Trade Integration and the Rise of the Service Sector in Latin America - The Case of Honduras

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Note of Gratitude

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1 Introduction

The free trade agreement between the USA, Central America (Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua) and the Dominican Republic (CAFTA-DR, in the following abbreviated CAFTA) is without doubt the most discussed trading issue of this region at current time. Like any modern trade agreement CAFTA includes several chapters on trade liberalization in services with especially detailed provisions on financial services and telecommunication services.

Enabled by the technological revolution in information and communication technologies and the resulting increased tradability of services, the phenomenon of outsourcing, i.e. the trend among high-income countries to off-shore wide ranges of services activities, has received growing attention. In this context, the case of India is often quoted as an example for a developing country (DC) which has managed to benefit from this trend and successfully exports services abroad. Naturally, other DCs consider their options to attempt a replication of the Indian model.

This thesis analyzes the implications of trade liberalization by CAFTA for El Salvador, Guatemala and Honduras. It finds that though these Central American countries could de iure provide services to the USA due to the enhanced market access they received, de facto they (yet) lack the necessary prerequisites to take advantage of this option, at least in larger scale. The major limitation of the region in this respect are the deficiencies in education: Only a small percentage of the population possesses the professional expertise and English skills which are needed in order to offer service provision to the exigent US market. In a few selected services such as software-engineering, medical services, and call centers some potential could be identified in El Salvador and, with further qualifications, in Guatemala.

However, the thesis also shows that enhanced access to foreign markets is not the only benefit of trade liberalization. Even more important are the effects of the entry of foreign enterprises to the domestic market. The resulting increased competition is likely to translate into higher efficiency and lead to more innovation. Since services play a crucial role not just for end consumers but also as intermediate inputs for the manufacturing sector, enhanced levels of efficiency in key service sectors will significantly improve the degree of competitiveness of manufactured goods on the world markets. In order to take advantage of trade liberalization in goods, a well-functioning and cost-efficient service sector must be existent. In a detailed analysis of the financial sector, it is found that the three countries had already before CAFTA begun to liberalize their sectors and thus CAFTA represents rather a consolidation
of previous reforms than a revolutionary novelty. However, due to the higher juridical certainty which CAFTA provides and due to potentially higher awareness of the positive development of the region, still positive effects of the agreement can be expected in form of higher investments from the US.

The concept of this thesis is throughout the entire text to start the analysis as general as possible and narrow it subsequently in consecutive steps further down. In its macrostructure the thesis consists basically of two separate parts: The first part presents the topic trade in services and its implications for DCs on a very abstract level. All aspects are considered in their broadest form in order to achieve the most extensive validity of the insights which are gained. Then, in the second part the analysis is conducted at the concrete example of the implications of CAFTA on the service sector of El Salvador, Guatemala and Honduras and, in a further precision, specifically on the financial sector. The motivation to choose this approach was to give a comprehensive panorama of the topic and allow for a maximum of generalization on all stages of the analysis.

The first part is formed by sections 2 and 3 which provide an overview of the three elements service sector, trade liberalization and developing countries and show how they can be thought together. Section 2 gives some introductory notes about the service sector such as definitions and a classification scheme, presents some stylized facts and outlines causes and consequences of the increasing tradability of services; it further briefly describes trade liberalization under the regime of the General Agreement on Trade in Services (GATS) and comments on the issue of statistics on services trade. Then, in section 3 the link between trade in services and developing countries gets established: Some generally attractive characteristics of service sector development in DCs are listed as well as the increased tendency of ICs to outsource a wide range of service activities and a potential role for DCs as service exporters are studied. Subsequently, the focus is shifted to the implications of service liberalization on the structure of the domestic industry in DCs. A brief review of some quantitative studies which assess the welfare gains from service liberalization is then followed by a short discussion that contrasts unilateral versus bilateral/multilateral liberalization under considerations of the theory of political economy.

The second part consists of sections 4 to 7.1 which analyze the implications of CAFTA on the service sector of the three selected nations. Section 4 presents some background information on the region as whole and each country in specific in order to impart an understanding of the general situation of the Central American
economies and to allow the placing of the subsequent analysis with in the right context. Moreover, a broader picture of CAFTA is delivered which shows how the agreement fits into recent developments of trade liberalization within the Western hemisphere and the worldwide resurgence of regionalism. Section 5 explains the strengths and weaknesses of the employed research design which complements a text and content analysis of the respective CAFTA chapters with semi-structured expert interviews and details the concrete proceedings.

The assessment of CAFTA’s impact on the service sector in general in section 6 and on the sector of financial services in particular in section 7 represent the core of this thesis. Section 6 starts directly with the text analysis of chapter 11 of CAFTA on crossborder trade in services. The evaluation of the interviews with the country experts are summarized first on regional scale, then, in greater detail for each country, thereby taking into account its specific current situation. Furthermore, the analysis is completed by some own supplementary reflections and a short conclusion of the results. Subsequently, section 7 focuses on the financial sector: After some introductory notes about the role of the financial system within the economy and selected aspects of financial sector liberalization, the respective chapter of the CAFTA text is analyzed. In the following, the evaluation of the sector expert interviews is presented, first with aggregated results for the region, then, on the country level portraying the situation of the financial sector in each economy. Finally, some considerations about a potential role for technical assistance in the context of CAFTA are given and the findings of the section are summed up.

The thesis concludes with section 8 which briefly summarizes and links the results of the single sections and presents the essence of the analysis of CAFTA’s implications on the service sector of El Salvador, Guatemala and Honduras.
2 The Service Sector and Trade in Services

In this section a brief panorama of the main characteristics of the service sector is given. As a natural starting point to enter the subject, section 2.1 provides a definition and the most commonly used classification scheme of services. Subsequently, section 2.2 emphasizes the importance of services as the predominant sector in most economies, their role as intermediate inputs and comments the underlying motivation for the public supply of many services. Section 2.3 summarizes the causes and consequences of the recent development of increasing tradability of services. The most relevant passages of GATS in context of this thesis are outlined in section 2.4. To complete the picture, section 2.5 ends with a report about the deficiencies of statistics on trade in services.

2.1 Definitions and Classifications

According to the System of National Accounts 1993 (OECD 1993; in the following abbreviated as SNA 1993) services can be defined as "outputs produced to order and which cannot be traded separately from their production; ownership rights cannot be established over services and by the time their production is completed they must have been provided to the consumers" (OECD 1993, p.42). However, though this definition might appear quite intuitive it is far from delivering a clear-cut classification scheme for practical purposes. Very often services imply inevitably the use and transference of certain goods thereby making it difficult to separate them from the pure service itself. The SNA 1993 therefore supplements the former definition by stating: "[A]s an exception to this rule there is a group of industries, generally classified as service industries, some of whose outputs have characteristics of goods, i.e. those concerned with the provision, storage, communication and dissemination of information, advice and entertainment in the broadest sense of those terms; the products of these industries, where ownership rights can be established, may be classified either as goods or services depending on the medium by which these outputs are supplied" (ibid.).

In order to give an overview of the wide range of services and their ubiquity in modern economies, table 1 lists the main service categories according to the GATS-
## 1. Business Services

A. Professional Services  
B. Computer and Related Services  
C. Research and Development Services  
D. Real Estate Services  
E. Rental/Leasing Services without Operators  
F. Other Business Services

## 2. Communication Services

A. Postal Services  
B. Courier Services  
C. Telecommunication Services  
D. Audiovisual Services  
E. Other

## 3. Construction and Related Engineering Services

A. General Construction Work for Buildings  
B. General Construction Work for Civil Engineering  
C. Installation and Assembly Work  
D. Building Completion and Finishing Work  
E. Other

## 4. Distribution Services

A. Commission Agents’ Services  
B. Wholesale Trade Services  
C. Retailing Services  
D. Franchising  
E. Other

## 5. Educational Services

A. Primary Education Services  
B. Secondary Education Services  
C. Higher Education Services  
D. Adult Education  
E. Other Education Services

## 6. Environmental Services

A. Sewage services  
B. Refuse disposal services  
C. Sanitation and similar services  
D. Other

## 7. Financial Services

A. All insurance and insurance-related services  
B. Banking and other financial services  
C. Other

## 8. Health Related and Social Services

A. Hospital services  
B. Other Human Health Services  
C. Social Services  
D. Other

## 9. Tourism and Travel Related Services

A. Hotels and Restaurants (incl. Catering)  
B. Travel Agencies and Tour Operators Services  
C. Tourist Guides Services  
D. Other

(for continuation see next page)
2 THE SERVICE SECTOR AND TRADE IN SERVICES

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<td>B. News Agency Services</td>
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<tr>
<td>C. Libraries, Archives, Museums and other Cultural Services</td>
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<td>D. Sporting and other Recreational Services</td>
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<td>E. Other</td>
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<th>11. TRANSPORT SERVICES</th>
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<td>I. Other Transport Services</td>
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<th>12. OTHER SERVICES NOT INCLUDED ELSEWHERE</th>
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Table 1: Classification of Services according to GATS (continued)

classification of the WTO (the GATS itself will be discussed in more detail in section 2.4).

2.2 Stylized Facts about the Service Sector

One of the main characteristics of the service sector is its heterogeneity. As can be seen from table 1, the range spans from pool-cleaning over safari guidance to brain surgery. Whereas rather traditional services like construction, transport and tourism can be found on the one side, highly innovative and dynamic segments like business services, communication services and financial services emerged over recent years on the other side. On a global scale, services account for about two-thirds of total output nowadays, though their contribution to national GDP varies widely depending on the state of development of the economies: In high-income countries the service sector makes up for about 70% of national GDP, whereas its share in low-income economies lies between 30%-45%. Figure 1 shows that services are by far the dominant sector in Central American nations, standing in sharp contrast to China which concentrates on manufacturing. CA’s share is also to a significant degree higher than in India that is most often cited in the context of the rise of the service sector and its implications for DCs (see section 3.2 for more details).

Another salient feature of this sector is that a wide range of services was and partly still is supplied by the state. Table 1 confirms that in more than half of the twelve subsectors the state traditionally is the supplier of key services in the majority
2 THE SERVICE SECTOR AND TRADE IN SERVICES

Figure 1: Structure of the economy, sector shares

of countries: The most obvious is the supply of communication services (postal service, telecommunication, audiovisual services), education (primary, secondary, higher education, and adult education), environmental services (sewage systems, waste disposal), finance (banking, insurance), health/social services (hospitals, social institutions), recreation/culture (sports arenas, parks, libraries, museums, operas, theaters), and transport (railway, local public transport).

The state assumes a role in offering these services, in order to avoid or combat market failures which could take place due to natural monopoly properties, public goods character, and information asymmetries in the respective sector. Moreover, considerations with regard to social justice and distribution of national welfare also lead to government interventions and regulation of markets: "Government often assumes responsibility to prevent non-service of the poor (‘cream-skimming’ by service providers) and the sale of substandard products when imperfect information exists for the buyer (e.g. by registration and qualification of professionals). Other reasons are national security and the importance of the certain service sectors to overall economic performance (e.g. banking and its crucial role in the monetary system of a country)” (Hodge 1998, p.23).

For quite some time, considerations which refer to services as intermediate inputs of production have gained increasingly more attention: Wöllfl (2005, p.21) finds that “more than half of transport and communications services are used as intermediate inputs and only about 20% for final demand. Financial and business services produce between 40% and 60% of their output for intermediate demand”. As a consequence, services have been identified as a potential source of competitive advantage, being of strategic importance not just for the sector itself but also for the future of the manufacturing industry. Upstream and downstream industries can hereby mutually reinforce their competitiveness and create a virtuous circle: If the quality and variety of services rise and their prices decrease this will positively affect downstream industries which can then offer cheaper and better products to their customers and, consequently, should be able to expand. This, in turn, results in a higher demand for the upstream service industries which can further reduce costs or innovate their offer and pass on improvements to downstream companies due to economies of scale and scope. The extent to which this dynamic process actually works depends to a large degree on the capacity of the downstream industry to control complex supply chains of inputs and to its willingness to transfer cost savings

1In some of these areas the state acts as the exclusive supplier, in others as a supplementary one to private companies.
2. THE SERVICE SECTOR AND TRADE IN SERVICES

Figure 2: Shares of demand components in total output of services and manufacturing (average shares across OECD countries), 1997

So far one important attribute of services has been, as already stated in the definition, that they could not be traded apart from their production. As opposed to goods, services could not be sent across borders (neither within countries). Instead, either the customer or the supplier had to travel to his counterpart. As a consequence, the main emphasis of trade policy traditionally has been put on the manufacturing sector while the service sector was neglected. In spite of its widely recognized importance for the economy at large, considerations on a specific trade policy for this sector only played a minor role due to the nature of services being supposedly non-tradables.

2.3 Changes in Tradability - Causes and Consequences

A couple of recent developments have forced policy-makers to rethink the role of trade in services and have necessitated a new definition of trade policy with respect to this sector, possibly followed by a shift in priorities on the agenda. In literature four developments are usually identified as the causes for the increasing relevance of
trade in services\textsuperscript{2}:

- The technological revolution in information and communication technologies (ICTs) set the ground for the increasing share of tradable services: The simple and almost instant transmission of substantial amounts of data via the global telecommunication network overcomes the former necessity for the service supplier and his customer to be in the same geographical place. Examples for global service delivery which benefit from these reduced transaction costs reach from basic services like back-office tasks (factoring, data-processing, call centers) to highly sophisticated services like the interpretation of x-ray images taken in US clinics by radiologists in Indian clinics.

- Led in large parts by industrialized countries, the international community increased efforts to liberalize trade in producer services by reducing regulatory barriers during the last years; on multilateral level these negotiations have taken place within the GATS-framework, which was established as part of the "Final Act" of the Marrakesh Ministerial Conference of the WTO in 1994 (see section 2.4).

- As international trade levels increase due to successful trade liberalization for goods, production within the manufacturing sector becomes more and more competitive. In order to maintain or raise the competitiveness of the domestic industry policy makers may focus on the provision of high quality intermediate inputs at reasonable prices. As Hodge (1998 p.14) notes, the importance of services as intermediate inputs rises dramatically as the absolute tariff levels for goods decline: "[W]ith international tariffs now at low absolute levels in most countries, the size of these marginal gains [i.e. marginal adjustments to the cost of domestic inputs] could well make a difference to competitiveness".

- Tightened government budgets in many countries also led to the perception that costly public provision of services must be replaced by more efficient supply through the private sector. The dismantling of state-owned monopolies in government-run services through privatization followed and complemented by deregulation fostered and enforced competition in those sectors that were previously non-accessible for private suppliers. Since the principal trade barriers for trade in services are regulations (and not tariffs as they are for goods), these reforms normally lowered the protectionism of domestic service markets and allowed foreign suppliers to enter the market as well.

\textsuperscript{2} It should be noted that this list is neither exhaustive nor are the described developments independent of each other.
The increase in tradability of services has far-reaching implications\(^3\): So far, the level of output and the product range of services were mainly determined and limited by the extent and preferences of local demand. Breaking the link between domestic supply and domestic demand in services eliminates the severe constraints which suppliers especially faced in small countries and DCs before. It allows suppliers to achieve higher levels of efficiency due to economies of scale and specialization which the domestic market demand was too weak to induce or support. Particularly for DCs this offers the potential to make use of their comparative advantage in labor-intensive services and to benefit from the increasing outsourcing activities of ICs (section 3.2 provides a more detailed presentation of this issue).

The above described developments result in a substantial change of the global economic environment and the challenges and opportunities countries face today. Trade agreements without a service dimension are history. Taking into account that with the out-phasing of the Multi-Fiber-Agreement at the beginning of 2005 international trade in practically all manufactured goods is widely liberalized, it is obvious that future negotiations will particularly focus on the service sector\(^4\).

### 2.4 General Agreement on Trade in Services

Service liberalization can hardly be negotiated or even be discussed without reference to the GATS standards and terminology. Therefore, a brief overview of GATS is given in the following.

GATS was signed as part of the "Final Act" of the Marrakesh Ministerial Conference in 1994 and entered into force in January of 1995. The objectives which inspired its establishment were "creating a credible and reliable system of international trade rules; ensuring fair and equitable treatment of all participants (principle of non-discrimination); stimulating economic activity through guaranteed policy bindings; and promoting trade and development through progressive liberalization" (Homepage of the WTO, Jan. 2006)\(^5\).

GATS gives a highly detailed classification of the service sector (see table 1) and introduces a scheme called the *modes of supply* to differentiate between distinct

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\(^3\) Naturally, the following considerations become only meaningful if trade liberalization in services can really be achieved and tradability exists not exclusively in theory.

\(^4\) Of course, the agricultural sector will also remain of interest, but this has yet a long-standing tradition.

\(^5\) [http://www.wto.org/english/tratop_e/serv_e/gatsqa_e.htm](http://www.wto.org/english/tratop_e/serv_e/gatsqa_e.htm)
forms of service delivery in cross-border trade: Mode 1 is usually phrased as cross-border supply and applies if a service provider of one country supplies services to consumers of the other country without neither of both parties leaving the national territory. Requirements of mode 2 or consumption abroad are met if the consumer moves from his home territory to the territory of the supplier to obtain the services of his choice there. Mode 3, also labeled commercial presence, describes the situation where a foreign supplier provides his services through foreign affiliates directly to the consumer in the latter’s home territory. Finally, mode 4, the presence of natural persons, implies that an individual moves from his home territory to the territory of the consumers in order to provide his services there. Figure 3 shows the most recent estimate of the shares of the different GATS modes in world trade.

Within the GATS framework there are two kinds of obligations: On the one side are the General Obligations and Disciplines which comprise most-favored nation treatment and transparency and have to be respected unconditionally by all member countries. On the other side are the Specific Commitments which include market access and national treatment and for which the countries make their own choices in how far they are willing to liberalize trade. Therefore, each member country sets up a so-called Schedule of Specific Commitments in which it specifies: "(a) terms, limitations and conditions on market access; (b) conditions and qualifications
on national treatment; (c) undertakings relating to additional commitments [...]” (GATS Art. XX, 1). Two more articles are of special relevance for the purpose of this thesis:

- **Article IV, Increasing Participation of Developing Countries**, which postulates for DCs and especially least developed countries: "(a) [T]he strengthening of their domestic services capacity and its efficiency and competitiveness, inter alia through access to technology on a commercial basis; (b) the improvement of their access to distribution channels and information networks; and (c) the liberalization of market access in sectors and modes of supply of export interest to them” (GATS Art.IV, 1) facilitated by industrialized member countries.

- **Article V, Economic Integration**, which assures that "[t]his Agreement shall not prevent any of its Members from being a party to or entering into an agreement liberalizing trade in services between or among the parties to such an agreement, provided that such an agreement: (a) has substantial sectoral coverage, and (b) provides for the absence or elimination of substantially all discrimination [...] between or among the parties [...]” (GATS Art.V, 1).

Article IV underlines the broad international consensus that trade shall be used to promote higher growth to DCs in order to enable them to reduce poverty. It gained new momentum with the formulation of the Millennium Development Goals (MDGS) at the UN Millennium Summit in September 2000: MDG 8, *Develop a Global Partnership for Development*, refers directly to MDG 1, *Eradicate Extreme Poverty and Hunger* by postulating to "[d]evelop further an open trading and financial system that is rule-based, predictable and non-discriminatory, includes a commitment to good governance, development and poverty reduction— nationally and internationally” (Homepage of the UN Millennium Development Goals, Jan. 2006)\(^6\).

Article V explicitly allows for regional integration and encourages bilateral respectively plurilateral trade agreements as long as they are sufficiently comprehensive. It is the legal foundation on which provisions on service liberalization within free trade agreements like CAFTA are based.

### 2.5 Statistics on Trade in Services

The growing demand from governments, the private sector and researchers for reliable, differentiated statistics on trade in services stands in stark contrast to the

quality of the de facto available data. Severe restrictions on most kind of statistic analysis due to missing or poor data substantially impede quantitative research and constitute a bottleneck to successful trade negotiations as well as to market research on the business level.

As a consequence of this increasingly perceived necessity to obtain more detailed and more precise data on the service sector and international trade in services the United Nations Statistical Commission founded a special Interagency Task Force on Statistics of International Trade in Services in 1994. Until 2002, the Task Force developed the Manual on Statistics of International Trade in Services, which provides "a coherent conceptual framework within which countries can structure the statistics they collect and disseminate on international services trade" (UNSD 2002, p.1). Most importantly, it is compatible with the existing standards of the main sources for data compilation on this issue, the fifth edition of the International Monetary Fund’s Balance of Payments Manual and the System of National Accounts of 1993 (OECD 1993).

Though the quality of data improved significantly in OECD countries, DCs are still far from meeting the requirements of the sophisticated standards. In consideration of their scarce resources the question arises in how far efforts to implement the elaborated data collection framework are justified. Though it is unquestionable that a broader base of information is desirable for decision-makers, it remains unclear whether the resulting gains for DCs exceed the investments which are necessary to achieve it.

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7 The Task Force consisted of members of Eurostat, IMF, OECD, UNSD, UNCTAD, and WTO.

8 So far, one major deficiency of most data is that they do not account for trade in GATS-modes 3 and 4; as a result, true trade flows in services are in general underestimated.
3  Development-Related Aspects of Service Liberalization

This section establishes the link between trade liberalization in services and aspects of the development agenda. Section 3.1 presents an extensive list of characteristics of services which explains why service sector development has become an increasingly discussed topic as integral part of long-term development strategies for DCs. Section 3.2 turns to the phenomenon of outsourcing, i.e. the trend among high-income countries to off-shore wide ranges of services activities, and examines whether and under which conditions DCs can hope to benefit from it. The often quoted case of India as a model of successful service exporting is analyzed in order to gain some insights about its replicability for other DCs. Then, in section 3.3, the implications of service liberalization on the structure of the domestic industry are studied and some ideas are given what DCs have to expect from the entry of foreign companies to their formerly protected service markets. Finally, a brief review of quantitative studies which assess the welfare gains from service liberalization is provided in section 3.4.

3.1  Appeal of the Service Sector to Developing Countries

In recent years the service sector and trade in services has been identified as an area of particular interest for the development agenda, since it offers several characteristics that make it quite appealing from the perspective of DCs (cf. BMZ 2003, p.12):

- For service production neither natural resources nor geographical restrictions play a major role.
- Since most services are labor-intensive this allows labor-abundant DCs to make use of their comparative advantage of large low-wage workforces; at the same time, unemployment can be reduced.
- The access to world markets allows to specialize in niches for which the local market does not offer the necessary demand.
- Service markets are characterized by high income elasticities and promise high growth potentials\(^9\).

\(^9\) Though it is a common assumption among economists that (final) demand for services is income elastic, Wöfl (2005, p.17) notes that the few empirical studies which actually estimated these elasticities could hardly find supporting evidence.
• As opposed to the production of industrial goods less imports are necessary, i.e. the local content in services is higher.
• Capital ratios per worker are in general lower than in manufacturing\textsuperscript{10}: Technological equipment used for services is highly standardized and supplied on competitive world markets; since in DCs financial resources are very scarce, this is an important aspect.
• Most services are not energy-intensive and hardly cause any form of pollution; therefore, they do not stress the environment nor the balance of payments due to high energy importation costs.

