# *The Central American Integration Process: Emergence and Consolidation of the Economic Union*


*by*

*Claudia Marcela Gazol Moncada*


*Submitted to*
*Central European University*
*Department of Public Policy*

*in partial fulfillment for the degree of Master of Arts in Public Policy*

Supervisor: Professor Uwe Puetter

Budapest 2010

## Table of Contents



## List of Tables and Graphs

# CHAPTER I: INTRODUCTION

Central America is one of the oldest regional integration initiatives, pre-dating even the European Union, and achieving effective union in its early stages during the 19th century. After some interruptions, the process was re-launched in the 1950's and since then the driving force and most successful sphere of the Central American integration process has been the economic one with the creation of the Central American Common Market (CACM), framed within the goal of achieving an Economic Union as one of the central dimensions of the full political-economic Central America Union the region has been pursuing. By the end of the 60's, it was considered 'the underdeveloped world's most successful regional integration effort' (Vilas 1994, p. 319), achieving notable gains and speedy agreements which pushed the economic integration process forward throughout the 70's and mid 80's. Nevertheless, despite its many advances in terms of trade and important steps towards a customs union, half a century after the energetic re-launch of the economic integration process, the progress towards an economic union is limited. On one hand, it has not eliminated the barriers to the free movement of goods, labor and other productive factors (ECLAC 2009, p.9) which characterize a common market, and on the other, it has failed to achieve a basic level of policy coordination and harmonization in macroeconomic, development, fiscal and monetary policy, which are the traits of an economic union. In the case of Central America, a variety of explanations have been advanced as being the ones responsible for the erosion and slowing down the process. Among the most common one is the short-lived 'Football War' between El Salvador and Honduras at the end of the 60's, and the Sandinista revolution and 'Contra' war in Nicaragua during the 80s. The global recession in the 80's and the structural adjustments of the 90's are also alleged culprits (Malamud 2007, p. 7). The existing literature however has failed to explain what fundamental differences existed in the process to make it so successful at first while lagging behind in its current period.

From a theoretical standpoint, the field of integration studies has been a rich ground for research and theorization. However, the overwhelming majority of it has been conducted by American and European scholars based on the experience of Europe (Rosamund 2000, p. 1). As such, these theories are built on a series of assumptions on economic and political structures, as well as actor dynamics which are characteristic of Europe, but which are not always present in developing countries. Moreover, the most important theoretical approaches which have been increasingly sophisticated, tested and revisited, such as the seemingly competing theories of neo-functionalism and liberal inter-governmentalism, continue to pose their analytical lens on the European context. This has happened despite the emergence of regional integration experiences in the 50-60's around the globe and their proliferation during a second regionalism wave at the end of the 80's (Wallis 2002). These experiences in Africa, Asia and Latin-American have usually been considered unsuccessful or limited, and have posed a challenge to scholars seeking to understand their process armed only with the mainstream theories of European origin. The scholarship in the regions themselves has not been particularly forthcoming with original theoretical proposals of its own and has mostly limited itself to the awkward application of the existing integration theories and reaching inconclusive results from a theoretical standpoint: that that particular theory only explains some elements of the study case and stagnation of the process not accounted for by the theory is due to external factors such as war, a crisis, etc (Sanchez 2009; Malamud 2007). Justifying the limitation of the theory on *ad hoc* factors has not given sufficient attention to the possible differences in developing countries in their structural and agency dynamics, which are key assumptions in the theory. The explanatory process advanced by these existing theories can only maintain their logical consistency if based on the same assumptions. Analyzing the differences in other regions and the implications on the process could point in the direction of an adapted explanatory proposal for integration in these cases.

Given these considerations, the question the research will set out to answer is: ***Why has the Central American integration process managed to achieve initial success yet failed to ultimately consolidate the economic union?***

This research aims to make a contribution in two ways. On a primary level, it sets out to explain a particular study case which at its starting point seemed like a successful integration experience but has ultimately failed to achieve the goals the region set out for itself and consolidate the economic union. At a secondary level, it sets out to contribute to the theorization efforts of integration studies for developing countries, particularly among smaller economies, and provide insight on some of the shortcomings of the existing explanatory approaches. To do so, it analyzes two crucial periods in the CA economic integration experience. Firstly, chapter 3 looks at the dynamic phase of integration during 50-70's, particularly focusing on the factors that triggered the process and determined its accelerated pace. Secondly, chapter 4 examines the period from the 80's to the present during which the process has lagged behind the achievement of its goals. Each period has been analyzed through the two competing theoretical approaches of neo-functionalism and liberal inter-governmentalism presented in chapter 2. The aim is to assess their explanatory power for this case, and centering the discussion on the fundamental difference which characterized Central America at the beginning of its economic integration process: the absence of economic interdependence among the countries. Interdependence is the elementary assumption of both existing theories and the lack of this condition crucially alters the explanatory dynamic of the process. The conclusions lay out the theoretical implications and main findings on the study case.

# CHAPTER II: CONCEPTUAL AND THEORETICAL FRAMEWORK

*Integration* is a broad concept that can describe a variety of dynamics ranging from the political to the economic, social, cultural and institutional dimensions. In its most basic meaning, it indicates the combination of parts so that they compose a whole. It has been widely used therefore to refer to a multiplicity of social phenomena, particularly from two main perspectives: integration as an outcome and integration as a process (Munoz Vivas 2001). The object of this research is this specific dimension of *regional economic integration*, and thus the concepts and theoretical approaches that will be examined in detail pertain to this specific type of integration.

## 1. Integration as an Outcome

### 1.1 What is Integration?

Having established the realm of study, the concept of regional economic integration has to be defined more precisely starting with what it is as an outcome at a determined point in time and the degrees on this spectrum of 'integrated' status, ranging from a minimum level of economic integration to full economic integration. This also represents the main components of the dependent variable by which it is possible to determine if integration exists and to what degree it has been consolidated.

#### *a) Free Trade Area*

A free trade area is the minimal degree of economic integration and it is usually the first goal to be pursued by countries within a region seeking economic integration. As the name denotes, a free trade area is limited to commercial activity and consists of removing barriers to trade among the member countries of the region by lowering or completely eliminating mutual trade tariffs and quotas to goods produced within the region. It does not apply to goods produced in third countries and thus limits the free movement of goods. Member countries are autonomous in determining their commercial affairs with non-member countries and determining the level of tariff and quotas with them (Munoz Vivas 2001).

***b) Customs Union***

A Customs Union goes a step further than a Free Trade Zone by including a common external tariff (CET) applied to imported goods from non-members countries, and thereby facilitating the free movement of goods within the region. From another perspective, this requires member states to jointly decide not only the commercial relations with each other but also the commercial relations with the rest of the world economies. It also means that once an imported good has entered the region and been charged the common external tariff it should then be able to move freely within the zone and not be subject to a repeat tariff if it crosses an intra-regional border (Munoz Vivas 2001). This has complex implications for the establishment of a full Customs Union that goes beyond just the existence of a common external tariff. It requires the the establishment of common and harmonized customs procedures for the entry of extra-regional goods, among other things (Bulmer-Thomas 2000, p. 50; SIECA 2009).

***c) Common Market***

Establishing a common market requires additional components from the ones mentioned above and includes the elimination of barriers to the free movement of labor, capital, services and people within the region. To achieve this, member states have to coordinate macroeconomic, social and immigration policy, and articulate to a significant degree fiscal policy, infrastructural planning and other measures which facilitate the interdependent and complementary functioning of production and economies of scale within the region. Moreover, it requires a common strategy for the attraction of foreign direct investment and acting as a single bloc in trading negotiations. The establishment of common policies and regional institutions becomes indispensable, and restricts further the individual and/or unilateral determination of economic and foreign policy by member states (Munoz Vivas 2001; Holden 2003).

***d) Economic Union***

An economic union represents the highest degree of regional economic integration, adding to the common market the adoption of a common currency, and a common fiscal and monetary policy, and requires the full harmonization of economic development policies: agriculture, industrial, labor, transport, social, investment, etc. At this point, it becomes one sole economic space functioning on the basis of supranational decision-making mechanisms, a common monetary entity, and policy coordination and regulatory institutions (Holden 2003; IMF 2005, p. 2).

## 2. Integration as a Process

The field of integration studies has a rich and diverse academic literature seeking to explain and understand the process of regional integration from its many dimensions, although a significantly large proportion of them have focused on the economic aspect of integration. The extensive body of integration theory, whether its emphasis is on economic or other spheres, does not have a single aim and rather spans across the wide range of theorization objectives: why integration emerges, how integration develops and consolidates, what elements constrain or foster it, how should integration be better conducted from a normative perspective, to mention the main ones (Wiener and Diez 2000, p. 17). Given that in the previous section regional economic integration was examined as an outcome and thus from the perspective of the dependent variable under analysis, this section will focus on the theoretical approaches that explain the process of integration.

### 2.1 What triggers Integration?

At the basis of most theoretical approaches to integration, there are a number of assumptions or conditions seen as a given for integration to jumpstart, which are linked to the mechanisms that then explain the 'process' of integration, but which can be distinguished as pre-requisites and motivations for integration to be pursued or to happen spontaneously. Without the presence of at least one of these conditions, integration would have little reason to emerge.

The first of these conditions is linked to *federalism*. Federalism is one of the oldest theoretical approaches to integration, and although it seeks to explain the particular constitutional and institutional frameworks of federalist integration, and the dynamics between previously autonomous units with a new center (process), there is a distinguishing feature that can be considered a trigger mechanism for integration: federalist beliefs. Integration is motivated by an ideal of unity between smaller units within a region based on common identities and purposes, what Moravcsik calls the 'ideological component of integration' (1993, p. 484). In other words, integration can be triggered by ideological motivations and initiated by willful political action to achieve this ideal of a larger union (Wiener and Diez 2009). The process in which political action is carried out is explained from different theoretical lenses, but the ideological motivation triggering it is the element of interest that can be drawn out from federalist theories. However, it is usually a motivation for political integration.

Secondly and perhaps the condition normally considered as a given for most recent theories of integration is that of *economic interdependence*. The notion of 'complex interdependency' was developed in depth by Keohane and Nye (1977), and from the purely economic perspective it emphasizes that a significant degree of structural interdependence between productive segments and sectors among the countries of the region as well as important levels of trade relations have to exist, for cooperation and coordination to be triggered and lead to further integration. The actual process of integration can be explained through the notions of automatic spillover by the neo-functionalist approach (Haas 1958) or through inter-state bargaining based on national preferences proposed by the inter-governmentalist approach (Moravcsik 1993), but the trigger is the already existing levels of economic interdependence and integration is a way of managing these flows of goods, people, factors and functions of production across countries.



