand for primary products in the centres, a moderate level of protection in the periphery is a way to correct that bias. On the other hand, protection of industrial centres against agricultural and primary imports from the periphery accentuates the bias, tends to retard periphery development and slows the pace of growth of world trade.

<sup>6</sup> At the present time, the technological revolution, the growth of intra-industrial trade in services and activities involving intensive know-how and new patterns in product and marketing/exportation chains require a reinterpretation of reciprocity narrowly defined in terms of industrial product trade balances. Nevertheless, the concept remains valuable because it directs attention directly to foreign-trade structures and their effects on the pattern of development (Antonelli, 1989; Rowthorn and Wells, 1987).

Another inference drawn by Prebisch from the foregoing is that diminished protection in the centres implies elements of reciprocity, because the resulting increase in periphery primary exports will lead to a correlative increase in their imports of industrial products. This occurs even without tariff reduction in periphery countries owing to the greater income-elasticity of their demand for industrial imports. "The traditional form of reciprocity, under which peripheral countries are asked to grant duty concessions similar to those introduced by the centers, does not take into account this implicit element of reciprocity" (Prebisch, 1959b: 264). As import capacity increases in the periphery, reciprocal customs concessions with industrial centres could impair the industrial development possibilities of peripheral countries instead of helping them to achieve higher rates of growth.

Two conclusions must be noted on this issue: a) Prebisch's concept of reciprocity is different from the traditional concept because it explicitly implies a notion of trade balance in the exchanges of industrial products and, therefore, *an argument in favour of promoting industrial exports* in relatively less developed countries; and b) it is clear that the planning suggested by Prebisch to guide the integration process does not involve nationalization, nor market substitution, nor obliging the private sector to fulfil predetermined plans; it does imply, however, the implementation of a trade policy directed towards progressive and strategic international trade competition, based on negotiated and rational efforts to achieve increasingly broader trade relations. This last point is amplified below.

### 3. *Forms of progressive integration and promotion of industrial exports to the rest of the world*

According to Prebisch, the path leading to industrialization which demands permanent and systematic market expansion, requires progressive forms of economic integration. Prebisch noted that this, in turn, required appropriate incentive policies and, specifically, a review of the protectionist tariffs: "*As progress is made in import substitution, modifications will have to be gradually introduced [in customs tariffs] because of the need to give protection to the new substitution industries, although this will not affect whatever reductions of duties it may be possible to establish in respect to industries already in existence*" (Prebisch, 1959a: 8).

In the dynamic scenario constructed by Prebisch, efficient import substitution in a broad common market would serve as a bridge for passing to a stage of mutually beneficial trade in industrial products with the centres: "[...] *the common market by helping to lower costs, might boost certain lines of industrial exports*" (Prebisch, 1959a: 8).<sup>7</sup> Cost reductions would, in turn, justify a reduction of average tariff levels *vis à vis* the rest of the world. This means that the common market offers the opportunity to negotiate reciprocal tariff reductions *vis à vis* the rest of the world as a trade bloc, which would be beneficial for international trade.

Nevertheless, by 1959, Prebisch observed that cost reductions for efficient import substitution had not occurred to a sufficient degree because "*since in many cases protectionist policy, in the shape of very severe import restrictions, if not bans, has been carried too far, the atmosphere of competition in the internal market has become appreciably less intense*". Therefore, "*the return to the customs tariff as an instrument of protection, the lowering of intra-regional duties in some case and their abolition in others would do much to restore the spirit of competition, greatly to the benefit of industrialization policy*: In this new environment, the gradual development of a flow of industrial exports to the rest of the world might be one of the objectives of Latin American trade policy. [...] It is thus possible to imagine reciprocally advantageous patterns of industrial trade which would have a significance very different from that of the traditional exchange of raw materials for manufactured products". Nevertheless, for that "trade policy would have to be readjusted in keeping with the new state of affairs. Otherwise, the Latin American common market would not suffice in itself to foster trade with the great industrial centres" (Prebisch, 1959a: 8-9).<sup>8</sup>

In 1964, Prebisch returned to this issue and argued the following: "Industrialization based on import substitution has certainly been of great assistance in *raising income in those developing countries, but it has done so to a much lesser extent than could have been the case had there been a rational policy judiciously combining import substitution with industrial exports*" (Prebisch, 1964: 21).

<sup>7</sup>This scenario was devised by Paul Krugman in his article on import substitution as export promotion, in Kierzkowski (1984).

<sup>8</sup>With respect to the increase in industrial exports to the rest of the world, Prebisch noted, in 1959, that "this is precisely what is happening to the countries of Western Europe in the market of the United States. What is more, some Asian countries are currently developing textile exports to European countries" (Prebisch, 1959a: 8).

In conclusion, in Prebisch's view, the common market is not an end in itself but rather an instrument for facilitating industrialization and progress towards new forms of integration into the world economy based on international competitiveness and reciprocal trade in industrial products with the centres.

#### 4. Application of the ECLAC model in Central America

A great number of the criticisms levelled against import substitution assume that the ECLAC strategy was tried and failed. However, in the light of the foregoing paragraphs, it is clear that, except for the central element of industrial promotion based on the regional market, the ECLAC model was not followed in Central America.<sup>9</sup>

First, early in the process, the principles of gradual progress and reciprocity proposed by ECLAC to guide and plan the transition towards the creation of a free-trade zone were discarded in favour of a rapid transition based on free trade behind the common foreign tariff. Therefore, the economic upswing which occurred and the cost-and-benefit distribution within the common market were thus determined by only one of the components envisaged by ECLAC in the process: the free market and the private decisions of investors. The other complementary element, which emphasized regional-level production and investment planning in order to face the problem of relatively less developed countries, was lost with this approach.

Secondly, and perhaps more importantly, the Central American Common Market foreign-trade policy in the last three decades also did not follow the strategy proposed by Prebisch and ECLAC: protection was exaggerated; incentives were not reviewed at the appropriate time; the domestic competitive environment dwindled; and industrial exports to the rest of the world were not promoted. In other words, far from being planned and adapted dynamically to new conditions, the structure of incentives remained frozen and relatively static for 25 years.

<sup>9</sup>Various analysts of the Central American integration process have arrived at this conclusion. For example, Eduardo Lizano (1980) notes that there is a domestic policy, followed for years, that has nothing to do with the ECLAC model. Alfredo Guerra-Borges (1988: 19) argues that "the final decisions moved away from the original CEPAL ideas completely". Bulmer-Thomas (1989) notes that the CMCA problems arose more from ineffective policies than from import substitution *per se*.



Thirdly, the domestic market too was not sufficiently enlarged by redistributive, agrarian and other social reform policies, as had been proposed by ECLAC. Finally, the objective that integration would serve as training for competitive participation in world markets was fulfilled to the extent that the current industrial estate and acquired technological skills are precisely the basis for the development of export capacity in the 1990s. However, the crisis of the 1980s destroyed part of that training and learning.

It can be argued that a good number of the problems which marked import substitution in the Central American Common Market framework were not due to the ECLAC model, but rather arose from not following its recommendations. Far from being supplanted by history, the original ideas of Raúl Prebisch on trade policy, ways of efficiently combining economic integration with international competitiveness, the common market and the industrial exports to the rest of the world, are still relevant and can serve as a source of inspiration for reconsidering the development and economic integration strategy under way in Central America.