Moreover, the generally small firm size of service suppliers is well-compatible with the industry structure of DCs, where mainly SSMEs dominate. The provision of fundamental services such as financial and telecommunications services improves the access of SSMEs to markets, knowledge and technology. It thereby enables professional and efficient work on a small scale and in non-metropolitan areas. Especially many knowledge-based services exhibit fixed development costs and replicability at low costs which allows SSMEs to enter and serve these markets.

Service sector development in DCs can also be used to give impulses beyond these mainly economy-focused considerations: The establishment of knowledge-based services leads to positive spill-over effects, gives incentives to improve educational systems and increases investment in human capital; often it also works as a pull-factor for attracting FDIs. Since in general, the employment share of women in services is significantly higher than in manufacturing, service sector initiatives can be combined with the pursuit of gender policies.

Taking into account the extensive list of attractive attributes of services the next logical step for DCs would be to analyze where and how projects focusing on the support and enhancement of the service sector can get integrated within their broader development strategies.

3.2 Outsourcing - A Chance for Developing Countries?

The increased tradability in services (see section 2.3) and the integration of provisions on service liberalization into the most recent trade agreements has widely given rise to expectations that services may work as an engine in revitalizing world

\textsuperscript{10} See Wöll (2005, p.37) for capital-labor ratios of selected service sectors across OECD countries; with the exception of the category ‘Transport, storage and communications’ physical capital stocks per worker are well below the levels of the total economy.
trade. In context of DCs the discussion usually centers around the question in how far these countries can benefit from the continued tendency of industrialized nations to outsource a wide range of activities. The idea of DCs as potential service exporters is hereby strongly influenced by the success story of India which is most commonly quoted as the model case of a DC in the process of transformation into a service economy. Following India’s example of supplying services for a growing market abroad sounds intriguing for DCs since it would not only diversify their narrow export portfolios, but also help to mitigate most DCs’ often notorious balance of payments deficits: According to an estimate of McKinsey (2003, p.5), "India gains a net benefit of at least 33 cents for every dollar of spend offshored". The same study further expects outsourcing "to grow at the rate of 30 to 40 percent a year over the next 5 years. Forrester, a leading IT analyst, projects that the number of U.S. jobs offshored will grow from 400,000 jobs today to roughly 3.3 million jobs by 2015, accounting for some $136 billion in wages" (ibid.).

However, especially with respect to value-added service activities, various researchers are highly critical about most DCs’ capacities to serve the exigent markets: "[M]any developing countries lack the locational prerequisites to make the rapid diffusion of such innovations to developing countries profitable. Such prerequisites are
basically human skills [...]” (Langhammer 2000, p.7). So far, if at all, DCs are only successful in labor-intensive services which do not require more than basic qualification; typical examples are maritime transport, construction, back-office operations like data processing and to a limited extent health services. In the same line, Lücke and Spinanger (2004, p.37) conclude that “[t]he modest growth of both traditional and nontraditional service exports by developing countries overall contrasts with the high expectations that surround many academic discussions and the public debate on this topic”.

It therefore becomes interesting to closer examine the case of India in order to identify the factors in which it differs from most other DCs and evaluate the latter’s chances to follow India’s lead:

- Protracted large subsidies by the Indian government for higher education resulted in the formation of a large pool of qualified graduates, particularly in informatics, mathematics and natural sciences. Competition among graduates is increasing, thereby leading to high motivation and work performance.
- Dating back to colonial times and nowadays promoted by the education system many Indians have a good command of the English language, with university graduates mostly being highly proficient.
- In a few core areas the prices and quality of the provided telecommunication services are competitive, the infrastructure enables broad access and is well-maintained.
- Wages, even of the highly skilled work force, are far below wage levels in ICs. According to a study by McKinsey (2003, p.3) the wage differential offers cost savings ranging between 45-55% even after taking into account additionally incurred costs for telecommunications and offshore facility management.
- India itself has a large domestic market that, first, might serve as a laboratory for service innovations and subsequently, as a springboard for exports to ICs.

As a result of this analysis Lücke and Spinanger (2004, p.38) are quite pessimistic about “how many countries can expect (or should even try) to replicate the Indian experience. First, in terms of reducing poverty, extensive government subsidies for higher education may not represent the best possible use of scarce resources; very likely, higher expenditures on primary education would be more effective. Second, [...] demand for some low-skill-intensive services [...] may well decline due to further technological changes; for example, improved voice recognition software could render various data processing operations redundant”. Further qualifications of the suitability of most DCs follow from the list above: An infrastructure which
fulfills the minimum requirements, a low wage structure, the necessary language skills, and a sufficiently qualified work force are prerequisites which are hard to find among DCs.

A brief look at figure 4 reveals that with the exception of India mainly industrialized nations like Ireland, Canada and Israel were preferred by companies as destinations for their outsourcing strategies. This leads to the conclusion that a large part of outsourcing, and particularly the most dynamic one, will de facto take place between ICs. Since the innovative segments of the service sector are intensive in skilled human capital, high-income countries have a clear comparative advantage due to their more advanced education systems. Langhammer (2000, p.9) finds empirical evidence that FDIs from the US in the service sector are more focused on OECD countries (which offer high standards of education) whereas FDIs in the manufacturing sector are proportionately higher in DCs. If each group of countries continues to specialize in the sector where it possesses comparative advantages, as economic theory predicts, "[f]urther liberalization of trade in services may [...] result in a continuation, and perhaps acceleration of the trend that labor-intensive and natural resource-intensive manufacturing industries relocate to developing countries and the OECD-countries become service-economies to an even greater extent than what is the case at present" (Hodge and Nordås 2000, p.28).

Nevertheless, these insights do not imply that DCs should refrain from endeavoring to enter world markets in services. Rather, they call for a more cautious view
and reality-adjusted expectations with regard to export opportunities. As high- and middle-income countries move on to focus on more sophisticated service segments, DCs will have the chance to take over services in the lower end of the spectrum (see figure 5). Their success will principally depend on their development in infrastructure and educational standards: The basic requirement for DCs to enter the stage as a potential supplier of back-office services is to build up a well-functioning telecommunications network which enables broadband access at reasonable costs. In order to extend the offer to customer contact services it becomes necessary to ensure that graduates possess a sufficiently good command of the English language. Professional expertise would then be the prerequisite to evolve to the next higher levels of offering specialized services in common corporate functions and knowledge services.

It becomes apparent from this list that the required elements only are achievable to a limited extent within a short or medium term perspective and involve high financial investments. DCs are, therefore, well-advised to set their priorities right and base their decisions on previous detailed analysis. This especially includes the identification and subsequent focusation on a few carefully selected activities.

Some final remarks shall be made that broaden the perspective beyond outsourcing of business services which mainly relate to ICT-enabled trade in the mode of cross-border supply. It has already been shown in figure 3 that this mode accounts for roughly one third of the trade volume in services. However, the true potential for far-reaching changes in services trade lies in the liberalization of the movements of natural persons. Since, until now, high-income countries successfully have resisted all demands of DCs to commit to further liberalization, the share of mode 4 is almost negligible with less than 2%. In order to enable DCs to exploit their comparative advantage in labor-intensive services to full extent ICs must agree to liberalization in mode 4 by lowering restrictions on work permits and visa requirements. There is little disagreement that barriers to international labor mobility constitute the main bottleneck for the attempts of DCs to participate in service trade: "Existing literature estimates suggest very large global gains from the removal of immigration restrictions to cross border flows of labour services, and seem to point to a conclusion that this could be the biggest part of the services liberalization nexus for developing countries."

The stand-still in negotiations about further (or better: beginning) liberalization of the movement of natural persons was one of the main reasons why DCs commented the outcome of the last WTO conference of the Doha Round in Hong Kong (15th-18th December 2005) with disappointment.
countries” (Whalley 2003, p.9)\(^{12}\).

### 3.3 Service Liberalization and Domestic Restructuring

Limiting the analysis of trade liberalization to the identification of export opportunities would deliver a highly incomplete picture\(^{13}\). Hence, the focus of attention shall now be turned to the prospects of domestic restructuring due to service liberalization.

The consequences of prolonged isolation of a country’s economy can best be illustrated by the failure of the import-substitution strategy which was considered as the state-of-the-art solution for DCs to achieve higher economic growth during the 50s and 60s. The underlying argumentation line that an infant-industry should be protected until it reached international competitiveness most often miscarried because supposedly temporary protection became permanent and resulted in inertia and stagnancy. The success of the more outward-oriented Asian Tiger states led to a shift of the paradigm toward favoring the inherent incentive system of international competition. Though the experience of that time was gained in the context of manufacturing it can be assumed that it equally applies to the service sector.

Since many DCs still maintain high levels of protective measures for key services such as finance, telecommunications and transport, they can expect fairly large gains if they commit to comprehensive liberalization. The lack of contention with foreign suppliers most often results in what economic theory predicts: Little incentives exist for targeting higher levels of efficiency to achieve competitive pricing, expanding and innovating the product portfolio and improving its quality to meet consumer satisfaction. The opening of national service markets for foreign companies spurs competition and diminishes the distortions that are caused by monopolistic or oligopolistic market structures. Furthermore, the market entry of internationally operating enterprises is usually accompanied by transfers of technology and managerial expertise, and leads to creative service product innovations. Following this line of reasoning, the somewhat sobering results of section 3.2 should not be overvalued: Opportunities for service exports are of minor importance compared to the

\(^{12}\) An issue that needs to be addressed in this context is the phenomenon of brain drain, i.e. the temporary or permanent loss of the most qualified group of the workforce for DCs. On the other side, this problem is already existent since ICs, in the few cases where they allow migration, tend to cherry-pick the most talented individuals.

\(^{13}\) So far, it was implicitly assumed that liberalization happens bilateral, plurilateral or multilateral; the special case of unilateral liberalization will be discussed in section 4.3.
dynamic effects in efficiency gains of the domestic service sector (and consequently manufacturing industry) due to higher competition and sectoral restructuring. The point is backed up by many "empirical studies [which] show consistently that the benefits of trade liberalization accrue first and foremost to the liberalizing country itself" (Lücke and Spinanger 2004, p.8).

In the context of CA Sarmiento (2000, p.177) emphasizes that "developing clusters\(^{14}\) in the region without facilitating the free and nondiscriminatory exchange of services could prove to be almost impossible. [...] [T]he liberalization of trade in services - and specifically professional and business services - is likely to have a more significant impact on the goal to convert Central America into a highly competitive region”. As has been shown in section 2.2, where the crucial role of services as intermediate inputs has been shown, protection of producer services acts like an effective tax on downstream (manufacturing) industries.

At the same time, service liberalization has, as compared to goods liberalization, the intriguing characteristic that no loss in tariff revenue has to be suffered: Whereas for trade in goods the most commonly employed instruments of protection are tariffs, in the case of services the barriers are usually regulations (table 12 in appendix B provides an overview of barriers to trade in services). The reduction or elimination of tariffs may result in revenue losses for the state which offset the gains in consumers’ surplus from the liberalization. This does not hold true for the removal of regulatory barriers against foreign service supply. Mattoo and Fink (2002, p.11) conclude therefore: "Where a country maintains regulations that impose a cost on foreign providers, without generating any benefit (such as improved quality) or revenue for the government or other domestic entities, welfare would necessarily be enhanced by preferential liberalization”.

However, service liberalization also carries some risks, especially if liberalization goes hand in hand with privatization of services which were previously supplied by the state. Since state-owned enterprises often pursue political goals by subsidizing a certain range of their service offer, it must be assured that the poor do not lose access to basic services if supply changes to private companies that demand cost-orientated prices. In this case, well-targeted reforms must be implemented in order to compensate the poor and sustain their standard of living.

\(^{14}\) Sarmiento refers hereby to 'industry clusters' in manufacturing. CA Presidents committed to improve the competitiveness of the region by promoting selected industrial clusters at their 15th Summit in Costa Rica in 1994.
From a global perspective, trade liberalization in services is even more promising than in goods: Markusen (1989, p.95) shows that "[p]ermitting trade only in final goods is an imperfect and inferior substitute for permitting trade in specialized services [...]. Free trade in inputs/services is superior to free trade in goods from the point of view of the world as a whole, although not necessarily [from] the point of view of each individual country" (Markusen 1989, p.95). Section 3.4 briefly presents some empirical evidence from various studies that support the notion that gains from service liberalization exceed goods liberalization.

3.4 Empirical Evidence from Quantitative Studies

Researchers who want to conduct quantitative studies related to trade in services face various difficulties. Section 2.5 already outlined that the availability of data is very limited as compared to goods and existing data are often of poor quality. As a consequence of these data constraints an often preferred form of analysis are computable general equilibrium (CGE) models which impose less demanding requirements to data quality than most econometrical estimation procedures: "One advantage of a CGE model is that it can provide quantifiable insights with relatively sparse datasets" (Konan and Maskus 2002, p.5).

A second major problem becomes apparent after a brief look at the extensive list of barriers to trade in services (see table 12 in appendix B). Whereas trade restrictions for goods are most commonly tariffs, the quantifiability of service trade barriers is extremely difficult and therefore assessments of potential effects of service trade liberalization become tricky\textsuperscript{15}.

Despite the fact that Whalley (2003), as the result of his survey of quantitative studies, concludes that "studies which address these issues remain informed by poor data, major conceptual difficulties, and in the modeling area are characterized by contradictory results" (ibid., p.11), some studies shall be shortly reviewed here\textsuperscript{16}.

Using the database of the Global Trade Analysis Project (GTAP) the Australian Department of Foreign Affairs and Trade (1999) calculates that by halving

\textsuperscript{15} A popular approach is the construction of indices of restrictiveness respectively openness: First qualitative information on existing barriers is gathered, then classified into groupings in order to assure comparability across countries and finally applied to a weighting scheme which captures the relative importance of single means, is applied (cf. McGuire 2003).

\textsuperscript{16} Dihel (2003) offers a less detailed but even more complete survey of quantitative studies estimating the welfare gains from service liberalization.
the trade barriers for goods and services over 45 regions and 50 sectors a total welfare gain of more than USD 400 bn would be achieved. In their simulation service liberalization accounts for about USD 250 bn as compared to USD 90 bn gains from liberalization of agricultural goods and more than USD 60 bn from manufacturing.

Augmenting the GTAP-model by the incorporation of FDI flows, Dee and Hanslow (2000, p.17) find that "in terms of real income, the world as a whole is projected to be better off by more than USD 260 billion as a result of eliminating all post-Uruguay trade barriers". According to their computations USD 130 bn accrue from service liberalization whereas USD 50 bn stem from liberalization of agriculture and USD 80 bn from manufacturing. However, it must be noted that the distribution of these gains is fairly unequal as they predict China to be the main beneficiary with the lion’s share of USD 90 bn out of these USD 130 bn.

A simulation by Brown et al. (2002) using the latest version of the Michigan Model of World Production and Trade (also accounting for FDI flows) predicts a global welfare gain of more than USD 400 bn from services liberalization as compared to USD 100 bn from manufacturing. These comparatively higher gains are especially remarkable since the authors only assume a reduction of post-Uruguay trade barriers by one third. In contrast to the study by Dee and Hanslow (2000), welfare gains are more evenly distributed and benefit mostly developing countries.

Running a CGE-simulation for the Tunisian economy Konan and Maskus (2002) find evidence that trade liberalization in goods has disappointed to some degree because it has not been accompanied by service liberalization: "[P]art of the explanation for this weak performance rests in the continued insulation, and resulting poor condition, of the domestic services sectors in many developing countries. These service sectors tend to deliver high-cost and unproductive input services to export industries, thereby limiting economic efficiency gains from trade reform." Their results confirm the crucial role of services as intermediate inputs for manufacturing (see section 2.2). Interestingly, their model also predicts that the distribution of gains across countries is more evenly distributed under liberalization of services than of goods. They conclude that "[f]ewer workers are required to change positions to accommodate service liberalization, implying less impact on frictional unemployment" (Konan and Maskus 2002, p.17).

Mattoo et al. (2001) perform a cross-country regression over 60 countries for

\[17\] The authors use data from social accounting matrices in a standard CGE-model of a small open economy.
the period 1990-1999. Their dummy variables are indices of openness for the telecommunications and financial services sectors which they construct under consideration of the degree of competition, the extent of foreign ownership and the nature of regulation. The results of their analysis indicate statistically significant effects for the positive influence of openness to trade in services on long-term growth performance: "The coefficient estimate [...] seems to suggest that countries that fully liberalized both telecom and financial services tend to grow up to 1.5 percentage points faster than others over the 90s" (Mattoo et al. 2001, p.18). Repeating their analysis for a subsample of developing countries the authors find that the magnitude of their coefficients is much higher, suggesting that service liberalization could bring even larger growth benefits to DCs.

Lücke and Spinanger (2004) offer an explanation for the widely differing numerical estimates of gains from service liberalization. They distinguish between simulation models (e.g. CGE-models) and cross-country growth regressions and stress the distinct characteristics of both techniques leading to correspondingly divergent results. Whereas simulation models typically focus on short- to medium-run effects of a particular (isolated) reform project, growth regressions tend to assign the impact of the sum of all reforms implemented in a country to the variable of service sector openness. "Since most growth regressions are specified parsimoniously, the service sector openness variable will often pick up the impact of a whole bundle of growth-promoting policies. In this sense, cross-country growth regressions demonstrate the long-term growth effects of interrelated institutional and policy reforms, including service sector openness" (ibid., p.27).
4 Setting the Stage: The General Background

This section aims at providing background information helpful to place the discussion about trade liberalization due to CAFTA and its expected impact within context. The difficult situation of Central America due to its comparatively small size, its tradition of military rulings and its vulnerability to natural disasters must be considered if trade integration in services is understood as a part of a development strategy for the nations on the Isthmus.

Section 4.1 presents some facts about Central America (CA), mainly focusing on its efforts of regional integration. Following, each of the three countries is briefly portrayed in order to underline their specific characteristics and to allow differentiation between the countries in the later analysis; descriptions are complemented by some tables displaying core data and indicators\textsuperscript{18}. In section 4.2 a broader picture of CAFTA is delivered, showing how it fits into recent developments of trade liberalization within the Western hemisphere and the worldwide resurgence of regionalism. Finally, section 4.3 considers liberalization of the service sector in the context of the theory of political economy; some light is shed on the issues of political feasibility and credibility which might render unilateral not viable respectively not preferable and lead to liberalization in form of bi/pluri/multilateral agreements.

4.1 Central America - Geography, Politics and Economics

\textit{Central America} as a political term, and as such it will be used in this thesis, denotes the unit formed by Guatemala, El Salvador, Honduras, Nicaragua, and Costa Rica. In contrast, \textit{Meso America} is a geographical term which additionally comprises to the aforementioned five states Belize and Panama and denotes the region between the North and South American continent.

In 1960 the five CA states founded the Central American Common Market (CACM); in order to support and accelerate its main goal, the integration and development of the region, several institutions were founded in subsequent years:

\textsuperscript{18} The descriptions of the CA nations are largely based on the most actual "Country Profiles" of the Economist Intelligence Unit, supplemented by information from encyclopedias and internet resources.
The Central American Bank for Economic Integration (CABEI), mainly serves as a development bank, providing loans to projects and initiatives directed at a deepening of integration. Since its foundation in 1960, the CABEI has accounted for almost 30% of total multilateral lending to its member nations.

The Central American Parliament (Parlacen) was created in 1987 but suffers from the countries' unwillingness to give up national sovereignty by ceding even limited juridical power.

The System for Integration in Central America (SICA), established in 1993, additionally includes Panama and Belize; its main task is the coordination and implementation of the agreements reached by its member states. It is complemented by the Secretariat for Economic Integration of Central America which manages the technical aspects of the integration process, mainly focused on the economic sphere.

The Protocol of Guatemala, signed in 1993, broadened the perspective of the original CACM agreement by adopting a stance of ‘open regionalism’, which encouraged integration beyond the region itself, hereby mainly targeting on Latin America. Moreover, efforts to achieve a zero-tariff floor and a lower common external tariff (CET) ceiling at 15% were reinforced and accomplished in 2000. This provision of
greater flexibility in negotiating trade agreements with other nations resulted in the ratification of various pacts in the period 1998-2001, most notably by El Salvador and Costa Rica.

Plans for regional integration got more ambitious with the launching of the Plan Puebla Panama (PPP) in 2001 which envisions integration of the entire Isthmus spanning from the most Southern provinces of Mexico to Panama. The project has the goal of improving transport and telecommunication infrastructure as well as the linking of national electricity grids.

4.1.1 El Salvador

El Salvador is the smallest and most densely populated country in CA. It was governed by the military until the 1970s. After an overturned election in 1972, the population’s frustration about its political powerlessness gave rise to the foundation of several guerrilla groups mainly formed by students, unionists and peasants. In 1980 five of these groups united to form the left-wing Frente Farabundo Martí para la Liberación Nacional (FMLN). For the next 12 years the El Salvador suffered from a civil war fought between the army and the paramilitary against the FMLN until an official peace accord negotiated under the auspices of the UN was signed in January.
1992. Relations between El Salvador and the USA are traditionally close; during the civil war the government received estimated US$6bn in economic and military aid.

At the beginning of 2001 two devastating earthquakes killed more than 1,000 people, destroyed the dwellings of around 1.2m Salvadoreños and caused overall damages taxed at more than US$1.3bn. "However, taking into account lost productivity and expense to individuals of replacing lost property, the total cost of the earthquakes will prove much greater" (EIU 2004, p.8). In the wake of this catastrophe parts of the population tried to emigrate, mainly to the US, where 2m Salvadoreños are estimated to live.

El Salvador is scourged by high levels of criminality: Widespread poverty, which aggravated substantially after the earthquakes combined with a large number of fire weapons, a heritage of the times of the civil war, resulted in increasing crime rates of armed assaults, highway robberies, kidnappings and general street violence. Like in its neighbor countries the formation of brutal youth gangs in bigger cities created a climate of fear and cries for higher public security. The government’s strategy to tackle the problem with an aggressive anti-gang offensive has shown only partial success so far since corruption in the police force and organized crime structures are insufficiently addressed.

Since 1989 El Salvador has pursued the most ambitious course of economic reforms of all CA nations. The cornerstones of its policy agenda follow closely the standard recipe of the Washington Consensus:

- Trade liberalization in the form of various free-trade agreements\(^{19}\);
- Privatization of state assets such as telecommunication and energy distribution enterprises;
- Fixing of the exchange rate in 1994 and adoption of the US dollar as legal tender in 2001;
- Keeping tight fiscal discipline to achieve low inflation and low interest rates;
- Creating stable macroeconomic conditions and a business friendly environment to attract FDI.

Although especially the loss of the exchange rate as a policy instrument may prove to have been a step too far lending rates lowered considerably and spreads have narrowed thereby boosting FDI and domestic credit growth as desired. Yet these

\(^{19}\) FTA were formed with Mexico, the Dominican Republic, Panama, and Chile in 2001 and 2002.
effects may "be offset to some extent by appreciation of the local currency against other currencies in the region, to the detriment of wage and export competitiveness." (EIU 2004, p.21). Disappointing growth rates of GDP which hardly have kept track with population growth in the recent years, seem to confirm this concern.

