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Global Integration and Growth in Honduras and Nicaragua

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Abstract

This paper discusses the experience with opening up to the global economy of two small Central American countries, Honduras and Nicaragua. They have both strengthened democratic processes and reduced defence expenditure dramatically. Both have liberalized their trade régimes in the context of regional integration within Central America and have encouraged foreign direct investment and investment in export processing zones. Nicaragua has made considerable progress toward macroeconomic stability. Honduras, on the other hand, has taken significant strides toward changing its pattern of exports toward more sophisticated primary-product based goods and simple manufactures. In addition, Honduras has emerged as a major assembler of clothing for the United States market. However, neither country has yet succeeded in launching rapid, export-oriented growth. Some of the reasons are weak linkages between the export sector and the rest of the economy, ambiguous signals to private sector producers emanating from economic policy, and low levels of labour productivity. Improving the latter will require major investments in human resources, mainly in education and health.

Keywords: globalization, Latin America and the Caribbean, sustainable growth

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Introduction

Honduras and Nicaragua are two small neighbouring Central American countries with a common history and similar economies. Together with other countries in the region, both countries are emerging from decades of civil unrest, they are in the process of consolidating democratic governments, and have embraced a market-oriented growth strategy. This strategy stresses privatization of state enterprises and trade liberalization. It attaches special importance to export growth and diversification as the main pillar of development. Both countries have been members of the Central American Common Market (CACM) since its creation in the early 1960s and recognize the importance of regional integration for their development strategies.

These two economies are very poor, small, and dependent on foreign trade (Table 1). After Haiti and Bolivia, they are the poorest countries in the Western Hemisphere. They are also examples of countries that are diverging from the world leader (the United States). For the last twenty-five years, their per capita GDPs in purchasing power parity terms have been falling relative to the United States' per capita GDP. At the same time, we are dealing with very open economies, where the importance of trade has been growing sharply over the last decade. As we shall discuss below, this has been due partly to very vigorous policies of trade liberalization. So, in a sense, these countries provide a counterfactual to the Sachs-Warner hypothesis that open economies tend to converge on the output level of the world leader (Sachs and Warner 1995).[1]

Table 1

Honduras and Nicaragua: Basic economic indicators

	Honduras	Nicaragua
Per capita GDP, 1997 (US$, PPP)	2,220	1,950
Per capita GDP relative to the United States		
1975	10.1	20.3
1985	9.4	9.3
1997	7.7	6.9[a]
Population, 1997 (millions)	5.99	4.69
Export-GDP ratio (percentage)		
1990-92	32.4	22.6
1996-97	46.9	41.9

Source: Author's calculations, based on World Bank, *World Development Indicators, 1999*.

Note: [a]1995.

1 To be fair to the Sachs and Warner argument, it is quite conceivable that trade liberalization, which dates from the early 1990s in both countries, has been too recent to yield the growth dividends that Sachs and Warner (1995) would predict. In addition, political instability until 1990, particularly in Nicaragua, has only very recently been overcome, and this could have discouraged investment.

This paper discusses why, in site of considerable progress in the 1990s toward opening up to the world economy and in achieving macroeconomic equilibrium, these two economies have failed so far to achieve sustained growth and a visible improvement in living standards. Section 1 discusses the new political environment in Central America. For the first time in decades, the region is at peace, and democracy has been restored. This favourable political scenario in itself offers Honduras and Nicaragua a window of opportunity for the pursuit of economic growth and development. Section 2 describes the opening up of the Honduran and Nicaraguan economies in the 1990s. Section 3 reviews the modest growth record of both countries during the past decade. In section 4 we attempt to attribute causes for the failure of both countries to generate export-oriented growth, in spite of the policy progress achieved. Section 5 offers some conclusions and policy recommendations.

1 The importance of peace as a precondition for growth

Economists working in the area of economic growth have learned the importance of initial conditions for subsequent growth. The most important initial condition for both of these countries is that, as the 1980s were drawing to a close, the governments of both countries inherited societies that were just beginning to emerge from decades of civil war. To a large extent, during the 1990s democratic institutions were rebuilt, and the rule of law was re-established. All countries in the region except Costa Rica had faced left wing armed insurgency of a regional character. Although Honduras was not at the centre of the conflict, it suffered its consequences. These took the form of intermittent threats to its government's authority and the use of its territory as sanctuary by combatants from other countries in the region, especially from bordering Nicaragua.

As armed opposition to the Somoza dictatorship grew in strength, Nicaragua suffered very severe civil upheavals since the early 1970s. The Sandinista forces that overthrew the Somoza Government in 1979 faced permanent armed threats from their opponents. In addition to civil strife, the economic and social fabric was subjected to severe strains, as the main orientation of policy swung first toward an attempt to implant a socialist, state-led model of development and, later, even before the Sandinistas left office, toward a more market-oriented approach. Since the assumption of an elected government in 1990, the strengthening of the market economy has been a major policy objective. As part and parcel of this approach, foreign trade has been freed from controls, macroeconomic policy has emphasized adjustment and disinflation, and state enterprises have been or are in the process of being privatized. Among the latter are telecommunications, electricity generation and distribution, and banks. Most of the enterprises taken over by the state during the Sandinista régime were re-privatized early in the 1990s.