There are several reasons for moderate optimism as regards Central American development and economic integration in the 1990s.

The first reason is that, in political terms, the progress achieved by Governments in the areas of peace and democracy has strengthened faith in the outcome of dialogue and negotiation and in the determination of those Governments to continue efforts along genuinely Central American lines.<sup>10</sup> Overcoming serious obstacles, the efforts of the 1980s culminated in the Esquipulas I and II meetings, at which, apart from reaffirming their decision to be masters of their own destiny, the Presidents of Central America assumed formal commitments with respect to amnesty, cease-fires, the consolidation of peace, arms limitations, democratization and free elections, civil and political rights, care of displaced persons and refugees, and acceleration of development. Since early 1989, there have been free elections in five countries. There has never been such democratic and political uniformity nor a greater peaceful situation as in the last decade, although the situation is certainly vulnerable in several countries.

<sup>10</sup>Guido Fernández (1989) offers an insider's view of those efforts, particularly of the genesis and development of the Peace Plan of Dr. Oscar Arias, President of Costa Rica, which served as the basis for the Esquipulas I and II agreements.

The second reason for optimism is the decision of Governments to concentrate on development, together with the opportunities arising from radical changes in the international economy. At the meeting held at Montelimar, Nicaragua, on 3 April 1990, the Presidents of Central America reaffirmed the thesis that peace, democracy and development are inseparable and decided that, in view of the progress due to the success of the first two factors, the time had come to concentrate attention and energy on the third, i.e., on development and economic reconstruction, to which end they met again in Guatemala, in June, at an economic summit dedicated exclusively to that issue.<sup>11</sup>

As the Sanford Commission report notes, starting from the Esquipulas II agreement, Central Americans have made an extraordinary effort to coordinate measures and proposals. This process, which includes activities ranging from presidential and vice-presidential meetings to regional caucuses of numerous private associations, reflects enthusiasm for integration and has laid some foundations for institutionalized coordination among Governments (INCEP, 1989). The summit adopted the Central American Plan for Economic Action which includes the following commitments and guidelines, some of which are analysed below:

To establish the new regional payments system and implement the Central American Programme for the Elimination of Trade Barriers, both of which have already been formulated and negotiated and are ready to operate;

To promote a physical infrastructure construction and reconstruction programme which will support trade integration, with a view to comprehensive inward-looking and outward-looking development;

<sup>11</sup>Together with the respective Ministries of Economy, different integration bodies and ECLAC, as Technical Secretariat to the interinstitutional commission, played active roles in preparing for the meeting and formulating the Governments' approach to the issue. See ECLAC (1990b), the document drafted by the Interinstitutional Commission for the Fulfilment of the Decisions of the Central American Isthmus Economic Cooperation Committee, whose members are: the Permanent Secretariat of the General Treaty on Central American Economic Integration (SIECA), the Central American Bank for Economic Integration (BCIE), the Central American Monetary Council (CMCA), the Central American Research Institute for Industry (ICAITI), the Central American Institute of Public Administration (ICAP), the Institute of Nutrition of Central America and Panama (INCAP) and ECLAC.

To tighten regional coordination of external trade, foreign investment and tourism, including coordinated action for joining and participating in GATT;

To promote consensus-building, consultation and participation processes among Governments and various social sectors;

To promote a gradual and selective industrial retrofitting policy at the regional level;

To support the transformation of State enterprises, encouraging broad-based stock ownership and economic democratization;

To set a three-month deadline for formulating a coordinated agricultural policy;

To set a six-month deadline for formulating a regional policy and programme in science and technology which will support the new joint strategy *vis à vis* third markets;

To promote coordination of macroeconomic adjustment processes;

To promote social compensation programmes for economic adjustment;

To establish a consultation and coordination forum on foreign debt.

A third reason for optimism is the willingness and interest of the Central American business sector, increasingly more organized and coordinated, to make progress on the issues included in the Central American Plan for Economic Action and even to move beyond it. At the economic summit, the business sector, regionally participating in the Federation of Central American and Panamanian Private Entities, proposed to the Central American presidents: the creation of a Central American economic community through the adoption of a regional social and economic development strategy; the development of a joint project among the public and productive sectors and regional agencies in order to devise and operate the Central American economic community; and the integration of Panama into that community (Federation of Central American and Panamanian Private Entities, 1990).

The new bases for the integration process emerging from the technical process and the dialogue can be summarized as follows:

*Integration for entry into world markets.* Integration must be reconsidered so as to make it functional for, and complementary to, a strategy

based on international competitiveness and on greater integration of the Central American economies into world markets. Perhaps the most important proposition of the Central American governmental and private sectors, and which was reiterated by them at the economic summit, is economic integration, defined on new bases, that is compatible with and functional for this new strategy. As mentioned earlier, for Prebisch the gradual and negotiated incorporation into increasingly wider commercial relationships is the key to progress. The Prebisch or ECLAC strategy did not conceive the common market as an end in itself but rather as an instrument for facilitating progress towards *new forms of integration into the world economy based on international competitiveness and reciprocal trade in industrial products with the centres.*

It can be argued that, owing precisely to the industrialization achieved by the Central American Common Market, and in spite of all its limitations and the ground lost in the 1980s, in the 1990s Central America may be able to benefit from such greater integration into the industrial centres anticipated by Prebisch. This topic is developed in section IV.

*Global plans versus consensus-building.* All-embracing approaches and comprehensive programmes, with their inherent danger of exaggerated abstraction and grandiosity, must be set aside, together with the lineal models of classic economic integration theory, which proposed successive stages of progress towards increasingly greater integration. This perspective must be replaced by a more versatile rationality and a more pragmatic approach which will take into account the diversity of existing conditions, respect national strategic policies and seek to achieve partial advances, through persistent encouragement, towards consensus-building processes which reveal areas for joint action.<sup>12</sup> Consensus-building, inside and among countries, encompasses a whole style of planning and is the basis for making a regional development programme viable through integration. As ECLAC has noted:

<sup>12</sup> This approach has been proposed by various analysts. See Guerra-Borges (1988), Lizano (1989), ECLAC (1990).

"There would seem to be a need to further improve and consolidate what already exists, move forward where possible [...] and continue to consolidate a network of integration efforts rather than trying to respond to the preconceived notion that commitments must be fulfilled in linear order until a final goal is reached" (ECLAC, 1990a: 158).

*Realistic expectations.* Integration must be seen as a process of support for national strategic policies and domestic efforts, and not the opposite. Several authors have noted that the common-market crisis was more a crisis of expectations than of achievements (Rosenthal, 1983; Lizano, 1989; Fuentes, 1989). Too high hopes were vested in the integration process and it came to be thought of as synonymous with development, when actually integration could not solve problems for which it was not conceived. As a result, the problems of Central American societies and economies led to disenchantment with integration which, in its turn, generated a series of myths and misconceptions about the "evils" of integration: unequal income distribution; persistent concentration of land ownership; penetration by transnational corporations; excessive protectionism; and other phenomena which, as Fuentes has noted, would have occurred to a greater or lesser degree with or without the common market (Fuentes, 1989: 19). The solution to many development problems depends, in the first place, on domestic economic and social policies, which integration and joint action can support but never replace.