Structural weaknesses of El Salvador’s economy include a high import propensity and a strong dependency on its two main export products, coffee and maquila\(^\text{20}\). Though the country’s notoriously large trade deficit is offset by sizable inflows of aid and family remittances, "in the long term the promotion of non-traditional exports will be important if the country is to avoid foreign exchange constraints" (EIU 2004, p.25).

Over the last three decades El Salvador has successfully shifted its economic activities from the agricultural sector to services (mainly commerce and financial services). Due to the heavy investments in maquila in the 1990s, the manufacturing sector has also developed positively, though most recently stagnating growth rates indicate the maturity of this industry.

### 4.1.2 Guatemala

Guatemala is the most northern CA country with its territory covering the heartland of the ancient Maya civilization. Like most countries on the Isthmus it has experienced several military coups, some of them backed by the USA like in 1954, the most recent one being ended in 1993. Relations with neighboring Belize are tense due to a long-standing dispute over territorial claims. In 1996 a 36-year lasting civil war, costing more than 200,000 lives, was brought to an end by a peace accord mediated by the UN between the government and the main guerrilla group, the URNG\(^\text{21}\). The treaty comprised not only political aspects but also various economic and social reform projects inspiring hope and expectations.

However, under the administration of President Portillo (2000-2004) confidence in Guatemala’s course of reforms vanished: "[A]llegations of corruption, attempts to politicise the judiciary, weaken the accountability of institutions, and increases in human-rights abuses" (EIU 2005a, p.6) accumulated. Moreover, Guatemala got de-certified by the USA for failing to comply on issues like money-laundering and drug interdiction. After taking office in 2004 President Berger set his country back

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\(^{20}\) The term denotes the offshore assembly of clothing for re-exportation to the US.

\(^{21}\) Unidad Revolucionaria Nacional Guatemalteca
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C Colón, Q Quetzal, L Lempira

Source: Economist Intelligence Unit (2005)

Table 2: Maco-data for El Salvador, Guatemala and Honduras
on track with various reform initiatives and improved bilateral relations with the US.

Although indicators of governance improved, Guatemala displays all other typical characteristics of a developing country: Corruption is wide-spread, transparency is poor and the justice system lacks the necessary strength; health provision and (basic) education are poor and human right abuses remain an issue; high levels of criminal activity are the consequences of widespread poverty, unequal distribution of land, high unemployment rates, and weak law enforcement.

Privatization of former state-owned enterprises (SOE) and large inflows of FDI were unable induce the aspired higher growth rates that would be necessary to combat poverty. "Despite greater macroeconomic stability, business and consumer confidence has been weak and economic growth has slowed to rates below that of population growth" (EIU 2005a, p.26). Furthermore, in its scope to set up initiatives and programmes the government is strongly limited by having the lowest tax-in-take in the region with less than 10% during the 1990s.

Since 1980 Guatemala has gradually changed its economic profile from a predominantly agricultural basis to a focus on services. The agricultural sector’s contribution to national GDP remains high at 22.8%, especially compared to industrial manufacturing (12.6%); the export structure has also diversified, moving away from the traditional agro-exports like coffee, bananas and sugar to maquila production, making Guatemala slightly less vulnerable to price movements in agro-products. Mainly due to an increase in oil prices Guatemala’s trade deficit has increased in the last years. Remittances which are sent by the more than one million Guatemaltecos living in the USA are largely used for consumption imports. The foreign exchange rate to the USD remains stable and is backed by a sharp increase in international reserves.

4.1.3 Honduras

Honduras is characterized by a wide variety of different geographical zones ranging from Pacific and the Caribbean coastlines over ragged mountain ranges to isolated rain forest. After returning to democracy in 1981 ending 18 years of military ruling, the country faced a "decade of political and economic turmoil marked by a debt crisis in 1982 and the US-funded Contra war in Nicaragua. In return for turning

22 According to the last agricultural census (1979) 2.5% of Guatemala’s farms cultivate about 65% of the arable land.
### Setting the Stage: The General Background

<table>
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<th>El Salvador</th>
<th>Guatemala</th>
<th>Honduras</th>
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<tr>
<td>GDP per capita PPP in US$, 2002</td>
<td>4,890</td>
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<td>Life expectancy, 2002</td>
<td>70.6</td>
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<td>68.8</td>
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<tr>
<td>Infant mortality (per 1000 live births)</td>
<td>32</td>
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<td>32</td>
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<td>Adult literacy rate (% ages 15+), 2002</td>
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<tr>
<td>Urban population (%)</td>
<td>60</td>
<td>47</td>
<td>46</td>
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<tr>
<td>Access to an improved water source (%)</td>
<td>82</td>
<td>95</td>
<td>90</td>
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<tr>
<td>Human Development Index (HDI) 2002</td>
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<td>0.649</td>
<td>0.672</td>
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<td>Human Development Index Rank 2002</td>
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<tr>
<td>Human Development Index (HDI) 1975</td>
<td>0.590</td>
<td>0.510</td>
<td>0.517</td>
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*Source: UNCTAD (2003)*

Table 3: Human Development Indicators

a blind eye to the presence of Contras in eastern Honduras, the [...] government [...] received substantial economic and military aid from the US" (EIU 2005b, p.5). Despite various attempts of pacification with El Salvador and Nicaragua, territorial disputes emerge periodically and dominate Honduras’ traditionally tense, partly even confrontational relations with its neighbors.

One of Honduras’ darkest moments in recent history was when Hurricane Mitch devastated the country in October 1998. It cost 7,000 lives, left 1.5m people homeless and shattered estimated 20 years of economic development: "Infrastructure was severely damaged, including 163 bridges, 6,000 km of roads, water and sewage pipes, airports, ports and schools. The replacement cost of the damage to social and productive sectors, infrastructure and the environment was estimated at around US$5bn, equivalent to 95% of 1998 GDP” (EIU 2005b, p.6). Despite extensive financial support on bilateral as well as multilateral basis, spending for reconstruction still widens the fiscal deficit.

Reinforced by the annihilating impact of Hurricane Mitch, Honduras is among the least developed countries in Latin America: In 2002 71.5% of the population lived in poverty, of which 74% suffered extreme poverty having less than US$1 per day. Public infrastructure is very poor, the education system is deficient in quality and efficiency and one quarter of Hondurans do not have any access to health services. High levels of crime poses one of the major threats to the country, especially in context with the surge of the *maras*, armed youth gangs, whose activities range from street crime to murders and massacres. Though the main tourists sites qualify as being secure, FDI in parts contracted in some years because potential investors
were deterred by the high criminality. While his predecessor followed a course of 
strong repression which led to overcrowded prisons, President Zelaya promised to 
focus more on the roots of criminality by intending to establish more social justice.

As most CA countries Honduras had some success in broadening its formerly 
narrow base of exports. Being once almost exclusively dependent on bananas and 
coffee, some non-traditional products such as palm oil, shrimp, and melon diversified 
the export portfolio. Moreover Honduras qualifies as the third largest supplier of 
textiles to the USA (after China and Mexico) with its large maquila sector at the 
North Western coast. So today, "[e]conomic performance is [...] mostly determined 
by the dynamism of external demand, particularly that of the US economy, because 
of the increasing importance of maquila and tourism activities" (EIU 2005b, p.22).

In March 2005 the IMF and the World Bank judged that Honduras had com-
plied successfully with the economic adjustment programme it had been prescribed 
in 2000 under the heavily indebted poor countries (HIPC) initiative. Therefore it 
was granted a debt relief of US$1.2bn of debt service, totaling almost 25% of its 
total foreign debt, over the next decade. The untied resources will primarily be used 
to improve the countries education and health system.

4.2 CAFTA Within the Broader Picture

It has already been noted that CAFTA, as a trade agreement of the third generation, 
comprises a wide range of provisions far beyond the classical pure trade in goods 
regulations. As can be seen from table 4, CAFTA’s scope reaches from Government 
Procurement and Investment over Trade in Services to provisions on Environment, 
Labor and Transparency. Moreover, it includes two mechanisms for Dispute Settle-
ments, one for general controversies and one specifically for investment issues.

4.2.1 CAFTA and Free Trade in the Americas

Within a remarkably short period of time CAFTA has been negotiated and ratified 
by its participant countries. Between President George W. Bush’s announcement of 
considering a trade agreement with CA in January 2003 and CAFTA entering into 
force at the beginning of 2006 elapsed only three years (see appendix B, table 13). 
Given the dense global political agenda of the US, its generally low interest in the 
region, and the overall ambitious scope of the agreement, the energy that has been 
dedicated to CAFTA deserves some commentary.
Hershberg’s (2005, p.12) observation that "Central America represents neither an economic nor a security challenge of great importance to Washington” stands in stark contrast to the attention CAFTA received by decision-makers in the USA and the echo it stirred in the US media. The actual economic impact of CAFTA for the world’s largest economy is expected to be rather modest. Though US exports to CA exceed the export volume to India, Russia and Indonesia, CAFTA’s high priority on the political agenda of the Bush administration, was owed to its supposed signaling character. The project of forming a FTA of the Americas (FTAA), that is spanning from Alaska to Tierra del Fuego, is a strategic US vision to create a strong counterweight to the EU: "Rather than being important on its own, ratification of the trade agreement with Central America is seen within the US administration as a potentially significant step toward achieving a much more ambitious goal - the construction of a free trade zone encompassing the entire [Western] Hemisphere” (Hershberg 2005, p.3). Figure 8 gives an overview of the current structure of trade agreements in the Americas.

The emergence of fierce opposition by a coalition of Brazil, Argentina, Uruguay, Venezuela, and Paraguay who favor a more comprehensive model of integration with
Figure 8: Preferential trading agreements within the Western hemisphere

Source: Crawford/Fiorentino (2005)

transfer payments to mitigate regional inequalities, led to delays and an eventual halt of the FTAA negotiations\textsuperscript{23}. Whether in anticipation of a potential failure of the FTAA or to pressure this coalition the USA started to settle various deals with single Latin American states like Panama or Chile or regions like CA. In this sense, CAFTA can be interpreted as being part of the Bush administration’s recent strategy of gathering allies for a coalition of the willing. Facing fervent opposition within the USA by lobbying groups like the sugar industry and by the Democratic representatives, CAFTA turned into a open battle mainly along partisan lines that resulted in an extremely close ratification by the House of Representatives (217:215 votes in favor of CAFTA on July, 27th).

Naturally, other conclusions are reached if CAFTA is analyzed from a CA perspective, for ”[t]he US remains the principal external actor shaping the course of events in the region” (Hershberg 2005, p.1); implications and consequences for the small countries on the Isthmus will be discussed in detail in the main section of this thesis.

\textsuperscript{23} During the last conference of the OAS in Mar del Plata (2005, November 4th and 5th) Hugo Chavez, president of Venezuela, declared the FTAA to be ”dead”.

36
4.2.2 CAFTA and the Resurgence of Regionalism

From a comprehensive, global perspective CAFTA must be seen in the broader context of the rise of preferential trade agreements (PTAs) over the last decade. The phenomenon of the sharp increase in the negotiation and ratification of PTAs, be it in the form of free trade agreements (FTAs), customs unions (CUs) or even more ambitious projects of regional integration, is probably the most important recent development in international trade relations (see figure 9). In order to clarify the terminology it shall be noted that regional integration or regionalism denotes any kind of formation of a PTA among a set of countries\textsuperscript{24}, where its member countries place “[...] lower restrictions on trade with each other than they do on trade with the outside world [...]” (Caves et al. 1996, p.307).

CAFTA almost perfectly fits into the scheme of the new regionalism which Ethier (1989, p.1150) characterizes by six typically prevalent features:

- One or several small countries link up with one large country: The five CA countries together with the Dominican Republic account for just a fraction of the economic power of their larger partner, the USA.

- The small countries previously undertook substantial unilateral reforms: At least El Salvador had already engaged in significant unilateral liberalization in the years before.

\textsuperscript{24} These countries do not necessarily have to be in geographical proximity nor needs the agreement extend to all goods; nevertheless, both is usually the case.
• **The degree of liberalization is of limited scope:** Almost 80% of the regions exports already enter the USA without any tariffs under the System of Generalized Preferences Trade Act (SGP, 1974) and the Caribbean Basin Economic Recovery Act (CBI, 1984). In this sense, CAFTA can be seen as a consolidation of a yet existing preferential access of the region to the US market combined with some innovations. Whereas so far, this market access was a voluntarily granted privilege, which frequently had to be re-approved by the US Congress, CAFTA cements it by putting it on a binding legal base which cannot be denounced unilaterally without sanctions.

• **Agreements are asymmetrical with small countries committing to more liberalization:** Due to the fact that CA countries already faced less trade barriers for their exports to the US market than vice versa, they had to agree to more liberalization than what the USA had to offer additionally.

• **Agreements comprise more than just reducing trade barriers, but also include closer cooperation and coordination in other areas:** It has already been argued that CAFTA is not exclusively limited to pure trade matters but extends to a much wider range of topics (see table 4).

• **Participants are in geographical proximity, if they are not neighbors:** Geographical proximity is certainly given, though Mexico lies in between the USA and Guatemala, being the most Northern of the CA countries.

The first wave of regionalism was primarily analyzed in terms of *trade creation* and *trade diversion*, the two basic concepts introduced by Viner (1950) in his seminal contribution "The Customs Union". Though, with the PTA domestic consumers gain a net surplus due to lower market prices, this effect might be outweighed by the loss of tariff revenues for the government. As a consequence, the formation of a PTA can either have welfare increasing or welfare decreasing effects for the participating economies.

In the context of the new regionalism and particularly with respect to DCs, the focus of economic analysis has shifted from the above outlined static effects to the *dynamic effects* of integration. Especially from a long-term perspective these dynamics are considered to be more important: Enhanced chances of specialization in niches due to economies-of-scales-effects in enlarged markets; higher incentives

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25 This wave could be witnessed during the 1950s and 1960s; however, with the exception of the EU, efforts to deepen integration did not prove to be successful and the impetus dissolved.

26 Trade creation takes place when a PTA prompts a country to import goods or services from a more efficient source, while trade diversion denotes the opposite. While trade creation is considered to be beneficial, trade diversion is potentially harmful to an economy.
(respectively pressure) for governments to promote structural reforms, fight corruption, and improve governance; knowledge and technology transfer via higher flows of FDI due to a more attractive investment climate; and increased domestic efficiency due to increased competition in former monopolistic or oligopolistic markets. Section 3.3 will provide a more detailed presentation of this issue.

Since international trade theory undoubtedly proves the superiority of worldwide free trade as the first-best outcome, an intensive discussion in the academic world about causes and consequences of the resurgence of regional integration has set in. In their regional trading agreement (RTA) kaleidoscope Crawford and Fiorentino (2005, p.2) observe that "countries across the world, including those traditionally reliant on multilateral trade liberalization, are increasingly making RTAs the centerpiece of their commercial policy; for some countries RTAs are on a par with multilateral trade objectives; however, for many others RTAs have become the priority". So the question arises: Why is the negotiation of bilateral trade agreements preferred to multilateral agreements, which ultimately promise higher gains? Usually the growing frustration about the slowdown of progress in multilateral trade negotiations within the forum of the WTO is quoted as the major cause.

Smaller, more homogeneous groups with only a few members promise a higher degree of flexibility and manageability as negotiations are less tedious and costly. This holds even more true if the agreements are formed among neighboring countries sharing similar interests due to geographical and geopolitical factors. Moreover, in international trade relations countries face a situation with imperfect information, which implies that strategic considerations of interaction apply: Small trading clubs offer lower monitoring costs, a higher verifiability of compliance and better working mechanisms of sanctioning than large multilateral organizations.

A more pragmatic explanation is that due to the success of former trade rounds only the most sensitive areas remain where, naturally, it becomes increasingly difficult to strike a deal that satisfies all interests. Moreover, developing countries are becoming more self-confident and determined in putting forward their claims. Traditionally, the USA and the EU could easily dominate the negotiation process since they faced a group of isolated DCs. But at the latest WTO meeting in Cancun, Mexico (2003), they were confronted by the new reality of a well-organized and cohesive bloc of twenty-two developing nations (G22) which let the negotiations

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27 The G22 is formed by Brazil, India, China, South Africa, Mexico, Thailand, the Philippines, Argentina, and Turkey, among others.
collapse as ICs failed to reconsider their positions. Especially Brazil has emerged as a leader by gathering and coordinating other DCs in an effort to develop a socially oriented model of trade and integration as opposed to the prevailing Washington Consensus and its paradigm of neoliberalism: "By negotiating as blocs highly concerned with the social agenda, Brazilian-led coalitions and their expanding alliances are attempting to turn Free Trade into Fair Trade by beginning to demand standards for workers and an end for protectionism only for wealthy countries [28], as conditions for trade" (Hernandez 2003).

Shams (2002, p.15) claims that security considerations and bargaining power are the main motivations for regional integration. In his opinion, economic considerations play only a minor role in the formation of regional groupings. Especially, with the long-standing background of CA’s military conflicts one additional side-effect of regional integration gains importance: "[R]egional integration binds the participating countries together and therefore increases security [...] based on the proposition that trade, by fostering understanding and raising the level of interaction, increases trust and therefore alleviates conflicts between partners" (ibid., p.6). Regional integration might also assist to document and preserve the status quo of recent achievements and developments beyond liberalization of trade: It may serve "as a means to demonstrate good governance and to prevent backsliding on political and economic reforms" (Crawford and Fiorentino 2005, p.16), thereby assuming the role of a lock-in-mechanism.

An interesting proposition comes from Ethier (1998, p.1160) who explains "[t]he new regionalism [...] in good part, [as] a direct result of the success of multilateral liberalisation" and as "the means by which new countries trying to enter the multilateral system[29] compete among themselves for the direct investment necessary for their successful participation in that system" (ibid.). The explanation underlying the second proposal is that external commitments by the government are more credible, since policy reversals become more costly (see section 4.3 for this line of thought in greater detail).

Turning from the causes of the sharp increase in PTAs to its potential consequences on the world trading system leads to an economic research programme with the label regionalism vs. multilateralism: An ever-growing strand of literature attempts to answer Bhagwati’s famous question whether PTAs serve as "building

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28 Hernandez refers here primarily to agricultural products and service trade in GATS mode 4, presence of natural persons.

29 Ethier refers hereby mainly to small countries and DCs.
blocks or stumbling blocks” (Bhagwati 1991) on the road toward multilateralism and the ultimate goal of worldwide free trade. Arguments in favor of the formation of PTAs are that they “can be laboratories for change and innovation and may provide guidance for the adoption of new trade disciplines at the multilateral level (Crawford and Fiorentino 2005, p.16). Moreover, they allow especially less experienced countries to gain valuable negotiation skills and, if the formation of trade blocs among DCs succeeds, strengthens their bargaining power for future negotiations. On the downside, the flood of PTAs creates a complex net of agreements with increasingly non-transparent international trade relations - known as the "spaghetti bowl" - thereby increasing the risk of confusion and making trade more costly again. The administration of several agreements each imposing different rules-of-origins will quickly bring DCs to the limit of their capacities. Furthermore, within the PTAs new vested interest groups are formed with the goal of defending their preferential trade margins against outsiders. Hence these are likely to oppose expansion of the PTA. In his paper "Is Bilateralism Bad?” Krugman (1992) comes to the conclusion that under certain, somewhat restrictive assumptions, the looming formation of three big trade blocs (the Americas, the EU and an Asian bloc) is the worst possible outcome regarding global welfare.

To enter this discussion even superficially is far beyond the scope of this thesis; it shall therefore just be noted that the results of dozens of publications30 show that even the type of integration is of relevance for the analysis: An accurate distinction of FTAs and CUs is crucial, since each form of trade agreement leads to significantly diverging results in tariffs, prices, trade volume and, welfare31.

4.3 A Supplement: Considerations on Political Economy

It has already been argued in section 3.3 that trade liberalization in services has the most benefits for the country which itself eliminates protective measures. Hence, the question arises why DCs do not pursue a course of unilateral liberalization as an alternative or complement to bilateral respectively multilateral negotiations? Especially for DCs which dispose only of limited administrative capacities unilateral liberalization may seem particularly appealing since it neither implies complex,
resource-binding negotiation procedures nor costly sanctions if policy reversals become more opportune. Moreover, unpredictability of developments in fast-evolving areas like ICTs and their implications give even more weight to considerations about cautious, revertible policy steps.

The crucial problem with unilateral liberalization is that it may not be politically feasible, because cohesive, well-organized interest groups oppose liberalization in order to protect their rents. The principal beneficiaries of reduced or eliminated trade barriers, i.e. consumers, are not sufficiently organized to articulate and lobby their stake: "For each member of those large groups [i.e. consumers or industrial customers], the cost of protection is too small to spend sufficient resources on opposing it. Multilateral [or bilateral] negotiations offer a way out of this dilemma by producing a package of measures that include improved market access for each country’s exporters. Hence the protection lobbies now face more focused opposition by exporters, and the full package of welfare-improving liberalization measures may now become politically feasible” (Lücke and Spinanger 2004, p.9).

In this sense, while the economic rationale would indicate unilateral liberalization, supplementary considerations about mechanisms of political decision-making are necessary to explain why this outcome is rarely observable in reality. The incorporation of political economy concepts into international trade models allows to explain why decision-makers most often do not implement policies which would be most desirable from an economic point of view. Within the framework of political economy models the assumption that authorities exclusively strive for social welfare maximization, meaning that they solely act in the interest of their country, is dropped: "[C]onsistency in the specification of behavioral motives of individuals [...] requires acknowledging the political-self interest motives of political agents [...]” (Hillman 1989, p.25). Therefore, the formulation of trade policy becomes endogenous since it is the result of the optimization behavior of all actors. Lobbying groups "address government officials as the providers of the public policies they desire and who in turn seek to maximize their own economic welfare [...] through re-election to political office” (Shams 2002, p.3).

The determination of trade policy is illustrated by Rodrik (1995, p.1459) as the interaction of demand and supply on a ’market place’, which is constituted by the institutional setting in which trade policy ultimately is formulated. The ’demand side’ of trade policy is given by the preferences of individuals over the domain of policy

32 In literature, this concept is labeled the "benign dictator".
choices available to policy-makers. Pressure groups, political parties or grass-roots movements act as aggregation platforms which channel these atomistic individual preferences to take a more powerful stand for a specific policy. The 'supply side' of trade policy is characterized by the preferences of policy-makers, which might, for example, be re-election or partisan motives\textsuperscript{33}. The most popular approaches include modeling the policy formation process by political support functions, by tariff-formation functions, by political contributions, by campaign contributions or by median-voter theory.

With reference to DCs, Shams (2002, p.4) stresses that a "number of special features have to be taken into account when applying interest groups theory to developing countries". Most importantly, he refers to the existence of informal 'strategic groups' which can form in shortest time periods, are not bound by democratic traditions and may exert substantial influence on the official political process.

