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[Alfred Schipke]

How the free trade pact can help foster Central America's economic integration

Regional integration is gaining momentum across the globe. In addition to the well-known integration efforts in Europe, policymakers in Latin America and the Caribbean, Asia, Africa, and the Middle East are considering policies to foster integration and regional coordination. Of course, the scope and rationale for these initiatives differ widely. For smaller countries, such as those in Central America, regional integration is a strategy to maximize economies of scale so that they can participate successfully in a more globalized economy.

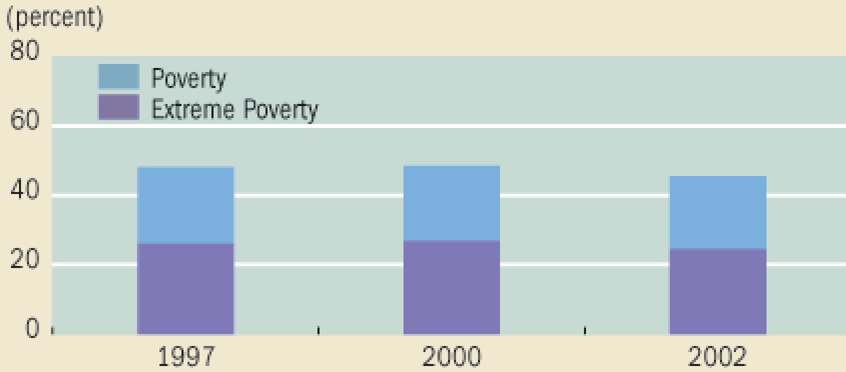
Efforts to foster Central American integration started in the early 1960s. The region appears to be a natural candidate for integration because the countries share many of the same characteristics and enjoy a common history and language. At that time, the objective was to create a common market similar to the European model. But this process was interrupted by a period of armed conflict in parts of Central America.

Renewed political and economic stability from the 1990s onward has not only led to a resumption of economic growth and overall macroeconomic stability but also increased integration efforts both among the Central American economies and between Central America and the United States. Integration is taking place against the backdrop of a broadly shared commitment to economic growth, stability, and reducing poverty. However, poverty is still widespread, with about 50 percent of the population living in poverty or even extreme poverty, except in Costa Rica (see Chart 1). The countries also remain vulnerable to economic shocks, and the political process is still fragile in some countries.

Chart 1

Much to do

Almost half of Central America's population still lives in poverty.[1]



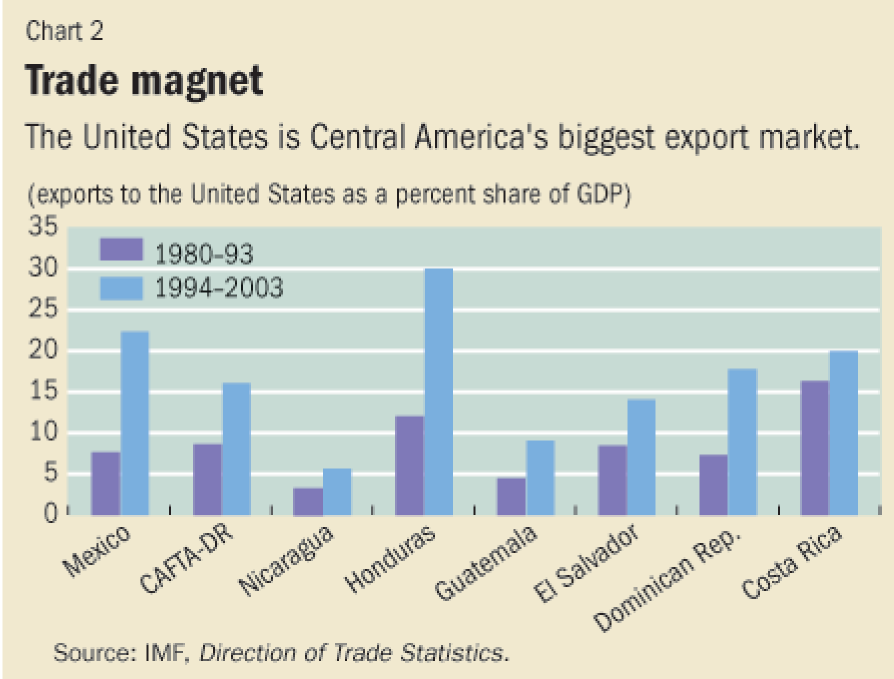
Source: Economic Commission for Latin America and the Caribbean, *Social Panorama of Latin America, 2002–03.*

[1]The poverty rate is defined as the percentage of households whose total income is below the cost of a basket of basic consumption goods, while extreme poverty is based on a consumption basket of basic food items only.