Defined in these new terms, integration can be effective for the new development strategy based on international competitiveness and greater integration into world markets, for two sets of fundamental reasons.

*First*, a symbiosis between regional demand and the demand of other markets may be generated to the extent to which trade among common-market countries is significantly reactivated and certain

aspects of macroeconomic policies are brought into harmony. This can occur in various ways: i) for a series of already established import-substitution industries, the regional market would allow for covering a high percentage of fixed production costs and exporting at marginal costs; ii) the regional market may serve as a testing ground for innovations involving products and processes at less cost and risk so that extraregional markets are penetrated at a second stage; iii) the regional market offers greater complementarity and specialization opportunities than individual economies for developing and exploiting comparative advantages; and finally, iv) a wide field looms ahead for joint action to improve regional competitiveness, for example, in joint export schemes, selective investment acquisition, shared use of duty-free zones, improvement of common infrastructure, development and strengthening of regional science and technological policy, development of a regional market for specialized consulting services, coordination of agricultural policies, capital and labour mobility, etc.<sup>13</sup> Some of these actions in support of competitiveness are described in section V.

*Secondly*, joint action gives strategic advantages in negotiations on trade, finance and international cooperation with other countries or economic blocs –advantages that are difficult or impossible to obtain on a basis of individual negotiation. In section IV, the advantages of joint strategies for integration into world markets are analysed.

Beforehand, however, it must be emphasized that a prior condition for advancing toward regional development through integration is the reactivation of intraregional trade in the short term, the prospects for which are reviewed below.

<sup>13</sup> See Rodríguez (ed.) (1990a) and ECLAC (1990a).

### III

## Reactivation of intraregional trade

Reactivation of Central American Common Market trade depends on several basic factors: first, on success in increasing the inflows of foreign currencies; second, on restoring the smooth operation of the system of payments and free convertibility; third, on dismantling or significantly reducing the trade barriers which Central American countries applied in the 1980s. The last two factors form part of the Plan for the Reactivation of Intra-Central American Trade, agreed upon by the Central American and the European Economic Community countries.

#### 1. Increasing the foreign-currency supply

In spite of the degree of industrialization achieved, the region is still specializing very largely in primary products and it is clear that the dynamics of its growth are still rooted in the pace of its primary-export growth (Siri, 1980). A drop in export earnings soon puts pressure on the domestic financial systems, depleting foreign-currency reserves and reducing real demand, imports and intraregional trade.

For this reason, the acquisition of foreign currencies through exports of traditional (bananas, coffee, meat, cotton, sugar) and non-traditional (melons, ornamental plants, papayas, pineapples, etc.) primary products is the key to maintaining the level of intraregional activity and trade within the integrated market, and is also in line with the comparative advantages deriving from the natural resources of the region. In Nicaragua, for example, one of the quickest ways to acquire foreign currencies and provide employment is to restore its capacity to export traditional products. Costa Rica, in spite of the rapid growth of its non-traditional exports in response to the incentives applied for these exports, has implemented a plan to promote banana production aimed at increasing foreign sales from 60 million to 90 million cases and is continuing with the programmes to improve the productivity and quality of its coffee and other products.

The foreign-currency supply will also be greatly helped by daring schemes for reducing the debt burden.<sup>14</sup> Costa Rica recently set a precedent by

<sup>14</sup> On the indebtedness of Central American countries, see Feinberg (1989) and Caballeros (1987).

buying back a large part of its debt with commercial banks under the Brady Plan. One component of the Bush initiative is concerted action in this area. The Central American Plan for Economic Action provides for the establishment of a regional-level consultation and coordination forum to deal with the external debt.

#### 2. New system of payments and settlement of intraregional debts

The Central American Monetary Council (CMCA) and Central American economic authorities have been considering various proposals in this connection.<sup>15</sup> With the technical and financial assistance of the European Economic Community, there are now two basic mechanisms: a new Central American Payment System, beginning operations in October 1990; and a Special Foreign-Currency Fund for relatively less developed countries with chronic intraregional trade deficits (Nicaragua and Honduras).

With the assistance of the United Nations Development Programme (UNDP), the Central American Monetary Council is working on a solution for the problem of old accumulated debts, which the Governments agreed to deal with separately from the new Central American Payment System.

This new system reactivates the Central American Clearing House, but in a new configuration acceptable to all member countries. The system is supplied from two sources of funds: an Intraregional Export Support Fund of 120 million European monetary units provided by the European Economic Community, which will finance part of the foreign-currency requirements per extraregional imported component of the regional enterprises which export to the region; and a network of credit lines among participating central banks. A "quota" is being established for each bank which sets the maximum debit or credit allowed to each member bank. Monthly multilateral clearing balances are financed

<sup>15</sup> These include: the Central American Import Law; the Parallel Mechanism; and the Special Fund for Intra-regional Trade. The description of the Central American System is based on a document of the Central American Monetary Council (1990), the Framework Agreement for the Reactivation of Intra-Central American Trade, and conversations with Carlos Luis Solórzano of the Monetary Council, to whom we are grateful for clarifying this matter.

by creditor banks of the system through "automatic loans". Each monthly clearing period, debt balances are limited to an eighth of the respective bank's quota.

The limit for automatic loans to any one bank is equivalent to that bank's quota. However, before reaching that limit, the bank may apply for a "special loan" from the Monetary Council responsible for administering the system, which involves a detailed analysis of the economic situation of the country concerned, and of its adjustment efforts in relation to its regional trade partners. The special loans, which are also limited to the amount of the quota, are to be used in their entirety to pay off automatic loans so that the bank concerned can continue to operate in the system as before.

The foreign-currency resources of the Central American Payment System are used in exchange operations for national currencies in the following manner: 10% of the payments for exports channelled through this system in each monthly clearing period is deposited payable to the central bank of the exporting country to account of the Intraregional Export Support Fund. Each central bank, on receiving funds from the Support Fund, will proceed to credit the equivalent amount in its national currency to the Central American Payment System. All the holdings generated in this way constitute the Counterpart Fund. Automatic loans are financed chargeable to the network of credit lines, while the special loans are financed chargeable to the Counterpart Fund.

The new Central American Payment System has several advantages: i) it separates the problem of old debts accumulated among countries from the new payment system. The problem of accumulated debts is attacked with another instrument; ii) it manages creditor-debtor relations multilaterally so that each central bank is a debtor or creditor of the System and not of other banks, with the result that the bilateral friction which affected Clearing House operations in the past is avoided; iii) it is supported by a foreign-currency fund, the Intraregional Export Support Fund, which helps countries to cope with the imported component associated with their exports; iv) it programmes the financing of resultant balances and allows for debt rescheduling under a system that permits "suggesting" adjustments to the macro-economic policy for each country in terms of its trade results; v) it promotes exports to the region via specific incentives in the form of foreign-currency availability, to be complemented by the Special Foreign Currencies Fund.