Directly applied to Central America the question must be posed why the implementation of policy agendas aiming at widely supported goals such as enhanced growth, poverty reduction and macroeconomic stability remains so difficult. The end of military conflicts within the region followed by politically open democratic systems and the increasing availability of information about the comparatively higher standards of living in other regions have constantly risen social expectations in CA over the last years. On the other side, natural catastrophes (hurricanes, earthquakes, flooding) and other adverse shocks like the worsening of the terms of trade and the global economic slowdown have exacerbated the divergence of ambitions and reality. "At the same time, many institutions remain hobbled by political polarization fueled by a simmering distributional conflict that tends to permeate the political discourse. The associated social tensions have tended to stymie the political process and set back efforts to move economic reforms forward and to fulfill the rising expectations" (Breuer and Cruz 2005, p.126).

Though governance in CA has improved over time (see figure 10), weak institutions, corruption, and lack of transparency and legal protection remain a primary source of inefficiencies and frustration. The further widening gap in income and power between a small, elitarian minority and the rest of the population aggravates social tensions and a climate of distrust. "Inequality weakens social cohesion,\textsuperscript{33}Of course, a sincere interest in maximizing social welfare shall not be excluded as potential motive.
and most countries have yet to build the social cohesion needed to reduce political polarization. [...] Sustained unfulfilled — and at times unrealistic — demands for redistribution strain the political process and undermine the economic policymaking process” (ibid., p.127).

A further strong limitation of reform processes in CA is political discontinuity and fragmentation. Since in most countries the re-election of presidents is not possible by law, governments have a strong tendency to favor short-term oriented policies. Strategic agendas that focus on long-run goals hardly have a tradition and, if implemented, always run the risk of getting dismantled by the successor government of the opposite political camp\textsuperscript{34}. Furthermore, periods of constructive, political work are short since not only the president and all ministers change after every election (even if the same party stays in power), but also high- (and mid-) ranking functionaries within the administration. The time span between the new government having acclimatized to executive responsibilities and processes and the next elections looming on the horizon is often insufficient to bring major reform projects on their way.

Serious ambitions to achieve more political stability and continuity bring us back to the distinguishing features between liberalization in unilateral and bilateral/multilateral frameworks: Conversing the argumentation line laid out at the beginning of this section, bilateral/multilateral liberalization bestows higher credibility on decisions due to increased costs of policy reversals. Binding commitments to trade agreements serve as a signaling device to foreign investors inspiring more confidence into higher predictability \textsuperscript{35}. In this sense, participation in the international trading system can work as an external anchor which forces governments to steer a course of state interventions which are more transparent and rule-based rather than discretionary (cf. Srinivasan 1994, p.26). Since the attraction of FDIs is a key concern for DCs, the importance of this signaling should not be underestimated.

\textsuperscript{34} In Guatemala governmental responsibility changed between six political parties within the last 20 years, without one party being re-elected once.

\textsuperscript{35} Participation in many IMF or World Bank Programmes work in a similar manner, since they include the mechanism of political conditionality which links the grant of benefits to DCs with their commitments to undertake certain reform projects.
4 SETTING THE STAGE: THE GENERAL BACKGROUND

(a) El Salvador

(b) Guatemala

(c) Honduras

(d) China

(e) India

(f) USA

Figure 10: Governance Indicators (from top to bottom: Voice and Accountability, Political Stability, Government Effectiveness, Regulatory Quality, Rule of Law, Control of Corruption; upper bar indicates 2004, lower bar indicates 1996)

5 Methodology

This thesis attempts to identify challenges and opportunities arising from CAFTA for the service sector (especially, the financial and the telecommunications sector) in El Salvador, Guatemala, and Honduras. So far, due to the high actuality of the issue and the countries’ decision to focus their limited analytical resources on CAFTA’s impact on the agricultural and the manufacturing sector, only very little materials like diagnostic studies or technical reports for the service sector of the three economies are available. Furthermore, the scarcity and questionable quality of existing numerical data severely restricts any kind of quantitative analysis.

Therefore, a research design has been chosen which bases its knowledge acquisition and evaluation on two other pillars. A text and content analysis of the legal documents of CAFTA is supplemented by qualitative expert interviews. The objective of the interviews was hereby two-fold: On the one side they should validate the findings of the text and content analysis and on the other side serve as an exploratory tool to unearth the most recent tendencies and issues and ensure a higher degree of completeness.

In the following the exact research design is presented and weaknesses and strengths of the employed methodology are discussed.

5.1 Qualitative Interviews

The strongly explorative character of this investigation required a sufficiently open framework for the interviews. Therefore, the expert interviews were conducted in a semi-structured form. This type of interview is one of the most often used knowledge acquisition techniques in social sciences, since it combines the advantages of a structured agenda with the flexibility to ask supplementary questions whenever the necessity arises to clarify or expand on the issues raised (cf. Schnell et al. 2005, p.387).36

36 However, it requires high interviewing skills as well as a time consuming preparation and evaluation.
In a semi-structured interviews the starting point of each session usually are general questions that can according to the interview partner’s expertise be deepened; furthermore this approach allows to probe for details or gain a range of insights into unexpectedly arising aspects. This less formal style of conversation permits also building up an atmosphere of confidence in which more sensitive areas can be approached. Moreover, the semi-structured interview guarantees a comparatively high validity since open-ended questions allow respondents to talk freely about issues without constraining their answers. Finally, as compared to the structured interview it permits a two-way communication and therefore also allows content-related feedback to the interviewer and, in this sense, also works as an extension tool.

One of the major difficulties in the process of conducting the interviews for this thesis was to make allowance for the regional distinctions and particularities of the three countries as well as for the different institutional backgrounds of the participants. Since the primary objective of the interviews was to gain knowledge of otherwise hardly accessible information, a flexible conduct of the conversations was valued higher than a strict and puristic approach. Due to the limited time frame for preparation and the complexity of the topic in some interview sessions significant deviations from the catalogue of questions had to be accepted in order to take best advantage of the specific knowledge of each expert. A further qualification of the comparability of the interviews was owed to the practice of integrating new question items and eliminating others that had proven to be of minor importance during the process. Since the emphasis was rather on explorative knowledge acquisition than on drawing conclusions from generalizations, the employed methodology can be justified as being best suited to meet the objectives.

5.2 Proceeding

The selection of interview partners was guided by the consideration of forming a meaningful sample in which representatives of the government, of state agencies, of the private sector and from independent institutions of each country were to be heard. An overview of the preferred profile of participants is given in table 5. All in all, 28 interviews were conducted whereupon two had the character of preliminary interview sessions to enable more profound and efficient realization of the subsequent ones.

37 Nevertheless, like with any kind of interview one of the principal challenges is to avoid the formulation of prescriptive or leading questions.
### Group I  Country Experts

Preferred expert profile is a "Country Expert" with a broad overview of the service sector, its different subsectors, their expected development and their role on the policy agenda:
- (Ex-)Negotiators of CAFTA of the government and the private sector;
- Officials of the National Programmes of Competitivity;
- Officials of Export Promotion Agencies;
- Independent experts of research institutes, consultancies and international institutions.

Interviews with Country Experts of different background serve
- to get a general overview of the service sector of the country,
- to learn the main considerations during the negotiation process of CAFTA,
- to identify the implications of CAFTA for the service sector as a whole and
- to understand the current and future policy agenda with respect to the service sector.

### Group II  Sector Experts

Preferred expert profile is "Sector Expert" with profound knowledge of his sector, its market structure, market access conditions, labour force characteristics and geographic features (conglomeration, concentration, etc.):
- Private Sector (entrepreneurs, sector associations);
- State officials (regulatory institutions, Central Bank).

Interviews with Sector Experts of the selected sectors per country of different background serve
- to get an in-depth assessment of the current state of this sector,
- to identify the main challenges and opportunities due to CAFTA and a future perspective of this sector and
- to formulate a tentative definition of the role foreign aid could play within the context of CAFTA and its implications.

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<th>Table 5: Preferred Expert Profiles</th>
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In the recruitment process of interview partners a description of the research project, containing its structure, objective and methodology was sent to potential candidates with the request of an appointment. The detailed information that was provided to the candidates at this first contact thereby fulfilled two functions: First, it served as a self-selection tool in the sense that only experts who considered themselves as sufficiently acquainted with the topic would agree to an appointment. If this was not the case, they were explicitly asked to redirect the message to other experts they regarded as more qualified for the specific subject or to provide contact data of other potential candidates or institutions. Second, the description of the investigation allowed the later participants an appropriate preparation for the interview, though without knowing the exact questions. The underlying idea of this approach was to make sure answers were spontaneous and not pre-formulated for political complacence.

On the basis of two preliminary interviews with a country expert and a financial sector expert as well as the foregoing analysis of the relevant literature, a catalogue of sample questions was developed. It was designed in a way that some key questions would be asked to all participants whereas a number of other questions would be asked according to the specific profile of the interview partner. The average duration of the interviews was around 35 minutes with only few sessions deviating from this. At the end of every interview each participant was asked to maintain contact and provide additional or updated information in case of later availability. A complete listing of the interview partners can be found in appendix A, tables 9-11.
6 CAFTA’s Implications on the Service Sector in General

In this section an overview of CAFTA’s impact on the service sector in the three CA economies is given; the emphasis is hereby on the effect on business services and to a lesser extent on transport. First, in section 6.1 the chapter on cross-border trade in services of CAFTA (chapter 11) is presented. The most important provisions are briefly depicted and their implications are explained. Then, in the following two sections the main results of the interviews with the country experts are summarized: Section 6.2 epitomizes those aspects which were found to be of regional relevance since they came up in conversations in all three countries. Subsequently, section 6.3 provides details about each country in particular, taking into account its characteristics and its specific current situation. Finally, section 6.4 supplements the preceding analysis by some own considerations.

6.1 Cross-Border Trade in Services in CAFTA (Chapter 11)

Chapter 11 of CAFTA comprises 14 articles that regulate cross-border trade of services between CA and the USA (see table 6), of which the most important ones are briefly presented in the following.

Article 11.1, Scope and Coverage, states the general application of the chapter to the production, distribution, marketing, sale, and delivery respectively the purchase, use of, or payment for all services exempting only financial services (which received a separate chapter), air services, procurement, and subsidies or grants. Moreover, the domain of application does not include services supplied in the exercise of governmental authority, i.e. any kind of service which is supplied neither on a commercial basis, nor in competition with other service suppliers.

The guarantee of National Treatment in Article 11.2 means that no service supplier of a partner country shall be treated less favorably than domestic suppliers. Article 11.3, Most-Favored-Nation Treatment, refers to the commitment that that no service supplier of a partner country shall receive any treatment less favorable than suppliers from other partner countries or non-partner countries. These principles
are well in accordance with GATS and prevent any kind of discrimination between suppliers from partner countries and those from the home country or non-partner countries.

Provisions on Market Access, Article 11.3, rule out any kind of limitation on (a) the number of service suppliers, (b) the total value of service transactions, (c) the total number of service operations or the total quantity of services output, or (d) the total number of natural persons that may be employed in a particular service sector. Furthermore, no restrictions or requirements with respect to specific types of legal entity or joint venture through which a service provider may supply a service are permitted. Articles 11.5, Local Presence, decrees that no country may require suppliers from partner countries to establish or maintain any form of local presence in its territory as a pre-condition for the cross-border supply of services.

Articles 11.2 to 11.5 constitute the core framework of trade liberalization in services; article 11.6, Non-Conforming Measures, ensures that any kind of qualification reserved by participating countries to these basic principles must be listed in Annex I or Annex II. Though, naturally, each country opted to maintain certain protective measures for its most sensitive subsectors, the described approach can be interpreted as a success: In contrast to GATS, which employs positive lists, meaning that each country announces explicitly where it commits to liberalization, CAFTA pursues the more ambitious course of negative lists: All services get liberalized except those which the countries explicitly exclude.

Table 6: Cross-Border Trade in Services (CAFTA, Chapter 11)

<table>
<thead>
<tr>
<th>Cross-Border Trade in Services</th>
<th>Art. 11.1</th>
<th>Scope and Coverage</th>
<th>Art. 11.8</th>
<th>Domestic Regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Art. 11.2</td>
<td>National Treatment</td>
<td>Art. 11.9</td>
<td>Mutual Recognition</td>
<td></td>
</tr>
<tr>
<td>Art. 11.3</td>
<td>Most-Favored-Nation Treatment</td>
<td>Art. 11.10</td>
<td>Transfers and Payments</td>
<td></td>
</tr>
<tr>
<td>Art. 11.4</td>
<td>Market Access</td>
<td>Art. 11.11</td>
<td>Implementation</td>
<td></td>
</tr>
<tr>
<td>Art. 11.5</td>
<td>Local Presence</td>
<td>Art. 11.12</td>
<td>Denial of Benefits</td>
<td></td>
</tr>
<tr>
<td>Art. 11.6</td>
<td>Non-Conforming Measures</td>
<td>Art. 11.13</td>
<td>Specific Commitments</td>
<td></td>
</tr>
<tr>
<td>Art. 11.7</td>
<td>Transparency in Developing and Applying Regulations</td>
<td>Art. 11.14</td>
<td>Definitions</td>
<td></td>
</tr>
<tr>
<td>Annexes</td>
<td></td>
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</table>

It has already been stated that the main obstacles to service trade are national regulations instead of tariffs. Provisions on Domestic Regulation are therefore of major importance; despite the fact that Article 11.8 lacks preciseness and leaves some room for interpretation, it still establishes a solid foundation, curbing discretionary protective regulations. Qualification and licensing requirements or technical standards shall not constitute unnecessary barriers to trade in services, summoning each country to ensure that any measures are based on objective and transparent criteria and are not more burdensome than necessary to guarantee the quality of the service. Processing of authorizations sought by foreign suppliers shall be considered within a reasonable time after the submission of the application.

CAFTA remains vague on the issue of Mutual Recognition of standards or criteria for the authorization, licensing or certification of services suppliers, postponing any kind of concrete arrangement to future supplementary agreements. Article 11.9 is mainly limited to prevent discrimination among partner countries and encourage them to undertake harmonization efforts. With regard to Professional Services Annex 11.9 calls upon the development of mutually acceptable standards and criteria for (temporary) licensing and certification of professional service suppliers.

Article 11.10 on Transfers and Payments confirms that all transfers and payments relating to the cross-border supply of services can be made freely, without delay, and in a freely usable currency into and out of every territory at any time; it thereby blocks any attempts to abuse payment modalities as obstacles to discourage trade. In order to achieve continuous progress, Article 11.11 demands all countries to consult annually to review the Implementation of the provisions of chapter 11 and consider other issues of mutual interest.

A common misunderstanding about CAFTA (and also about GATS) is the perception that signing these agreements prevents countries from setting their own policy agendas in the future. In contrast to this belief, member countries do not lose their independence to formulate and implement new legislation in order to pursue country-specific goals in whatever policy area, be it environment, labor regulations or other issues. What the agreements do prohibit are provisions that apply in a discriminatory manner, i.e. provisions that violate the principles of national treatment or MFN-treatment by favoring either domestic suppliers or those of any other countries over the rest. The core philosophy which underlies all multilateral trade agreements is achieving free trade by ensuring that the same rules of the game apply to all players independently from their home country. Principally, all other provi-
sions such as on transparency, domestic regulation etc. either are precisions of these most basic rules or are definitions for exceptions and qualifications. In this sense, CAFTA effects an elimination of discriminatory measures (except those listed in the annexes) and ensures that no more protective measures are taken in the future. However, all countries maintain their full sovereignty of legislation to the extent that they do not disregard the principle of non-discrimination.

Focusing on the relationship with the USA, there is little doubt that intensifying trade relations with the region’s largest trading partner is an important step into the right direction. Since CAFTA’s predecessor, the Caribbean Basin Initiative (CBI), did not contain provisions on services trade, the commitments which are now reached in the agreement break new ground and inspire confidence in future progress: “[P]olicymakers and specialists from Central America have expressed optimism in the sense that these aspects of the treaty should boost the credibility of the reforms of recent years that opened provision of most services to private operators, including those from abroad” (World Bank 2005, p.42).

From a broader perspective, the integration of the service dimension into CAFTA can be regarded as an important success for CA in keeping up with recent developments in international trade relations. Although El Salvador, Guatemala and Honduras by then had negotiated a free trade agreement with Mexico which includes provisions on services, the four chapters on services trade in CAFTA are far more extensive and forced CA countries to dive deeper into the topic and to work it in greater detail. Despite the fact that resources are scarce and considerable capacities were and still are bound on this issue, this investment can be expected to prove worthwhile. CA nations cannot afford to lag behind other DCs which have also become aware of the relevance of trade in services and are already extending their agendas by the subject. Since the integration of services trade into CAFTA will initiate respectively accelerate the formulation of policies aimed at enhancing service sector development, its value cannot be overestimated even if few immediate benefits for the examined countries can be anticipated (see the following sections for more details).

In consideration of the ambitions of the US government to strike free trade deals with various nations around the globe, CA must fear that the relative advantage

39 A good example is South Africa which, for some years, has been working ambitiously on trade and industrial policies for the service sector (see Hodge (1998)).

40 In contrast, immediate effects are expected in cases where existing quotas for goods are reduced or eliminated, for example for sugar.
which it gained by the CAFTA agreement toward outsiders will become eroded over time. Hence, time is scarce for the region to use its headstart in order to actively define its trade objectives and claim its niches. Losing more time will bring CA into the uncomfortable position of having to react passively to the moves of other nations that successively will gain privileged access to the US market.

6.2 Evaluation of the Interviews - Regional Results

The essence of almost all interviews was that no clear course for the promotion of the service sector existed. Despite the broad consensus about the crucial role of the service sector for the future growth of the CA economies, governments were struggling to draft action plans on service sector development for their countries. Interviewees attributed difficulties and neglects less to a lack of political will-power as rather to a lack of vision. Initiatives in the service sector were perceived to be at best singular and isolated instead of being embedded into a broader, comprehensive strategy. Interviewees further agreed unanimously that the lack of meaningful data and statistics imposed major constraints on research analysis aimed at the identification of opportunities, the diagnosis of prevailing problems and the projections of future developments.

Though interviewees confirmed that CA countries had shifted their focus increasingly on industry clusters in an effort to build up value chains and enhance their vertical integration, they mostly conceded that the role of services as inputs within these clusters had been neglected. Interviewees agreed that the link between manufacturing and services had not yet been analyzed sufficiently in the CA economies. Several interviewees (in all countries) expressed the opinion that their governments had missed to issue the necessary sectoral studies and lacked the preparation to take full advantage of trade liberalization by CAFTA.

A concern raised in the majority of the interviews, though not surprisingly to a lesser extent by the representatives of the private sector, was the need to strengthen

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41 After all, though prospects of advances in multilateral service negotiations within the GATS framework remain dire, there is no guaranty that the stand-still will continue indefinitely.

42 The only service segments for which useful statistics are available are finance and telecommunications due to legal provisions; to a lesser degree data also exist for the tourism sector. The problematic of unreliable statistics is aggravated by the high degree to which services are provided within the informal sector.

43 Furthermore, these clusters were exclusively defined around goods and did not involve one service cluster.

44 Statements refer to the service sector in general; the financial sector was regarded to be an exception to this shortcoming.
the regulatory framework\textsuperscript{45}. In expectation of more foreign investments the necessity to provide functional regulatory and supervisory institutions was underlined as being one of the most important points on the agenda. Interviewees argued that liberalization necessitates better regulation and not just simply less as the commonly used term deregulation might suggest. They emphasized that challenges for the regulatory authorities would increase with the market entry of well-seasoned international companies. In this context a strengthening of laws of competition and of consumer protection would become more urgent.

Some interviewees argued that even before becoming effective CAFTA might already have had its most important merits: It had initiated a broad public discussion about the competitiveness of the region. The almost daily media coverage of the agreement had raised the general public’s awareness of the ongoing process of globalization and its relevance for the traditionally more self-centered region. Forums and seminars had made a larger fraction of the population acquainted with such terms as cost structures, efficiency, and competitiveness and an intense debate about necessary changes within the region had come into life. In the words of one interviewee more public awareness and sensibilization for global changes and their inherent challenges for CA had been won in a couple of months than in the whole decade of years before. In this sense, CAFTA had served to wake up the region and to incite increasing interest in crucial topics like systemic competitiveness. It thereby had layn the foundation for a shift of attention to the service sector and its role as provider of inputs which crucially determine the prices and quality of the manufacturing industry.

However, interviewees agreed that the topic of service sector development and service trade was still very elitarian in the sense that it had only reached the top levels of decision-making. The objective to enhance systemic competitiveness had resulted in the setting-up of national programmes such as PRONACOM in Guatemala or COMPITE in Honduras in which services were at least partly integrated \textsuperscript{46}. Nevertheless, several interviewees concluded that service sector development and trade in services would have to move up further on national policy agendas and that it would become crucial to start spreading the issue down to the operational levels. For the latter it was considered necessary to further refine the definition of respective goals and translate them into concrete initiatives and projects.

\textsuperscript{45} This concern most often came up in relation to telecommunications services, financial services and utilities.

\textsuperscript{46} PRONACOM emphasizes, for example, the importance of transport and telecommunications infrastructure.
Directly related to this were the observations of some interviewees that the population started to get tired of seminars and conferences praising in too abstract terms the opportunities which CAFTA might offer. Their impression was that in parts functionaries were still giving presentations to sell CAFTA and convince their audiences of its potential benefits. These interviewees stressed that since time was pressuring it would be necessary to move on to the next stage and to start with concrete actions. Hands-on-style workshops and capacitations ought to be offered that were tailored to the needs of specific target groups such as SSME and provided them practical advice. One of the core messages from these interviews was the call to come from the stage of discussion to the stage of implementation and application.

A further merit of CAFTA was seen by several interviewees in the fact that it had served to put in order the current legislation of the region. The agreement forced CA countries to take an inventory of existing regulations of the service sector and thereby provided an accurate snapshot of the region’s current status quo. CAFTA further necessitated a revision of the applying legislation, its supplementation, and its adaptation to modern standards. One interviewee commented that CAFTA negotiations had had a substantially deeper impact in form of modernized and adapted laws than multilateral negotiations within the WTO framework had had so far. Considering CAFTA’s more ambitious agenda, this result is not surprising. Furthermore, almost all interviewees agreed that CAFTA had revitalized efforts to harmonize the national regulations on a regional scale and thereby promoted further integration of CA.

Another aspect emphasized by many interviewees was the importance of the region’s industry structure which is dominated by SSME. The process of trade liberalization is commonly seen to be in favor of large (international) enterprises and to impose additional challenges to SSME. Therefore, interviewees argued that the implementation of CAFTA should be accompanied by more assistance for SSME in order to prepare them for the changed conditions. Technical assistance might hereby play an important role in supplementing the support for SSME.

Suggestions for an agenda designed to enhance the positions of SSME and allow them to take advantage of CAFTA often included to build up and bolster as-

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47 This line of argumentation is not limited to the service sector.