Given the regional nature of the civil conflicts in Central America, it took a regional presidential initiative to achieve a lasting peace. The peace agreements have involved not only governments, but also the armed forces and armed groups from the left and right of the political spectrum (ERDSH 1999: 37). Today, all Central American countries have democratically elected governments committed to market-oriented reforms, the armed forces are increasingly subordinated to civil authorities, and human rights violations are no longer state policy anywhere in the region. Economically, pacification has yielded a large peace dividend. In all four countries, but especially in

Honduras and Nicaragua, military spending as a share of GDP has declined remarkably (see Table 2). In addition, the disappearance of armed conflict, the establishment of the rule of law, and the replacement of military by civilian governments have had a positive effect on economic growth.

Table 2

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

(percentage)

	1989	1996
Honduras	8.4	1.3
Nicaragua	28.3	1.5

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

However, there are still several important problems to be resolved in relation to human rights and personal security. Crime rates are high, and people continue to have a sense of insecurity about life and property. Human rights violations by the police, often with the complicity of the armed forces, have been reported in both countries. In Honduras there are reports of widespread illegal seizures of land by organized groups, and affected parties have scant possibilities of redress in the courts.

In Nicaragua, protection of property rights is still inadequate. There still exist a large number of unresolved disputes surrounding expropriations of real estate and commercial property carried out during the 1980s (ERDHS: 210). Uncertainties surrounding the validity of claims to property rights are acting as a serious deterrent to foreign and domestic investment. In 1997, Congress passed a new property law with a view to putting an end to these conflicts. However, Nicaragua still suffers from a general weakness in its institutions and in the enforcement of laws and contracts that discourages domestic and foreign investment.

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

2 Policies to achieve greater global integration

As already suggested, both countries have shifted their growth strategies toward greater market orientation and integration into the global economy. We examine here three aspects of the new policy package: macroeconomic adjustment, opening up to trade in the context of ‘open regionalism’, and policies toward foreign direct investment (FDI).

2.1 Progress in macroeconomic adjustment

It has become conventional wisdom that it is impossible to bring about structural adjustment without first having achieved effective and lasting stabilization. In turn, this latter objective depends fundamentally on prudent fiscal and monetary policies. Perhaps the single most important reform in this regard is the reduction of the public deficit. If the objective of achieving a new, growth-promoting insertion into the world economy is to be preserved, expenditure cuts must fall on items other than investments in education and health.[2] Indeed, in most countries, such expenditures will have to increase. Where the tax burden is low, an important contribution to the needed reductions in the deficit will have to come from tax reform.

Nicaragua's adjustment programme, implemented with the return to democracy in 1990, consisted in first using the exchange rate as an anchor for domestic prices while bringing down drastically the budget deficit, which was due to the inefficiency of nationalized enterprises and, above all, to a swollen military budget. Inflation fell from over 13,000 per cent per annum in 1990 (January-December) to between 10 and 20 per cent in the second half of the 1990s (Table 3). As we shall see, the price was currency appreciation in real terms, supported by official capital inflows. The reductions in government spending and employment were draconian. Public employment fell from 208 thousand workers in 1990 to 100 thousand in 1994. Most of the cuts took the form of reductions in the armed forces, from more than 100 thousand soldiers to barely 24 thousand over the same period (Agudelo 2000).

Table 3

Inflation, measured by the consumer price index, 1990-99

(percentage)

	Honduras	Nicaragua
1990	23.3	7,485
1991	34.0	2,945
1992	8.8	23.7
1993	10.7	20.4
1994	21.7	7.8
1995	29.5	10.9
1996	23.8	11.6
1997	20.2	9.2
1998	13.7	13.1
1999	16.5	11.2

Source: International Monetary Fund, *Intenational Financial Statistics*, various issues; and Solórzano (2000).

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2 Conventional national accounting classifies expenditures in education and health as consumption. We view them as essential inputs into rapid and broad-based growth.

But Nicaragua has also implemented tax reform and has succeeded in raising its tax burden from 15 per cent of GDP in 1990 to over 30 per cent in 1998 (Table 4). As part of the effort to put the fiscal house in order, the Nicaraguan government has made efforts to charge users for public services. The conjunction of spending cuts and revenue increases resulted in a reduction of the public deficit from over 20 per cent in 1990 to 2.2 per cent in 1998 (Solórzano 2000). However, the public sector continues to rely heavily on foreign aid (about 8 per cent of GDP, which is the difference between government receipts and tax revenues plus off-budget donations).

Table 4

Some fiscal indicators, 1990-98

(percentage of GDP)

	1990	1992	1994	1997	1998
Honduras					
Total receipts	16.2	20.0	17.2	18.0	19.8
Tax revenues	14.8	15.9	14.8	14.1	16.7
Total expenditures	19.8	24.6	22.2	20.1	21.8
Deficit[a]	3.6	4.6	5.1	2.1	2.3
Nicaragua					
Total receipts	17.7	27.9	29.3	33.8	37.2
Tax revenues	14.8	23.4	23.4	27.3	30.1
Total expenditures	38.0	36.3	41.9	40.9	39.5
Current expenditures	35.7	26.3	26.7	26.1	26.8
Capital expenditures	2.3	9.9	15.2	14.8	12.7
Deficit[a]	20.3	8.4	12.5	7.1	2.2
Donations	1.9	49.1	6.5	5.4	1.1
Deficit after donations[a]	18.4	-40.7	6.0	1.7	1.1

Source: International Monetary Fund, *International Financial Statistics*, various issues, Mejía (2000), and Solórzano (2000).

Note [a]Deficits are indicated with a positive sign.