The Special Foreign Currencies Fund, with an initial supply of 30 million European monetary units to assist the relatively less developed countries with chronic intraregional trade deficits, is equipped with a mechanism for strengthening the productive sector, increasing its exports, and thus reinforcing the soundness of the Central American Payment System and encouraging the gradual elimination of trade barriers. It will finance the working capital and the purchase of extraregional inputs for enterprises and activities capable of improving the exportable supply.

### 3. Programme for dismantling trade barriers<sup>16</sup>

This programme, the immediate implementation of which was approved at the economic summit as a preparatory step towards bringing the Central American Payment System into force, includes, *inter alia*, the following commitments together with a defined schedule for implementation:

- A realistic and non-discriminatory exchange rate shall be established between the Central American peso and the respective national currencies.
- Costa Rica, El Salvador and Guatemala undertake to revoke the provision of not selling foreign currencies for imports coming from Nicaragua; and Costa Rica, El Salvador and Honduras undertake to revoke the provision requiring prepayment for exports to Nicaragua.
- In all member countries, the central bank permits of licenses required for imports and exports to and from Central America paid for through the Central American Payment System shall be revoked. Moreover, these transactions shall not be subject to advances or to prior or guarantee deposits.
- The bilateral trade agreements between Honduras and the other countries shall become multilateral by the end of 1992 for the purpose of achieving free trade in accordance with the General Treaty for Central American Economic Integration.
- Quotas and other quantitative controls on products originating in Central America and all import surcharges affecting intrazonal trade shall be abolished and no further controls of this nature shall be established.

<sup>16</sup> See annex 3 of the financing agreement between EEC and Central America, 30 April 1990.

— Finally, there is a series of commitments: to eliminate non-tariff trade barriers relating to transport; to improve physical installations and communication facilities; to simplify frontier-

post formalities; and to coordinate standards, regulations and procedures relating to animal and plant health control.

## IV

### The strategy of economic openness and entry into world markets

The objective of greater Central American economic entry into world markets calls for reflection and strategic decisions on the part of the Central American Governments and private sectors. The international economy is experiencing the most rapid and profound political, economic and technological changes since the Second World War. One aspect of this process is the formation and strengthening of worldwide consumer and producer blocs. The reunification of Germany and the opening up of the countries of Eastern Europe, plus the European Economic Community programme for 1992, are strengthening and expanding the European bloc enormously, giving it new competitive advantages. The 1992 plan alone constitutes an integrated common market of nearly 380 million people. In Asia, a commercial bloc, with Japan and the "small tigers" in the lead, has been taking shape, with a second line of export platforms (China, the Philippines, Thailand, Indonesia, Malaysia), whose competitive advantages have been a source of friction with the United States and Europe.<sup>17</sup>

The challenges presented at the global level by the formation of these economic blocs has prompted the United States to reinforce the economic and strategic ties on its own continent. On the one hand, a North American bloc is being formed by the Free Trade Agreement (Canada-United States), into which the second largest economy of Latin America, Mexico, will be incorporated, according to recent announcements. On the other hand, on 27 June 1990, the United States Government proposed the Enterprise for the Americas, supported by three pillars: trade expansion, increased investment and reduction of the debt burden. As for trade, the latest proposal calls for the formation of a continental free-trade zone, immediately making partial advances to dismantle trade barriers through bilateral and subregional agreements and concerted efforts in

GATT. The text of the Bush initiative states that such far-reaching changes may require years of preparation and difficult negotiations, but that the reward, in terms of mutual prosperity, is well worth the effort (Bush, 1990).

What are the implications of all these changes for Central America and how can they be put to the best advantage? Should every effort be made to consolidate a single Latin American common market or is it more to the advantage of Central America and the Caribbean in the immediate future to redefine the terms of its integration into the North American bloc, now enlarged by Mexico, without prejudice to attractive trade and financial schemes with the rest of Latin America? What is the role of trade and financial relations with the European and Asian blocs? These are some of the most relevant questions today and are the subject of the following commentary.

#### 1. *Adjustments in trade strategy*

In the 1980s, Central American integration into world markets was characterized by individual and unilateral policies of openness and trade liberalization, in some cases under programmes of structural adjustment individually negotiated with international agencies, and by a rather passive group movement towards greater integration into the North American bloc, based on the Caribbean Basin Initiative. It can be argued that both elements constitute a relatively inefficient strategy of integration into the world economy and, at the same time, that Central America would benefit from the following adjustments in its trade strategy: joint negotiation of its economic openness strategy *vis à vis* other trade blocs and within GATT; greater economic integration with the United States and the North American bloc, but within a framework different from that of the Caribbean Basin Initiative.<sup>18</sup>

<sup>17</sup> See Ernst (1989), Gerçifi (1989), Hillecoat and Quenan (1989), "Reshaping Europe", *Business Week*, December 1988.

<sup>18</sup> The Caribbean Basin Initiative has been evaluated by Ray (1987), Tucker (1989), Rodríguez and others (1989) and Salazar and Vargas (1989).

With respect to the first element, it is to be hoped that, in the 1990s, the openness and trade liberalization processes of all Central American economies will continue, since they are part of the new strategy to promote exports adopted by all countries of the region. However, inasmuch as openness is achieved unilaterally, the opportunity to negotiate beneficial trade and financial concessions with the North American bloc would be lost. Mexico, for example, unilaterally liberalized its economy and, by doing so, lost part of the negotiating power it would have had if, instead of liberalizing, it had negotiated concessions from the United States within the framework of the recently announced trade agreement. A similar argument can be made for incorporation into GATT and participation in the Uruguay Round.<sup>19</sup>

Moreover, the diverse evaluations of the commercial repercussions of the Caribbean Basin Initiative coincide in noting how limited this scheme is as an instrument for promoting industrial and agricultural exports from Central America and the Caribbean to the United States. Salazar and Vargas (1988: 219) find that, five years after implementation of the plan, exports to the United States from the countries that signed the Caribbean Area Economic Recovery Act are on the decline. Ray (1987) argues and demonstrates that the Caribbean Basin Initiative is not managing to promote imports of consumer goods and agricultural products of the region, while systematically discouraging imports of textile products. Tucker (1989: 361) concludes that it was hoped that, with the Caribbean Basin Initiative and the consequent collapse of trade barriers, the full economic potential of the region would be realized. He adds that, unfortunately and unsurprisingly, the "unblocking" of trade has produced minimum results.

Motivated in part by these limited results, Stephen Lande and Nellis Crigler (1990) recently presented an innovative proposal consisting in the transformation of the Caribbean Basin Initiative into a fair trade agreement with the United States, which would transform the relation with that country from a donor/recipient relationship into a strategic economic alliance. The following are some further reasons which would justify that strategic decision:

a) Although the recently announced Bush initiative calms the fears of a possibly diminished private and public United States interest in the region, Lande and Crigler detect tendencies in the international economy which may make investing in Central American countries less attractive. The opening up of Eastern Europe poses a threat, to the extent that those countries have wage levels which are competitive with those of Central America, a skilled labour force, a relatively developed industrial base and access to the integrated European market, all of which makes them attractive to investment from the United States, Europe and Japan, thus limiting resources which, in other circumstances, could be invested in Central America. Moreover, as the Sanford Commission has repeated, there is the possibility that, once the hostilities are over, external economic assistance will be suspended and the doors now open to Central American exports will be closed, because the region will then no longer constitute a zone of geopolitical crisis (INCEP, 1989).

b) Secondly, unless the Central American countries together exercise their negotiating power, their region's share in obtaining trade preferences could be reduced by the extension of similar preferences to the countries of Eastern Europe and Mexico, and by other sweeping concessions made in the context of the Uruguay Round. Moreover, this share could be limited by the Bush initiative itself, to the extent that other Latin American countries carrying greater economic and political weight make use of the plan. This shows the importance of carrying out joint negotiations and of establishing mechanisms that will increase Northern bloc and European Economic Community preferential treatment of the Central American region, within the context of the GATT.