In sum, these elements are considered as necessary conditions or motivations which trigger the process of integration, and they are present as underlying assumptions throughout the body of integration theories. Once integration has been jumpstarted, the process through which it develops and consolidates has been addressed through different lenses, a topic the paper now turns to.

## 2.2 How does the Process of Integration unfold?

Describing, explaining and understanding the process of regional integration has been an important concern of the academic community for more than half a century, particularly inspired by the experience of Europe after World War II (Rosamund 2000, p.1). In very broad terms, integration studies were and to extent still are divided into two main camps: neo-functionalism and inter-governmentalism.

The first emerges as the intellectual effort to explain European integration from American scholars based on the notion of functionalism, in vogue during the interwar years. Based on the work of Ernst B. Haas (1958), *neo-functionalism*, just as its theoretical functionalist predecessor, was built on the assumption of an ever-growing level of interdependence and the internationalization of socio-economic problems in industrialized societies, as was mentioned before. Individual states could not address them properly on their own and there was thus a need to solve them on a supra-state level by establishing cooperation mechanism and arrangements. The basic notion is that two or more states will cooperate on a technical, low politics area to integrate a functionally interdependent segment of the economy. The more the states cooperate in this manner more pressure is created for further integration so that the increasing policies commitments can be fulfilled or in other sectors that have somehow been affected by the previous policy (Lindberg 1963, p. 10). This is called functional spillover. At a second stage, the supra-national institutions set up to manage this process gain autonomy and power, and have an interest in further deepening of integration through ‘activist’ policy-making and increasing institutional-building. This activist supranational bureaucracy coupled with the successful problem-solving merits of functional spillover would eventually lead to political spillover, meaning to high politics areas such as policies with welfare implications (Finn 2003, p. 5-6; Rosamund 2000, p. 2). Neo-functionalism thus implies a self-perpetuating dynamic and a progressive deepening of integration. However, with the various interruptions of the EU integration in practice, neo-functionalism came under heavy criticism.

*Inter-governmentalism* emerged as an answer to many of the shortcomings of neo-functionalism but also as a substantively different theoretical lens to regional integration. Inter-governmentalism assumes a rational state behavior, that is, a cost-benefit analysis of integration that will help achieve national preferences. These national preferences are the result of the interaction and pressure among interest groups on the domestic arena and are aggregated by national political institutions. It thus assumes not only the centrality of the state for the integration process (in contrast to the primacy of supra-national bureaucracies of neo-functionalism), but also of the capacity of influence of social domestic forces on the formation of national preferences, meaning organized civil society, economic elites and other issue groups (Moravcsik 1993, p. 483; Finn 2003, p. 12). Liberal inter-governmentalism is also based on the same premises explained above about the existence of increasing levels of economic interdependence, which causes ‘negative externalities’. Given the interconnectedness among countries, the actions of one can have negative impact on the policies of another, creating in this way incentives for states to coordinate policies at the supra-level to diminish these negative externalities on their national goals and preferences. From an economic perspective, trade restrictions and tariffs are negative externalities between two countries with an important flow of goods exchange, and thus liberalizing trade though inter-state agreements removes these restriction. Positive externalities on the other hand produce little or no incentive to cooperate (Moravcsik 1993, p. 485), as the policies on one country produce an unintended positive benefit to another.

Based on the national preferences and the goal to reduce negative externalities, states engage in bargaining among each other to achieve the most beneficial cooperation agreement for each and at the same time make the least concessions possible. Depending on how concrete or diffuse benefits and costs appear, more or less organized societal pressure will be put on the state to pursue or reject a cooperative agreement (Moravcsik 1993, p. 487-488; Finn 2003, p. 13). On the other hand, bargaining will occur according to a dynamic of relative power. The more intense a state desires a particular cooperation agreement, the more concessions it will make, and thus its position is weaker. The states with less intense preferences and the possibility of beneficial alternative agreements will have greater leverage and use the threat of non-agreement in its favor (Moravcsik 1993, p. 515).

## CHAPTER III: EMERGENCE OF THE CA INTEGRATION PROCESS

### 1. Historical Origins

Central America started out in its contemporary political form during colonial times as a single administrative unit called the Captainship of Guatemala, lasting as such for over two hundred years and which comprised today's five Central American countries: Costa Rica, Nicaragua, Honduras, El Salvador and Guatemala.[1] As the loosely defined provinces of the Captainship declared independence from the Spanish crown separately but simultaneously in 1821, they reunited as a Central American Federation soon after independence creating supranational institutions in the three branches of the state: a supreme court, a bi-cameral parliament and an executive presidential system, all under the framework of a Federal Constitution. Both the legislative and executive were directly elected (Rodriguez, p. 104). The region would dissolve and re-establish the federal union six times over the next century in the midst of civil wars, but

[1] These five republics are to date considered the 'political' Central America, given that Panama was a part of the Province and then Republic of Colombia until 1903 and Belize was a British colony until 1981 and is now a constitutional monarchy under Queen Elizabeth II.

the unionist efforts persisted based on the region's historical legacy as a single polity and common identity as the 'Central American nation', an aim which remained expressed and still does in their respective Constitutions (Villalta Vizacarra n/d, p. 4-5; Rodas 1994).

**Table 1. Historical Timeline: Origins of Central American Political Integration**

| Years | Political Unit | Countries |
|---|---|---|
| 1540-1821 | Captainship of Guatemala | Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica |
| 1822-1823 | First Mexican Empire (annexed itself by vote) | Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica |
| 1824-1839 | Federal Republic of Central America | Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica |
| 1842-1844 | Confederation of Central America | El Salvador, Honduras, Nicaragua, Costa Rica |
| 1849-1852 | Confederation of Central America | El Salvador, Honduras, Nicaragua |
| 1896-1898 | Major Republic of Central America (briefly called United States of Central America) | El Salvador, Honduras, Nicaragua |
| 1908-1918 | Court of Central American Justice or Court of Cartago (the first court of international law and first international human rights tribunal in recorded history) | Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica |
| 1920-1922 | Federal Republic of Central America | Guatemala, El Salvador, Honduras |

Sources: SICA 2005; Villalta Vizacarra n/d, p. 5.

## 2. Launch of the economic integration process: 1950-1970s

In 1951 Central America re-launched its integration process, which had been cast aside since the dissolution of the last Federal Republic of Central America in the 20's, and established the Organization of Central American States (ODECA) defining Central America as a political-economic community and setting out the process through which to achieve full integration (Villalta Vizacarra n/d, p. 6; ODECA 1951, p. 1). The goal of the Economic Union was specifically delineated in the ***General Treaty of Central American Economic Integration*** (known as the Managua Treaty) in 1960, which established the Central American Common Market (CACM), the objective of a Customs Union, and created the Permanent Economic

Integration Secretariat and the Central American Bank for Economic Integration. The entire process would be coordinated by the Economic Council born under the ODECA (SICA, 2008, p. 431-36; SIECA 2009).

### 2.1 Revisiting the Assumptions: Economic Interdependence as Trigger of Integration

Looking at the economic structure and trade relations in Central America when the countries set out to create the first common market and customs union in Latin America, it would seem to be contradictory with the central assumption of economic integration theory: that of a pre-existing level of economic interdependence and a significant level of industrialization (Keohane and Nye 1977, Haas 1958, Moravcsik 1993). Industrialization in Central America before the 1950's was virtually inexistent with the exception of non-traded manufactured products, and trade of other goods was insignificant among the Central America countries (Bulmer-Thomas 1998, p. 313). Intra-regional trade before the creation of ODECA and the Managua Treaty amounted to an exiguous 2.8% as a percentage of all intra-regional exports, as can be seen in the table below.

**Table 2. Central American Intra-regional exports 1950-1960**

*in millions US$ (as a percentage of total exports)*

| | 1950 (pre-ODECA) | 1960 (Managua Treaty) |
|---|---|---|
| Costa Rica | 0.3 (0.6) | 2.5 (2.9) |
| El Salvador | 2.2 (3.3) | 12.9 (11.0) |
| Guatemala | 1.3 (1.7) | 5.0 (4.3) |
| Honduras | 4.0 (6.2) | 8.1 (12.9) |
| Nicaragua | 0.5 (2.0) | 2.8 (4.5) |

| | | |
|---|---|---|
| Central America | **8.3 (2.8)** | **31.3 (7.0)** |

Sources: Bulmer-Thomas 1987, Table 13.2, p. 292.

This is explained by the nature of Central American economic structure and its colonial past. From its origins Central America was as many colonies almost exclusively agricultural, especially given the absence of mineral resources of industrial importance. It was throughout its colonial and post-independence history up until the 1950's an agricultural export-led model, of a predominantly monoculture or scarcely diversified production, as can be seen in the table below. Thus, for most part of the 19th century and early 20th century, all 5 countries essentially produced the same two goods: coffee and banana. Beginning in the 1950s, it would add cotton, sugar and meat, always as agro-exports. The countries produced some manufactured goods for local consumption and imported all other goods: industrialized and manufactured consumption goods, building materials, and other foodstuffs. Both the export destination as well as the import purchases had one main market which was the United States, and to a lesser degree England (Bulmer-Thomas 1987, p. 7; Vilas 1994, p.39). Given this situation, there was no reason or complementary logic for intra-regional trade. By 1960, the exports/imports from the CACM to the CACM represented only 1.4% of the region's GDP (Perez Brignoli, p. 368). Moreover, this structural bias towards agriculture limiting intra-regional trade did not seem likely to change through an increase in industrial production given the negligible levels of foreign direct investment channeled to that sector (Vilas 1994, p. 73).



**Table 3. Economic Profile of Central America before CACM**

| | 1950 | 1960 | 1960-1964 | 1960 | 1959 |
|---|---|---|---|---|---|
| **Countries** | **Labor force in Agriculture** | | **5 Main Agricultural Exports**[a] | **Industrial Exports** | **FDI** |
| | *as % of total* | *as % of total* | *as % of total exports* | *as % of total* | *% directed to* |

| | | | | *exports* | *Industry* |
|---|---|---|---|---|---|
| Costa Rica | 58 | 52 | 83 | 5 | 0.8 |
| El Salvador | 68 | 63 | 79 | 6 | 0.2 |
| Guatemala | 69 | 64 | 84 | 3 | 0.8 |
| Honduras | 81 | 71 | 66 | 2 | 6 |
| Nicaragua | 69 | 62 | 68 | 2 | 27.8 |
| Central America | 69 | 62 | 77 | 3.6 | 3.8 |

Note [a]: Coffee, cotton, bananas, sugar, meat.
Sources: Vilas 1994, p.67.