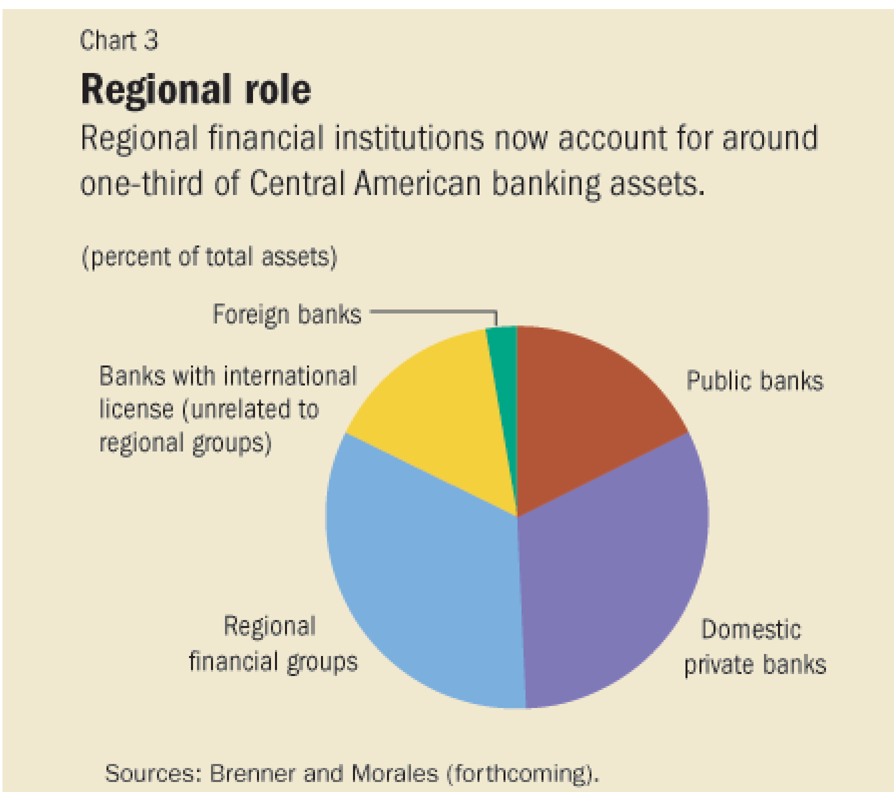
While the implementation of a clear reform agenda is often hampered by fragmented and sometimes highly polarized political landscapes, minority governments, entrenched interest groups, short election cycles, and governance problems, there is a growing consensus in favor of more integration and regional cooperation to ensure that the region takes full advantage of its potential. The implementation of the free trade agreement of Central American countries (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua), the Dominican Republic, and the United States—referred to as CAFTA or CAFTA-DR—is expected to provide an additional boost to Central America's global and regional integration and to serve as an anchor for further economic and institutional development. This article examines the progress to date and where the region is heading.

Progress so far

Central America's integration has been advancing on two fronts. Economic ties with the United States have strengthened over the past decade, especially in trade, with exports to the United States now accounting, on average, for 80 percent of Central America's total exports and 15 percent of GDP (see Chart 2). But strong and growing linkages are not limited to trade. For example, remittances of the large Central American community living in the United States are sizable and have increased rapidly over the past couple of years, amounting to 10–15 percent of GDP in 2004.



At the same time, integration among the Central American economies has also advanced. While intraregional trade continues to be limited—despite the elimination of most taxes on such trade and the establishment of a common external tariff—the region's financial systems have become highly integrated. Local financial institutions that originally focused on the home market are increasingly providing services throughout Central America, and region-based institutions account for 30 percent of total bank assets (see Chart 3). Despite these developments, policy coordination at the regional level is still in its infancy, and the respective countries continue to pursue independent fiscal, monetary, and exchange rate policies.