48 Frequently quoted arguments are, among others, that large enterprises (a) can influence trade negotiations in their favor by more effective lobbying; (b) can better take advantage of trade provisions since they have more administrative capacities to conduct the necessary analysis; (c) are more likely to achieve economies to scale due to increased exports.
sociations in order to strengthen SSME. Although this measure is probably of higher relevance for SSME in manufacturing in order to improve their bargaining position in the purchase of inputs and the sale of their products associations nevertheless might also serve as information networks for service suppliers. Moreover, they can be used to join efforts for market research in order to identify niches and gain knowledge of demand characteristics. Interviewees stressed that it was necessary to take SSME’s interests into consideration during the aspired process of vertical integration and to integrate them into the value chains. They all agreed that securing access of SSME to credits should be regarded as a priority.

Since almost all interviewees emphasized the crucial role of transport services, some of their considerations will be shortly summarized although the transport sector has been excluded from CAFTA. Despite the fact that the liberalization of transport services has been left out in negotiations, this sector will still be affected from CAFTA indirectly and, more important, it will have a significant effect on the benefits that CA can reap from CAFTA. Some interviewees identified the inefficiency of transport as one of the most severe constraints on achieving gains from trade liberalization by CAFTA. According to their opinion costly and unreliable transportation and distribution channels were one of the main obstacles for increasing exports in goods. In some cases the lack of well-functioning transport structures would render otherwise internationally competitive sectors without any chance to keep up with foreign suppliers.

This notion is well in line with results of a recent study of the World Bank (2005) which provides evidence that in international comparison CA’s exporting sectors suffer from substantially higher costs of transportation, especially in maritime transports.

6.3 Evaluation of the Interviews - Country Results

6.3.1 Services in El Salvador

Interviewees underlined that within CA El Salvador had been leading economic reforms from the early 1990s. In the spirit of the Washington Consensus recent governments had consequently pursued a course of market orientation and trade liberalization. Especially the financial sector had been the focus of public policies.

49Besides the unfavorable cost structure, other indicators such as rates of cargo moved per hour or time of containers lying idle in port revealed severe inefficiencies in administration and logistics management in CA seaports.
during the first years, then followed, though to a lesser extent, by the telecommunications sector. Trade liberalization had often been implemented in form of unilateral measures exposing domestic service providers to competition from abroad. As a consequence of this partly radical treatment practically all interviewees (in all countries) rated El Salvador as the best prepared country for CAFTA. Little impact in form of further domestic restructuring was expected due to CAFTA since market consolidation was seen as comparatively far advanced as a consequence of the anticipated liberalization over the last years. One interviewee argued that El Salvador could be regarded as the clandestine winner of CAFTA since its neighbor countries were now obliged to liberalize trade and offer access to their markets which El Salvador had already granted them before\(^\text{50}\). However, in the meantime its own service economy had already run through the necessary adjustment and transformation processes and now enjoyed a headstart in terms of competitiveness.

Other interviewees articulated concerns about market fundamentalism in the sense that confidence into the problem-solving power of the markets was so high that the state was not perceived as being in charge (or not being able) of drafting and implementing a strategic development agenda and of conducting industrial policy. The fact that state interventions were seen to be per se dubious and were avoided under most circumstances partly resulted in imposing heavy burdens on the poor who neither received protection nor compensation from losses caused by liberalization.

It has already become apparent from figure 1 that El Salvador experienced a significant shift away from agriculture to services over the last two decades\(^\text{51}\). Interviewees stressed that the country was in a position to further this development by ambitions to establish itself as the region’s powerhouse in financial services and its most recent intention to become an important logistics center for CA. Plans for the latter project include for example the construction of a highway from Puerto Cutuco (Pacific coast) to Puerto Cortés at Honduras’ Caribbean coast in order to offer an alternative to the Panama Canal. Furthermore, with the region’s largest airline, TACA\(^\text{52}\), and its air cargo business as well as the country’s compact size and its comparatively modern roadways El Salvador can boast some comparative advantage toward its neighbors. Implementing this strategy will further benefit the

\(^{50}\) This line of argumentation refers mainly to the service sector.

\(^{51}\) Its share of services of the national GDP increased by 11\% as compared to 4\% in Guatemala and 2\% in Honduras.

\(^{52}\) TACA started as a local company and expanded by an aggressive take-over strategy highly successful over the last years, meanwhile serving the entire Western Hemisphere.
construction sector due to the large investments that will be made in infrastructure. Additionally, it will allow El Salvador to profit from the increase in economic activity and the higher trade volumes stimulated by CAFTA.

One interviewee held that the country also benefited from the high affinity which it had developed toward services as a consequence of the large number of Salvadoreños working in this sector in the USA\(^{53}\). Salvadoreños returning home from abroad would provide some kind of knowledge transfer to their families and communities.

Besides finance and transport interviewees named telecommunications services another strategic sector. Comparatively low costs and high quality of telecommunications were cited as the main reasons for attracting call centers to the country (DELL, TACA). However, it remained to be seen whether the country could build up on these first successes in order to gain reputation and become more present as an alternative location for US companies' outsourcing strategies in this field. Services related to air transport were given as an example for lucratively taking advantage of the specific strengths of the country: Maintenance and reparation services for aircrafts could be extended from TACA’s own fleet to the fleets of US airlines since costs are significantly lower than for comparable services within the USA. Though this example is not related to CAFTA it can still illustrate how comparative advantages can be found even in highly specialized services under certain circumstances.

In the area of professional services interviewees pointed to the fact that El Salvador posed a special case in CA since it did not have a system of obligatory ‘colegiatura’\(^{54}\) like its neighbor countries. Though a system of supervision and public control existed in these professions, it was less formalized than elsewhere. Some interviewees voiced concerns that this lack might be abused by other CA countries to apply protective measures against El Salvador under the pretext to secure their quality standards. They stressed that harmonization of the national provisions on ‘colegiatura’ would be crucial in order to promote trade in professional services within the region; at the same time, interviewees doubted quick progress with respect to the recognition and accreditation of educational standards and titles, especially for the case of El Salvador. According to one interviewee this national particularity prevented liberalization of trade in services in most professions.

\(^{53}\) It should be noted that emigration rates of El Salvador are almost double of those of its neighbors (ESV: -3.67 migrants per 1000, GUA: -1.63 m/1000; HON: -1.95m/1000).

\(^{54}\) The term refers to the graduation from colleges for technical professions.
The highest potential for exports in professional services was seen in medical services such as dentistry, cardiology, and life-style surgeries. So far, health tourism had been mainly confined to Salvadoreños living in the USA and undergoing treatments in El Salvador for cost reasons when they visited their families. Several interviewees (also from other countries) attested medical schools in El Salvador to have a good reputation for their standards. Many students specialized abroad before they returned to the country and possessed the necessary professional expertise to extend health tourism beyond emigrated locals and also attract foreigners. Cuba was quoted as an excellent example of how medical services could be combined with a wide range of touristic offers in order to draw visitors from all over the world and benefit from their spendings on various ends of the service spectrum. However, some interviewees remained skeptical whether it was possible to establish El Salvador as a destination for health tourism since they discerned severe deficiencies in the entrepreneurial part of building up this service segment and marketing it appropriately.

6.3.2 Services in Guatemala

As compared to El Salvador interviewees characterized Guatemala as more conservative with regard to liberalization and more cautious in its commitments. CAFTA was partly understood as an experiment for which gradual steps were seen as the most appropriate approach; all things working out well further liberalization would be undertaken. Though in general interviewees rated the quality of Guatemala’s regulatory framework and the country’s level of competitiveness as comparable to El Salvador’s they all agreed that the country pursued a policy course far less aggressive as its Southern neighbor. The general marketing of the country as an alternative for foreign investment within the region was partly perceived to be improvable.

The current order of the service sector segments according to their contribution to national GDP of Guatemala was reported to be tourism followed by transport and distribution, then telecommunications and financial services; business services, especially professional services, were seen to be of marginal importance.

Interviewees pointed out that efforts to integrate services into the national value chains were mainly led by PRONACOM, Guatemala’s programme for increasing the country’s systemic competitiveness. So far, initiatives referring to the service sector were limited to infrastructure projects, leaving aside business services

55 Considering that almost two million Salvadoreños live abroad the implied potential is noteworthy
all together. However, interviewees assured that sensibilization for service sector development had risen, having moved it slowly up the political agenda.

Some interviewees stressed that particularly the issue of professional services was considered to be of great importance and that initiatives would increasingly start to focus on it in the medium and long run. As a topic of vital importance interviewees considered the accreditation of titles and mutual recognition of academic and technical carriers within the region. However, efforts were seen to be just at the beginning of gaining momentum. The numbers of specialized degrees in professional services at universities and colleges were expected to increase slightly. Notwithstanding, interviewees noted that changes only happened slowly and often lacked direction. Particularly technical colleges were reported to be rather inflexible and little open to innovation. It would be necessary to encourage reforms in these institutions and accelerate them where they were already in process.

One interviewee provided a rough estimate of about 4,000-6,000 professionals who met the requirements necessary for exporting their services. This group consisted mainly of engineers and medical persons who possessed the professional expertise and language skills which allowed them to enter the business of cross-border service supply. The interviewee regarded this amount as sufficiently large for a beginning. Nevertheless, he/she underlined that though the opportunity existed for these professionals, it was essential to promote the idea and sell it to them. He/she called for some initiatives in order to capture their attention and interest and offer them some guidelines for orientation and further support to initialize the process. In the beginning stage, some effort would be necessary to encourage a first wave of professionals to venture this new field and back them up with entrepreneurial advice and best practices from other regions. Once the critical mass of some well-functioning service exporters would have been reached, these would serve as models and motivate others to follow their example.

E-commerce was named by some interviewees as an area of interest to which more resources should be dedicated in future in order to identify niches and enter the market. However, concerns were articulated about high costs for internet access excluding especially SSME from the growth potential of this market segment. A further opening up of the ‘brecha digital’, the digital gap, should be prevented under all circumstances. Chile, Colombia, and Peru were quoted as benchmarks for sound legislation in e-commerce and policy agendas fostering development in this field.

As examples for concrete projects and initiatives a cooperation with Cuba for medical professions and single projects on a very small scale in the financial sector,
software engineering, call centers and transport services were reported, mainly led by Guatemala’s agency for promoting non-traditional exports, AGEXPRONT.

6.3.3 Services in Honduras

In Honduras interviewees underlined the country’s efforts in enhancing its systemic competitiveness though many conceded that neighbor countries were advancing faster. Despite the fact that Honduras improved in absolute terms it struggled to keep up with other CA countries. The strength and efficiency of the financial sector and the telecommunications sector lagged considerably behind El Salvador and Guatemala (see section 7.4). It was noted that in most recent time the government had pushed the restructuring of the telecommunications sector.

Interviewees considered the area of professional services to be highly limited by both supply and demand. Whereas educational standards posed severe restrictions to the supply of well-qualified services, the demand was constrained by a lack of awareness. Most entrepreneurs were not aware of the opportunity costs of inefficient in-house service production and the possibility to outsource these activities to more cost-efficient specialists. Raising conscience about the existence of business services was therefore seen as the first step in creating a domestic market for these services.

With respect to supply, interviewees characterized the policies of public universities to have been focused on broad access for larger groups of the population over recent years. As a result, educational standards had lowered and would rarely provide the necessary qualification and expertise to offer services to international markets. In parts, private universities were seen to concentrate more on quality and niches, thereby achieving higher standards especially in a few segments such as software engineering or agrar-science. Nevertheless, interviewees agreed that service sector initiatives should focus on the development of the domestic market. Programmes to promote service exports were not considered to be of high relevance in the near future.

Concrete efforts in business services were limited to software engineering. A cooperation between universities and the private sector was planned as a long term project with one component fostering start-ups and the other committed to establish centers for technology and innovation.

The access to credit, particularly for SSME, was seen as the most urging problem besides education by most interviewees. Interest rates were often unaffordable
high for many entrepreneurs if they were eligible for credit at all. Since the vast majority of SSME entrepreneurs did not have any kind of business plan, i.e. could neither provide information about their cost structure nor their market potential, banks were often unwilling to grant credit or offered it at correspondingly high risk premiums. Interviewees emphasized two directions for improving situation: First, strengthening and stabilizing the banking sector would be crucial in order to ensure its ability to give credits. Second, capacitating SSME entrepreneurs to gather and provide vital information about their business ideas would be key in order to have their credit requests processed more favorably based on objective criteria. Especially the latter might open up a small market segment for offering services in basic managerial techniques and concepts.

Some interviewees pointed out that knowledge about CAFTA was extremely superficial. Discussions almost always revealed that there were massive misunderstandings and blanks even in basic issues. The private sector, particularly SSME, was not sufficiently prepared on concrete matters such as how to confront dumping, how to check for norms of origin, etc. Public discussions had remained on a level too abstract for most parts of the audiences, causing more confusion and preoccupation than giving orientation and practical advice. However, the potential to establish business consultancy services for these matters were judged critically since the primary addressees, SSME entrepreneurs, would probably shy at costs of these services.

As an additional problem interviewees mentioned that a range of services had been provided by foreign assistance agencies often for free or at least at highly subsidized prices. They argued that this prolonged practice had led to the formation of a mentality of expectation taking help for granted. As a consequence they predicted difficulties in getting people used to pay for certain services which they were accustomed to receive gratis. Due to the country’s history as the principal destination of foreign aid within the region this problematic was seen to be more pronounced in Honduras than in its neighbor countries.

6.4 Supplementary Considerations

It has already been argued that in order to benefit from the increased outsourcing of service activities of high-income countries a range of prerequisites is imperative which can only be found in a few DCs. In the case of CA education has been
identified to be the principal restriction with regard to the promotion of service exports.

The deficiency of educational standards and insufficient language skills severely limit the extent to which CA can make use of the market access it gained to the US services market through CAFTA, at least in the short and probably also in the medium run. One interviewee argued that the region suffered from two forms of illiteracy: One part the population could not read and write and most of the other part could not communicate in English. In order to position itself as service supplier to the US market the language barrier can be regarded as one of the most salient limitations: “The presence of an English-speaking population is a key factor in the choice of location of offshore services, as the commonality of language helps to ensure that quality and performance criteria can be fulfilled” (McKinsey 2003, p.2).

The fact that the industrial structure of Central America is dominated by SSME aggravates the problematic: Exporting directly abroad poses a major challenge to most SSME (cf. Berry 2004, p.6). Especially for supplying the exigent US market many SSME will lack the necessary abilities and capacities. Service trade within the region might prove to be of higher relevance for a given time span. No language and cultural barriers have to be overcome and, though still far from being homogeneous, the more similar levels of development within the region make service trade better feasible. Since CAFTA is expected to accelerate the process of regional integration ranging from overhauling regulations and institutions to facilitating higher trade volumes of intra-regional trade, the opportunity could also be used to advance projects such as the formation of value chains on a regional scale. The integration of services into the industry clusters will be of crucial importance in order to enhance the region’s competitiveness and boost exports newly enabled by CAFTA.

A further key message of most interviews was the necessity to create more awareness and to captivate particularly the younger generations’ attention for the service sector by better marketing the topic. Since interviewees hardly provided concrete ideas on this issue, some own considerations on how more future potential could be activated shall be presented in the following. Universities and technical colleges could make graduates more acquainted with the topic and promote their interest to specialize in services by offering more information in workshops and

\[^{56}\] This might be even more true for SSME in services than in manufacturing due to a higher degree of customer contact.
seminars. Since the target group consists of mainly young people initiatives could be less traditional and could attempt more unconventional approaches to attract interest. Contests for innovative ideas at universities where the best concepts are awarded a sponsorship and support to follow them up might be one approach.

Students could be given the option to develop some concept for service-related business ideas instead of writing the obligatory thesis. One interviewee in Honduras commented that students in engineering had under certain conditions the possibility to choose practical projects instead of submitting a thesis (for example, construct a pump-station on a farm). One could also think about transferring this concept to service-related activities: With appropriate preparation in specifically tailored courses, graduates could attempt to introduce, implement, or enhance accounting systems or marketing concepts in SSME. Their graduation certificate would certainly give students the right incentive to take the project seriously. SSME willing to participate voluntarily in the programme could be expected to have the necessary intrinsic motivation to cooperate and support students in their efforts.

Government or foreign assistance could initiate some projects aimed at service sector development in the metropolitan centers of each country where the infrastructure is given and young urban professionals offer the necessary human skills. Project components might consist of financial support in form of credits or grants or of technical assistance in form of capacitations or information networks transferring knowledge and best practices from other enterprises.

6.5 Conclusions of the Section

In contrast to the commitments within the framework of the General Agreement on Trade in Services (GATS) which are formulated in positive lists, CAFTA pursues the more ambitious approach of negative lists where all services are liberalized except those which the countries explicitly exclude. However, since the trade relations between the USA and the examined Central American countries have been characterized by the grant of significant preferential treatment respectively unilateral liberalization during recent years, CAFTA does not offer many novel commitments on market access.

CAFTA’s principal merits related to the service sector are to be seen in two different areas: First, the agreement establishes a binding legal framework which documents and preserves the status quo of recent reforms and liberalization efforts.
It assumes the function of a lock-in-mechanism that prevents backsliding on the previous achievements in privatization of state-owned enterprises (for example in finance, telecommunications, energy distribution etc.), regulatory reforms and legislation on non-discriminatory treatment of foreign companies. The binding character of the commitments reached by CAFTA provides higher juridical certainty and increases the costs of policy reversals. Thereby it serves as a signaling device to foreign investors inspiring more confidence into a positive development of the region in future.

Second, the almost daily media coverage about CAFTA over the three years of its negotiation and ratification initiated a broad public discussion about the competitiveness of the region. It raised the population’s awareness of the ongoing process of global integration and directed the governments’ attention to their countries’ systemic competitiveness. As a consequence, considerations about the promotion of the service sector in order to enhance the manufacturing industry’s prospects to increase their exports emerged and gained significant weight. In this sense, CAFTA increased the sensitivity of all actors and moved the issue of service sector development further up on the political agenda.

The results of the analysis of potential areas for service exports are well in line with what could be expected in view of the considerations presented in the general part: The range of promising service exports to the US is severely restricted by the shortage of appropriately qualified workers. Both, the lack of the required English skills as well as the insufficient standards of higher education limit the extent to which the three countries can take advantage of the extended market access which they obtained through the agreement. However, some differentiation between the three nations is necessary: El Salvador and, to a slightly lesser degree, Guatemala fulfill the basic requirements such as a functional telecommunications infrastructure and a minimum number of bilingual professionals, at least in their metropolitan areas, as some recent success in the attraction of call centers indicates. In a few selected service segments such as software engineering and medical services some confidence in a positive future development seems to be justified. Despite the considerable reform efforts which Honduras undertakes, the country lags behind its neighbors and might, at best, opt for the development of software engineering in the medium run.

Future efforts focused on service sector development might include the following elements:
The issuing of sectoral studies which examine the interlinkages between the service sector and the manufacturing industry. The identification and subsequent amelioration of specific weaknesses will allow to enhance overall competitiveness of the economy. The lack of this kind of analysis, partly due to the poor quality of quantitative data, poses a major constraint for well-targeted measures.

The development of a vision for the domestic service sector which allows to formulate a long-term strategy and its successive implementation. El Salvador seems to be most successful in this regard: It started early to focus on reforms of its financial sector and has reached a leading position within the region in the meantime. Recent investments in infrastructure (extension of the road network, modernization of seaport Cutuco) underline the country’s ambition to establish itself as an important logistics center for CA. Whereas Guatemala might start to define its niche in services, Honduras is probably best served by concentrating its efforts on the improvement of its infrastructure and educational standards.

The formulation of plans on how to captivate particularly the younger generations’ attention for the service sector. A better marketing is necessary in order to make young people more acquainted with the topic and promote their interest to specialize in services. All countries, though to a different extent according to their standards of education, might consider how they can best build up pool of skilled graduates that qualify for increasingly sophisticated services.

The exploration of the potential of services trade within the Central America. Since the region mostly lacks the prerequisites for supplying services to the exigent US market intra-regional service trade might prove to be a more promising option. No language and cultural barriers have to be overcome and, though still far from being homogeneous, the more similar levels of development within the region might make service trade better feasible.

Especially with respect to the conduct of research, technical assistance might assume an important supportive role. Detailed analyses of the industry structure might enable a better understanding of interlinkages between the manufacturing industry and the service sector. These findings might serve as a valuable orientation guideline for policy-makers and might enable the formulation of well-targeted reforms which increase systemic competitiveness and overall economic growth.
7 CAFTA’s Implications on the Financial Service Sector

After the more general overview of the implications of CAFTA on the service sector in the last section, the analysis now focuses on financial services. Section 7.1 provides some introductory notes about the financial sector: In order to outline the motivation to select this specific sector, the role of the financial system within the economy is sketched in section 7.1.1; moreover, some empirical studies, which examine the relation between financial sector development and economic growth are surveyed. Then, section 7.1.2 discusses the entry of foreign banks as a highly relevant aspect of financial liberalization and reflects on its implications on efficiency, financial system stability and access to credit for SSME.

The subsequent sections are then dedicated to the concrete analysis of the expected implications of CAFTA on the financial sector of El Salvador, Guatemala and Honduras. Section 7.2 sifts the legal text of CAFTA and delineates the most important provisions of chapter 12 on financial services. In section 7.3 the evaluation of the interviews with the sector expert are summarized as far as they apply to all three countries. The main topics which are presented include, among others, family remittances, the insurance sector, and capital markets. Sections 7.4.1-7.4.3 provide more detailed information on each country: First, some background information and key data on the financial sector are given. Then, the legal framework is briefly depicted and the main challenges imposed by CAFTA are described and, finally, some supplementary notes are given. In section 7.5 one potential role for technical assistance is derived from the expected implications of CAFTA on the financial sector in the three countries. Section 7.6 concludes with a brief summary of the main considerations and results.
7.1 Theory and Evidence about the Financial Sector

7.1.1 Financial Sector Development and Economic Growth

The functionality of the financial system of an economy is often recognized as one of the key determinants for its future economic development. Stiglitz (1998) likens "the financial system to the 'brain' of the economy. It plays an important role in collecting and aggravating savings from agents who have excess resources today. These resources are allocated to others - like entrepreneurs and home builders - who can make productive use of those resources. Well-functioning financial systems do a very good job of selecting the most productive recipients for these resources. [...] Selecting projects is only the first stage. The financial system needs to continue to monitor the use of funds, ensuring that they are continuing to be used productively. In the process, they serve a number of other functions, including reducing risk, increasing liquidity, and conveying information. All of these functions are essential to both the growth of capital and the increase in total factor productivity". Financial systems provide an inter-temporal link between presence and future, thereby enabling economic agents to transfer purchasing power across time. Hence, the creation of functional "financial markets [...] gives more flexibility to the economic system in choosing a desired combination of growth and consumer’s welfare" (Checchi 1993, p.825).

In the following, the results of some quantitative studies are briefly presented in order to show that empirical evidence confirms that the functionality and development of the financial system has a positive impact on economic growth:

King and Levine (1993) find that their indicators for financial development "are strongly and robustly correlated with growth, the rate of physical capital accumulation, and improvements in the efficiency of capital allocation" (ibid., p.734). Moreover, they confirm the consistency of a causal relationship running from more efficient financial systems to economic growth with their data since "the predeter-

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57 Goldsmith (1969) and McKinnon (1973) were among the first authors who paid closer attention to the link between financial sector development and growth of output.