Honduras did not suffer from the serious macroeconomic disequilibria that afflicted Nicaragua until 1989. However, the authorities have not been successful in bringing inflation down to single digits. In spite of some progress, the fiscal deficit remains problematic, and there is still considerable room for raising the tax burden. It is not possible to tell what part of total government receipts is represented by foreign aid, but presumably it is close to the difference between total government receipts and tax revenues, which amounts to about 3-4 per cent of GDP. Accounting for debt refinancing, an extra 3 percentage points of GDP ought to be added.

2.2 The challenges of 'open regionalism'

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

The CACM, created in the early 1960s, had been a model of regional integration that many other regional groupings have tried to emulate. By the end of the 1970s, the CACM had been responsible for the high degree of integration achieved by the Central American economies. About a quarter of the total exports of the five signatories had the region as destination, free trade in manufactures had been practically achieved, and a common external tariff (CET) applied to most goods.

Table 5

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

(percentage)

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

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

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

The Central American Import Tariff is divided into three parts. Part 1 encompasses goods to which common tariffs are expected to apply at the latest by December 2000 (about 90 per cent of tariff lines). Part 2 covers tariff lines that have not yet been harmonized, and Part 3 includes goods that will retain national tariff treatment, essentially for revenue purposes.

The CET pertains, then, to Part 1 goods and contains only four tariff rates. A zero rate applies to raw materials, intermediate goods, and capital goods not produced in Central America. Raw material produced in the region carry a duty of 5 per cent. Capital goods produced in the region are subject to a tariff of 10 per cent, and a tariff of 15 per cent is applied to finished goods.

Some examples of goods excluded from the CET are certain agricultural goods, meat, poultry, tobacco, non-alcoholic and alcoholic beverages, petroleum, and automobiles. Tariffs on these goods can be much higher than the maximum of 15 per cent agreed to for the CET. However, these higher rates are often justifiable on government revenue or equity grounds.

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

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

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

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

Fourth, groups of countries within CACM are pursuing the formation of more exclusive ‘clubs’ Before their dispute over maritime jurisdiction in early 2000, Nicaragua had started negotiations with Honduras toward the formation of a complete customs union by 2002. In May 2000 Honduras announced that it was joining El Salvador and Guatemala in a customs union.

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

There are yet other challenges ahead for the CACM. One of them is agreement on a uniform drawback and export-subsidy scheme for exports outside the region. The distortive effects of excluding these policies from regional harmonization efforts are bound to grow as integration deepens. A second concern is failure to arrive at a common regional approach toward FDI in general and toward Export Processing Zones (EPZs) in particular. Third, effective integration will require a concerted effort to improve regional infrastructure. Fourth, greater exchange rate and macroeconomic coordination will have to be pursued.

In spite of these difficulties and while much remains to be done, the efforts to strengthen regional integration can be judged as very successful. Moreover, regional integration is being pursued in the context of a very significant reduction of tariffs on a Most Favoured Nation (MFN) basis, which, for small economies, undoubtedly has greater development potential than the protectionist policies of the past.

2.3 Opening up to FDI

The liberalization of FDI régimes is part and parcel of global integration, and the Central American countries have understood this well. Accordingly, Honduras and Nicaragua (together with other CACM members) have liberalized very considerably their foreign direct investment regimes. National treatment is guaranteed to foreign investors. In addition, they have complete freedom to invest in any sector of the economy (except those related to defense) and to remit earnings or repatriate their capital abroad. No performance requirements are imposed on investors. Both countries have signed the Multilateral Investment Guarantee Agreement (MIGA).

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

Up to now, Nicaragua has been more successful than Honduras in attracting FDI. In recent years, FDI in Nicaragua has represented a significant share of GDP (see Table 6). Beginning in 1996, there have been important new investments in the energy and mining sectors. Other sectors that have received significant foreign investments are hotels, shrimp farming, and cellular telecommunications. The low figures for Honduras could be somewhat deceptive, since multinational enterprises (MNEs) in EPZs operate mostly through domestic subcontractors.

Table 6

Foreign direct investment, as a share of GDP

(percentage)

	1990 – 1992	1993 – 1995	1996	1997	1998
Honduras	1.5	1.5	2.2	2.7	1.9
Nicaragua	0.3	2.8	4.9	8.6	10.2

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

Both countries have attempted to attract foreign investors to EPZs set up for foreign firms or for domestic subcontractors of MNEs assembling products with imported parts for the international market. Firms in EPZs enjoy complete tariff exemptions over imported inputs and income tax holidays. The latter are permanent in Honduras and have a duration of 15 years in Nicaragua (Gitli 1997: 202-210; see also Jenkins, Esquivel and Larraín 1998). Owing to greater political stability and more clearly defined property rights, Honduras has been more successful in this activity. As we shall see below, one of the most important changes in Honduras' production and export structure during the 1990s relates to the expansion of the *'maquiladora'* sector.

3 The growth record

The growth performance of these two countries was quite different in the 1990s. Despite considerable structural change, GDP in Honduras did not grow in per capita terms. By contrast, despite less structural change, in Nicaragua there was positive per capita growth in the 1990s, after two decades of economic contraction (see table 7). In fact, in Honduras, the growth rate decelerated somewhat in the second half of the decade. In Nicaragua, once the disinflation and adjustment of the first half of the decade had been essentially completed, there was a visible improvement in growth performance in the second half.