To sum up, joint negotiation of trade openness within the framework of an agreement, be it a "fair trade" agreement as Lande and Crigler propose or a variation thereof the context of the Bush Plan, would have several advantages:

- It would allow for coordinating the economic openness processes and achieving, in exchange beneficial concessions for the region, thus improving the preferential treatment of the Central American region with the Northern bloc and, potentially, other economic blocs.
- It would ensure an orderly transition, with frequent consultation of the Central American private sector, which would take increased

<sup>19</sup> See SIECA (1988), De La Ossa (1988) and Lobo (1987).

competitiveness into account when gauging the pace of openness.

- It would avoid the vulnerability and asymmetry of schemes such as the Caribbean Basin Initiative which, while making unilateral concessions, also allow the "donor" to eliminate or modify such preferences unilaterally.
- The foregoing factors would generate greater security in trade and economic relations and a better climate for investment than would be achieved by individual and uncoordinated openness processes.
- It would allow for periodic reviews and renegotiations which would improve the agreement benefits and include other issues such as investment, non-tariff barriers and financial assistance.

## *2. Technology and patterns of global and regional integration*

The tendency towards creating consumer and producer blocs is the result not only of geopolitical but also of economic and technological factors. The current technological revolution, based on information, know-how, flexibility and adaptability, demands a revolution in the forms of organization for extracting the maximum benefit from the new technologies. The impact of this revolution is of such magnitude that it is argued that we live in a period of transition to a new techno-economic and organizational pattern with which new managerial and organizational models are associated and which demands global social changes. There are several interpretations and a full debate about the implications of this new pattern for peripheral countries, their possibilities of closing the technological gap and the way in which they can adapt themselves successfully to the opportunities being created by the rapid comparative and absolute advantages caused by the new technologies (Ernst, 1989; Antonelli, 1989; Pérez, 1988).

The most optimistic outlook<sup>20</sup> suggests, especially for countries which have already achieved a certain level of industrial development and are equipped with a critical mass of skills and knowledge in their labour force, that the new technologies and the period of transition between models open "windows of opportunity" for "skipping over stages" and joining the current industrial revolution even though they missed the previous one.

<sup>20</sup> Antonelli (1989); Pérez and Soete (1988).

Competitiveness in many products and dynamic sectors is increasingly more often based on factors unrelated to price (design, innovation and product differentiation) and demand (quality). At the same time, the traditional factors of supply (economies of scale, mass production and lines of homogeneous goods) are completely redefined in the new model. For example, the scale of factories is, in many cases, independent of market size. It is possible to achieve very high levels of efficiency while manufacturing a wide array of different products, with frequent changes of model and variable volumes. This transforms the factors that determine competitiveness and redefines the barriers to entry, lowering them for many products and processes, which makes the proliferation of highly competitive small and medium-sized businesses possible. Activities which acquire great importance are: "economies of scope" (optimization of the range of products), "economies of place, time and motion" (based on proximity, response speed, integration of design-production-administration phases, "just in time" management of inventories and of delivery, etc.), and "economies of specialization" (based on narrow market segments).

The current transition toward a new techno-economic and organizational model raises two important issues for the strategy of productive transformation and integration of Central America into the world economy.

*First*, optimism with respect to the possibilities of encouraging the spread of technical progress and technological development in Central America is justified. Propagation of the new model throughout the production system requires the conversion and restructuring of the well-established industries in the developed countries as well; established products are redesigned, new products and industries emerge, important parts of the present industrial estate become technically and organizationally obsolete. In other words, the requirements of the technological learning process and industrial retrofitting are felt not only in developing countries but also in developed countries. Pérez and Soete argue that, during transition periods between models, there are two types of conditions conducive to closing the technology gap. First, there is time to learn while all the others are learning; second, given a reasonable level of productive capacity and an advantageous site, together with an adequate supply of human resources skilled in the



new technologies, a temporary window of opportunity is opened, with low barriers to entry where this is most important (Pérez and Soete, 1988: 477).

*Second*, these technological factors influence the formation of economic blocs linking centres and peripheries situated near to each other, and they determine the international competitiveness of regions such as Central America and the Caribbean basin. The main centres of global growth and

innovation will continue to be in the blocs of developed countries; nevertheless, according to the technological outlook suggested here, if Central American internal conditions are sufficient for coordinated trade negotiation efforts to be made and for efforts to be focused on development and integration, greater integration into these blocs—especially the North American bloc—could boost the region's economy and improve its possibilities for growth and development.

## V

### Joint action for the development of international competitiveness and the conversion of productive sectors

Greater integration into the world economy presents not only opportunities but also threats. It is possible to lessen the impact of the transition and to make the most of these opportunities through coordinated action in the public and private sectors to hasten the transformation of productive sectors and encourage international competitiveness and interlinked production. Joint Central American fields of action towards these goals can be grouped into several categories: action to harmonize motivating systems and other market policies; action to use economic integration as a source of competitive advantages through specialization and productive complementarity; action to develop structural competitiveness; and action to promote efficient import substitution and conversion of the industrial base.

#### 1. Harmonized incentives and market policies

The liberalization of intraregional trade can find itself limited or distorted, if active steps are not taken to harmonize incentives, together with passive measures such as dismantling tariff barriers. Active steps are important in the following areas:

##### a) *Non-tariff barriers*

As noted above, the Programme for Dismantling Intra-regional Trade Barriers includes a number of commitments to dismantle non-tariff barriers connected with obstacles to transport; improvement of physical installations; communication facilities and speeding up frontier-post formalities; standardization of rules, regulations and procedures for animal and

plant health control. Fulfilment of these commitments is important for the free movement of merchandise in the region.

##### b) *Export incentives*

Lack of harmony in this area can have a number of negative consequences: countries with fewer incentives will be less attractive for investment; there is the risk of wars incentives to attract more investment; intraregional trade flows may be distorted toward the exploitation of the benefits accruing from the use of those countries offering greater incentives as a base for exporting.

##### c) *Common external tariff*

At the present time, the common external tariff has two problems: uniformity was broken by measures taken by individual countries (e.g., surcharges, duties, excise taxes, duty-free treatments, etc.) and the tariff level is ineffectual because it has not been adjusted to the requirements of export promotion and efficient import substitution. These objectives make it necessary to bring down the common external tariff gradually to a low and uniform level.