58 A common objection which is sometimes quoted by critics is that the financial system is a mere product and reflection of the real economy on which it is footed. However, based on the evaluation of several empirical papers this thesis supports the view that the financial sector does play an important role for the economic development of a country.

59 The authors therefore use the size of the formal financial intermediary sector relative to GDP, the importance of commercial banks relative to the central bank, the percentage of credit allocated to private firms, and the ratio of credit issued to private firms to GDP as indicators for the level of financial development.
mined components of these financial development indicators significantly predict subsequent values of the growth indicators” (ibid.).

Beck, Levine and Loayza (2000) employ GMM dynamic panel estimation in order to rule out methodological problems which limited the meaningfulness of previous studies examining the finance-growth nexus. They note that their “results tell the same story: the exogenous component of financial intermediary development is positively associated with economic growth. Specifically, the large, positive link between financial intermediary development and economic growth is not due to potential biases induced by omitted variables, simultaneity or reverse causation” (ibid., p.18).

Eschenbach and Francois (2002) perform a cross-country regression including standard growth and financial sector indicators for 130 countries during the 1990s using three-stage least square estimation. They find “that there is a strong positive relationship between financial sector competition and financial sector openness, and between growth and financial sector competition” (ibid., p.11). Their results suggest that moving from a degree of financial sector protection that is typical for low-income countries to more open regimes (as they can be found in high-income countries) might lead to per-capita growth rate increases between 0.4-0.6 percent per year. They emphasize hereby that “the question of gains from liberalization can also be viewed as one particularly relevant for developing countries” (ibid., p.10).

Christopoulos and Tsionas (2004) examine the long run relationship between financial development and economic growth via panel unit root tests and cointegration tests. They conclude “that there is fairly strong evidence in favor of the hypothesis that long run causality runs from financial development to growth, that the relationship is significant, and that there is no evidence of bi-directional causality. [...] The empirical evidence also points out to the direction that there is no short run causality between financial deepening and output, so the effect is necessarily long run in nature. The important policy implication is that policies aiming at improving financial markets will have a delayed effect on growth, but this effect is significant” (ibid., p.72).

One can summarize that the studies support the view that better developed financial systems enable faster and more stable long-run growth through channeling savings into (the most) productive investments.

In any case, supervisory and regulatory institutions which have to control market concentration, keep track of capital flows and avoid excessive risk-taking
assume a key role in ensuring the functionality of the financial system. Preconditions for the sound and effective operation of these institutions are political autonomy and financial independence in order to secure their integrity. Moreover, staff must be well-qualified and possess far-reaching authority in order to guarantee the effective enforcement of regulations and protect consumer’s interests.

7.1.2 Financial Sector Liberalization: Foreign Bank Entry

Among the most important considerations in the context of the liberalization of a country’s financial system are those related to the market entry of foreign enterprises. On account of the dominance of the banking sector in CA, the following brief discussion of some selected aspects such as the implications on competition, efficiency, financial system stability, and access to credit is limited to banks.

In general, the market entry of foreign banks is likely to spur competition and, thereby, enforce higher levels of efficiency and innovation. In context of DCs an additional and probably more important effect is the transfer of technological and managerial expertise from abroad. The introduction of more sophisticated management techniques as well as modern IT-systems and software applications by foreign banks is expected to diffuse into the local system and raise the level of technification and efficiency of the financial system. The gradual adoption of international credit standards such as Basle II by domestic banks is assumed to proceed more quickly if their foreign competitors have already implemented them into their operational business.

Another argument presented by Mishkin (2001, p.26) is that "encouraging entry of foreign banks is [...] likely to lead to a banking and financial system that is substantially less fragile and far less prone to crisis". The underlying line of reasoning is that large, regionally or globally operating banks with broadly-diversified portfolios are more resistant against adverse local shocks and thereby contribute to maintain stability of the financial system of its host economy. Moreover, the mere presence of well-known international banks might inspire more confidence and trust in the stability of the financial system and the economy of a country. This psychological effect should not be underestimated, especially in the context of the attraction of FDIs to DCs.

Though the overall 'global' results of foreign bank entry are expected to be positive and growth-enhancing, a more detailed analysis shows that various aspects need specific attention, especially in DCs, in order to ensure an optimal outcome.
The informational advantage which large foreign banks have due to their lead in more sophisticated risk management techniques will enable them to cherry-pick the projects with "good risks". Domestic banks in DCs who lack the resources to conduct comparable screening processes will have to serve the rest of customers which will, in sum, impose a higher share of "bad risks" on their balances. The resulting larger percentage of defaults will further lower the rentability of those banks and endanger their liquidity. As a consequence, a continuing consolidation process can be expected with presumably mainly domestic banks having to exit the market.

Due to the increased overall efficiency of the financial system substantial shares of the laid-off workforce cannot be absorbed within the same sector. Since social safety networks and re-education programs are poor in DCs, the resulting unemployment has far more serious consequences for the persons affected than it is the case in the societies of ICs. Even a temporal loss of employment can pose a severe if not existential threat if no compensation mechanisms exist. In the context of foreign bank entry to DCs it therefore becomes necessary to include the aggravated social problematic into the analysis of the benefits and costs of the adjustment processes. Also related to this aspect are considerations about the pace and the sequencing of reforms steps.

Another issue of great importance in DCs is the access to credit for SSME. In general, foreign banks tend to have a bias toward lending to larger companies due to more profound screening options and due to a lack of familiarity with the conditions of local small-scale business. Since the industrial structure of DCs is characterized by SSME representing often more than 90% of the countries’ productive activity, the question arises how foreign bank entry affects SSME. If foreign bank entry leads to a market consolidation whereby mainly domestic banks get eliminated due to their lacking competitiveness and foreign banks do not expand into SSME-lending to compensate for the loss of loans availability to this clientele, this would have a drastically negative impact on SSME. From a theoretical point of view predictions are difficult and empirical studies shedding some light on the issue are still scarce.

Clarke et al. (2001) combine survey responses of over 4,000 enterprises in 38 countries (DCs and transition economies) with data about foreign bank penetration in those countries in order to assess the impact of foreign bank entry on SSME’s access to credit. They find that "[a]lthough some evidence suggests that entry by

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60 The line of argumentation commonly runs with reference to the distinct administrative capacities of large and small banks instead of foreign and domestic banks. However, foreign banks entering a market also tend to be on average larger than domestic banks.
foreign banks benefits large enterprises more than small ones, there is strong evidence that even small enterprises benefit in some ways and there is no evidence that they are harmed by foreign bank entry." Clarke et al. offer two explanations for their results: If total lending increases due to higher efficiency, the credit volume obtained by SSME might be higher even if their share of total loans falls. Second, if foreign banks mainly focus on large enterprises, this might force domestic banks to shift their orientation even more toward SSME, enhancing their offer of services and products and thereby improving access to credit for SSME.

7.2 Financial Services in CAFTA (Chapter 12)

In the following the most relevant provisions of CAFTA with regard to trade in financial services will be highlighted (see table 7).

Article 12.1 specifies Scope and Coverage of the chapter: It extends to any kind of measure of a country relating to (a) financial institutions of another country, (b) investors of another country, and their investments in financial institutions in the home country; and (c) cross-border trade in financial services. Chapter 12 has prevalence to chapters 10 and 11, i.e. measures described in these chapters apply only to the extent to chapter 12 in which they are explicitly incorporated into it. Chapter 12 excludes any kind of measures relating to activities or services forming part of a public retirement plan or statutory system of social security as well as activities or services conducted by public entities of the member countries. Provisions (temporarily) do not apply to relations between the Dominican Republic and the Central American states but have to be negotiated within a time frame of maximally two years in a supplementary agreement.

As in chapter 11, National Treatment and Most-Favored-Nation Treatment, articles 11.2 and 11.3, rule out discrimination between subjects of the reference group of a partner country and domestic or non-partner ones. MFN-treatment also extends to the recognition of prudential measures. Provisions on Market Access for Financial Institutions are identical to those established in the more general Article 11.4 for all services.

Of great importance is article 12.5, which, in connection with Annex 12.5.1, establishes the rules for Cross-Border Trade: Each Party shall permit cross-border supply for all financial services specified in the annex. Interestingly, though the purchase of financial services from cross-border financial service suppliers located
in partner countries shall be permitted, this obligation does not require a country to permit such suppliers to do business or solicit in its territory\textsuperscript{61}. Moreover, each country may require the registration of cross-border financial service suppliers of another country and of the financial instruments offered.

Article 12.6, \textit{New Financial Services}, ensures that financial innovations from suppliers of partner countries do not face undue legislative action. In case a country requires authorization to supply a new financial service, a decision shall be made within a reasonable time and the authorization may only be refused for prudential reasons\textsuperscript{62}.

\textit{Treatment of Certain Information}, Article 12.7, states that no country has to allow access to any confidential information the disclosure of which would be contrary to the public interest or prejudice legitimate commercial interests of particular enterprises. Any kind of requirements of a country to engage individuals of any particular nationality as senior managerial or other essential personnel or establish majorities of nationals in the board of directors of a financial institution of another country are prohibited by Article 12.8 on \textit{Senior Management and Boards of Directors}.

All \textit{Non-Conforming Measures}, Article 12.9, which qualify the core articles 12.2 through 12.5 and 12.8 are listed in the country schedules of Annex III. Furthermore, Annex 12.9.2 and Annex 12.9.3 set out specific commitments and supplementary information for each country. Article 12.14 on \textit{Domestic Regulation} supplements that except with respect to these non-conforming measures each country shall ensure that all measures of this chapter are administered in a reasonable, objective, and impartial manner.

Article 12.10, \textit{Exceptions}, guarantees countries that they shall not be prevented from adopting or maintaining measures for prudential reasons, including for the protection of investors, depositors, policy holders, or to ensure the integrity and stability of the financial system. This underlines the right of each country to intervene with equitable, non-discriminatory measures in case of potentially harmful transfers or payment processes and to prevent deceptive and fraudulent practices.

Acknowledging that \textit{Transparency} of regulations, Article 12.11, is a key condition in facilitating access of foreign financial institutions to each other’s markets all

\textsuperscript{61} In this context, each country is allowed to define 'doing business' and 'solicitation' for purposes of this obligation.

\textsuperscript{62} The term 'prudential reasons' refers hereby to maintaining the safety, soundness, integrity, or financial responsibility of individual financial institutions or cross-border financial service suppliers.
# Financial Services

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## Annexes


Table 7: Financial Services (CAFTA, Chapter 12)
countries commit to promote regulatory transparency in financial services: Changes in regulations shall be promptly published or otherwise made available, inquiries shall be responded within a reasonable time and administrative decisions on investor’s applications shall be made within 120 days succeeded by a directly following notification of the applicant of the decision. All provisions are designed to ensure clear structures of authoritative competencies and a prompt processing of administrative actions in order to prevent that opaque bureaucratic procedures, labyrinthian clauses or undue delays deter foreign investors from market entry.

In order to enable locally established financial institutions of partner countries to pursue their daily operations each country shall grant access to Payment and Clearing Systems operated by public entities as well as to official funding and refinancing facilities\textsuperscript{63}. The recognition of the necessity of an Expedited Availability of Insurance Services by appropriate regulatory procedures is underlined in Article 12.15.

The establishment of a Financial Services Committee is laid out in Article 12.16. The committee’s main functions shall be: (a) Supervision of the implementation (and further elaboration) of this chapter; (b) consideration of issues regarding financial services that are referred to it by a country; and (c) participation in dispute settlement procedures. Moreover, it shall meet on an annual basis to assess the functioning of the agreement.

Another important provision of the chapter is its modification of Dispute Settlement modalities set out in chapter 20. All parties are requested to form by consensus a roster of up to 28 experts in financial services from which, in case of disputes, a panel shall be constituted. Where a panel finds a measure under dispute to be inconsistent with this agreement, the extent to which the financial sector of the complaining country is affected shall be estimated. This country may then react with a suspension of benefits against the other country which have an effect equivalent to the effect of the violating measure and which have to be restricted to the financial services sector.

Article 12.19 defines the status and role of the Financial Services Committee in Investment Disputes in Financial Services. The Committee has to decide in how far Article 12.10, Exceptions, is a valid defense to the claims of an investor, who sees his rights violated.

\textsuperscript{63} Access does not necessarily extend to lender of last resort facilities.
7.3 Evaluation of the Interviews - Regional Results

Remittances

It has already been noted in sections 4.1.1-4.1.3 that family remittances are a major source of national income for CA countries. An extensive discussion about the role of remittances and their implications on the involved economies is in progress. The most relevant observations and considerations with respect to CAFTA and the development of the financial sector shall be outlined very briefly.

The large number of CA citizens who have emigrated from the region and currently reside and work in the USA represents a very attractive market for CA banks since they can expect to be preferred to US banks due to the shared cultural identity and language. However, because most Central Americans entered the country illegally and do not possess valid visas or work permissions their illegal immigration status prevents them to open bank accounts in order to save or invest the money they earn. The only financial transaction which they can unrestrictedly perform is the direct sending of money to their relatives in CA via companies like the Western Union Company. Two major problems arise for the immigrants in this situation: First, they lose a considerable amount of their income for the money transfer itself since often the fees per single transaction range between 25-45 USD. Second, immigrants do not have any possibility to control the use of the remittances. Increasing empirical evidence shows that the beneficiaries in the home countries tend to consume the entire money they receive instead of saving and investing it at least in parts. There is even the phenomenon of ‘intra-family-shirking’ reported where family members in the home country stop working and finance their expenses by the remittances.

CA banks could benefit from this situation and remedy it at the same time: Addressing the first problem, they could build up (or extend already existing) networks of branches in the US in order to break up the monopoly in the business of money transfers and offer a cost-oriented alternative. One interviewee reported that in the case of Mexico after ratification of NAFTA and entrance of Mexican banks into the remittance business transaction fees lowered from originally 25-45 USD down to 4.

To give a comparison: The wage for a room maid or a construction worker in Honduras is between 0.30-0.60 USD per hour; the wage for a similar job paid to an illegal immigrant in the USA can be expected to be less than 4 USD on average.

Banks would hereby clearly benefit from the inclination of immigrants to concentrate densely within a few areas in mainly California, Florida, New York, Illinois.
8 USD for the central parts of the country. The secondly outlined problem is probably of higher economic relevance and also more difficult to tackle. Currently, mainly foreign assistance organizations are dealing with the topic by developing financial instruments that serve to channel remittances into more productive uses. Under the assumption of motives of self-interest, immigrants can be expected to favor appropriated transactions which can be bound to a specific purpose to pure money transfers. This way they could ensure that savings or other more profitable investments exist when they return to their home countries. Though commercial banks would clearly create such new financial products in order to attract customers and gain market shares these innovations could be expected to simultaneously raise the saving rates\textsuperscript{66} of CA countries thereby enabling more investments and higher overall economic development.

Enhanced market access to the USA granted by CAFTA will prove to be of even higher relevance to CA banks if US immigration laws shall change over time. Most recent public considerations of the Bush administration about dealing with illegal immigrants or the prospects of a potentially more liberal immigration policy under following administrations might inspire some confidence that in future times increasingly more CA citizens in the US will be able to open bank accounts. If CA banks can offer a comparable product range at similar conditions as their US competitors it can be conjectured they will have good chances to serve this growing group of new clients. The preconditions for the entry of CA banks to the US financial market are, basically, that branches are well capitalized and well administrated\textsuperscript{67}.

**The Insurance Sector**

The insurance sector is particularly interesting for CA for numerous reasons: First, insurances always had a strong social dimension and obligatory insurances could be used to achieve social development ends. Considerable weaknesses in the region include basic social insurance, private pensions funds, medical expenses plans, obligatory car insurance. Second, product innovations like agricultural insurances would mitigate the effects of crop failures. Since the agricultural sector is still of major importance in CA and poverty is particularly prevalent in rural areas insurances

\textsuperscript{66} This is based on the assumption that a smaller fraction of the remittances can be ‘abused’ for pure consumption; possibly, this knowledge might also encourage US immigrants to send larger amounts back home.

could accomplish relief where it is most needed. Third, due to the region’s high vulnerability insurances for damages caused by natural disasters to private property are of great interest. Thinking on a bigger scale equivalent insurances for public infrastructure such as schools, hospitals, bridges, roads would be another highly relevant issue for CA economies in order to secure their level of development.

In all three countries interviewees expressed the opinion that probably the largest changes in the financial sector due to CAFTA were to be expected in the insurance sector. Although, liberalization of the insurance market had already begun in context of previous trade agreements in El Salvador and Honduras, a much stronger impulse was expected from CAFTA. In the case of Guatemala, profound changes were awaited since the insurance sector had been closed, so far, and the country had committed in CAFTA to significant steps of liberalization.

Interviewees stressed that in order to protect consumers, insurance trade in mode 4, i.e. the selling of insurances by traveling foreign agents had been ruled out in all three countries. Commercial presence in the respective territory was obligatory for every foreign insurance company which wanted to serve clients in CA. Increased transparency and clear time frames for authorization processes for new products were seen as important provisions in order to foster innovation and broaden the variety for consumers in this market segment: Provisions on the Expedited Availability of Insurance in Annex 12.9.2, Specific Commitments, rule that regulatory institutions in El Salvador and Guatemala must grant approval or issue disapproval within 60 days, in Honduras within 30 days. Since one interviewee commented that such a process had at times taken up to several years before, this can be considered as a huge progress.

One interviewee noted that a lack of conscience about the importance of insurances for the functionality of the economy existed. A public debate would become necessary in order to sort out and newly define the role and the limitations of the public social security system and the potential role which the private sector could play by taking over certain fields of activities. At the same time this discourse would serve to gain more public attention and provide information to the population about the purpose and usefulness of insurances.

Technical assistance from a third neutral side with adequate expertise would be necessary to accompany this process. Its objective professional advice would

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68 It has already been noted in section 4.1.3 that, for example, Hurricane Mitch destroyed about 95% of Honduras’ GDP in 1998.

69 This happened, for example, in the case of the trade agreement of El Salvador with Panama.
ease the discussion of socially sensitive issues. Furthermore, assistance in form of market analysis and identification of the inherent structural problems was seen as a top priority. However, to enable this analysis the prior improvement of data quality would become imperative.

**Capital Markets**

Capital markets in CA are little developed since they face difficulties on several fronts. On the one side a minimum number of large and stable firms is necessary in order to run a sufficiently thick and cost-efficient market. Even for the more successful countries like Costa Rica or El Salvador this requirement poses a major challenge due to their economy’s size and their industrial structure which mainly consists of SSME. On the other side large-scale institutional investors are needed which provide sufficient liquidity in order to ensure vital turnover rates. Such investor are either not existent or are, due to legal regulations, not allowed to invest in private assets, as it is, for example, the case for public pension funds in Honduras. However, El Salvador already has legislation about private pension funds in place. In Guatemala and Honduras reforms are underway or at least on the short term agenda. Modernization of the law of insurances in Guatemala and impulses from CAFTA for the insurance sector might also work as a positive stimulus.

Another issue of far-reaching implications will be the introduction and development of collective investment schemes within the region. In Annex 12.9.2, *Specific Commitments*, CAFTA includes provisions on *Portfolio Management*: El Salvador committed itself to grant market access for US financial institutions which will provide investment advice and portfolio management services as soon as the necessary legislation is established. In the case of Guatemala, market access for US investments funds will be granted as soon as the country allows its domestic insurance companies to manage collective investment schemes.

In general, interviewees noted that a ‘culture of capital’ had still to develop, since even managers in large institutions lacked the financial background knowledge to conduct investment analysis and ‘let the money work’. As a consequence, the existing resources were not well-used since a large amount of capital was lying idle. A strategy designed to mend the situation would need to be two-fold: On the one side, it would have to build the markets employing modern technology and to create standardized, well-structured financial instruments. On the other side it would

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70 In any case, legislation must be in place within the next four years.
have to win the interest and confidence of institutional investors by increased transparency and supervision of the system and capacitate them in investment analysis and techniques.

**Miscellaneous: Culture, Financial Integration, and Dollarization**

Some interviewees underlined the aspect of culture and mentality: Despite the fact that for a couple of years a substantially higher transparency with regard to the financial system existed which allowed broad access to financial key information like statistics on inflation, deposit and credit rates general interest within the public was still rather modest. One interviewee added that though a wider range of financial products was naturally desirable it would probably benefit only a very small fraction of the population. For the large rest it would be more important that they were educated about the already existing basic products.

One interviewee stressed that a strong local orientation of consumers existed. Although banks started to think of CA as a single market and developed strategies for regional expansion, consumers still strongly identified with their national banks. As a consequence, instead of opening new branches in neighbor countries many banks pursued the course of forming regional alliances which would be perceived as a less invasive approach. Getting clients accustomed to foreign banks would be a medium to long run project which necessitates country-specific marketing concept.

Interviewees commented that the adaptation of existing respectively the introduction of new national laws related to CAFTA could not be translated into concerted legislation on a regional scale. The situation was not perceived as an opportunity to directly achieve a higher degree of harmonization between CA countries. However, interviewees agreed unanimously that CAFTA would stimulate cooperation indirectly and lead to higher integration in the medium and long run.

The regional institution which is in charge of the promotion and coordination of financial integration is the Central American Monetary Council\(^71\). The list of its projects and initiatives comprises efforts of establishing a CA stock market, respectively enhance the linkage of the existing national markets, the setting up of a regional system of transfers and payments, and establishment of a market for the trading of debt titles on a regional scale.

A final interesting issue which can be related to CAFTA is the dollarization of the region. Assuming that CAFTA will promote trade between the USA and CA

\(^71\) “Consejo Monetario de Centroamerica”
and also intra-regional trade between CA economies, i.e. with the already dollarized El Salvador, the adoption of the US dollar as legal tender can be expected to move on the agenda at least in the long run. At current time between one quarter to one third of the economic activity in Guatemala and Honduras is conducted in dollars. The continuing inflow of dollars through family remittances might further raise this share. Even if both countries managed to keep their exchange rates comparatively stable over recent years, it can be presumed that for political and/or practical reasons switching to one universal currency will become of interest. Interviewees commented that CAFTA might provide the first impulse for pushing the mindset of government officials in this direction.

7.4 The Financial Sector - Country Evidence

7.4.1 El Salvador

General Background

Reforms of the financial sector of El Salvador started earlier than in the other countries of the region with the "Programme for the Modernization of the Financial System"\(^72\) in 1990. In subsequent years the juridical framework of the financial sector was overhauled and gradually completed: Establishment of the legal base which defined the roles and authorities of (a) the Central Bank and (b) the regulatory institution of the financial system\(^73\); (c) setting up of comprehensive provisions of every aspect of commercial banking; and (d) adoption of the US dollar as the country’s legal tender\(^74\).

As in all of CA the financial system is strongly bank-based with the banking sector directing almost 90% of the financial activities within the economy and a only rudimentary developed capital market. Within the banking sector a series of fusions and mergers took place during the years 1997-2001 as a reaction of banks to increasing solvency problems\(^75\). Figure 11 illustrates the concentration process: The number of banks fell sharply while the market share of the largest five banks rose.