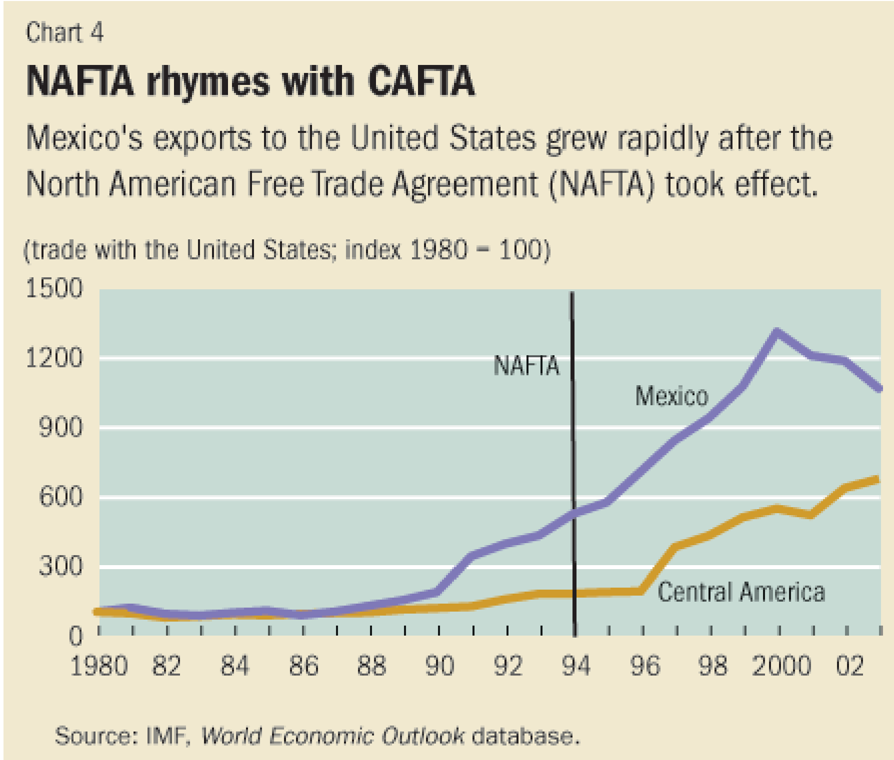
But a number of regional institutions involved in information sharing and the harmonization of regulations are now taking the first steps toward coordinating policies. For example, the Central American Monetary Council provides a forum for the region's central bank presidents to exchange information on monetary policy developments and risks to financial systems. The Central American Council of Financial Sector Superintendents has become a forum for financial sector superintendents searching for ways to reduce the risks associated with cross-border financial transactions, including the sharing of information and the adoption of common financial frameworks.

Other important regional institutions are the Central American Bank for Economic Integration, which finances, among other things, regional infrastructure projects; and the Secretariat for Central American Economic Integration (SIECA), which has played a key coordination role in the negotiations of CAFTA-DR. In the negotiations for the free trade agreement, Central America for the first time negotiated as a group. SIECA is also playing an important role in the negotiations of a free trade agreement with the European Union and in the planned creation of a Central American Customs Union.

How will CAFTA impact integration?

The CAFTA-DR free trade agreement is modeled after similar U.S. free trade agreements with Chile and Singapore, and the United States is currently negotiating similar bilateral agreements with Colombia, Ecuador, Panama, and Peru. Although the region already has preferential access to the U.S. market under the Caribbean Basin Initiative, CAFTA-DR will make this access permanent, providing greater predictability for both domestic and foreign investors. In addition, CAFTA-DR provides enhanced market access to the United States, including reduced local content requirements. And it goes substantially beyond trade to include investment flows, financial and government services, and provisions that will strengthen the institutional framework in the region, including property rights.

Trade agreements similar to CAFTA-DR are relatively recent and, therefore, empirical evidence to analyze the impact of such agreements is scant. Nevertheless, Mexico's experience under the North American Free Trade Agreement (NAFTA) suggests that CAFTA-DR will provide a boost to trade and foreign direct investment flows, which, in turn, should spur economic growth (see Chart 4). Estimates by Hilaire and Yang (2003) suggest that output could increase by 1.5 percent as a result of the agreement. While the impact will vary by country, it could be substantially larger owing to various dynamic effects associated with the accumulation of capital, changes in specialization patterns, and stronger productivity spillovers.