Table 7

Rates of growth of GDP and GDP per capita, 1970-99

(percentage)

	Honduras	Nicaragua
GDP		
1971-80	5.4	0.0
1981-90	2.4	-1.5
1991-99	3.1	3.2
1991-95	3.4	1.7
1996-99	2.6	5.2
Per capita GDP		
1971-80	2.1	-3.2
1981-90	-0.8	-4.1
1991-99	0.2	0.3
1991-95	0.4	-1.2
1996-99	--	2.3

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

We will not comment extensively on investment rates. There is evidence that, in Honduras, investment is overestimated, and that GDP is probably underestimated (Ramos Lobo 2000), so that recorded rates of investment in recent years in excess of 30 per cent of GDP are hardly credible, especially in view of stagnation in per capita output. In Nicaragua, the gross investment to GDP ratio declined from an annual median of 25 per cent in the 1980s to an annual median of slightly under 20 per cent in the 1991-97 period. The high rate of investment in the 1980s is likely to be a reflection of misallocation of resources during the period of Sandinista rule. The rate of investment of 20 per cent achieved during the 1990s is consistent with the moderate growth performance of Nicaragua in the 1990s.

Since global integration is one of the key objectives of the new development strategies adopted by both Honduras and Nicaragua, particular importance attaches to the evolution of exports in the 1990s. A good sign that change has begun is, indeed, the performance of the export sector. Exports have led economic growth in both countries in the 1990s, and there is evidence that export growth is accelerating (table 8). In Honduras there was a strong pick up in the growth of exports beginning around 1995. Up until 1998, export growth had been very strong. The 1999 figures were affected by the adverse impact of Hurricane Mitch. In Nicaragua, high export growth was sustained through 1997. In 1998-99, poor export performance can be attributed to the elimination in 1998 of export incentives benefiting non-traditional exports and to the effects of Hurricane Mitch.[3]

Table 8

Growth of exports of goods and services, in constant prices, 1971-99

(average annual rate, percentage)

	Honduras	Nicaragua
1971-80	4.6	7.2
1981-90	0.8	-5.7
1991-99	3.3	5.0
1991-95	0.9	6.1
1996-99	6.4	3.6
1997	17.3	40.1
1998	17.0	-17.7
1999	-6.4	0.3

Source: Author's calculations, based on World Bank, World Development Indicators, 1999; CEPAL, Estudio Económico de América Latina, 1999, Santiago; and CEPAL, Balance Preliminar de las Economías de América Latina y el Caribe, 1999, Santiago.

The transformation of the structure of exports since the early 1990s has been remarkable, particularly in Honduras. Indeed, export growth has concentrated on new exports. The share of traditional commodity exports (bananas, coffee, sugar, cotton, and meat) fell significantly in the 1990s in both countries; in the case of Honduras, the decline was dramatic (Table 9). Since the arrival of peace, new export crops have been developed, especially fruits and vegetables (so-called ‘dessert products’), ornamental plants, new agricultural staples, cultivated shrimp, tobacco products, prepared fruit products, and some light manufactures such as soaps and detergents. Exports to Central America have grown very rapidly, but so have non-traditional exports to destinations outside the region.

3 Based on interviews with exporters, analysts and government officials in July 1999 and May 2000.

Table 9

Traditional and non-traditional exports: shares in total exports and average annual rate of growth, 1990-98

(percentage)

	Share in total, 1990	Share in total, 1998	Growth, 1990-98
Honduras			
Traditional[a]	82.7	37.0	1.0
Non-traditional	17.3	41.3	24.5
Central America	(4.2)	(11.3)	(26.2)
Rest of the world	(13.0)	(30.0)	(23.9)
Maquila value added	--	21.7	45.2[c]
Total	100.0	100.0	9.8
Total (million US$)	831.5	2,011.0	
Nicaragua			
Traditional[b]	79.2	56.5	4.2
Non-traditional	20.8	32.7	15.0
Central America	(13.2)	(19.2)	(13.8)
Rest of the world	(7.6)	(13.5)	(16.8)
Maquila value added	--	10.7	96.2[d]
Total	100.0	100.0	8.7
Total (million US$)	330.5	642.2	

Sources: Authors' calculations, based on data from Banco Central de Nicaragua, Secretaría de Integración Económica de Centro América (SIECA, Banco Central de Honduras, Consejo Monetario Centroamericano, and Gitli (1997).

Note: [a] Basically coffee and bananas. It includes modest values of other unprocessed primary products.

[b] Coffee, bananas, marine shrimp, gold, silver, cattle, molasses, and cotton.

[c] 1991-98.

[d] 1992-98.

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

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

The growth of the *maquiladora* industry has been phenomenal (Table 10). In 1990, in Honduras national value added by *maquiladoras* constituted barely 4 per cent of total export earnings from goods, and they employed 17.5 thousand workers. In Nicaragua, there was no *maquiladora* industry at all in 1990. In 1998, national value added represented 21.7 per cent of the value of goods exports in Honduras. In Nicaragua, where this activity is still in its infancy, in 1998 the share of national value added by *maquiladoras* in export revenues was 10.7 per cent. In Honduras, employment in *maquiladoras* accounts for nearly 50 per cent of total manufacturing sector employment.

Table 10

Importance of the *maquiladora* industry

	1990	1998
Honduras		
National value added (US$ million)	31.6	436.4
Percentage of exports	3.9	21.7
Employment (thousands)	17.5	100.0 [a]
Percentage of industrial employment	22.3	50.0 [a]
Nicaragua		
National value added (US$ million)	-	68.7
Percentage of exports	-	10.7
Employment (thousands)	-	11.0 [b]
Percentage of industrial employment	-	30.0 [a]

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

Note: [a] Estimate; [b] 1996.