\(^72\) Programa de Modernización del Sistema Financiero (1990)
\(^73\) Superintendencia del Sistema Financiero (SSF)
\(^74\) The respective laws constitute the core legislation on the financial system: (a) "Ley Orgánica del Banco Central de Reserva de El Salvador" (1991), (b) "Ley Orgánica de la Superintendencia del Sistema Financiero" (1996), (c) "Ley de Bancos" (1999 and 2002), and (d) "Ley de Integración Monetaria" (2001).
\(^75\) Interestingly Herrera (2005, p.20), listing the take-overs and mergers during recent years, finds that most of them were not beneficial for the buying bank.
dramatically from 68% to 88%. However, this high level of concentration did not result in anti-competitive behavior injuring consumer’s interests: Beginning in 2000 spreads lowered and non-performing loans declined continuously thereby confirming that market consolidation enhanced the overall efficiency of the banking sector (see figure 11). The fact that the volume of credits in absolute terms is still higher than that of Guatemala is especially remarkable since El Salvador’s overall economy measured by its GDP is about one third less than that of its neighbor. Not surprisingly, according to a Investment Climate Survey quoted by the World Bank (2005, p.189), the share of firms with access to credits is almost 20% higher in El Salvador than in Guatemala.76

In general, the financial sector of El Salvador has a good reputation on the regional scale for the high degree of competitiveness of its banks and the stability of the system. No bigger financial scandals occurred since 1997 when a larger bank had gone bankrupt and no credit crisis shocked the country as it did in Guatemala and Honduras (see figure 11, non-performing loans). This might also be the reason for the presence of six foreign banks (see table 8), thereby constituting the highest ratio of foreign banks to national banks in CA. The relevance of public banks has been decreasing over the last decade from a share of 13% of total activa in 1992 to a share of 4% in 2005. The successful regional expansion efforts of El Salvador’s banks over the last years are expected to continue and are well in line with the country’s target to establish itself as the region’s financial center77. Financial sector growth is considered to be especially interesting since its offers an attractive type of employment which is characterized by a high degree of technification and professionalization.

**Legal Framework and Supervision**

Interviewees in El Salvador commented that their supervisory institutions had been strengthened during recent reforms and were among the most developed in Central American countries. However, one of the major future challenges was seen in the fusion of the three separate entities (supervision of the financial system, of the stock market and of pensions) into one single institution. The fusion had become necessary as a consequence of a new legislation which allowed the establishment of financial conglomerates embracing activities of all three aforementioned areas. The creation of a single supervisory institution which bundled all competencies was felt

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76 However, it is substantially lower than for example in Thailand or Malaysia: Thailand 87%, Malaysia 87%, El Salvador 63%, Honduras 52%, and Guatemala 44%.

77 Its most serious and, currently, stronger competitor in this ambition is Panama.
7 CAFTA’S IMPLICATIONS ON THE FINANCIAL SERVICE SECTOR

(a) Number of Banks

(b) Market Share of the Largest Five Banks

(c) Total Volume of Deposits in bn USD

(d) Total Volume of Credit in bn USD

(e) Percentage of Non-Performing Loans

(f) Implicit Spread

Figure 11: Indicators for Financial Sector Development (1997-2005)
Source: SECMCA (2005)
to be the next logical step to ensure effective control and oversight of the conglomerate’s activities in the different fields. It was estimated that the integration would take up to 2 years due to the very distinct organizational structures, the necessary reform of the budgetary provisions and the introduction of a uniform IT-system. Most importantly, independent funding had been secured to guarantee the new entity’s integrity. Interviewees pointed out that the entire development was originally independent of CAFTA, but at the same time enhanced El Salvador’s ability to comply with its commitments in the agreement. Since CAFTA could be expected to additionally foster the creation and expansion of conglomerates as a result of market consolidation a further strengthening of the supervisory institution would become necessary to improve its capacity to enforce existing regulation.

Furthermore, interviewees noted that El Salvador’s banking sector had reached a level of concentration where each future fusion or take-over would necessitate very careful analysis in order to prevent the formation of oligopolistic structures. Strict application and enforcement of the new law of competition was considered to be of top priority if first signs of anti-competitive practices of enterprises indicated upcoming rent-seeking behavior. Interviewees stressed that they considered the legal framework to be well-functional but saw its enforcement as the major challenge that primarily needed to be addressed.

It is noteworthy that in Annex 12.9.2 which lists the countries’ Specific Commitments, El Salvador is the only CA nation with provisions on Foreign Banking. The respective passus decrees that "El Salvador shall allow banks organized under the laws of El Salvador to establish branches in the United States, subject to their compliance with relevant U.S. law. The Salvadoran regulatory agency will develop and issue prudential and other requirements that such banks must meet in order for them to obtain authorization to apply for the establishment of branches in the United States". Though one would in general expect that it is in the interest of El Salvador to obtain market access for its banks to the US market, this passus reads as if the opposite is the case: It appears that the USA had a self-interest in negotiating that El Salvador cannot prevent its banks from establishing branches in the larger partner country given that they fulfill certain requirements. One possible interpretation of this commitment is that the USA considers banks from El Salvador as mostly suited to channel capital from CA to its own economy in order to provide credit to its citizens. The high liquidity within El Salvador’s economy mainly due to its dollarization, as well as the stability of the banking sector due to its early liberalization and comparatively proceeded consolidation probably make it the most
attractive of the CA countries.

Miscellaneous

Evaluations of the dollarization were mostly positive, though interviewees noted that not enough time had passed since the introduction of the US dollar as legal tender in 2001 in order to draw definite conclusions. One interviewee argued that the years after dollarization coincided with a decline in US interest rates, which also led to lower interest rates in El Salvador and helped to spur the country’s growth. However, it remained to be seen whether the currently rising interest rates would not trigger a new liquidity crisis since at least some banks were significantly indebted abroad. The increasing struggle to maintain El Salvador’s competitiveness due to rising costs and the loss of the exchange rate as monetary instrument was seen as a serious drawback which put the exporting industry in disadvantage to their competitors from neighbor countries.

As a consequence of dollarization interest rates fell significantly and slowly converged to US levels; liquidity increased tremendously and led to high levels of credit allocation of El Salvador’s banks to the rest of CA. One interviewee noted that the trend to extend lending to a regional scale also posed a new kind of risk to the stability of the country’s financial system and correspondingly implied increased capacities of the supervisory institutions in order to control lending practices and guarantee the protection of depositor’s interests. In this context, CAFTA would be particularly valuable for El Salvador since it provided more juridical certainty for the country’s investments in its neighbor countries.

Interviews agreed upon the priorities on the agenda for the financial sector. The formulation and ratification on the law of investment fonds and the law of "titularizacion de activos" was seen to be one of the key priorities. The successful fusion of the three superintendencies was also considered one of the key projects. Finally the implementation of consolidated supervision was evaluated to be of major importance for the future development of the financial system. In the context of advancing on the agenda with the objectives outlined above, CAFTA was not seen as a separate issue but as a complementary one. Interviewees commented that during the years 1991-2002 the standards of Basle I had been incorporated into national regulations; they described the implementation of the Basle II standards as a long-term goal, which did not have top priority at current time. However, one interviewee commented that there were discernible advances as operative risk management increasingly became a part of the discussion. The entry of further
foreign banks from North America which employed more sophisticated risk analysis techniques and operated under Basle II regime would accelerate the adoption of such higher standards by domestic banks.

**Supplement: Remittances**

In the case of El Salvador the considerations about remittances which were outlined in section 7.3 are particularly relevant. First, El Salvador receives more family remittances than the other CA economies and, second, imported inflationary pressure on non-tradables poses a particularly serious problem to the country because, as already noted, no compensatory exchange rate adjustments are possible. Curbing imported consumption by directing a higher share of family remittances into savings and investment could be more politically feasible than freezing or cutting wages of public employees or reduce state expenses in order to fight inflation. The development of innovative financial products which are attractive for emigrants working in the USA would be the best way to take advantage of the enhanced market access obtained through CAFTA. Due to their size and competitiveness banks from El Salvador are probably best suited to enter the US market and take a chance.

### 7.4.2 Guatemala

**General Background**

The first period of reform of the financial system of Guatemala started with the "Programme of Financial Modernization"\textsuperscript{78} during the years 1993-1995. Then, in a second phase during 2001-2002 several regulations were supplemented and the currently effective legal framework got implemented. The overhauling and completion of the legislation on Guatemala’s financial sector included (a) the general revision of the monetary system’s groundwork; (b) the strengthening of the independence and authority of both the Central Bank and the supervisory institution SIB; (c) the modernization and completion of provisions on the stock market; (d) the formalization, regulation and control of all financial entities operating within the system; and (e) the implementation of provisions on the use of foreign currencies\textsuperscript{79}. The modernization of the legal framework included the integration of various non-banking

\textsuperscript{78} "Programa de Modernización Financiera"

\textsuperscript{79} The corresponding laws form the core legislation on the financial system: (a) "Ley Monetaria Revisada", (b) "Ley Orgánica del Banco de Guatemala" and "Ley de Supervisión Financiera", (c) "Ley del Mercado de Valores y Mercancías", (d) "Ley de Bancos y Grupos Financieros", (e) "Ley de Libre Negociación de Divisas".
segments in order to ensure that all financial entities were well-regulated and supervised. Thereby, the stability and transparency of the financial system could be improved and better protection of consumer’s interests could be achieved.

The banking sector of Guatemala is strongly fragmented with many small and medium sized banks. Though the number of institutions decreased since 1999, it is still comparatively high considering the size of the country’s economy. Market concentration measured by the share of the five biggest institutions is slightly above 60%, i.e. 30% lower than in El Salvador (see figure 11). This is also reflected by the fact that Guatemala’s financial groups are considerably smaller than those of its neighbor country despite its much larger economy (Balsells 2005, p.11). The higher degree of fragmentation which results in a more complex market structure might be a possible explanation for foreign investor’s reservation to enter the market. Currently, only five of the 25 banks are foreign institutions (see table 8). However, interest spreads almost continuously declined since 1997 and developed parallel for the last five years to those of El Salvador ranging at considerably lower levels than those of Honduras. Since the last credit crisis in 2001 when some banks went bankrupt and state interventions became necessary the percentage of non-performing loans could get reduced from 15% to below 5% indicating better risk analysis and screening processes. Banking infrastructure also improved significantly in terms of persons per bank agency making the largest strides in the period from 1990-1996 and then levelling off but still improving slightly during recent years. However, total volume of credit remains low, indicating that access to credit is heavily restricted for many enterprises.

Legal Framework and Supervision

Even though one interviewee roughly estimated that more than 40 national laws had to be modified in order to ensure compatibility with provision agreed in CAFTA, all interviewees underlined that the necessary changes were of comparatively minor importance. They taxed that over the next two years more than 80% of CAFTA-related legislation would be in place, with priority of the legislation linked to SSME. Key legislation still on the agenda was concerned with a law about pension funds which is demanded by CAFTA, laws about leasing and factoring and

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80 This refers to the cases of Banco Empresarial, Banco Promotor and Banco Metropolitano.
81 In 1990 there were about 34,000 persons per bank agency, in 1996 about 13,000 and in 2004 about 9,000.
82 The Investment Climate Survey, quoted by the World Bank (2005, p.189) offers a comparison of the share of firms with access to loans: Thailand 87%, Malaysia 87%, El Salvador 63%, Honduras 52%, and Guatemala 44%.
a law for the insurance sector. All in all, interviewees considered their legal and regulatory framework of the financial system to be one of the most modern in whole Latin America. However, they identified serious deficiencies in the enforcement of regulations due to a lack of administrative and technological capacities and sufficient qualified experts.

Challenges to the Financial System

In general, interviewees rated the competitiveness of banks quite moderately. Only two banks were seen to be sufficiently competitive in order to expand regionally and withstand foreign bank entry without bigger adjustment processes. The lack of well-qualified personnel was seen as one of the major limitations of further development. Moreover, interviewees voiced concerns that analysis and market research which were necessary in order to timely identify opportunities and challenges were not sufficiently conducted. As a consequence, banks had to react passively and could only achieve slow and moderate growth\textsuperscript{83}.

With regard to the adaption of the Basle II standards interviewees commented that the banking system was adapting extremely slowly due to a lack of expertise in risk analysis and managerial inertia. Though the largest six banks had recently introduced sections for risk management and were advancing steadily, the necessary sophistication of techniques could be expected at best in the medium run and only limited with the bigger institutions. One interviewee offered a potential explanation for the lagging development of risk analysis: After the government had not received anymore credit from the Central Bank, it started borrowing from the commercial banks. Since the latter regarded lending to the state as riskless, this practice eliminated incentives to enhance analysis techniques and prevented further advances in this field. Interviewees expressed confidence that CAFTA might put more pressure on the domestic banking sector and accelerate the process of adaption.

At the same time interviewees emphasized that the gradual implementation of the Basle II standards would further restrict SSME’s access to credit. They underlined unanimously the necessity and urgency to mitigate this effect which would have a considerably negative impact on more than 90% of the country’s enterprises. One interviewee commented that the government had given the issue top priority and planned to tackle the problem by the ratification of a series of laws targeted at enhancing SSME’s ability to provide guarantees in order to receive credit. Laws

\textsuperscript{83} Banco Rural was named as an exception since it pursued an innovative course of developing new market segments and could expand successfully over the last years.
## Table 8: Banking Groups in El Salvador, Guatemala and Honduras

<table>
<thead>
<tr>
<th>Banking Group</th>
<th>El Salvador</th>
<th>Guatemala</th>
<th>Honduras</th>
</tr>
</thead>
<tbody>
<tr>
<td>BAC Internacional (Nicaragua)</td>
<td>Banco de América Central</td>
<td>Banco de América Central</td>
<td>Banco de América Central</td>
</tr>
<tr>
<td>Banco Agrícola (El Salvador)</td>
<td>Banco Agrícola</td>
<td>Scotiabank</td>
<td>Banco de la Producción</td>
</tr>
<tr>
<td>Bank of NovaScotia (Canada)</td>
<td>Citibank</td>
<td>Citibank</td>
<td>Banco BGA</td>
</tr>
<tr>
<td>Citigroup (USA)</td>
<td>Banco Cuscatlán</td>
<td>Banco Cuscatlán</td>
<td>Banco Cuscatlán</td>
</tr>
<tr>
<td>Corporación Cuscatlán (El Salvador)</td>
<td>Banco</td>
<td>Banco</td>
<td>Banco</td>
</tr>
<tr>
<td>Grupo del Istmo (Panama)</td>
<td>Banco</td>
<td>Banco Cuscatlán</td>
<td>Banco</td>
</tr>
<tr>
<td>Grupo Pacific (Nicaragua)</td>
<td>Banco Uno</td>
<td>Banco Uno</td>
<td>Banco Uno</td>
</tr>
<tr>
<td>Lafise/Bancentro (Nicaragua)</td>
<td>Banco</td>
<td>Banco</td>
<td>Banco Futuro</td>
</tr>
<tr>
<td>Red PRO (Nicaragua)</td>
<td>Banco Promérica</td>
<td>Banco Promérica</td>
<td>Banco Promérica</td>
</tr>
</tbody>
</table>

*Source: SECMCA (2005)*
about reciprocal guarantees, real estate and mortgaging would allow for higher judicial certainty and give SSME more options to offer guarantees to banks. Thereby, while banks would lose increasingly scope for discretion when allocating their credits, the new legislation would provide them the necessary and enforceable securities to maintain a certain level of lending to SSME.

Supplement: Dollarization

Some interviewees rated Guatemala’s economy more stable than that of El Salvador due to the latter’s high dependency on family remittances and its dollarization. They argued that Guatemala had maintained a very stable exchange rate over the last years and, at the same time, had been able to acquire a record stock of foreign exchange reserves. Interest rates and spreads had lowered significantly and inflation had also been under control. In this sense, the country could offer foreign investors macroeconomic stability and predictability comparable to that of El Salvador but without having given up its own currency and sacrificing the instrument of monetary policy. Interviewees hoped that CAFTA could be used to direct more attention to their country and convey the message of the positive developments over recent years which had largely gone unnoticed.

7.4.3 Honduras

General Background

In comparison to its neighbor countries Honduras started the reform and liberalization of its banking sector considerably later. First efforts to modernize the legal framework of the financial sector started in 1998, but great strides could mainly be made during the years 2001-2004 when, partly with the support of the IMF, most weaknesses of the system got systematically eliminated by various comprehensive reforms: (a) The introduction of a law on the stock market and trading activities; (b) the establishment of a back-up fund in order to recompensate the public in case of bankrupts of commercial banks; (c) the strengthening of the role and authority of the national supervisory institution of banks and insurances, the Comisión Nacional de Bancos y Seguros (CNBS); (d) the establishment of the general structure

\[84\] “Ley de Sociedades de Garantías Recíprocas”, “Ley de Garantías Mobiliarias”, “Ley de Catastro”, and “Ley de Sociedades de Microfinanzas”

\[85\] Guatemala employs an exchange rate regime of dirty floating.

\[86\] The Central Bank of Guatemala follows a policy of inflation targeting with a target rate ranging between 4-5%. As a comparison, the European Central Bank targets an inflation rate of close to, but below 2%.
of legislation and organization of the financial system; and (e) the precision of the role and authority of the Central Bank.\footnote{The corresponding laws constitute the modernized juridical framework of the financial sector of Honduras: (a) "Ley del Mercado de Valores" (2001), (b) "Ley de Seguros de Depósitos en Instituciones del Sistema Financiero (FOSEDE)" (2001), (c) "Ley de la Comisión Nacional de Bancos y Seguros" (2004), (d) "Nueva Ley del Sistema Financiero" (2004), and (e) "Ley de Banco Central" (2004). For a more detailed illustration see Tabora (2005).}

In Honduras the banking sector accounts for almost 95% of operations within the financial system. Though consolidation is discernible in the reduction of banks, the sector is even more fragmented than that of Guatemala. Accounting for roughly one quarter of the larger neighbor’s economic activity, its number of banks is more than half. Six of the 16 banks are foreign banks from El Salvador, Nicaragua and Panama. However, as opposed to El Salvador (Citibank, Sotiabank) and Guatemala (Citibank) no banking group from North America has entered the market so far (see table 8). The development of all indicators of the financial system has been positive over recent years (see figure 11) After an extended period of credit crisis in 1999-2002 the share of bad debt in commercial bank’s portfolio decreased from 17% to 6%; the implicit spread fell from 19% in 1997 down to 12% in 2001, however, stagnating at this comparatively high level since then. The volume of credits rose steadily over the entire period. Nevertheless, a considerable gap in terms of efficiency and competitiveness to both Guatemala and, particularly, El Salvador remains obvious.

**Legal Framework and Supervision**

Interviewees noted that there had been considerable effort in implementing new legislation over the last years. They rated the laws as highly modern and in parts more advanced than those of its neighbor countries and underlined that it also included regulation of off-shore operations, financial conglomerates, consolidated supervision and provisions on processes of liquidation. The regulatory framework was considered well-suited to enhance the stability and competitiveness of the country’s banking system in the short to medium run. The increasing interest in investing in Honduras’ financial sector which could be observed in the last two year was seen as an indicator of trust and confidence into the soundness of the new legislation and the supervisory institutions. However, it was also noted that the sweeping reforms currently imposed a heavy burden on banks: Their administrative capacities were seriously strained during the process of necessary adjustments as they had to implement the novel requirements into their daily operational business.
The current legal framework was regarded sufficiently complete in order to take on the challenges imposed by CAFTA, though various modifications and adaptions remained on the agenda. Interviewees agreed that the remaining key issue would be the further strengthening of the supervisory institutions with sufficient financial resources and well-qualified staff in order to ensure effective enforcement of regulation.

Challenges to the Financial Sector

Honduras’ more cautious approach to the liberalization of the financial sector was explained by social considerations: The favored course was gradual liberalization which would allow the domestic sector more time to strengthen and adapt to free competition with foreign financial institutions. Pursuing gradual adjustment with small but significant changes over an extended period would make the process politically and especially social more viable.

One interviewee noted that, at current time, Honduras’ banking sector was best served by focusing on internal reforms and re-structuring in order to get the basics right. Especially high administration costs were identified as a structural deficiency seriously constraining the level of efficiency. Further consolidation of the banking sector was expected in the short and medium run. Given the size of Honduras and considering its economic activity the number of banks was expected to decline considerably over time with about only half of the banks being sufficiently competitive to stay in the market.

The implementation of the Basle II standards was targeted for 2008; interviewees agreed that special attention would have to be paid to the necessities of SSME since the gradual implementation of the standards would severely aggravate their already existing difficulties to obtain credit. One interviewee noted that banks focused their lending on financing large companies and consumption but neglected the area of microfinance. New legislation was in process targeted at supporting SSME by granting them preferential treatment in case of government purchases, improving their access to information networks, fostering their incorporation into value chains, and promoting cooperation with bigger companies.

Supplement: Capital Markets

Interviewees commented that the crisis of the country’s stock exchange\(^{88}\) was still present in the minds of the Hondureños. As a consequence of their last painful

\(^{88}\) The crisis occurred in the stock exchange of San Pedro Sula in 2000.
experience, the majority of private investors still mistrusted the stock exchange, so that trading levels were extremely low or even non-existent. Interviewees were skeptical about chances to regain the population’s confidence and trust in capital markets in the short and medium run. They saw a larger chance for revitalization if reforms would enable the only group of institutional investors, the public pension funds, to invest in private values. However, modification of the respective law was considered as well as the introduction of new legislation preparing the admission of private pension funds. Both developments could be expected to give the system new impulses as large institutional investors channel sufficient capital into stock markets and increase liquidity. With adequate supervisory regulation in place, markets could slowly recover and start building up a track record. A soundly operating system also would be able to win back small private investors over time.

7.5 Some Remarks: A Role for Technical Assistance

The necessity for technical assistance was mainly identified in 3 areas: (1) Transfer of knowledge and expertise to strengthen supervision and prudential control; (2) conduct of research and analysis; (3) support in the area of microfinance in order to ensure SSME’s access to credit.

1. Interviewees emphasized that supervision in general, but particularly consolidated supervision of regionally operating financial conglomerates, was perceived as an area where well-qualified agents were scarce. The building up of a pool of experts would become a key challenge in order to ensure effective supervision. Technical assistance could provide a transfer of knowledge and expertise in order to enhance the standards of professionalization within the supervisory institution (in form of seminars, manuals, exchange of experts). Moreover, the transfer of modern technology in form of more powerful software linked with capacitations of personnel would be highly desirable. Financially independent supervisory institutions with far-reaching authorities and well-trained and well-equipped specialists are the spearhead to ensure the effective enforcement of regulations and protect consumer’s interests.