Such deep economic isolation between the Central American nations might seem surprising given its multiple periods as a Federation. However, both during its colonial era as well as its federal phases, the 'union' had been eminently political with a central administration heading the federation, but managed separately from an economic production perspective along the provincial-geographic lines that now form the republics. The geographic characteristics, the low infrastructural investment and the monoculture profile kept the nations physically disconnected. What limited infrastructure was built (railways, ports) was financed with the capital and for the use of the export producing companies. The U.S-owned banana companies (United Fruit and its subsidiaries) and British-capital coffee production built the railways from the plantations to each national port, but disconnected from the small production units[2] of goods for local consumption. This created both a disconnection between the internal subsistence economy and the export sector, but also between each Central American country (Rodriguez 2002, p. 149; Bulmer-Thomas 1987, p. 7), limiting in this way the possibility for the creation of intra-regional economies of scale or economic linkages of importance.



**Table 4. Railways and International Ports in Central America before 1950**

[2] According to the censuses carried out around 1950, they consisted in their majority of less than five employees (Bethell 1990, p. 187).

| Countries | Mileage | Railway and Ports Connections | Capital and Ownership |
|---|---|---|---|
| Costa Rica | 269 | Capital-Ports Limon and Puntarenas | United Fruit Co. and Costa Rican government |
| El Salvador | 300 | Capital-Port Acajutla-Santa Ana (coffee region) | British capital and United Fruit Co. |
| Guatemala | 455 | Capital-Ports Barrios, Champerico, Ocos-Verapaz (coffee region), 1 line to El Salvador | United Fruit Co., German and Guatemalan private capital |
| Honduras | 57 | Southern Honduras-Port Cortez | United Fruit Co. and Standard Fruit |
| Nicaragua | 165 | Capital-Ports Corinto and San Juan del Sur-Leon and Granada (producing regions) | Nicaraguan Government |

Sources: Bulmer-Thomas 1987, p. 6; Manfut 2008.

Moreover, Central America had a very low population density in 1950[3], with a mere 18hab/km² and most countries suffered from labor shortage, leading the countries to frequently import labor force from outside the region (Rodriguez 2002, p. 148). The only exception was high density population El Salvador, which was the only important flow of intra-regional migrants, mostly undocumented labor force, migrating towards Honduras, Guatemala and Nicaragua (Vilas 1994, p. 66; Bulmer-Thomas 1987, p. 12).

In sum, there was a marked structural economic isolation between the countries of Central America with nearly insignificant levels of intra-regional trade of goods, connecting infrastructure, flows of labor migrants, cross-border economies of scale or chains of production of either agricultural or industrial nature, and an overwhelmingly pro-agriculture investment bias which made it unlikely for greater manufacture or industrial diversification to make the economies more complementary between each other. In other words, if anything characterized Central America at the start of its economic integration process it was the absence of interdependence instead of its presence.



[3] The 5 Central American countries had 8 million inhabitants in 1950 living in 423,493 km². That is about the extension of Germany and Austria together with the current population of greater London.

## 2.2. Explaining the process: emergence of economic integration

The absence of the main assumption to trigger economic integration, given that the process of integration is aimed at managing the increasing interdependence among countries of a region, implies not only the need for an alternative explanation as to what can initiate such a process, but also suggests that the dynamic of the process itself is deeply altered.

Firstly, the emergence and initial consolidation process nearly mirrors the opposite logic of **neo-functionalism**. Instead of small technical cooperation among countries in functionally interdependent areas of the economy of two or more countries, leading to increasing and incremental levels of integration spilling over to high politics, the emergence of Central America economic integration ran in what would seem a counterintuitive direction. It departed from a situation of absent economic interdependence and consequently of any relevant technical or other type of cooperation among the states, and was initiated as a decision at the top of the 'high politics' spectrum. It was a politically conscious decision to deeply and radically modify the structure, the model and the economic relations of the region with the goal of achieving an economic union. Integration was not the process through which to manage economic interdependence, but the process through which to create it from the very first step. On the one hand, with the establishment of ODECA and the aim of the economic union in the Managua Treaty, this high politics agreement would then have to be translated from the highest levels all the way down to the technical level, by creating the cooperation links between the public economic bureaucracies of the countries that did not exist before the 1950's (Bethell 1990, p.188). On the other hand, the outcome of the process was aimed at creating economic interdependence through structural modifications of the economy that would render it complementary, and this meant industrialization achievable only via a closed regionalism model.

Given that no relevant levels of intra-regional trade were present and that the bulk of economic production was isolated from each country and even internally, no formal economic cooperation agreements existed between the nations prior to ODECA at technical or even political level (Bethell 1990, p.188). In fact, it was until 1952 that the first ever meeting among economic ministers of CA took place (Rodriguez 2002, p. 162). The reality was that CA integration before this period had been exclusively political, as mentioned in the previous section. Political cooperation and agreements at the highest level (of authority and scope) between the political elites, between ministers of foreign affairs and between presidents persisted throughout its history with the sole aim of reuniting Central America as a political unit. During all the periods when the federation had dissolved, efforts were renewed through pacts, alliances and signed agreements and various times even by military campaign. Moreover, the two main political parties that existed in each country, conservative and liberal, were direct descendants from their regional expression born under the colony and continued under the federation, to which were later added parties such as the Central American Unionist Party (PUCA) founded in 1898. The political parties, particularly the latter two, contained the political union as a central ideal and even the Constitutions of the republics 'included rather dramatic references to the aspiration of union' (Busey 1961, p. 49-50). This led to strong ties and constant cooperation among the political elites within and outside the state apparatus, but always focused on the lofty objective of political union at its maximum expression. This is the 'ideal of unity' contained in federalist theories and is akin to what Moravcsik calls the 'ideological component of integration' (1993, p. 484).

Many authors point out that it was in fact the lack of an economic dimension of the integration process prior the 50's that had lead to the stagnation of the frequent federal pursuits, and it was also a weakness that was identified by the governments of the time (Rodriguez 2002, Bulmer-Thomas 1987, Bethell 1990, Villas 1994). In the meeting of Foreign Ministers of 1951 in San Salvador which would lead to the establishment of ODECA that same year, this concern would change the eminently political approach to integration that had prevailed until then stating that 'only a gradual reduction of economic barriers would eventually create the union which all desired' (Busey 1961, p. 51). The joint statement adopted by the country delegations reflected this explicitly and expressed 'the interest of the governments to develop agricultural and industrial production and the transportation systems of the countries, in a way which promotes integration of the economies and the formation of larger markets, through the exchange of goods, the coordination of development plans and the creation of enterprises that all or some of the countries have interest in' (ECLAC 1951, p. 1).

Given this new awareness and although the preamble charter of ODECA inaugurating the new integration period reflects the historic aspiration and ultimate aim as a political union 'Whereas: The Central American Republics, disjointed parts of a single nation, remain united by indestructible bonds', it then expressly recognized the inadequate procedures of previous reintegration attempts and this time establishes an 'economic-political community' (ODECA 195, p. 1). If the political union was to be achieved, it would have to first reach an economic union, and for an economic union to be established all the inexistent cooperation bridges from the top to the bottom would have to be created. Thus high politics decisions at the political level had pressured and 'spilled over' to high politics at the economic level, and from there the need for it to 'spill down' to the technical levels to implement the process. In other words, it runs in a reverse dynamic than what neo-functionalism proposes. Furthermore, it was a process that was far from automatic and that without strong regional/supra-national entities to foster this top-to-bottom transfer it was unlikely to happen.

If analyzed from the theoretical perspective of **liberal inter-governmentalism,** some of its features can help to elucidate the process by which the economic integration emerged, particularly looking at the issue of: state rational behavior, national preference formation, and interstate bargaining. First, the theory considers the *state a rational actor* that will seek to guarantee the achievement of national preferences. The premise behind this is that by doing so the actors in power will increase their likelihood for reelection and during non-election periods keep the support of most important interest groups and diminish social opposition and conflict. This premise holds only to a point in the case of Central America. During the period of the re-launch of integration through its new economic emphasis, the region was not in a particularly characterized by its democratic status, with regimes that were downright dictatorial or were so-called 'façade democracies' (Vilas 1994, p. 94). Nicaragua was under a dynastic military dictatorship since the 30's; El Salvador had uninterrupted military coronels 'mock elected' as presidents from 1932 to 1979; Guatemala had a succession of military coups and provisional military presidents during those same decades; Honduras had a more mixed experience with a U.S. backed elected president in the early 50's and the beginning of the several military coups during the end of the 50's and 60's, interspaced with elected liberal governments; and Costa Rica, the exception and only case of continuous democratic rule since 1948 when the military was abolished (Vilas 1994, p. 94, 102, 109, 122). In this context, social protest and pressure against unpopular reforms were controlled with repressive means and elections were not a significant concern except in Costa Rica. This however does not necessarily mean that states did not act rationally to pursue national preferences, but rather that the *formation of national preferences* was significantly limited to the political and economic elites that were in power or were part of the power system: a) the landed conservative oligarchy who controlled agricultural production, with or without foreign capital involvement, and favored the maintenance of colonial style institutions, and b) the liberals who controlled commercialization and the nascent manufacture industry, favored modernization and were the historical leaders of Central American 'unionism'. The formation of national preferences was a result of the struggles and concessions between the two fractions, and the enactment of reforms too radical on either side of the spectrum was opposed through military uprising instead of by the democratic process, as was demonstrated specially by the succession of coups in El Salvador, Guatemala and Honduras (Haggarty 1988, Vilas 1994). The Somozas in Nicaragua avoided this by virtue of their iron fist control of the army and by an extensive spoils system shared with the conservatives. Costa Rica's democratic system instead has influenced the more reluctant and slower-paced involvement in the integration process, and is still to date the Central American union skeptic by excellence given its position as the most stable and economically advanced country of the region (Bulmer-Thomas 1998, p. 315). In the other four countries however, to decrease potential opposition the actor in charge of the state would seek to achieve a balance between the interests of the two main groups. Thus, the 'liberal' component of state preference formation and rational state behavior, meaning democratic preference aggregation and a basic form of constraint on the state through elections, was very limited or in many cases absent. It could be said to have followed the same rational dynamic, but just one based more on balance of power than a liberal democratic nature.