The agreement will solidify regional economic ties with the United States and also foster integration among the Central American economies themselves. Furthermore, the expected impact of CAFTA-DR on trade and financial linkages between Central America and the United States suggests that their business cycles will become more synchronized. This is expected to reduce the overall macroeconomic volatility in the region, given the relative stability of the United States. As Mexico found with NAFTA, CAFTA-DR could further reduce volatility by accelerating the diversification of the export base and by fostering intra-industry and vertical trade linkages with the United States. Faced with more common shocks, the synchronization in business cycles will facilitate the coordination of macroeconomic policies in the region, allow for the adoption of similar policy responses, and contribute to the region's integration efforts. In addition, the adoption of standards that in some cases mirror those in the United States will facilitate the harmonization of standards within the region.

Whether the expected impact of CAFTA-DR will actually materialize, however, depends crucially on whether complementary policies, including measures to foster labor mobility, improve the investment climate, and help address the negative effects that some groups could face during the transition period, are also implemented.

Need for more policy coordination?

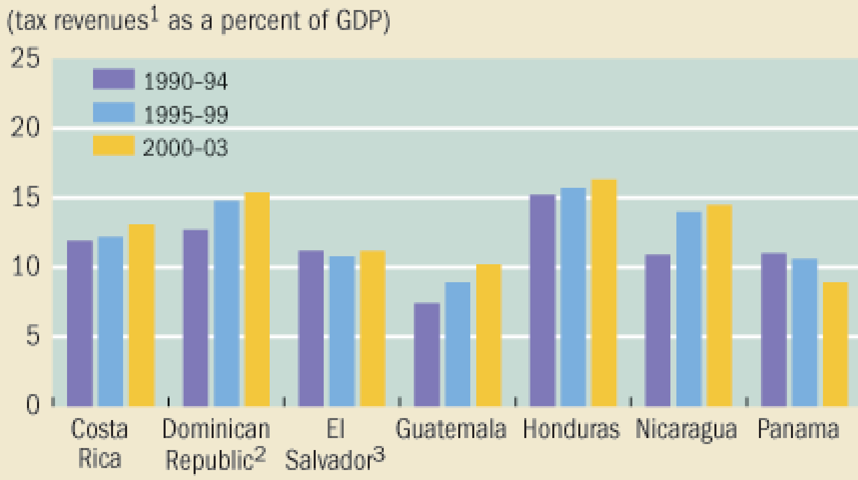
Without appropriate regulation, supervision, and (in certain areas) policy coordination, the benefits of integration could be limited. In the case of Central America, more coordination may be needed in areas such as taxes, the financial sector, and exchange rate policy.

Tax coordination. CAFTA-DR makes the need for tax coordination in Central America more urgent. In the absence of such coordination, harmful tax competition could lead to a "race to the bottom." Countries may lower tax rates or concede unnecessary tax privileges to attract foreign direct investment, eroding the already low revenue-to-GDP ratios, which average 13 percent of GDP (see Chart 5). In particular, the adoption of a "code of conduct" could help avoid a further reduction in corporate tax revenue. With increased regional integration, other areas of tax policy and administration might also benefit from increased coordination, including strengthening the base of corporate profit taxes (beyond streamlining of tax incentives and exemptions) by introducing a coordinated treatment of transfer pricing, concealed profit distribution, accounting standards, and a minimum income tax. There might also be scope for coordinating consumption taxes, including value-added tax, excises, and taxes and subsidies on petroleum derivatives.

Chart 5

Underfunded

Tax revenues in Central America are relatively low, meaning governments must guard against conceding tax privileges to attract foreign investment.



Sources: Country documents; and IMF staff calculations

[1]Excluding social contributions.

[2]Second column refers to 1997–99.

[3]First column refers to 1992–94.

Financial sector. Increased policy coordination and harmonization is also warranted in the financial sector. Financial integration in Central America is a positive development because it improves access to financial services, reduces funding costs, and allows for the diversification of risks across markets. This in turn should help spur economic growth. However, cross-border financial sector integration raises new challenges for regulation and supervision. In particular, there is a need to guard against regulatory arbitrage—that is, efforts by institutions to exploit differences and loopholes in regulations across regions—and the transfer of risks to less supervised areas. For example, differences in capital adequacy ratios could provide incentives for financial institutions to move operations to the country with the weakest prudential requirements.