4 Some explanations for weak growth performance

In spite of very significant policy reform, both of these two countries have yet to generate a process of sustained economic growth. Honduras has been more successful in changing the structure of its exports and production, but paradoxically, it exhibits a comparatively weaker growth performance than Nicaragua. In the latter country, after several years of consolidating structural adjustment, since 1996 growth has been relatively strong.

One important explanation is that market-oriented reform is a necessary but insufficient precondition for growth. More is clearly needed. What this ‘more’ entails is a complex matter. Economic agents must be willing and able to respond to new price signals emanating from the reforms, and this has not yet been achieved in Honduras and Nicaragua.

As already noted, in both countries, there are still problems associated with violence and, particularly in Nicaragua, with insecure property rights. This must surely count as a major deterrent to investment and growth. But setting these problems aside, both countries face other, very similar impediments. In the first place, the impulses stemming from the export sector have not radiated to the rest of the economy. Second, the signals emanating from the reforms have not oriented producers unambiguously toward the production of new goods for export markets. Third, the private sector's weaknesses in responding to price signals are evident. In order to produce for export markets, the skills and health of the labour force need to be improved considerably. Small enterprises lack the technology, management skills, education, and credit to participate in an increasingly open national economy, let alone penetrate export markets.

4.1 Weak linkages between export activities and the domestic economy

Since the early 1990s, the fastest-growing sector of the Honduran economy has been the *maquiladoras*. They have been responsible for the dynamism of the region around San Pedro Sula and have transformed that city into the most prosperous in the country. Unfortunately, the dynamism of the *maquiladoras* has not translated into faster growth for the country as a whole. The reason is not hard to find. Besides labour, electricity, rents, and a few other services, firms operating in the sector purchase practically nothing in Honduras. Thus export processing generates few backward linkages to other sectors of the economy. International experience shows that, for export assemblers to develop linkages to other parts of the economy, specific policies are needed, because linkages do not arise spontaneously, even many years after export processing régimes have been established (Jenkins, Esquivel, and Larraín 1998).

In Nicaragua, export activity has been considerably less dynamic. Although new export sectors did emerge in the course of the 1990s, they are far from becoming consolidated. In fact, non-traditional exports suffered a severe setback in 1998-99. The main source of growth has been the recovery of domestic demand from the shocks associated with macroeconomic adjustment. Unless the economy can generate an export-oriented growth momentum, the relatively satisfactory performance of recent years could be short-lived.

4.2 Weak signals encouraging export production

Signals arising from the opening up of the economy have favoured non-tradables rather than the export sector. This is mainly because national currencies in both countries, but especially in Nicaragua, have tended to become overvalued from the point of view of the needs of the real economy.[4] There have been two major causes for currency overvaluation, a sort of 'double Dutch disease in the tropics'. In the first place, both countries have come to count on wage remittances to meet their foreign exchange needs. Official balance of payments figures consistently underestimate the value of remittances. In Nicaragua, wage remittances are estimated to be in the range of US$ 400 to US$ 600 million, compared with total export earnings from goods of about US$ 700 million. The second cause is heavy reliance on foreign aid. Both countries, and particularly Nicaragua, are heavy recipients of official development assistance, mostly soft loans.

The weaknesses of balance-of-payments statistics do not allow a precise calculation of the value of aid and wage remittance flows. We tried to approximate the sum of both by adding some items in the balance of payments, as reported in the *IMF's International Financial Statistics.* These were transfers (which presumably include grants plus registered wage remittances), net flows to the government, errors and omissions (a proxy for unrecorded remittances), and exceptional financing (mostly public debt renegotiation).

The results of this exercise are shown in Table 11. Nicaragua has had to refinance continuously heavy debt service requirements that it is unable to meet and that account for between 30 and 40 per cent of GDP. Even excluding such refinancing, estimated net aid receipts plus wage remittances are above 10 per cent of GDP. The situation is somewhat less dramatic in Honduras, although net foreign exchange receipts from these two sources also account for between 5 and 10 per cent of GDP. Even so, it is likely that our calculations continue to underestimate wage remittances, since keeping track of them can be notoriously difficult.

4 We use the term ‘overvaluation’ in a rather loose manner. Clearly, foreign exchange markets are more in equilibrium today than they were in the 1980’s. From the point of view of trade objectives, however, the price of the dollar is being kept too low by wage remittances and foreign aid.

Table 11

Estimates of foreign aid plus wage remittances, 1996-98

(as a percentage of GDP)

	1996	1997	1998
Honduras			
With debt refinancing	15.5	11.5	8.8
Without debt refinancing	12.9	8.6	5.5
Nicaragua			
With debt refinancing	46.2	53.8	34.7
Without debt refinancing	3.1	11.7	10.8

Source: Author's estimates, based on data of International Monetary Fund, *International Financial Statistics*, May 2000.

The large figures shown in Table 11 for debt refinancing, particularly in Nicaragua, suggest that definitive debt relief is needed to end with the fiction that these debts will someday be repaid. Both countries are likely to be accepted to the HIPC Initiative in 2000.[5] This would wipe out 80 per cent of the net present value of outstanding debt.

These peculiar forms of Dutch disease have rendered export diversification an uphill battle. At the same time, domestic producers of importables have had increasing difficulty in competing with imported goods.