This can help explain how the process of economic integration was shaped and why a model of closed regionalism was chosen. Looking at the economic situation of the region, a radical departure from the status quo did not seem the most rational. The region as whole had been growing at an average rate of 5.3% for two decades and at the threshold of the 1950's the prices for Central American products were even improving (Bethell 1990, p. 188). Three elements came into play that shaped national preferences towards this model of closed economic integration. The first was the alignment of liberal governments simultaneously in power across all five countries in 1951 when ODECA was created: the Somocista Liberal party in Nicaragua, the anti-oligarchic progressive alliance of Arbenz in Guatemala, Galvez's reformist National Party in Honduras, the moderately modernizing Revolutionary party of Osorio in El Salvador and the centrist Unity party with Ulate in Costa Rica (Perez Brignoli 1989). Thus, the region had an auspicious setting to pursue the union given the federal ideal that framed the aspirations of this political tendency now in power all across Central America wielding the main preference-setting power through the control of the state and the military. Moreover, this was the political tendency that was increasingly aware and vocal about the need to change the approach towards the union and integrate economically (Granados 1986, p. 4). Secondly, even though the region had maintained a high growth rates it had however felt the impact of the drop in exports during the Great Depression and World War II and realized its excessive dependence on external markets given its export-led growth model. This was more acutely felt by the commercializing sector as they were the ones directly in contact with foreign markets, the economic activity traditionally tied to the liberals who represented in practice and in political ideology the entrepreneurial and modernizing vision of the economy. Thirdly, the rise of a critical perspective of the export-led model and the proposed alternative approach of import substitution industrialization (ISI) which emerged from the influential Economic Commission on Latin America (ECLAC) resonated with the modernization concerns of the ideologically aligned elites in the five Central American countries (Rodriguez 2002, p. 155). The combination of these three elements would give rise to a brand of integration known as 'closed regionalism', which merged both the concerns of industrialization together with economic integration, and would later be promoted and replicated elsewhere in Latin America (e.g the Andean Community) and in sub-Saharan Africa.

On another hand, the central idea behind policy coordination *and inter-state bargaining* of national preferences is to decrease the negative externalities caused by increasing economic interdependence. It is in a way the management of this interdependency. However, this was the missing condition in the Central American case. The basic purpose behind this integration model was thus to foster economic interdependence between the countries by promoting productive diversification through industrialization. The usual way to do it was by applying protectionist trade barriers to imports of foreign industrial goods so national industrial production could be incentivized by protecting it against cheaper external competition. It was a temporary policy until the industry had developed and could compete more equally with other markets. However, industrial production can only be efficient on a certain level of economies of scale and with a market that is capable of absorbing this optimum production amounts. Given the small size of the Central American economies and their scarce population individually, this was not a viable solution (Bulmer-Thomas 1998, p. 1-2). The idea was then to create a larger market by transforming Central America into a single economic space. Only at this level could industrialization be viable. The countries would liberate trade amongst each other thereby expanding the market for goods of Central American origin, and foster national industrial sector by setting a protectionist common external tariff (CET), and coordinate policy to develop the industries.

To achieve these goals, the states had to engage into a bargaining process and shape the newly announced common market and future economic union, according to their preferences and interests. The state with most intense preferences for the speedy advancement of the process of economic integration was El Salvador, the country with less natural resources, more constrained market and the problem of undocumented migrant outflow, as was noted in the first section (Rodriguez 2002, p. 171; Vilas 1994, p. 66). Moreover, El Salvador together with Guatemala had the biggest interest in opening up the other Central American markets to their manufacture-industrial products, as the two countries were responsible for 65% of the region's industrial production in 1950. Honduras and Nicaragua on the other hand were the weakest economies and had the smallest industrial sector, but were thus the most dependent on agricultural production and the most reluctant to liberalize or reduce tariffs on these sectors. Costa Rica had a smaller industrial base than El Salvador and Guatemala but was the strongest economy of the all the countries with a GDP growing at an impressive 7.2% during the 50-60 decade and less willing to concede on any front with such a favorable status quo (Vilas 1994, p. 77). Given however the lack of existing interdependence and thus logically the absence of existing negative externalities brought by interdependence, the process of bargaining had another dynamic: that of negotiating the division of positive yet uncalculated gains of the creation of a whole new industrial sector and avoiding a decrease in the present gains of the till then nationally independent agricultural sectors.

**Table 5. Manufacture Industry in Central America (US$ millions)**

| Countries | 1950 | 1960 |
|---|---|---|
| Costa Rica | 34.3 | 65.8 |
| El Salvador | 66.0 | 112.2 |
| Guatemala | 98.0 | 150.5 |
| Honduras | 29.9 | 53.4 |
| Nicaragua | 25.8 | 50.1 |

Source: Vilas 1994, p.69.

Given that the expansion of markets for industrial products was of most interest to El Salvador and Guatemala, since the rest of the countries could continue purchasing them at lower prices in the extra-regional market, they were the one willing to make more concessions. The bargain made was thus the elimination of all of intra-regional barriers to industrial products and a speedy and automatic increase of a harmonized CET for these same products, in exchange for exclusion of agricultural products from free trade. This protected the interests not only of the other three countries, but also guaranteed the non-opposition of the powerful national landed oligarchies represented by the conservatives. It was from this perspective a rational optimizing cost-benefit solution. The General Treaty of Central American Economic Integration (Managua Treaty) thus did not include agricultural goods, and as soon as it was signed in 1960 74% of all other goods went under intra-regional free trade. By 1966 this ascended to 94%. On the other hand, the harmonization of the CETs was also done is a rapid way, protecting heavily the goods produced more predominantly in El Salvador and Guatemala (consumer goods) while only slighty increasing the rest as they were used in the industrialization process (Bulmer-Thomas 1998, p. 313), as can be seen below.

**Table 6. Nominal Common External Tariff (%)**

| Type of Good | Pre-Union | Union |
|---|---|---|
| Consumer Goods | 64 | 82.5 |
| Raw materials and intermediary goods | 30 | 34.4 |
| Building materials | 30 | 32.2 |
| Capital Goods | 12 | 13 |

Source: Bulmer-Thomas 1998, p. 314

Intra-regional trade soared and increased by nine times in the first decade and continued to grow at remarkable rates in the 1980s as well, as shown on table 7, fueling the emergence of Central American industrial sector. These initial agreements would not be sustainable in the long run for a variety of reasons including the performance of the extra-regional exports, the fiscal costs of tariff elimination and industrial incentives, and the unequal benefits in the growth of the industrial sector given the distortion of the planned industrial distribution (Bulmer-Thomas 1998, p. 315). However, the dynamic of interstate bargaining at the emerging stage of an economic integration process where interdependence does not exist diverges from the inter-governmentalist theory. Given that it is focused not on the negotiation of existing negative externalities, but on the distribution of potential yet unknown future benefits, agreements are likely to be easier and quicker to reach. The lowest common dominator at this point can only be a net gain, as it will always represent the distribution of some new benefit while non-agreement will simply maintain the existing individually productive situation. In the context of the creation of economic interdependence, inter-state bargaining has thus an increased likelihood to push forward the economic integration process in a more accelerated way, as the experience of Central America at its emergence phases seems to suggest.

**Table 7. Central American Intra-regional exports 1950-1980**

*in millions US$ (as a percentage of total exports)*

| | 1950 | 1960 | 1970 | 1980 |
|---|---|---|---|---|
| Costa Rica | 0.3 (0.6) | 2.5 (2.9) | 45.2 (19.8) | 260.1 (26.8) |
| El Salvador | 2.2 (3.3) | 12.9 (11.0) | 73.7 (32.3) | 295.8 (27.6) |
| Guatemala | 1.3 (1.7) | 5.0 (4.3) | 102.3 (35.3) | 440.8 (29.0) |
| Honduras | 4.0 (6.2) | 8.1 (12.9) | 18.0 (10.6) | 91.4 (11.0) |
| Nicaragua | 0.5 (2.0) | 2.8 (4.5) | 46.0 (25.8) | 75.4 (18.2) |
| Central America | **8.3 (2.8)** | **31.3 (7.0)** | **285.2 (26.0)** | **1,163.5 (24.2)** |

Sources: Bulmer-Thomas 1987, Table 13.2, p. 292; ECLAC 1994, Tables 281, 282 and 284.

# CHAPTER IV. CHASING AFTER THE ECONOMIC UNION: 1980'S TO DATE

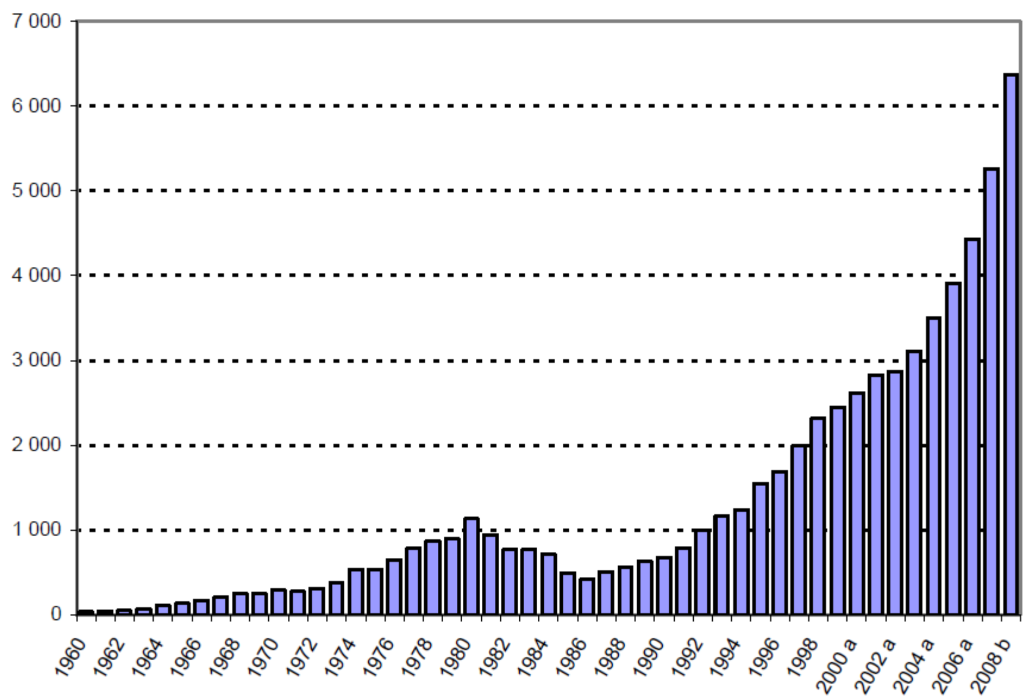
In the early 1990s, the process of Central American integration underwent profound reforms in its legal and institutional framework as well as in the focus of the process. In 1991, the member states signed the Tegucigalpa Protocol reforming ODECA and establishing the System of Central American Integration (SICA). From the economic perspective of integration, the General Treaty of Central American Integration was reformed by the ***Guatemala Protocol*** in 1993 reiterating the goal of reaching an Economic Union in the framework of 'the equitable and sustainable economic and social development of the Central American countries' yet signaled the changing shift in the vision of economic integration by stating 'the efficient and dynamic reinsertion of Central America in the international economy' as its ultimate aim (SIECA 2009a, p. 4), as will be seen throughout this chapter.