#### 2. Mechanisms for exploiting the competitive advantages of specialization and complementarity at the regional level

Gereffi (1990) distinguishes four roles, played by recently industrialized countries in the world economy, which are useful to bear in mind when contemplating the Central American export strategy,

the relations between economic integration and exports, and possible avenues for joint action in the area of exports and the promotion of investment. These are the roles of exporters of primary products; export platforms (foreign-owned, labour-intensive manufactures processed in duty-free zones); international subcontractors (consumer goods, finished on the part of enterprises whose output is distributed and marketed by the main centre and its agencies, the principal niche occupied by the recently industrialized Asian countries); suppliers of components (production of components in the capital-intensive and technology-intensive peripheral industries for subsequent export and final assembly in the central country; a characteristic of this procedure is that it generates a higher degree of technology transfer).<sup>21</sup>

#### a) *Combined exports*

Combined Central American exports can help to generate competitive advantages and production-export-marketing chains in several ways:

i) As regards economies of scale, it could be possible to have available minimum quantities of some products for a large volume of trade that is beyond the reach of a single country; in other cases, a relatively high output could even allow Central American enterprises to adopt dynamic trade strategies, especially in the case of some non-traditional agricultural products for which the countries have similar comparative advantages.

ii) The differences in information, contacts and external trade experience among Central American countries, especially the advantages of those more advanced in the export process, can be put to good use (through fairs, conferences and other information exchanges) for mutual benefit instead of being a source of competition among entrepreneurs in related fields. In the case of many products, the size of overseas markets offers Central American entrepreneurs opportunities to leave their competitive behaviour behind and begin to collaborate.

<sup>21</sup> In the last 15 years, the front-line recently industrialized Asian countries (the Republic of Korea and Taiwan) have been yielding their role as export platforms or processing zones established on the basis of low wages to China, the Philippines, Thailand, Indonesia, Malaysia, and have achieved greater success as international subcontractors and component suppliers.

iii) It is easier to exploit the advantages and benefits of specialization at the regional level than in individual countries. Liberalization of intraregional trade opens up opportunities for subcontracting export schemes at the regional level, either through leading enterprises in each country under new joint export schemes or in conjunction with foreign capital. These schemes are more advantageous than export platforms based in duty free-zones, because they are less vulnerable to changing costs and open the way to production of exportable goods that make intensive use of technology and are very specialized. In other words, economic integration offers competitive advantages to countries which opt to serve as suppliers of components. Separately, those countries would probably tend more to serve as export platforms based on in-bond assembly.

#### b) *Studies, information and follow-up*

A first step toward achieving the above would be to carry out in each country a series of detailed and comparative diagnoses in each subsector for the purpose of identifying, on the one hand, complementarity possibilities and, on the other, the potential leading enterprises which, in each subsector, could make the export grade and coordinate regional subcontracting. Several studies of this kind have already been carried out by the Permanent Secretariat of the General Treaty for Central American Economic Integration (SIECA, 1986). A second step would be to bring the entrepreneurs in branches having the greatest identified potential together in order to discuss possible specific joint export projects and the coordinating mechanisms necessary in each case. The Federation of Central American and Panamanian Private Entities has plans to proceed in this direction (Rodríguez, 1990b).

The data bases of such institutions as CINDE, in Costa Rica, and FUSADES, in El Salvador, are very useful for identifying enterprise networks which could participate in sectoral joint export initiatives in the Central American region. However, the export effort implies creating and coordinating the capacity to compile and transmit information, to follow up and to prepare technical studies in each country.

These information and follow-up systems can also include exchanges for joint ventures, sectoral strategies and cases of industrial restructuring. Availability of the means necessary for exchanging

experiences and information on competitive and retrofitting strategies, at the subsectoral and specific enterprise level, would strengthen these processes in the region.

c) *Flexible specialization and subcontracting at the regional level*

The success of the industrial districts in Italy, formed by networks of small and independent enterprises organized on the basis of an external division of labour among them, is a model which teaches important lessons about production organization and the export potential of Central America as a whole. This model has been very competitive in international markets, offering distinctive and innovative products at low prices. A shared characteristic of these districts is the stability of their social environment: all are linked to areas with long traditions of craftsmanship in specific sectors, together with a solid agricultural base and an array of trade-related activities. All are near middle-sized towns, with good study and training centres, connected by highway networks. Local government assistance in infrastructure has been substantial in some cases: several textile districts have opened centres for design and forecasting fashion trends; in several cases, export consortia have been promoted; in most cases, the leading enterprises determine production standards, control quality and organize the strategic aspects of production, distribution and marketing.

In fact, the strategies for the industrial reorganization of large European and United States enterprises have included the decentralization and subcontracting of products and processes. Industrial subcontracting allows an enterprise to acquire parts or intermediate goods at a lower cost than if it produced them itself, because it avoids investment in space, machinery and equipment, raw materials and working capital. Other benefits include greater quality control and greater flexibility in the light of changes in technology and in the quantities and characteristics of demand.

Useful mechanisms for promoting regional subcontracting in Central America are the subcontracting exchanges. Carlos Martín Alcalá (1990) has analysed some of their operational characteristics, defining them as intermediary entities, generally in the private sector, often linked to an industrialists' trade association. He adds that the Central American

countries are among those which have most need of these subcontracting exchanges, precisely because their industries, for the most part, grew vertically, "doing a bit of everything". These exchanges can be an effective mechanism for retrofitting, contributing to the modernization of networks of small enterprises and exploiting to the full the advantages of flexible specialization at the regional level.

CINDE, in Costa Rica, is developing subcontracting schemes among the leading enterprises in the textile and metal-transforming industries. Rodrigo Ortiz (1990) and Elmer Arias (1990) have stressed the potential advantages of developing Central American complementarity through subcontracting schemes. For example, in the metal-transforming sector El Salvador has a number of processes more developed than in the rest of Central America: basic aluminium and iron industries, metal-extending processes, casting and light forging processes. Costa Rica, in its turn, has advantages in in-bond assembly and precision engineering. A subcontracting exchange for the metal-transforming industry would have information on the types of products and the advantages of each country and would make that facility available to all the other countries of Central America. In this way, as Rodrigo Ortiz (1990) notes, if an entrepreneur arrives in Costa Rica wishing to make telephones, it can import plastic products from Mexico, buy wire in Costa Rica, and El Salvador and Honduras can make their contribution. In those conditions, any telephone manufacturer will be interested in producing them in Costa Rica, instead of going to Taiwan.

The subcontracting schemes for exports or the regional market, to be used by leading enterprises, whether assisted by private institutions such as FUSADES in El Salvador or CINDE in Costa Rica, or developed through subcontracting exchanges, have intraregional free trade as a prerequisite. In this sense, economic integration means progressing towards forms of production, of exportable supply and of products and processes which make intensive use of technology and are very specialized. This is to say that integration offers greater opportunities for surpassing the in-bond assembly stage and exploiting the competitive advantages associated with flexible specialization and the supply of components by Central American enterprises. To the extent that important sectors of small and medium-sized enterprises are made to participate, progress would be made towards greater equity in regional development.

d) *Complementarity and specialization in duty-free zones*

It was recently suggested that the complementary export effort in Central America could be begun more rapidly through duty-free zones. On this point, Ortiz notes that the advantages are obvious because new legislation would not be necessary; no talk of treaties is necessary nor must projects be submitted to the legislative assembly of any Congress; nor are bilateral agreements required; nor would balance of payments arise because payments would not have to pass through the Central American Clearing House. Moreover, employment would rise, which is the goal in these times, foreign investment would increase, as the countries of the region and the region as a whole became more attractive, exports would increase and joint enterprises would emerge (Ortiz, 1990).

e) *Investment promotion*

The goals of international competitiveness, greater coordination of the production apparatus and regional complementarity, together with clarification of the economic functions performed by recently industrialized countries in the integration of the world economy, as described by Gereffi (1989), constitute a solid basis for defining dynamic and selective criteria to guide investment-promoting policies. In this way, it will be possible to arrive at a set of temporarily selective criteria for guiding the productive transformation of each country and the region as a whole.