The management of the exchange rate has been quite different in both countries. In Nicaragua, during the period of disinflation (1990-92), a fixed nominal exchange rate (albeit with a major discreet devaluation in March 1991) was used as an anchor for domestic prices. Since January, the Central Bank has used a preannounced rate of monthly devaluation of the córdoba. As a result of these policies (and, of course, of the fundamentals determining the real exchange rate), there was a steep initial real appreciation of the córdoba, followed by a gradual real depreciation as from early 1993 (see Figure 1). It is very likely that during the hyperinflation of the late 1980s the exchange rate was severely undervalued and that the stabilization effort involved a correction of that situation. The process of disinflation was accompanied by substantial foreign assistance, which, as already noted, was one of the causes underlying the appreciation of the exchange rate.

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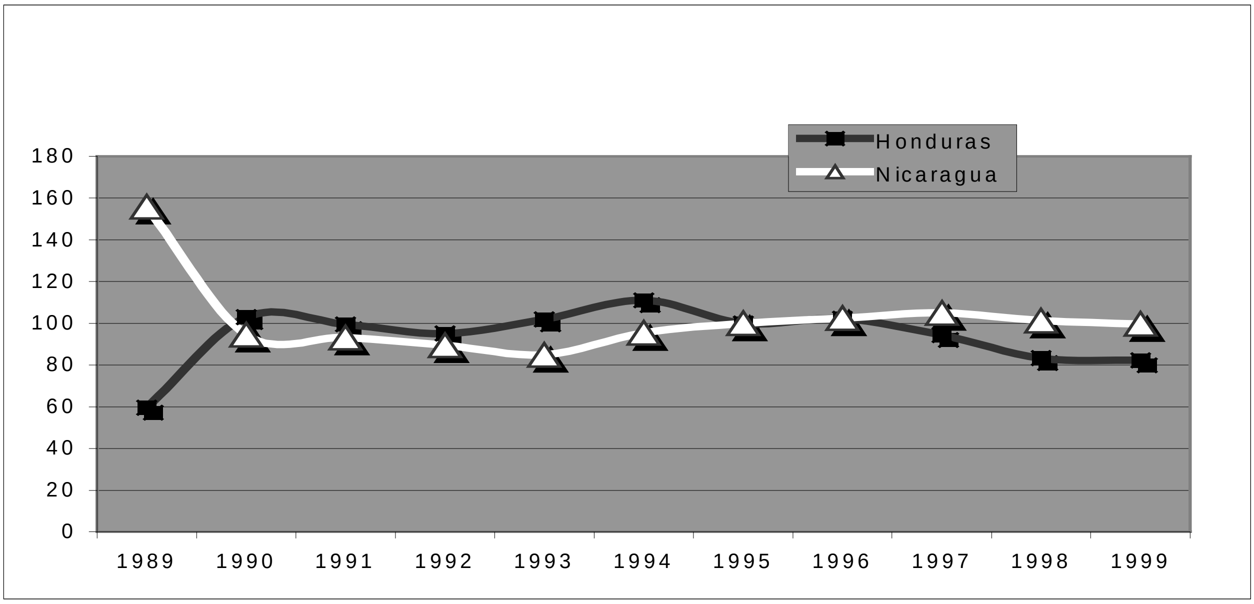
5 HIPC stands for 'Highly Indebted Poor Countries'. The HIPC Initiative is a programme of the multilateral financial institutions to provide debt relief to poor countries that have made progress toward macroeconomic adjustment. For a discussion of the HIPC Initiative in the context of Honduras' and Nicaragua's debt problems, see Esquivel, Larraín and Sachs (1998).

Figure 1

Real exchange rate (1995=100)



Source: Author's calculations, based on International Monetary Fund, International Financial Statistics, various issues.

In the case of Honduras, for decades the authorities had insisted in maintaining a fixed nominal exchange rate with respect to the dollar (one dollar was worth two lempiras). During the 1980s, a rate of domestic inflation that exceeded international levels, mainly the result of monetizing persistent budget deficits, led to mounting currency overvaluation. Eventually, the resulting current account deficits could not be financed with voluntary capital flows, and in 1990 the authorities effected a sharp nominal devaluation. Since 1994, the exchange rate régime has consisted in a managed float, with an effort made to keep the real price of the dollar within a certain target band. As can be seen in Figure 1, the initial real depreciation of 1990 has been gradually eroded.

Export subsidies, used quite successfully during the 1980s and early 1990s in neighbouring Costa Rica, have proven difficult to implement in Honduras and Nicaragua. True enough, outward-bound assembly for the United States market enjoys generous (perhaps overly so) income tax exemptions. However, neither country has a genuine drawback system on imported inputs used in export production located outside EPZs. Moreover, they do not avail themselves of the leeway they have as low-income members of the World Trade Organization (WTO) to use subsidies to encourage the emergence of new exports.

Until early 1998, Nicaragua used to grant exporters of non-traditional goods exemptions on income taxes on their profits earned in export production, as well as Tax Benefit Certificates (*Certificados de Beneficio Tributario*) equivalent to a certain proportion of export earnings. These Certificates could be used to pay income taxes or could be sold to third parties. This incentive was patterned after Costa Rica's very successful *Certificados de Abono Tributario* (CATs), which were instrumental in diversifying exports away from primary commodities and toward manufactures.[6] Nicaragua eliminated (wrongly, we believe) both of these incentives in 1998 and replaced then by subsidy of 1.5 per cent of the value of exports (applicable to all exporters) in lieu of a drawback on duties paid on imported inputs.

The use of export subsidies to stimulate the emergence of new exports is particularly appropriate in the light of the structural problems that affect these countries' real exchange rate and which are very difficult to deal with successfully. We will have more to say below on exchange rate and export subsidy policies in the concluding section of the paper.