## 1. Revisiting the Assumptions: Economic Interdependence

As noted in the previous section, the Central American Common Market (CACM) fostered the growth of intra-regional trade in a decisive way. Trade within the region has kept a positive and accelerated trend since its creation with the exception of the 1981-85 period during which rates fell as internal conflicts spread throughout the region triggered by the Nicaraguan Sandinista Revolution in 1979 and the subsequent rise of other revolutionary leftist movements in El Salvador and Guatemala spurring civil war and armed conflicts. After this brief slowdown, the region has kept increasing its intra-regional trade, as can be seen in the graphic below, at an annual average of 11.8% between 1960 and 2008 (SIECA 2009a, p. 8).

**Graph 1. The Evolution of Intra-regional trade, 1960-2008 (millions of US$)**

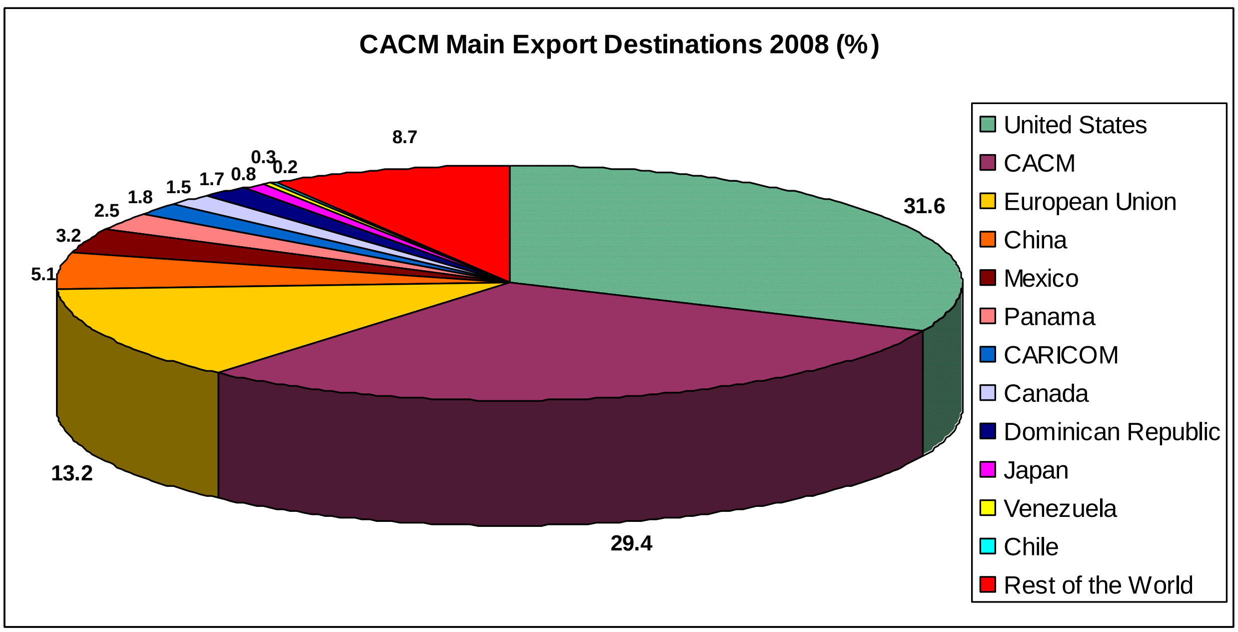



Notes: a Preliminary data; b Estimated data
Source: ECLAC 2009, p. 5

With this growth rate, the CACM has become the second biggest commercial partner of the countries of the region itself going from representing 2.8% in 1950 of intra-regional exports (as a

% of total exports) to 29.4% in 2008. The United States has remained as the number one export destination but just slightly above with 31.6%, while the European Union represents the third destination of importance with 13%.2 (SIECA 2009a, p. 6). From this global perspective, the process of economic integration has created a strong commercial interdependence among the countries of the region, where virtually none existed before the common market. As can be seen, it has also diversified to some extent its export portfolio with the growing importance of the People's Republic of China and Mexico as destination for its products.

**Graph 2.**




Source: SIECA 2009a, p. 6.

The process of economic integration has also modified the structure of the Central American economies as a result of the import substitution industrialization policy, decreasing the importance of agriculture and establishing a small but important industrial base. The importance of exports to the rest of the world from the five main agricultural products decreased from 77%

from the 1960s to just over 24% in 2009, whereas the five main industrial products which once ascended to a mere 3.6% now represent 19%. When examining GDP, the industrial sector almost doubles that of the agricultural sector, amounting to 21 and 11.2% respectively out of the total GDP. Other sectors such as tourism and services have become important contributors to the regional GDP. However, when looking at the economically active population (EAP), it still indicates a high concentration in the rural sector of almost 40% (SIECA/DGTI 2008, p. 1-2). This suggests that despite the smaller contribution of agriculture to the regional GDP, the high rural EAP is a reflection of the large auto-consumption subsistence agricultural activity.

**Table 8. Economic Profile of Central America - 50 Years of CACM**

| 2010 | 2009 | | 2007 | |
|---|---|---|---|---|
| **Rural Economically Active Pop.** [a] (as % of total EAP) | **5 Main Agricultural Exports** [b] *(as % of all exports)* | **5 Main Industrial Exports** [b] *(as % of all exports)* | **Agricultural GDP** *(as % of total GDP)* | **Industrial GDP** *(as % of total GDP)* |
| 39.49 | 24.2 | 19 | 11.2 | 21 |

Notes: a Based on population estimates and projections. b Exports to the world (excludes intra-regional exports)
Sources: SIECA 2008, p. 1-2; SIECA 2009b, p. 6; ECLAC 2009, p. 10, 12.

From a population and migration perspective, Central America today has an estimated population of 40 million inhabitants (SIECA 2008, pg. 1), with important intra-regional migration and Nicaragua replacing El Salvador as the main migrant 'exporter' mostly towards Costa Rica. According to the 2000 census, Costa Rica had 300,000 Central American migrants 75% of which were Nicaraguan (ILO 2006, p. 91), posing a significant problem as a large proportion is composed of undocumented workers despite Costa Rica's stringent migration laws and controls (EC 2007, p. 6).

Lastly, considerable developments have been made in regional infrastructure. Although the railroads have mostly been disabled, the regional transport network for vehicular circulation has been developed over the decades, in part financed by the Central American Bank for Economic Integration, foreign cooperation loans and donations and national budget resources of each country. In 2001, the regional network linking the maritime ports, international airports, border crossings and main centers of production and consumption of goods and services across the five countries ascended 10,289 km of roads (SIECA 2001, R-2). Despite that 36% of the network presents inadequate conditions, the development of the regional road network has been both a planned expansion in function of economic integration as well as a reaction to increasing commercial traffic across the region (SIECA 2001, R-3) and facilitating the flow of people and tourism, and a greater connectivity in general.

**Table 9. Central American Regional Road Network 2001**

| Countries | Longitude (Kms) |
|---|---|
| Costa Rica | 1,793 |
| El Salvador | 1,279 |
| Guatemala | 3,350 |
| Honduras | 1,985 |
| Nicaragua | 1,882 |
| **Central America** | **10,289** |

Source: SIECA 2001, p. B-2



## 2. Explaining Integration: the consolidation of the process

As seen above, the CACM established in 1960 had a fundamental impact on the economic structure of the region. However, its goal of creating economic interdependence was achieved only in a distorted, unequal manner among Central American countries by concentrating the negative externalities only on some of the countries of the region and thus creating disincentives for deeper integration. This specific form of interdependence has shaped the process of integration and limited the consolidation of the economic union until today.

Using again the analytical lens of **liberal inter-governmentalism**, there are some aspects of which are not included in the theory given the European context where it emerged but that is of fundamental relevance for certain developing regions: the strong influence of a preference-shaping foreign power(s). Within Europe, the large states such as France and Germany are sometimes seen as having enough leverage to shape the outcomes of the process (Hoffmann 1966, 1982), but these are powers from within the region itself and it is part of the inter-state bargaining dynamic. As a single EU bloc, its policies are undoubtedly shaped to an extent by the international context and 'take into consideration' the positions and policies of international power-players such as the U.S and China. Nevertheless, being a power-player itself the EU determines the course of its integration process autonomously and European policy is not modified by external impositions. External policy intervention is however a constant feature in certain regions of the world where integration efforts have been undertaken (Grindle and Thomas, 1991), such as Central America, the Caribbean Community and Sub-Saharan Africa to name a few. The range of instruments to interfere in policy formation in these countries has ranged from direct military intervention, economic sanctions and less coercive contemporary forms of policy 'transfer' such as financial aid conditionalities (Dolowitz and March, 2000, p. 9). These are not ad hoc or contextual events, but an established policy intervention practice resulting from historical colonial ties, geo-strategic motivations, economic interests and lately development cooperation.

As seen in the previous chapter, the economic integration process which established the basic components of a customs union (the elimination of intra-regional tariffs and the creation of a common external tariff) had been the results of *inter-state bargaining* among the countries of the region. However, the complementary elements needed to transform it into a common market and ultimately an economic union underwent a series of extra-regional policy interferences that distorted the logic of the integration model and the future consolidation of the process. The centerpiece of the common market was the Central American industrialization policy needed to create economic interdependence and make the integration scheme work. The original objective outlined in the ***Central American Industries of Integration Regime Agreement*** was to create 'integration industries' in a planned and equitable way, given especially the fact that despite some differences in the embryonic manufacture industries across the countries they were not drastic disparities and could be easily balanced and then fostered equally in all member states (Rodriguez 2002, p. 178).