Rodríguez (1990b) proposed three major centres of specialization for Costa Rica and, more recently, offered them as a working hypothesis at the regional level (Rodríguez, 1990b). The first centre consists of the metal-transforming, electronics and plastics industries. This includes a wide spectrum of products and processes which combine products from the three sectors, contains a high percentage of leading categories in the world market's expansion and offers ample opportunities for complementarity and regional specialization. A second specialization centre consists of farming, agro-industry and the production of inputs and machinery for these two sectors. The third comprises the service sector, especially information science and tourism. Selective investment promotion could encourage coordination of production in these three areas in a regional context. Among other advantages, this would generate competitive advantages within the integrated market more quickly

than could be achieved by any one country alone; it would also surpass the in-bond assembly stage and move on to industries and processes which would make intensive use of know-how, with a greater regional content and a larger transferred-technology component in the investments. In other words, it would mean progress in Central America towards the role of first-line recently industrialized countries.

Rodrigo Ortiz, General Manager of the CINDE Investment Promotion Programme, describes the programme's evolution in Costa Rica and its progress towards this type of criteria, for which they are initiating processes of "complex contracting" and retrofitting (action to transform enterprises into efficient exporters with technical assistance in diverse aspects such as ranging from estimating prices to designing and exporting products), together with activities designed to encourage joint ventures. Ortiz comments that the model (based in the past on the in-bond assembly industry) is fragile because small wage or exchange-rate adjustments may remove a country from international competition, adding that, even though the in-bond assembly industry has been very successful in Costa Rica, other areas are being given priority over textile assembly industries, as the country is seeking for internal and regional integration (Ortiz, 1990: 4).

3. *Mechanisms for developing structural competitiveness*

Competitiveness is the guiding economic concept for the new Central American development strategy, but it is a complex concept which implies action and strategy at three levels: the individual enterprise level; the subsectoral or branch level; and the level of the economy as a whole or of various integrated economies. At the last two levels, competitiveness is greater than the average competitiveness of each enterprise and depends on a number of structural, economic and institutional factors such as scientific and technological capacity; the supply of skilled human resources; the communications and transport infrastructure; and the development of capital markets and the quality of financial intermediation. All these elements give rise to the concept of structural competitiveness and point to the systemic nature of competitiveness. Below, several types of joint action which Central American countries can take in the first and last areas are suggested.

### a) *Science and technology policy*

The systemic character of technological development and of competitiveness, implying interrelationships among very diverse institutions and enterprises, suggests that emphasis for joint efforts in the area of technological policy should be placed on the creation of information networks, contacts and agreements at the regional level in order to promote an intense exchange of information, personnel, goods and services in the technological field, and the development of joint projects. Space does not allow more than a list of suggestions of the kinds of action which can be developed in this area.<sup>22</sup>

- Formal development commitments and harmonization of certain policies related to foreign investment, the development and standardization of technical norms, State purchases, and mid-level and higher education.

- Modernization and standardization of legislation on the protection of industrial property, which can contribute to greater technological integration. For example, simultaneous recognition of patents and brands would eliminate bureaucratic obstacles in the way of enterprises operating at the regional level. The adoption of a common position in the Uruguay Round discussions on intellectual property can be the beginning of a regional task force on these topics.

- The similarities existing among a great variety of agricultural and industrial products and the costs of research and development make the development of joint scientific and technological projects one of the most attractive areas for collaboration. These projects can give priority to such areas as animal and plant health control, quality procedures and norms for exports, biotechnology, information science, etc. State aid and subsidies for research and development are amply justified by economic theory and the experience of developed countries. This effort must include close collaboration among universities, research centres and businesses, together with legal mechanisms for guaranteeing the use and economic appropriation of the know-how generated.

<sup>22</sup> Several points in this section have been taken from ECLAC (1990), chapter VI, where some of them are developed in greater detail.

- Over and above personal contact in seminars and conferences –one of the most effective mechanisms for the development and transfer of technology– obstacles should be removed and the mobility and movements of skilled personnel should be encouraged.

- Application of the powerful, modern information technologies should be promoted at the regional level in order to achieve rapid communication that will link the regional scientific and technological system internally and with the rest of the world. This system ought to include modern methods of technological forecasting.

- A regional market of specialized industrial consulting services in the areas of design, publicity, marketing, finance, engineering, etc., ought to be created and developed through the elimination of national and professional barriers to the transfer of skilled personnel, together with the creation of “contracting exchanges”, registration and selection mechanisms.

- Training in the modern conduct of business and management techniques, both for private entrepreneurs and for the managerial levels of public administration, is one of the main instruments for changing attitudes and inducing the organizational changes required by the new technologies and international competitiveness.

- The technological element is central to programmes of retrofitting which should concentrate the efforts in selected sectors. The development of selective retrofitting policy, directed towards certain sectors common to several countries, ought to integrate the best human and institutional resources of the regional scientific and technological system. Costa Rica has begun a pilot project on technology and information science for retrofitting with external technical and financial support which could serve as a model for similar efforts throughout the region.

### b) *Capital markets and productive investment*

Retrofitting, which in some countries means reconstruction, the development of international competitiveness and increased exports require a steady rate of investment in new generations of equipment, products and infrastructure. One prerequisite for this is the creation of a climate of greater confidence in investment and a coherent and stable macroeconomic framework. Given such conditions, foreign investment and international cooperation could play an important role in financing

the new investments. However, the greater effort in the area of savings and investment should be domestic. Several areas of action are important for achieving this end:

1. The correction of fiscal disequilibria is essential for a stable monetary and exchange policy. Moreover, in terms of monetary policy and financial strategy, certain basic rules should be adopted, such as: a) establishing positive, real interest rates that will avoid distortions in the financial markets, attract more savings and promote "deeper financial analysis". However, care must be taken to ensure that greater linkage of the domestic financial system with international markets does not create instability and does not sacrifice productive sectors by maintaining upwardly distorted interest rates; b) subsidized and selective credit is a necessary instrument in certain sectors and areas, but it is sound policy to ensure that such subsidies are financed by the national budget and not by financial institutions; c) currency exchange control is justified so long as strong fiscal distortions persist (McKinnon and Mathieson, 1982); d) financial strategy ought to promote an institutional framework with a strong dose of long-term financing and improved access for small and medium-sized enterprises which characteristically suffer from segmentation in capital markets (French-Davis, 1990: 30). The most important challenge for Central American financial systems will be to render large segments of the population access to financial services.

Although monetary and fiscal policies are matters within the purview of Governments, regional coordination of macroeconomic policy can help to generalize this type of objective and rules.