4.3 Inadequate investments in human capital and health

Since the pioneering paper by Barro (1991), the levels of human capital (as generally proxied by indicators of school enrolment) have been considered essential initial conditions explaining subsequent economic growth. Certainly, both of these countries had very inadequate levels of educational achievement at the beginning of the past decade. However, here we wish to broaden the issue beyond initial conditions as regards human capital and consider the capability of the economy as a whole to respond to signals emanating from policy reform. In countries where education and health indicators are at very low levels, it is certain that access to such services is very heavily concentrated in a few well-off segments of society. This means that most of the population will be unable to participate creatively in the modern economy, especially as it integrates into the global economy. Honduras and Nicaragua also have severe problems of gender equality, which lower the participation rates of women in the labour force and reduce the quantity and quality of educational and health services available to women. Thus women contribute less than their potential to economic growth.[7] Our two Central American countries are very unprepared for participating in a more creative manner in the global economy by exporting goods and services other than raw materials, which requires learning to produce new things, attracting FDI into new kinds of activities with more sophisticated technologies and with higher skill requirements.

We use neighbouring Costa Rica as a benchmark against which to compare Honduras' and Nicaragua's indicators of investment in education and health. We also broaden our inquiry to look at four major dimensions of human development:[8] the demographic transition,[9] basic health indicators, child malnutrition indicators, and education indicators (Table 12).

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6 The CATs were gradually dismantled by Costa Rica during the 1990s.

7 For a fuller examination of human development issues in Central America, see Agosin, Bloom and Gitli (2000b).

8 For an exposition of the concept of human development, see United Nations Development Programme, *Human Development Report,* any issue. The HDR has been published since 1990.

9 In a conventional Solow model of growth, fertility and population growth would affect the steady-state level of per capita income, not its rate of growth (see the classic article, Solow, 1956). We contend that demographic variables affect an economy’s growth potential. For example, a decline in fertility rates lead to higher saving and to more investment in the quality of children and, hence, in

Demographic variables are taken as proxies for two objectives of human development: gender equality and availability of education for all. Fertility rates and the ratio of dependants to workers are strongly influenced by gender equality and by the availability of education for women. In societies where women can find productive employment and are allowed to work, fertility rates eventually decline. The effect of access to education for girls is similar: educated women have less children and invest more in the health and education of their (fewer) children.

All four categories of indicators tell the same story: Honduras and Nicaragua have serious human development problems that not only affect adversely the welfare of their populations but also seriously retard their development. The comparison with Costa Rica is telling.

Honduras and Nicaragua still have very high rates of growth of population, more than double Costa Rica's. Their high fertility rates imply that the share of dependent young people in the total population will remain high for a long time, making it difficult to provide education for all who need it and reducing the saving rate of households. Relatively low life expectancies and high rates of infant mortality bespeak of populations with poor health and, therefore, low productivity. High indicators of infant malnutrition are accurate predictors of poor school achievement. As regards school enrolment, the basic problems are a high rate of desertion in primary school, low quality of primary school education (which prepares students poorly for secondary school), and very low rates of enrolment in secondary and higher education.

Fertility rates are kept high partly because of inadequate investments in the quantity and quality of education. Put more positively, an improvement in education, particularly at post primary levels, would probably result in a fall in fertility rates, which in itself would yield an important one-off demographic dividend.

One particular problem in these two countries is the abnormally large size of the informal sector, which is evidence of the inability of the formal sector of the economy to provide productive employment for all those who are able and willing to work. Part of the problem arises from urban-rural migration. Average living conditions for workers in the informal urban sector may be no better than in the countryside. However, migration occurs because there is a non-zero probability of having access to higher wages in the formal urban sector, very much in the spirit of the Harris-Todaro model (Harris and Todaro 1970).

In Nicaragua, in addition, the rate of open unemployment is high, mainly as a consequence of the dramatic shrinkage of the state sector during the adjustment of the early 1990s. While measured unemployment receded gradually from its high of 17.8 per cent in 1993, it still was 12.5 per cent of the labour force in mid-1999 (Solórzano 2000). In Honduras, measured unemployment is much lower, but one suspects that much that passes for 'employment' is at such low levels of productivity that it is really disguised unemployment.

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labour productivity over the long run. Of course, the impact of demographic variables is not permanent, in the sense that demographic transitions end. However, they can take a long time and can, therefore, exert a long-term effect on growth rates that goes well beyond tahat expected in the Solow model. For details, see Agosin, Bloom and Gitli (2000a)

Table 12

Human development indicators, 1990s

(unless specified otherwise, percentage)

	Honduras	Nicaragua	Costa Rica
Demographic transition			
Rate of growth of population	2.8	2.7	1.3
Fertility rate (live births per woman)	4.3	3.9	2.8
Age dependency ratio[a]	0.82	0.85	0.61
Basic health indicators			
Life expectancy at birth (years)	69	67	77
Infant mortality rate (per 1,000 births)	35	41	11
Malnutrition indicators			
Low birth weight (% of births)	9	15	7
Low height for age (% children under 5)	40	24	6
Low weight for age (% children under 5)	18	12	5
Education indicators			
Illiteracy rate (% people aged 15 and above)	30	23	5
Persistence to grade 5 (% of cohort)	60	54	88
Gross school enrolment rates (% of age cohort)			
Pre primary	33	33	72
Primary	108	96	103
Secondary	34	42	47
Higher	9	9	22

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

Note: [a] Population aged between 0 and 15 and above 65, as a share of population aged between 16 and 65.