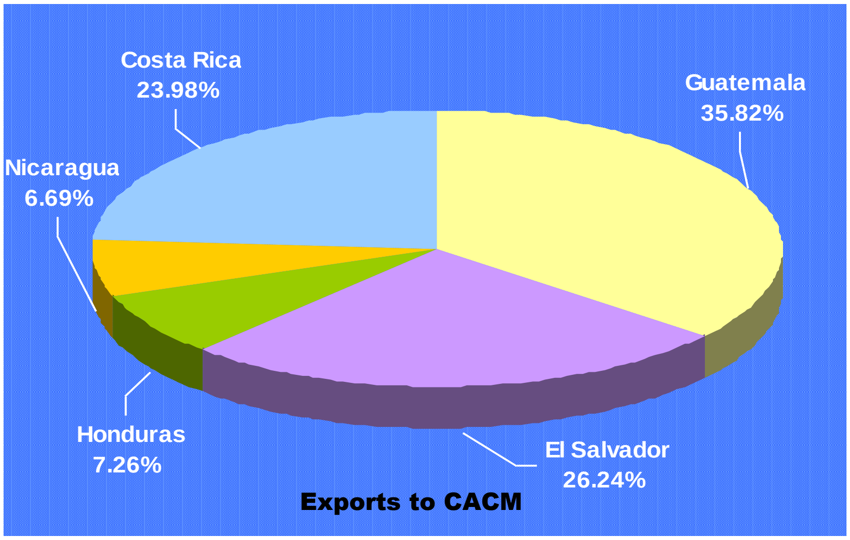
In this context, a series of studies were conducted based the competitive advantage of each country, the market demand for the goods and the sizes required for each 'integration industry' plant to achieve efficient economies of scale. The integration industry would receive a ten year protection regime through an agreed, progressively decreasing CET, would enjoy the intra-regional free trade regime, and be liable to Central American capital participation while limiting foreign capital. The decisions of 'adjudication' of each industry had to be agreed upon by all five member states at the Economic Council, and to prevent non decision-making, the Regime Agreement included a clause of equity and reciprocity which prevented the adjudication of a second industrial plant to a country until all the remaining four countries had received one (Rodriguez 2002, p. 179, Rodas 1994, p. 182). This was in line with the negotiation of future positive benefits dynamic that characterized the emergence phase of integration and was searching to create interdependence in a planned manner to distribute the benefits as agreed.

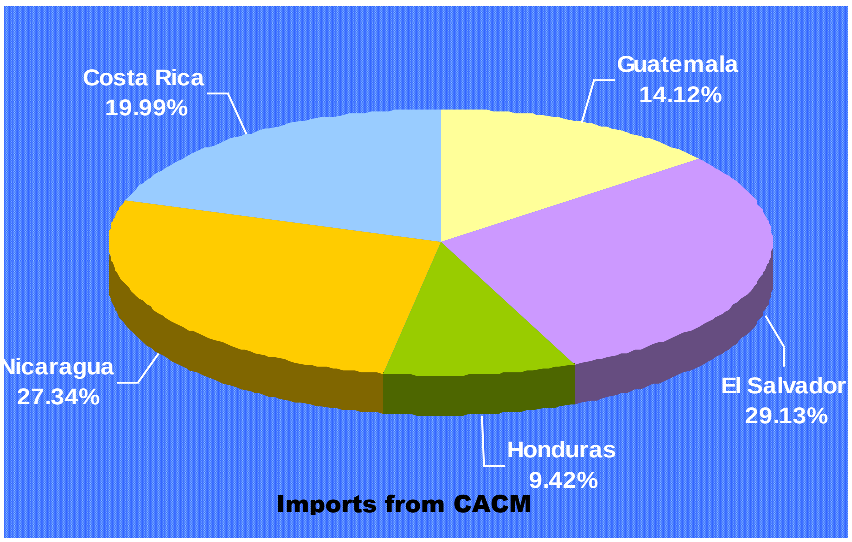
However, because of its high protectionist tariffs on external consumer industrial goods, mostly imported from the United States, this integration scheme was a threat to American commercial interest in the region as it closed off the market to its products. A delegation from the State Department was sent to put pressure on the governments to change to a low external tariffs regime, but as this was not likely to happen given the conviction on the need to industrialize, the pressures were concentrated on Guatemala and El Salvador which had the most to gain given their larger industrial sectors. The proposal was then to: a) eliminate the integration industries planning mechanism established by the Regime Agreement leaving it up to market forces to decide, and b) to eliminate the limitations to foreign capital investment in the new industries. In exchange, the U.S. government offered the governments 100 million dollars to support the rest of the integration process. Guatemala and El Salvador took the deal and together put their collective bargaining weight on the rest of the governments to agree (Gordon Rapoport 1989, p. 40-41; Rodriguez 2002, p. 185). The latter who were also under pressure to keep their access to the American market for their agricultural exports finally gave in and thus the common industrial policy was significantly changed from its original purposes. The result was the exacerbation of differences between the Central American countries as capital, 75% of which was unsurprisingly North American, flowed to the two already more industrialized economies of Guatemala and El

Salvador to take advantage of the favorable protectionist and fiscal incentives of the common market (Gordon Rapoport 1989, p. 44, Perez Brignoli 1983, p. 374).

This external interference on the formation of national and regional preferences had dramatic effects of the type of structural interdependence that was created among the countries. The aim of the planned industrial policy had been even more crucial given the type of free trade agreement which had been at the basis of the common market. By excluding agricultural products from intra-regional free trade, the viability of the model of integration depended on the reciprocity that would be created by a planned industrial development. The trade-off that is created with a closed integration and a high CET is that cheap imports are replaced by much more expensive (as industries are still not optimally efficient) regional products. If all countries develop a manufacture or industrial base, the higher expenditure of intra-regional imports can be maintained by the selling of equally expensive exports to another country in the region. With the concentration of industries in Guatemala and El Salvador and to a lesser degree in Costa Rica (Gordon Rapoport 1989, p. 44), Nicaragua and Honduras remained limited to the export of primary goods outside the region and constrained to buy more expensive consumer goods from their regional partners. Without including agricultural products in the regional market scheme, these countries could not raise their income by exploiting their agricultural comparative advantages and sell to the rest of Central America so they could finance the higher import bill. Thus, these two countries became net importers of expensive regional industrialized goods and a structural trade deficit was created between them and the rest of the countries (Bulmer-Thomas 1998, p. 315). El Salvador roughly managed to balance both its imports and exports while Guatemala and Costa Rica became net exporters, as can be seen below. The external intervention on policy preference formation had set off the creation of a structurally unequal interdependence and shifted most of the negative externalities on two countries and the benefits on the other three.

**Graph 3. Structure of Trade of the Central American Common Market 1980**



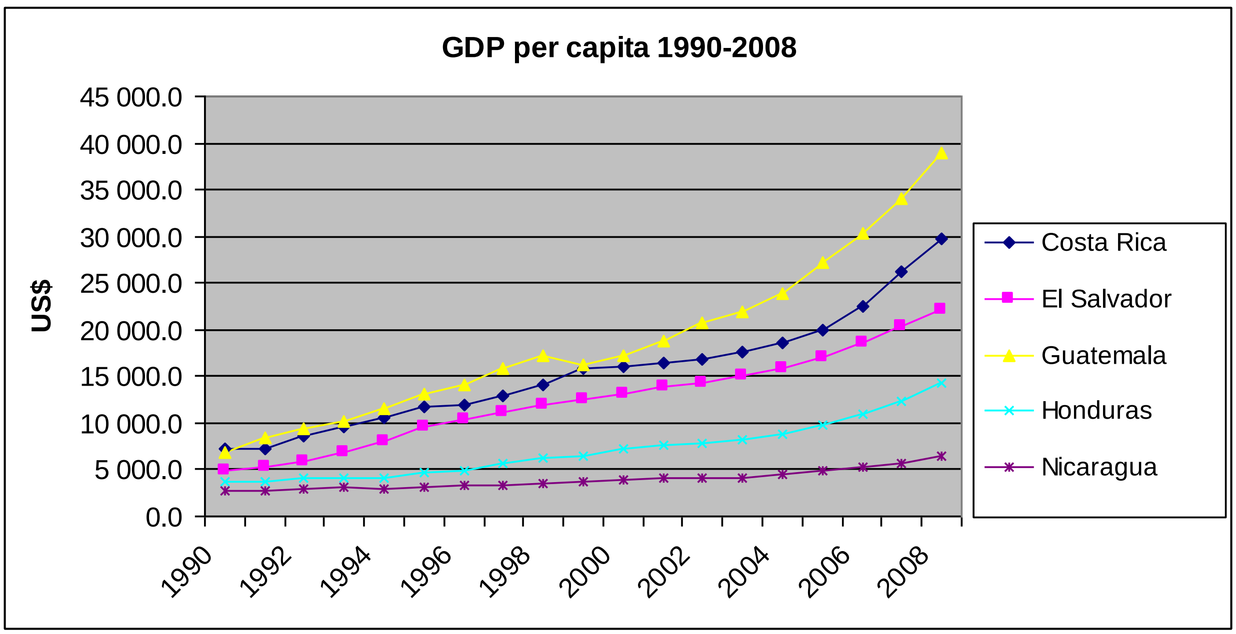

Source: SIECA-DGTI Database 2010a.

In this context, the process entered a stagnation phase with Honduras' dissatisfaction given the lack of benefits and Nicaragua's internal conflicts in the 80's which produced a slow down of intra-regional trade for a short number of years (Bulmer-Thomas 1998, p. 315). The renewal of the integration framework at the beginning of the 90's gave an opportunity to address the skewed interdependence which had been previously created. Nevertheless, external influence on the formation of national and regional preferences would yet again play a fundamental role and limit this possibility.

To correct and distribute more evenly the gains from regional integration, the states bargained to include agricultural products into the renewed intra-regional free trade regime. However, during the slowdown period of the 80's fundamental changes had come about in the economic paradigm dominating western thought, abandoning Keynesian style planned economics to the supremacy of the neo-liberal free market philosophy (Harvey 2005, Hazlitt 1995). For developing countries, this was a turning point in most developmental efforts and economic policy, as it was the beginning of the Washington Consensus embraced by the international financial institutions (World Bank and IMF) which promoted the doctrine of trade liberalization as conditionality for loans and debt relief. The gradual reduction of external tariffs was a condition for the IMF program, on which were dependant loans from the World Bank and non-refundable cooperation resources as most donors made their disbursements conditional on an approved IMF program (Acevedo 2008). The presidents thus signed the Guatemala Protocol in 1993 by including the agricultural sector to guarantee the adhesion of all the countries, but plied to the demands of lowering all external tariffs according to a fixed timetable until it reached 0% for capital and intermediary goods, and 15% for consumer goods (Bulmer-Thomas 1998, p. 317).

Central America had gone from closed to an open regionalism model in conditions that would deepen the structural distortions created in the first phase of integration. By including agricultural trade, Honduras and Nicaragua could have potentially increased their consumption capacity for their partners' industrial goods and re-activate their own industrial policies under a protectionist scheme. With the lowering of the external tariff however they were put under the competition with extra-regional competition, at a point where even the more developed industries of the other three countries were not fully ready to compete with (Rodriguez 2002, Bulmer-Thomas 1998). This then limited the possibilities of Honduras and Nicaragua to converge upwardly in the development of their industries with the rest of Central America, but also limited the possibilities of Costa Rica, Guatemala and El Salvador to expand their exports in the common market given the restricted absorption capacity of low income Nicaragua and Honduras, as can be seen below in the GDP per capita trends of the last two decades.