2. The objective of promoting exports requires the rapid establishment of quick-acting financing mechanisms for foreign trade which will include working capital, new investments and technical support for export projects. Fitzgerald and Croes (1990) have proposed the creation of a regional fund, supported by an intergovernmental institution, to finance Central American foreign trade. This could be managed by the Central American Economic Integration Bank (BCIE) or become a new specialized financial agency. Seed capital for this fund could come from foreign-debt reconversion operations. Another alternative, in line with the search for greater economic integration into the large trade blocs, could consist in expanding the Bank's capital by incorporating the United States, European, Latin

American or other countries as Bank members,<sup>23</sup> which would strengthen and increase international confidence, in the Bank. Another institutional framework would consist in establishing foreign-trade trust funds in each country of Central America, as is now being done in Costa Rica with the support of the United States Agency for International Development. These schemes are not exclusive. Their implementation requires technical and financial cooperation at the regional and external levels.

3. Retrofitting and the new efficient import-substitution industries, the creation of which will be boosted by revitalizing intraregional trade and lowering common external tariffs, also require financing. As a complement to national credit schemes, a regional retrofitting fund could also be considered, with suitable instalments and interest terms and the flexibility necessary for assisting specific sector and enterprise conversions. The institutional options are similar to those for the foreign-trade fund. For this fund long-term capital and indirect credit schemes for financing networks of small and medium-sized businesses, in support of the subcontracting schemes outlined above, is of particular importance. In this way, the retrofitting fund could function as a "second-floor bank"<sup>24</sup> for credit transacted directly by non-governmental and professional institutions in each country.

4. The process of upgrading capital markets and financing industrial modernization must not be limited to payment and credit mechanisms. It is important to promote, on the one hand, greater integration by developing and strengthening national stock exchanges and, on the other, new sources of savings and financing, by encouraging the development of stock markets. In Central America, there are only two national stock exchanges which deal almost exclusively in fixed-income-bearing securities: that of Guatemala, in operation for only two years, and that of Costa Rica, 12-years-old, with a daily trade volume of about US\$12 million. However, the registered stock of only 40 companies is traded in the latter market and stock transactions account for only 1% of the total transactions. There are informal markets in the other countries and national stock exchanges are being formed in El Salvador and Honduras.

<sup>23</sup> Taiwan recently made a capital contribution as an extraregional member of BCIE and advanced talks are under way with Spain and Germany.

<sup>24</sup> This scheme was proposed by Olaso (1990) and Salaverri (1990) to finance retrofitting in Costa Rica.

The free movement of capital through stock exchanges and stock markets is a long-term objective which, however, opens up a very wide field for joint action, including the upgrading and coordination of tax incentives for opening up the capital of regional enterprises; the creation of institutions specializing in technical and financial services for subscribing to shares; the creation of cash funds to activate the primary and secondary stock markets; legislation to protect minority stockholders properly; legislation to facilitate institutional stock investments (for example, pension funds), and workers' participation in the capital stock of enterprises.<sup>25</sup>

Opening up business capital in Central America is more than can be realistically hoped for in this decade, but rapid capital flows through that channel would be a powerful instrument for economic integration and would contribute to profitable transformation, together with the advantage that it encourages greater fairness to the extent that it facilitates broad-based participation in the capital stock of important regional enterprises. The processes for privatizing public enterprises underway in several countries can be used to promote the development of stock markets and educate the public in this matter.

5. Finally, upgrading and integrating capital markets calls for bringing the framework for regulating financial institutions and sectors at the regional level into alignment, including similar rules for the supervision of loan portfolios, financial statement disclosures, auditing practices; and other mechanisms for achieving transparency at the national and regional levels.

#### *4. Mechanisms for promoting the conversion of the existing industrial base*

In the Central American Plan for Economic Action, the presidents of Central America agreed to promote a policy of gradual and selective retrofitting. Most of the activities for achieving international competitiveness mentioned here imply implementation of a

regional-level retrofitting policy. However, there are strong reasons for adopting subsectoral industrial policies, based on an explicit effort to bring the business, scientific, technological, financial and other supportive governmental and non-governmental institutional efforts together into line with coherent retrofitting or industry-restructuring strategies. The aim would be to develop subsectoral cooperation in selected branches.

It is clear that sectors with one or only a few large enterprises, having substantial foreign-capital participation and strong international technological, financial and market contacts will determine their own retrofitting strategy.

However, it is in the sectors with predominantly domestic capital resources, or which are characterized by a large number of relatively uncoordinated small and medium-sized enterprises, that greater benefits from consensus-building processes and support measures for competitive and restructuring strategies at the subsectoral level will arise. These measures could include all the mechanisms mentioned above such as subcontracting exchanges connecting leading enterprises with the networks of small enterprises, exchanges for co-investment projects, combined exports, mechanisms for market information and follow-up, financial mechanisms for promoting modernization, support for technological activities, etc.

The objectives of this retrofitting approach would be: to facilitate the process of adjusting the different sectors to the new economic conditions; to increase productivity and competitiveness and to generate a system for consensus-building to solve problems and formulate plans and strategies for industrial restructuring.

The essence of the retrofitting approach is to focus attention selectively on the development of subsectoral strategies. The joint and coordinated formulation of subsectoral strategies accelerates the learning pace of participating agencies, improves the decision-making process so as to "manage the complexity" of developing competitiveness and is in itself one of the best mechanisms for the rapid and efficient dissemination of information (Salazar-Xirinachs, 1990; Salazar-Xirinachs and Doryan, 1990).

<sup>25</sup> See CODESA (1989), Salazar-Xirinachs (1990), Rodríguez (1990).

## VI

## Final observations

In spite of the economic and social "disintegration" of Central America in the 1980s and the presence of great political, economic and military obstacles, the Central American Common Market has managed to endure and is on the threshold of an important reactivation.

Recently, big steps towards the consolidation of peace and democracy have been taken. Moreover, the Central American Governments and private sectors are both currently committed to an extraordinary effort to define the areas of cooperation in the economic sector and to move ahead towards development and regional economic integration. This means that, of the three possible scenarios for the 1990s—further disintegration, growth with limited integration, and accelerated development with integration—favourable conditions for the third possibility are being generated.

The present global tendency to form consumer and producer blocs is determined by technological, economic and geopolitical factors. In Central America, it is necessary to begin with an understanding of the international environment in order to make the most of these transformations. Two factors can contribute thereto: greater integration into trade blocs, especially that of North America; and

joint implementation of the openness and trade strategy.

Taking international competitiveness as the guiding economic concept, several forms and mechanisms whereby regional economic integration together with greater mobility in goods, services and factors and specific policies for transforming the productive sectors, can complement and strengthen the strategy for greater openness and insertion into the world economy, have been reviewed in this article. The technological revolution offers opportunities which can be turned to account only through a regional effort in the field of science and technology and the use of mechanisms for exploiting the competitive advantages of specialization and complementarity at the regional level.

The Central American Plan for Economic Action includes various strategic areas for joint action not analysed here but which are of great importance for Central American development and strengthening integration: agricultural policy, the fight against poverty, and strengthening integration institutions. In all these efforts, foreign economic and technical cooperation is essential as an input for the current process of consensus-building and joint policy formulation.

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