2. Interviewees saw a general lack of research and analysis: Studies about the future potential and challenges of capital markets, about the reforms of the

89 Though not necessarily related to technical assistance, it shall be noted that increasing coordination and cooperation between the supervisory institutions of the CA countries will become indispensable in this context. Integration of the markets of the region will necessitate strengthened regional entities that coordinate the national institutions.
insurance systems and their implications, about the development of microfinance issues, about various aspects related to further regional integration of the financial systems. As opposed to almost all other service sectors, the availability and quality of data and statistics for such studies was given. However, limited research capacities and methodological deficiencies posed the major constraint.

3. Interviewees stressed unanimously that the microfinance sector needed more strengthening. In their opinion, future market consolidation due to CAFTA and the gradual adoption of the Basle II standards would increasingly cut off SSME from credit. A revision of the existing financial products and analysis of the success of their implementation would be necessary in order to get a better orientation for future innovations. Enhanced access to information about credit options for entrepreneurs and a wider range of products accounting for the specific needs of SSME would improve the match between demand and supply of credit which was partly seen to be suboptimal.

7.6 Conclusions of the Section

The importance of the financial sector in initializing and sustaining stable growth in the real sector can be explained by the role it assumes within the overall economy. A functional financial system allocates economic resources where they are most efficiently used. It works as a selection mechanism by channeling investments to the most promising projects and works as a control mechanism for managerial performance by enforcing sound corporate practices. A vast body of empirical studies confirms the existence of a positive causal relationship running from financial sector development to economic growth. Reforms targeted at the establishment of a well-functioning financial system are therefore of great interest. Particularly for DCs which are strongly limited by their scarce resources, the allocation of the latter to their most productive use is crucial.

One of the most dominant effects of liberalization is the entrance of foreign companies to the formerly protected domestic market. In the case of liberalization of the financial sector foreign bank entry is commonly associated with an increase in competition and the gradual adaption of international standards such as Basle I or Basle II which enforce higher levels of efficiency. The transfer of technological and managerial expertise from abroad fosters innovations so that the domestic market offers a wider variety of products and services which raise consumer’s welfare.
Moreover, the presence of internationally operating banks which are more resistant to local shocks due to their broadly diversified portfolios is likely to stabilize the financial system of its host country. Especially in the case where the host country is a comparatively small economy, like the CA states are, this effect can be expected.

The analysis of the chapter on financial services in CAFTA yielded the result that the agreement should primarily be interpreted as the consolidation and lock-in of prior reforms and liberalization efforts. Its principal merit is the documentation and preservation of the achievements in the privatization of banks and the modernization of the financial system’s legal framework over recent years. The fact that the last round of reforms took place in all countries before US president Bush’s announcement of his plans about setting up CAFTA shows that reform efforts were entirely independent of the agreement and rather were the point of reference for entering into CAFTA negotiations. Some limited impact of CAFTA on the banking sector can be expected in Guatemala and Honduras since both countries maintain a small number of restrictions which they committed to eliminate. More profound changes are likely in the insurance sector where all countries will grant market access to US companies in mode 3, commercial presence, within the next four years. Increased competition spurred by the market entry of US insurance companies might favor the development of more customer-oriented services which are specifically tailored according to the needs of the clients.

Furthermore CAFTA necessitates and promotes the strengthening of the regulatory and supervisory authorities of the financial system. First, the agreement obliges regulatory institutions to more transparency of administrative routines and to strict obedience to the time frames for specific procedures which are set out in the provisions. Second, strong institutions with excellently qualified specialists and sufficient funding are necessary to control the proper working of the increasingly complex financial system. While an adequate legal framework seems to be in place due to extensive reforms over the last years, further efforts must be undertaken in order to provide the authorities with the necessary capacities and competencies which are crucial to ensure the effective enforcement of these regulations. In view of the progressive CA integration the closer cooperation and coordination of national regulatory entities on a regional scale will be the next bigger challenge.

Although CAFTA cements enhanced access for CA financial institutions to the US market, this option can at best be expected to become of relevance in the medium run. The attractiveness of the US market will be mainly limited to the segment of offering services to CA emigrants with the primary business consisting of
transactions in the area of money transfers. Both, innovations in insurance services and in financial products related to family remittances are particularly interesting for the CA countries from a development perspective since they might serve to tackle two key concerns of the region: Novel insurance services could mitigate the economic losses caused by natural disasters which frequently strike CA; innovative financial products related to remittances could raise the region’s saving rate and channel investments into more productive use than pure consumption.

One final important aspect of financial liberalization are the implications of foreign bank entry on SSME’s access to credit. While theoretical considerations do not lead to unambiguous results, empirical evidence indicates that higher levels of efficiency benefit both large enterprises and SSME. Nonetheless, since the industry structure of CA is clearly dominated by SSME, special attention should be paid to the issue of loans availability for the region’s economic backbone and, if necessary, compensatory measures must be taken.
8 Conclusion

This thesis examines the economic implications of trade liberalization in services for developing countries (DCs): It analyzes the service dimension of the Central American Free Trade Agreement (CAFTA) and the challenges and opportunities which it entails on El Salvador, Guatemala and Honduras with a particular focus on the financial sector.

In the first, more general part, the important role of services as intermediate inputs which significantly determine the competitiveness of the manufacturing industry is underlined and the causes and consequences of the increased tradability of services are illustrated. Furthermore, a link between liberalization of trade in services and the specific situation and interests of DCs is established: First, one potential role for DCs as service exporters is considered, then, the effects of the entry of foreign enterprises to the domestic market of DCs are studied.

The evaluation of the relevant literature leads to the conclusion that most DCs cannot expect to benefit significantly from the increased outsourcing of service activities by industrialized nations. The primary obstacles that constrain them from replicating the often quoted successful example of India are their deficiencies in the necessary telecommunications infrastructure and the insufficient qualification of their workforce which often lacks the required professional expertise and language skills.

It is emphasized, that the implications of the entry of foreign enterprises to the domestic market of DCs are even more important than the potential export of services. The reduction or elimination of discriminatory regulations allows companies from abroad to supply the formerly protected markets. As a consequence, competition is spurred and higher levels of efficiency become likely. The transfer of technological and managerial expertise from abroad fosters innovations so that a wider variety of services gets offered and raises consumer’s welfare. In sum, it is found that trade liberalization in services has the most benefits for the country which itself removes protective measures.

Subsequent to this inquiry, which is led in very broad terms in order to establish a general frame of reference, the second part of the thesis turns to the concrete case
of service liberalization through CAFTA. First, some background information on
the region and the three selected countries El Salvador, Guatemala and Honduras
is provided and CAFTA is placed in the broader context of trade integration within
the Western hemisphere and the phenomenon of the resurgence of regionalism on a
global scale.

Then, the actual investigation of the implications of CAFTA on the service
sector of the three states are presented. One part of the analysis examines the
service sector from a more comprehensive perspective, whereas the other focuses in
greater detail on financial services. In both cases, the analysis of the legal provisions
of the CAFTA text is complemented by the evaluation of a series of expert interviews
which had been conducted within the region. The section about financial services
additionally comprises some introductory notes which outline the sector’s important
role as the ‘brain’ of the economy.

The examination of the legal text of CAFTA and the evaluation of the expert
interviews lead to the conclusion that CAFTA has two principal merits related to
the service sector: First, the agreement establishes a binding legal framework and,
thereby, assumes the function of a lock-in-mechanism that prevents backsliding on
the previous achievements in privatization of state-owned enterprises, regulatory re-
forms and unilateral service liberalization. Second, the almost daily media coverage
about CAFTA over the last three years has initiated a broad public discussion about
the competitiveness of the region. The agreement has increased the sensitivity of
all actors and has moved the issue of service sector development further up on the
political agenda.

The results of the analysis of potential areas for service exports are well in line
with what could be expected in view of the considerations presented in the general
part: The range of promising service exports to the US is severely restricted by
the insufficient qualification of the region’s workforce which often lacks the required
professional expertise and English skills. However, a differentiation between the
three nations is necessary: In the case of El Salvador and, with qualifications, of
Guatemala some confidence in a positive future development of a few selected service
segments such as software engineering and medical services seems to be justified.

A tentative agenda of future efforts focused on service sector development
might include: (a) The issuing of sectoral studies which examine the interlinkages
between the service sector and the manufacturing industry; (b) the development
of a long-term vision for the domestic service sector; (c) the formulation of plans
on how to captivate particularly the younger generations’ attention for the service sector; and (d) the exploration of the potential of services trade within the Central America.

The analysis of the chapter on financial services in CAFTA yielded the result that the agreement should primarily be interpreted as the consolidation and lock-in of prior reforms and liberalization efforts. Some limited impact of CAFTA on the banking sector can be expected in Guatemala and Honduras since both countries maintain a few restrictions which they committed to eliminate. More profound changes are likely in the insurance sector where all countries will grant market access to US companies in the mode of commercial presence, within the next four years.

Furthermore CAFTA necessitates and promotes the strengthening of the regulatory and supervisory authorities of the financial system. While an adequate legal framework seems to be in place due to extensive reforms over the last years, further efforts must be undertaken in order to provide the authorities with the necessary capacities and competencies which are crucial to ensure the effective enforcement of these regulations. One final important aspect of financial liberalization are the implications of foreign bank entry on SSME’s access to credit. The fact that the industry structure of CA is clearly dominated by SSME, emphasizes the high relevance of monitoring the loans availability to SSME and, if necessary, of the implementation of compensatory measures.
REFERENCES

References

AUSTRALIAN-DEPARTMENT (1999): “Global Trade Reform: Maintaining Momentum,” Australian Department of Foreign Affairs and Trade, Canberra (AUS).


REFERENCES


REFERENCES


REFERENCES


A Appendix A

A.1 Overview of the Interview Partners

- List of Interviewees in El Salvador
- List of Interviewees in Guatemala
- List of Interviewees in Honduras
B Appendix B

B.1 Barriers to Trade in Services

B.2 Chronology of CAFTA

B.3 Overview of Sources of Information - List of URLs

International Institutions

World Bank  
http://www.worldbank.org/

International Monetary Fund  
http://www.imf.org/

World Trade Organization  
http://www.wto.org/

Regional Institutions

Secretariat for Economic Integration in Central America  
Secretaría de Integración Económica Centroamericana (SIECA)  
http://www.sieca.org.gt/

Central American Bank for Economic Integration  
Banco Centroamericano de Integración Económica (BCIE)  
http://www.bcie.org/spanish/index.php

Central American Council for Competitiveness  
Consejo Mesoamericano para la Competitividad (CMC)  
http://www.mesoamericanacompite.org/principal.php

Executive Secretariat of the Monetary Council of Central America  
Secretaría Ejecutiva del Consejo Monetario Centroamericano (SECMCA)  
http://www.secmca.org/Indice.htm

Central Banks
Central Bank of El Salvador  
*Banco Central de Reserva (BCR)*  
http://www.bcr.gob.sv/

Central Bank of Guatemala  
*Banco de Guatemala (BANGUAT)*  
http://www.banguat.gob.gt/

Central Bank of Honduras  
*Banco Central de Honduras (BCH)*  
http://www.bch.hn/

Financial Superintendencies

Superintendency of the Financial System of El Salvador  
*Superintendencia del Sistema Financiero (SSF)*  
http://www.ssf.gob.sv/

Superintendency of the Banking System of Guatemala  
*Superintendencia de Bancos (SIB)*  
http://www.sib.gob.gt/

National Comission for Banks and Insurances of Honduras  
*Comisión Nacional de Bancos y Seguros (CNBS)*  
http://www.cnbs.gov.hn/

State Departments

State Department of Economics of El Salvador  
*Ministerio de Economía (MINEC)*  
http://www.miniec.gob.sv

State Department of Economics of Guatemala  
*Ministerio de Economía (MINECO)*  
http://www.mineco.gob.gt/

State Department of Economics of Honduras  
*Secretaria de Industria y Comercio (SIC)*  
http://www.sic.gob.hn/index.htm

Export Promotion Agencies

Export Programme for Smallest, Small and Medium Enterprises (El Salvador)  
*Programa de Exportaciones para las Micro, Pequeñas y Medianas Empresas (EXPRO)*  
http://www.expro.org/

EXPORTA El Salvador (El Salvador)  
*EXPORTA El Salvador*  
http://www.exporta.gob.sv/home.htm
B  APPENDIX B

Association of Exporters of Non-Traditional Products (Guatemala)  
Asociación Gremial de Exportadores de productos no Tradicionales (AGEXPRONT)  

Foundation for Investment and the Development of Exports (Honduras)  
Fundación para la Inversión y Desarrollo de Exportaciones (FIDE)  
http://www.hondurasinfo.hn/

Programmes for Competitiveness Enhancement

National Programme for Competitiveness (El Salvador)  
Programa Nacional de Competitividad  
www.competi.gob.sv/www.competi.gob.sv/

National Programme for Competitiveness (Guatemala)  
Programa Nacional de Competitividad (PRONACOM)  
http://www.pronacom.org/home/

COMPITE - National Programme for Competitiveness (Honduras)  
COMPITE - Programa Nacional de Competitividad  
http://www.hondurascompite.com/
Erklärung

1. Ich versichere hiermit, dass ich die vorliegende Arbeit mit dem Thema:

   Trade Integration and the Rise of the Service Sector in Latin America
   - The Case of Honduras


Benjamin Hauck
<table>
<thead>
<tr>
<th><strong>El Salvador</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Campos, Mauricio</td>
<td>Banco de América Central (BAC)</td>
</tr>
<tr>
<td>Lic. Duch, Juan</td>
<td>State Department of Economics (MINEC)</td>
</tr>
<tr>
<td>Ing. Garay, Roberto</td>
<td>telecom</td>
</tr>
<tr>
<td>Lic. Lemus, Rafael</td>
<td>Technical Secretaria of the Presidency</td>
</tr>
<tr>
<td>Lic. Monge, Rigoberto</td>
<td>Organization for the Support of the Private Sector (ODASP)</td>
</tr>
<tr>
<td>Lic. Novoa, Flor de María</td>
<td>Central Reserve Bank of El Salvador (BCR)</td>
</tr>
<tr>
<td>Dr. Pleitez, William</td>
<td>United Nations Programme for Development (UNDP)</td>
</tr>
<tr>
<td>Lic. Queck, Stephan</td>
<td>Banco ProCredit (El Salvador)</td>
</tr>
</tbody>
</table>

| **Financial Manager**    |                                                                                                                                 |
| **Coordinator for Services and Investments** |                                                                                                               |
| **Manager for Regulatory Relations** |                                                                                                                |
| **Economic Coordinator** |                                                                                                                  |
| **General Coordinator**  |                                                                                                                  |
| **Chief of Department of Financial Development** |                                                                                                           |
| **General Coordinator**  |                                                                                                                  |

Table 9: Overview of the Interview Partners - El Salvador
Guatemala

<table>
<thead>
<tr>
<th>Name</th>
<th>Organization</th>
<th>Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lic. Bonilla, Aldo</td>
<td>Superintendency for Telecommunications (SIT)</td>
<td>International Relations Manager</td>
</tr>
<tr>
<td>Lic. de Estrada, Fanny</td>
<td>Association for the Export of non-Traditional Products (AGEXPRONT)</td>
<td>Executive Director</td>
</tr>
<tr>
<td>Lic. Gonzalez, Carlos</td>
<td>Institute for Economic and Social Research - University Rafaél Landívar (IDIES)</td>
<td>Economic Coordinator</td>
</tr>
<tr>
<td>Lic. Granados, Luis Felipe</td>
<td>Central Bank of Guatemala</td>
<td>Economic Advisor</td>
</tr>
<tr>
<td>Abg. Mendoza, Rubén</td>
<td>Lexincorp</td>
<td>Laywer</td>
</tr>
<tr>
<td>Lic. Monterroso, Raúl</td>
<td>Association of Banks of Guatemala (AGB), Association of Insurance Companies of Guatemala (AGIS)</td>
<td>Adviser</td>
</tr>
<tr>
<td>Dr. Rodas, Pablo</td>
<td>Association for Research and Social Studies (ASIES)</td>
<td>Project Director</td>
</tr>
<tr>
<td>Lic. Urízar, Carmen</td>
<td>Estrategias de Inversión, S.A.</td>
<td>Project Director</td>
</tr>
<tr>
<td>Lic. Zamora, César</td>
<td>State Department of Economics (MINECO)</td>
<td>Negotiator for Foreign Commercial Policies</td>
</tr>
</tbody>
</table>

Table 10: Overview of the Interview Partners - Guatemala
<table>
<thead>
<tr>
<th><strong>Honduras</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lic. Amaya, Cándido</td>
<td>Chamber of Industry and Commerce of Tegucigalpa (CCIT)</td>
</tr>
<tr>
<td>Lic. Caballero, José</td>
<td>National Commission for Telecommunications (CONATEL)</td>
</tr>
<tr>
<td>Lic. Chavez, Arturo</td>
<td>Foundation for Investment and Promotion of Exports (FIDE)</td>
</tr>
<tr>
<td>Lic. Jerez, Nelson</td>
<td>Banco de los Trabajadores</td>
</tr>
<tr>
<td>Lic. Lagos, Juan José</td>
<td>Microfinance Group COVELO</td>
</tr>
<tr>
<td>Lic. Majón, Siomara</td>
<td>State Department for Industry and Commerce (SIC)</td>
</tr>
<tr>
<td>Dr. Mejía, Ana Cristina</td>
<td>National Comission for Banks and Insurances (CNBS)</td>
</tr>
<tr>
<td>Lic. Mejía, Arles</td>
<td>Federation of Savings and Credit Cooperatives of Honduras (FACACH)</td>
</tr>
<tr>
<td>Lic. Moncada, José Luis</td>
<td>Chamber of Insurance Companies of Honduras (CAHDA)</td>
</tr>
<tr>
<td>Dr. Nuñez, Oscar</td>
<td>Central Bank of Honduras</td>
</tr>
<tr>
<td>Ing. Pavón, Hector</td>
<td>National Commission for Telecommunications (CONATEL)</td>
</tr>
<tr>
<td>Lic. Pinto, Ileana</td>
<td>Inter-American Development Bank (IADB)</td>
</tr>
</tbody>
</table>

Table 11: Overview of the Interview Partners - Honduras
### MODE 1: Cross-Border Supply

<table>
<thead>
<tr>
<th>Market Access</th>
<th>National Treatment</th>
<th>Other Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Quantitative restrictions</td>
<td>• Price-based instruments</td>
<td>• Government procurement and sourcing problems</td>
</tr>
<tr>
<td>(e.g. market-sharing, local</td>
<td>(e.g. price controls, subsidies, tariffs)</td>
<td>• Discriminatory access to distribution networks</td>
</tr>
<tr>
<td>content requirements)</td>
<td></td>
<td>• Intellectual property rights</td>
</tr>
</tbody>
</table>

### MODE 2: Consumption Abroad

<table>
<thead>
<tr>
<th>Market Access</th>
<th>National Treatment</th>
<th>Other Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Requirements relating to</td>
<td>• Limits on foreign currency available to</td>
<td>• General consumer regulations</td>
</tr>
<tr>
<td>travel documentation</td>
<td>traveller</td>
<td></td>
</tr>
<tr>
<td>• Exit visas</td>
<td>• Taxes on travel</td>
<td></td>
</tr>
<tr>
<td>• Entry visas</td>
<td>• Regulations relating to cross-border</td>
<td></td>
</tr>
<tr>
<td>• Residence permits</td>
<td>medical insurance</td>
<td></td>
</tr>
<tr>
<td>• Proof of vaccination</td>
<td>• Rules relating to the recognition of</td>
<td></td>
</tr>
<tr>
<td></td>
<td>educational standards and certificates</td>
<td></td>
</tr>
<tr>
<td></td>
<td>obtained abroad</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Restrictions on land ownership</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Restrictions relating to local currency</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Restrictions on freedom of movement</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Price discrimination</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Measures relating to gainful employment</td>
<td></td>
</tr>
</tbody>
</table>

*(for continuation see next page)*
### MODE 3: Commercial Presence

| **Market Access** | • Total prohibition of FDI (e.g. monopolised sectors, administrative discretion in licensing)  
| | • Partial prohibition or limitations on certain types of investment  
| | • Restrictions on the geographic location of foreign affiliates  
| | • Restrictions on the number of foreign firms in the market (e.g. license quotas)  
| **National Treatment** | • Limits to the scope of business operations and access to local finance (e.g. non-access to government procurement)  
| | • Performance requirements (e.g. trade balancing, employment and training, technology transfer, local content, export requirements)  
| | • Investment incentives (e.g. tax incentives, concessional loans)  
| | • Rules relating to external financial transfers (e.g. exchange controls)  
| **Other Measures** | • Tax measures (e.g. double taxation)  
| | • Promotion of FDI in services (e.g. investment promotion, information services)  
| | • Protection of FDI in services (e.g. transfer of investment income, insurance guarantees)  
| | • Intellectual property rights |

### MODE 4: Presence of Natural Persons

| **Market Access** | • Visas, residence permits, and work permits  
| | • Licensing requirements  
| **National Treatment** | • Restrictions on living conditions and civil rights  
| | • Restrictions on the rights of dependents  
| | • Taxation of foreign providers  
| | • Discrimination against foreigners in the workplace  
| | • Restrictions on local government procurement and subsidies  
| **Other Measures** | • Rules relating to repatriation  
| | • Cultural barriers |

*Source: Hodge (1998)*

Table 12: Barriers to Trade in Services (continued)
### Phase of Planning and Negotiations

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 16, 2002</td>
<td>US President George W. Bush announces his plan to establish a free trade agreement with Central America.</td>
</tr>
<tr>
<td>January 27, 2003</td>
<td>The first of nine negotiation rounds is held in San José, Costa Rica.</td>
</tr>
<tr>
<td>January 28, 2004</td>
<td>United States Trade Representative (USTR) Robert B. Zoellick releases a first draft version of CAFTA.</td>
</tr>
<tr>
<td>May 28, 2004</td>
<td>USTR Zoellick and trade ministers from Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua sign CAFTA in Washington, DC.</td>
</tr>
<tr>
<td>August 5, 2004</td>
<td>All parties sign the addition of the Dominican Republic to the agreement.</td>
</tr>
</tbody>
</table>

### Phase of Ratifications

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 17, 2004</td>
<td>Ratification by El Salvador</td>
</tr>
<tr>
<td>March 3, 2005</td>
<td>Ratification by Honduras</td>
</tr>
<tr>
<td>March 10, 2005</td>
<td>Ratification by Guatemala</td>
</tr>
<tr>
<td>June 30, 2005</td>
<td>Approval by the US Senate (54:45 votes in favor)</td>
</tr>
<tr>
<td>July 28, 2005</td>
<td>Approval by the US House of Representatives (217:215)</td>
</tr>
<tr>
<td>October 10, 2005</td>
<td>Ratification by Nicaragua</td>
</tr>
<tr>
<td>August 26, 2005</td>
<td>Ratification by the Dominican Republic</td>
</tr>
<tr>
<td>August 2, 2005</td>
<td>Bush signs CAFTA into law</td>
</tr>
<tr>
<td>January 1, 2006</td>
<td>Due to post-negotiations CAFTA does not enter into force as originally planned; each country sets its own time schedule for postponed implementation.</td>
</tr>
</tbody>
</table>

*Source: Own Elaboration*

Table 13: Chronology of CAFTA