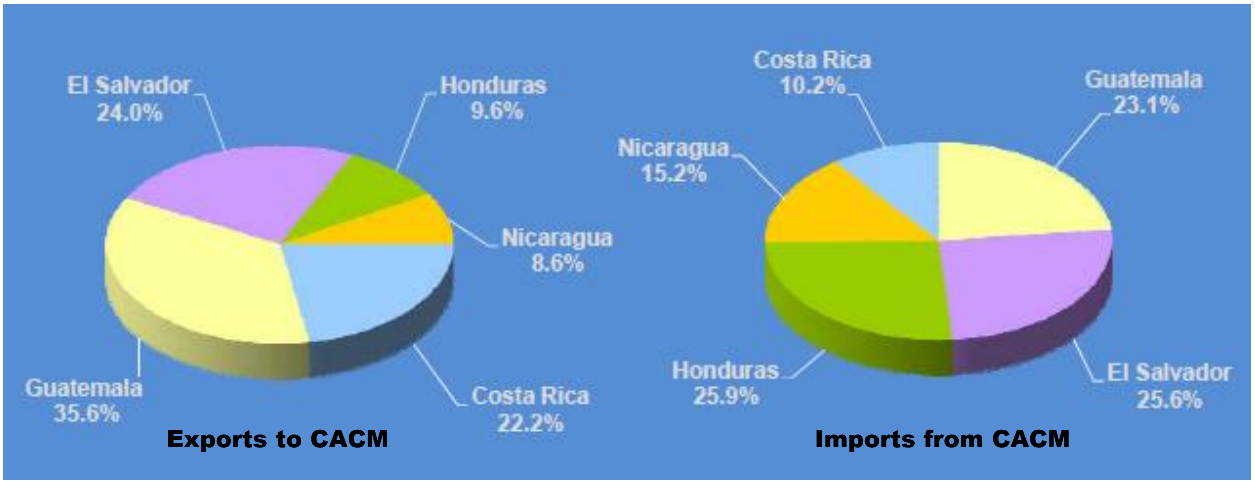
**Graph 4.**




Source: ECLAC-CEPALSTAT 2009.

Two decades later, this structural trade deficit has persisted for Nicaragua and Honduras, while Guatemala and Costa Rica continue as the net exporters and El Salvador in a balanced position, as is shown on the second graph.

**Graph 5. Structure of Trade of the Central American Common Market 2009**




Source: SIECA-DGTI 2010b, p. 5.

This scenario has resulted in the search for additional markets outside of the region with the signing of a number of bilateral free trade agreements (FTA) by each country with extra-regional partners in an effort to maintain their national economic growth rates. Despite the importance of intra-regional trade, which as was shown in the previous section represents nearly 30%, 70% of trade is still concentrated in the rest of the world (ECLAC 2009, p. 5). The main factor guiding foreign trade policy of each member state is then still extra-regional trade, leaving the concerns of regional integration on a second plane. Furthermore, the over-lapping trade regimes created by the multiple FTA's of each country, often time with better terms of trade than the ones offered to the regional partners or granting 0% tariffs to products that have an agreed regional common external tariff (CET), has made the task of harmonizing CET's an extremely complex challenge. Although there has been an exhaustive effort to harmonize the CET for 96% of products, the FTA's have created parallel tariff regimes at the national level causing confusion on which to apply for the free circulation of goods and services within the region and thus limiting the consolidation of the customs union (ECLAC 2009, p. 21).

**Table 10. Bilateral and Multilateral Free Trade Agreements signed by Central American**

<table>
<tr><th></th><th>Bilateral FTAs</th><th>Multi-lateral FTAs</th></tr>
<tr><td>Costa Rica</td><td>Mexico 1995, Canada 2001, Dominican Republic 2002, Chile 2002, CARICOM 2005, Panama 2008. In negotiation with China and Singapore.</td><td rowspan="5">Central America-U.S. (2004-2005); In negotiation Central America-CARICOM, Central America-EU.</td></tr>
<tr><td>El Salvador</td><td>Mexico 2001, Dominican Republic 2001, Chile 2002, Panama 2003, China-Taiwan 2008</td></tr>
<tr><td>Guatemala</td><td>Mexico 2001, Dominican Republic 2001, Panama 2009, China-Taiwan 2006</td></tr>
<tr><td>Honduras</td><td>Mexico 2001, Dominican Republic 2001, China-Taiwan 2008, Panama 2009,</td></tr>
<tr><td>Nicaragua</td><td>Mexico 1998, Dominican Republic 2002, China-Taiwan 2008, Panama 2009</td></tr>
</table>

Source: ECLAC 2009a, p. 20; SIECA 2009, p. 20-22.

This dynamic created by the external interference on the formation of national and regional preferences at critical moments of the economic integration process has exacerbated the structural difference among the economies of Central America and fostered a process of divergence and competition more than convergence and coordination, especially on commercial and industrial policy, and quite markedly in fiscal policy as the countries compete for the attraction of FDI (ECLAC 2009, p. 19).

In other areas of more technical nature and which are similar to the ‘emergence phase’ given that negotiation is focused on the distribution of net future benefits instead of the negotiation of negative externalities, the process has advanced with more celerity. By using in this case the theoretical framework of **neo-functionalism**, the dynamic can be understood although it has run in an exactly opposite logic to that of functionalism. An example of this have been all processes related to the administrative aspects of the customs union where important advances have been made, among which the adoption of the Unique Customs Procedure Manual; the strengthening of peripheral customs; the creation of a Central American Customs and Taxes Training School for customs personnel; the implementation of the normative on the free mobility of Central

American citizens[4] (except in Costa Rica); and the harmonization of sanitary, health and safety measures and registries (SIECA 2009b, 2-4; SICA 2009). This work has been mostly carried out by the sector specific technical committees at the regional level (e.g. Customs Committee; Food and Beverage, Medical Supplies, and Agricultural Inputs Working Groups), and function as purely inter-governmental bodies. These are constituted by the Directors of Internal Revenues, the heads of Customs and Revenue administration, technical directors of food health and safety, among others, instead of creating expert-staffed regional bureaucracies (SIECA 2009b, p. 3-4). This feature has in fact allowed their direct implementation at country level and decreasing transposition problems from the regional to the national level. This however is the result of the top-down nature that integration has had in Central America, as all these technical regulation agreements only take place after a decision at the ministerial level has been taken through the Council of Economic Integration Ministers. In simple terms, economic interdependence did not create eventually the need for a customs union and its linked regulations, but rather the original political goal of creating a customs union has then triggered a ‘spill down’ to the technical level. The progress has led to the approval of the Framework Agreement of the Customs Union in 2007 by the governments of the region (El Economista, 2007, InfoAgro, 2004; SIECA 2009b). However, even with the advances in lower politics decisions the full customs union will only be consolidated if the burdensome task of harmonizing all tariff regimes resulting from the free trade agreements with CET’s is achieved.

The same reverse logic has applied to other areas crucial to the consolidation of the common market, such as the coordination of infrastructural policy. From the original goals of the 1960 Managua Treaty creating the common market, the coordination and creation of a regional

[4] Without the need of visas or passports, and vehicle plates/registration harmonization.

transport infrastructure policy to foster integration was enounced (ECLAC 1951, p. 1). From this political agreement, the spill down has happened similarly to that of the administrative customs union regulations. The Council of Transport Ministers has operated with this end goal from its creation and set up the technical groups headed by the Directors of Planning of each ministry to develop into technical instruments the directives agreed by the Council of Transport. Here again the involvement of the directly responsible has lead to the quick and efficient implementation at the country level. Results have been moderately productive with the uniformization of transit signs, technical regulations for the construction and transport of passengers on regional roads, improvement of border crossing infrastructure, and the transport infrastructure development policy which has allowed for the significant expansion of the regional road network described in the first section of this chapter (SIECA 2001, R-2). Agreements, particularly the ones restricted to road infrastructure construction to connect the countries, have also been facilitated not only because of the initial political end-goal, the direct involvement of national implementation agents in the regional coordinating mechanisms, but also because it is a net benefit creating area. All countries benefit from the connection to the rest of the countries' markets, and in this case they negotiate to distribute implementation costs and efforts for this increased future gain, as opposed to negotiating restrictions or decreases of negative externalities where vested interests clearly exist.

In sum, political agreements on the high level on more technical, positive benefits areas has allowed for greater progress on the complementary issues of the customs union and the common market such as customs administration and transport infrastructural policy. Political agreements have spilled down to the technical levels through inter-governmental regional bodies, using the involvement of the direct implementing agents at the national level to adopt the measures in a more efficient manner.

## CHAPTER V. CONCLUSIONS

The Central American economic integration case provides a series of insights relevant to both explaining the early successes and later slow down of one the oldest integrationist projects, and also at advancing some elements of adaption to the existing integration theoretical approaches used for the analysis of integration in developing regions.

Firstly, the main trigger for integration in the 1950's was the persistence of federalist ideals given the historical formation of Central America as a single political-administrative unit since its colonial past. This had led political leaders and elites to continually seek the re-establishment of the political union. Given the past failures and a growing awareness on the necessity to include the economic dimension for it to work, the goal of the economic union was established by the five republics in 1950. The central assumption behind economic integration was missing however, that of an existing economic interdependence, and thus the core aim of the process was to create it. From the perspective of neo-functionalist theory, it is the cooperation at the technical level to manage this interdependence that creates incremental spillover from the technical to the political realm. Due to the absence of interdependence, no cooperation links among the public economic bureaucracies or even economic authorities existed prior to 1950. Rather, the decision to jumpstart economic integration was a result of a 'high politics' decision at the political level, and the dynamic was one of 'spill down' of high politics towards the technical levels to achieve its implementation. In other words, it runs in a reverse dynamic than what neo-functionalism proposes. This is an important element to consider when thinking about other regional integration efforts in developing countries which presented similar initial conditions.

Secondly, from a liberal inter-governmentalist lens the emergence of economic integration in the absence of interdependence acquires an interestingly distinct dynamic. In the Central American case, the trigger of the process was the alignment of pro-Union political parties across the countries, but the preferences which shaped the adoption of an industrializing closed regionalism process was the result of the rational balance of power bargaining between the commercializing class represented by the liberals in power and the conservative landed oligarchy. More importantly, in the absence of existing negative externalities brought by existing interdependence, the process of bargaining had another dynamic: that of negotiating the division of positive yet uncalculated gains of the creation of a whole new industrial sector and avoiding a decrease in the present gains of the until then nationally independent agricultural sectors. Thus, the decision and measures to establish the common market by setting protectionist external tariffs and liberating intra-regional trade, excluding all agricultural products, was swift and efficient, producing an early trade boom and industrialization process in the region.