In addition to the convergence of adequacy ratios, Central America needs a comprehensive framework for effective consolidated supervision of regional conglomerates. Supervisors need to work together in overseeing cross-border institutions and transactions, and the principle of consolidated supervision should be implemented rigorously and consistently across the region.

Exchange rate arrangements. Currently, the exchange rate systems in Central America cover the entire spectrum from official dollarization (El Salvador and Panama) to crawling pegs (Cost Rica, Honduras, and Nicaragua) to independent floats (Guatemala and the Dominican Republic). As the region continues to pursue sound macroeconomic policies, strengthen its institutions, and integrate further, the question arises whether the

Central American economies should reevaluate their long-run exchange rate options. Apart from maintaining the status quo, the region might consider moving toward increased flexibility and inflation targeting, adopting a common currency (either independently floating or pegged), or full dollarization.

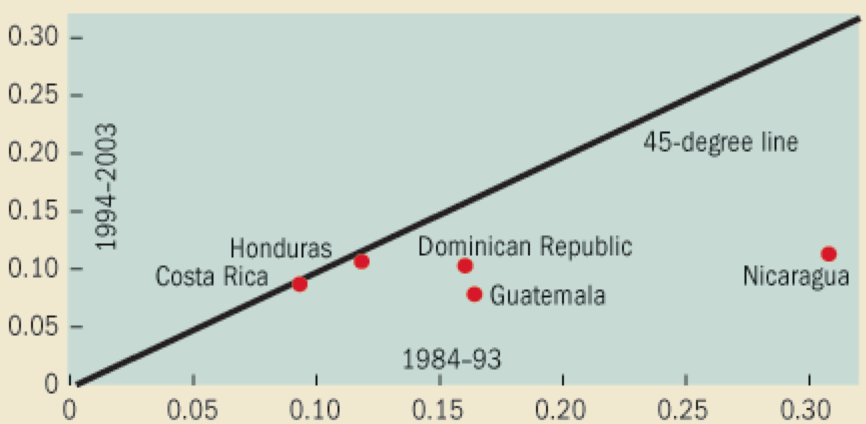
Using an optimal currency area index, which provides a summary measure of the relative suitability of different exchange rate systems, Central America has become more suited for a dollar peg or dollarization, reflecting increased synchronization of business cycles and a reduction in inflation differentials with the United States between 1993 and 2003 (see Chart 6). However, even after taking into account the expected impact of further CAFTA-DR–related integration with the United States, Central America is still less suitable for a common currency than Western Europe was in the 1970s. As the European experience has shown, the choice of a common approach requires full commitment at the political level.

Chart 6

Not ready yet

Despite improved conditions for a common currency,[1] Central America is still less ready for such a step than Western Europe was in the 1970s.

(optimum currency area indices versus the U.S.)



Sources: IMF, *World Economic Outlook; Direction of Trade Statistics;* and IMF staff estimates.

[1]Lower values indicate greater suitability for dollarization. Points below the 45-degree line indicate that the respective country became more suitable for dollarization during the period 1994-2003.

Moving forward

The surge in regional or bilateral trade arrangements is in part a reflection of the slow progress of negotiations at the multilateral level. Completion of the Doha trade round is still the most important vehicle for promoting strong global growth and sustained poverty reduction. However, Central America is well positioned to benefit from further regional integration.

CAFTA-DR is expected to provide a further boost to this integration process, both with respect to the United States and within the region. But to ensure the greatest benefits possible, while minimizing the risks of increased vulnerabilities, the integration process calls for enhanced policy coordination and harmonization, especially in the area of taxes and in the financial sector.

*References:Brenner, Patricia, and Armando Morales (eds.), "Central America: Structural Foundations for Regional Financial Integration" (Washington, International Monetary Fund), forthcoming.Hilaire, Alvin D., and Yongzheng Yang, 2003, "The United States and the New Regionalism/Bilateralism," IMF Working Paper 03/206 (Washington: International Monetary Fund).***Alfred Schipke** is a Senior Economist in the IMF's Western Hemisphere Department. The article draws from Markus Rodlauer and Alfred Schipke (eds.), 2005, "Central America: Global Integration and Regional Coordination," IMF Occasional Paper 243 (Washington, International Monetary Fund).