Thirdly, an element that is not considered by inter-governmentalism but which is common a feature in developing countries, including in Central America, is the presence of a preference-shaping foreign power. A series of external preference imposing interventions from the U.S. and international financial institutions distorted the inter-state bargaining process and changed the planned industrialization policy based on reciprocity and equity to market mechanisms. This resulted in the exacerbation of small initial differences in the industrial bases of the countries and created structural trade deficits for Nicaragua and Honduras, as industrial forming capital was directed the three other countries. The former were left to continue depending predominantly on their agricultural extra-regional exports but were supposed to purchase more expensive consumer goods from their regional partners. When agricultural goods were finally included in the common market scheme, the industrial protection regime was also lifted as an IMF requirement, limiting the possibilities of these two countries to catch up with the rest of the region and also given their low income status to provide the possibility for increased consumption of regional production. External interference on preference formation and inter-state bargaining has thus corrupted the internal logic of the process and resulted in the structural concentration of newly created negative externalities on the same member states and the benefits on others. It thus decreased the incentives for deepening integration and has in this case negatively affected the possibilities for industrial, fiscal and trade policy coordination which are the essential components for consolidating the common market and advancing towards an economic union.

Lastly, some significant progress has however been made in positive benefits areas such as customs administration and transport infrastructural policy which have contributed to important steps in the direction of the customs union and the common market. This has been the nature of the top-down dynamic of the integration process given the absence of interdependence. The dynamic of integration in this case, as opposed to what the neo-functionalist proposed, runs in the other direction as interdependence is being created. Political agreements to create it have spilled down to the technical levels through inter-governmental regional bodies, using the involvement of the direct implementing agents at the national level to adopt the measures in a more efficient manner. The agreement of the Customs Union Framework and the significant advances in the regional transport networks are particularly interesting examples of this dynamic.

By examining some of the central assumptions of the existing theories which represent the most obvious absences in many developing countries, such as economic interdependence, some important insights are found on the differing integration dynamics. This can help explain emergence, stagnation periods or structural constraints. Further research on other regional blocs could contribute to a greater refinement of the findings, especially looking at examples in the Caribbean and the Andean region, which might present similar low interdependence levels. An important issue not very little covered by this study was the role of regional institutions of a more supranational character. This could provide fertile research ground examining the links and roles of these bodies in relation to external preference-shaping powers, and hopefully further our understanding of integration in the developing world.

## REFERENCES


Acevedo, Adolfo. 2008. Nicaragua 1994-2007 – 5 programmes with the IMF: 16 lost years, *Revista Envio,* 313, April 2008, n. pag. [Online] Available: http://www.envio.org.ni/articulo/3737 [viewed on 10/05/2010]

Altman Borbon, Josetta. 2007. Challenges of Central American Integration, *Flacso Journals of Integration in Latin America*, August 2007: 1-29.

Bethell, Leslie. 1990. *The Cambridge History of Latin America: Latin America since 1930: Mexico, Central America and the Caribbean.* Cambridge: Cambridge University Press.

Bulmer-Thomas, Victor. 2000. *Central America 2020: Towards a New Regional Development Model.* Hamburg: Institut für Iberoamerika-Kunde.

Bulmer-Thomas, Victor. 1987. *The political economy of Central America since 1920*. Cambridge: Cambridge University Press.

Bulmer-Thomas, Victor. 1998. The Central American Common Market: From Closed to Open Regionalism, *World Development* 26 (2): 313-322.

Busey, James L. 1961. Central American Union: The Latest Attempt. *The Western Political Quarterly* 14 (1): 49-63

Central American Economic Integration System/SIECA. 2001. *Central American Study of Transport: Roads and transport services- Final Report*. Guatemala City: SIECA.

Central American Economic Integration System/SIECA. 2009a. *Situation Report of the Central American Integration Process.* Guatemala: SIECA.

Central American Economic Integration System/SIECA. 2009b. Unit of Economic Statistics-System of Trade Statistics in Central America. Database.

http://www.sieca.int/Publico/CA_en_cifras/NewLook/Comercio_Graficas_2000-2009/Comercio_00-09.htm

Central American Integration System/SICA (2005) *Economic Institutional Framework of Central America.* [Online], Available: http://www.caue.sieca.org.gt/Principal.aspx [viewed on 20/05/2010]

Dada Sanchez, Hector. 2004. *Elements for the construction of a vision of Central American Integration*. San Salvador: SICA/PAIRCA.

Dolowitz, David. and Marsh, David. 2000. Learning from Abroad: The Role of Policy Transfer in Contemporary Policy Making, *Governance*, 13: 5-24.

Economic Commission on Latin America. 1951. *Document E/CN.12/275 (195*1), Mexico D.F : ECLAC.

Economic Commission on Latin America. 2009. Central American Integration and its perspectives in the international crisis. Mexico D.F : ECLAC.

El Economista. 2007. Central American Customs Union will allow negotiations with the European Union, *El Economista*, 15 December 2007. [Online], Available: http://www.eleconomista.es/empresas-finanzas/noticias/331833/12/07/Union-aduanera-centroamericana-facilitara-negociacion-con-Union-Europea.html [viewed on 19/05/2010]

European Commission. 2007. *Central America Regional Strategy Paper 2007-2013*. E/2007/481. European Commission.

Gordon Rapoport, Sara. 1989. *Political Crisis and War in El Salvador*. Mexico D.F.: Siglo XXI.

Granados Chaverri, Carlos. 1986. Geo-politics in Central America, *Cuadernos Políticos* 46 (April-June): 74-89.

Grindle, Merilee and Thomas, J. W. 1991. *Public Choices and Policy Change: The Political Economy of Reform in Developing Countries.* Baltimore: The Johns Hopkins University Press.

Haas, Ernst B. 1958. *The Uniting of Europe: Political, Social, and Economic Forces 1950-1957*. Stanford: Stanford University Press.

Harvey, David. 2005. *A Brief History of Neo-liberalism*. New York: Oxford University Press.

Hazlitt, Henry ed. 1995. *The Critics of Keynesian Economics*. 2nd edition. New York: Foundation for Economic Education.

Hoffmann, Stanley. 1966. Obstinate or Obsolete? The Fate of the Nation-State and the Case of Western Europe, *Daedalus* 95: 862-915.

Hoffmann, Stanley. 1982. Reflections on the Nation-State in Western Europe Today, *Journal of Common Market Studies* 21 (September-December): 21-37.

Holden, Michael. 2003. *Stages of Economic Integration: From Autarky to Economic Union Economics*. Division13 February PRB 02-49E. [Online], Available: http://dsp-psd.pwgsc.gc.ca/Collection-R/LoPBdP/inbrief/prb0249-e.htm [viewed on 18/05/2010]

InfoAgro. 2004. Central America-EU: the Customs Union is the main requisite for a free trade agreement with the EU, *InfoAgro*, 01 June 2004, [Online], Available: http://www.infoagro.com/noticias/2004/6/9437_centroamerica__ue_la_union_aduanera_es_principal_.asp [viewed on 18/04/2010]

International Organization for Migration. 2006. *World Migration 2005: Costs and Benefits of International Migration.* Geneva: Academic Foundation.

Keohane, R. and J. Nye. 1977. *Power and Interdependence: World Politics in Transition*. Boston: Little-Brown.

Laursen, Finn. 2002. *Theories of European Integration*. Background paper for lecture on European Integration: What and Why? at The Graduate Institute of European Studies, Tamkang University, Taipei, Taiwan, March 2002.

Lindberg, Leon N. 1963. *The Political Dynamics of European Economic Integration*. Stanford: Stanford University Press.

Manfut, Eduardo. 2008. *Brief History of the Railway of Nicaragua.* [Online], Available: http://www.manfut.org/managua/tren.html [viewed on 01/06/2010]

Moravcsik, Andrew. 1993. Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach, *Journal of Common Market Studies* 31 (4): 473-524.

Munoz Vivas, Ximena. 2001. *Central American: Theory and reality of its integration and international trade.* [Online], Available: http://www.gestiopolis.com/recursos/documentos/fulldocs/eco/centroint.htm [viewed on 29/05/2010]

Organization of Central American States/ODECA. 1951. *Charter of the Organization of Central American States*. San Salvador: ODECA.

Perez Brignoli, Hector. 1983. Growth and Crisis in the Central American Economies, 1950-1980, *Journal of Latin American Studies* 15 (2): 365-398.

Perez-Brignoli, Hector. 1989. *A Brief History of Central America*. California: The University of California Press.

Richard A. Haggarty, ed. 1988. *El Salvador: A Country Study*. Washington: GPO for the Library of Congress.

Rodas, H. 1994. Some consideration on the conditionings of Central American Integration, *Pensamiento Iberoamericano*, 26 (July-December): 181-202.

Rodríguez, Irene. 2002. *El proceso de integración Centroamericana: entre el agotamiento y la*

Rosamond, Ben. 2000. *Theories of European Integration*. Houndsmills: Macmillan.

Sánchez Sánchez, Rafael A. 2008. *The politics of Central American integration*. New York: Taylor & Francis.

Spanish Commercial Information/ICE. 2001. The Central American Integration System and main Regional Economic Indicators, *Boletin ICE Economico* 2686 (April): 23-27.

Trinidad, Alfredo. 2003. The state of Central American integration – negative and positive aspects. In *Central America What's Next?,* European Commission, 75-77. Brussels: European Commission.

Vilas, Carlos M. 1994. *Market, States and Revolutions : Central America 1950-1990*. Mexico D.F.: UNAM.

Villalta Vizacarra, A .n/d. *New Developments in the process of Central American Integration*. Organization of American States. [Online], Available: http://www.oas.org/dil/esp/XXXV_curso_los_nuevos_desarrollos_en_el_proceso_de_integracion_centroamericana_ana_villalta.pdf [viewed on 18/05/2010]

Wallis, Allan. 2002. *The New Regionalism*. [Online], Available: http://www.munimall.net/eos/2002/wallis_regionalism.nclk [viewed on 25/05/2010]

Weiner and Diez, 2009. 'Introducing the Mosaic of Integration Theory', in Antje Wiener and Thomas Diez (eds.), *European Integration Theory*. Oxford: Oxford University Press. Pp. 1-22.

Zamora, Ruben I. 2003. *The new Central American Integration: dead integration, living integration*. San Jose, Costa Rica: Lara Segura y Asociados.

*revitalización.* Tesis PhD. Madrid: Universidad Complutense de Madrid.