In both countries, many who are considered employed work in petty trades, personal services, or handicraft production. These micro enterprises operate with archaic technologies and management methods, they usually do not carry books, and very few are able to save and invest. A major problem faced by micro and small enterprises in both countries is very inadequate access to credit, for reasons that have been well-rehearsed in the literature: they lack assets that can be used as collateral and the costs of servicing small credits tend to be very high (Morduch 1999).

Micro enterprises represent a problem and an opportunity. At present, much of what is classified as 'micro enterprise' is no more than disguised unemployment. If ways could be found to help them improve their technological level and if credit were more readily available to them, it might be possible to raise living standards, wages, and employment. Some micro enterprises may eventually be in a position to produce import-competing goods or inputs for export production.

5 Some conclusions and policy recommendations

It is evident that Honduras and Nicaragua are becoming more integrated into the global economy. They have opened their economies to trade and investment. As a result, their production structures are beginning to shift away from heavy reliance on primary commodities for export and production of import substitutes for the home market towards a mix of simple manufactures and processed primary products for international markets. Honduras is more advanced in this direction than Nicaragua. On the other hand, Nicaragua appears to be a few steps ahead of Honduras in macroeconomic stability and in having raised its tax burden to levels that are compatible with the investments in human resources that will be needed for successful global integration.

In spite of considerable progress toward greater openness and stability since the early 1990s, these economies have not taken off. The main problems they face are:

- Poor governance, as reflected in severe difficulties in the design and implementation of coherent economic policies and in the significant levels of corruption that exist in government circles;
- Inadequate protection of property rights, particularly in Nicaragua;
- Weak growth impulses emanating from new exports;
- Absence of strong backward linkages from exports to the rest of the economy;
- Weak supply responses to the price signals emanating from the economic reforms;
- Low levels of investment in human capital and in health.

The experience of these two countries shows that passive liberalization policies are insufficient to spur export-oriented growth. It also shows that liberalization must be accompanied by proactive policies to ensure that resources are transferred from hitherto protected sectors of the economy to new export sectors that can potentially arise from the policies of dismantling protection. In economies characterized by technological backwardness, weak private sectors, and low levels of human capital, this is neither easy nor automatic.

In low-income countries exhibiting these traits, there are two basic requirements to successful integration into the global economy. In the first place, market signals emanating from policy change must be strong and unequivocal. Second, supply responses must be encouraged through deliberate policies to stimulate investment and develop appropriate human resources.[10] So far, these conditions have not been met fully in Honduras and Nicaragua.

Both countries need to align the structure of incentives more closely with the goal of encouraging export diversification. This will involve correcting currency overvaluation or counteracting its effects. The first option—attempting to fight currency appreciation—is not easy under any circumstance, much less when the sources of overvaluation are in some sense desirable. Wage remittances raise the living standards of those who receive them, who tend to be among the poorest segments of society.

[10] The full argument can be found in Agosin (1999b) and Agosin, Bloom and Gitli (2000a).

Foreign aid supplements government budgets. Nonetheless, it will be difficult for these two countries to jump start strong, export-oriented growth processes with their current degrees of currency overvaluation.

There are a few things that can be done to correct currency misalignment. In the first place, Honduras and Nicaragua must become accustomed to decreasing amounts of foreign aid, not only because such resources appreciate their currencies. The degree of support that these countries can expect from the international community in the next few years will undoubtedly diminish, especially if they are both admitted to the HIPC Initiative.

For this to happen, public saving must rise. Nicaragua has done much to raise tax revenues and cut some current expenditures. It still has space to cut non-essential expenditures to make room for investment in education and health.[11] As it succeeds in replacing foreign aid with domestically generated resources, the córdoba should depreciate.

As regards Honduras, it is essential that it raise its tax burden to levels that will allow it to finance needed investments in human resources. There is also a need to cut expenditures unrelated to investments in human capital and health.

After they have wound down their excessive dependence on foreign aid to balance their budgets, both countries will have to come to terms with heavy wage remittances, which will remain a long-term feature of their economies. Some effects could be obtained from encouraging recipients of wage remittances to save a larger proportion of their receipts. This could be done through special housing programmes or educational schemes tied to prior saving. While important, the impact of such schemes on currency appreciation is likely to be limited.

A clear picture of what awaits Nicaragua and Honduras is provided by the experience of El Salvador, where wage remittances, about two thirds of goods' exports, are the main factor behind the severe currency appreciation that has taken place since the early 1990s. Since it maintains a fixed nominal exchange rate, El Salvador has had to face a continuous accumulation of reserves. Policies of sterilizing the monetary impact of reserve accumulation have kept domestic interest rates very high and have inhibited private investment. So, El Salvador is stuck with the worst of all possible worlds: an appreciated real exchange rate that renders exportables uncompetitive and a high real interest rate, which discourages investment generally.

One way to dampen real exchange rate appreciation in Honduras and Nicaragua would be for the Central Bank to accumulate reserves and to sterilize their monetary impact by issuing dollar-denominated paper backed by Central Bank reserves (rather than paper denominated in domestic currency). This would prevent domestic interest rates from rising, but would certainly have a cost. In order to make the dollar-denominated paper attractive to private investors, the Central Bank would have to wind up paying interest

[11] The classification of expenditures into current and capital expenditures is rather dubious in both of these countries. It is highly uncertain that what is classified as capital expenditure always represents real public investment.

rates in excess of what it receives on its own reserves. This loss would, in effect, represent a subsidy to the production of tradables.

An alternative to fighting this form of Dutch disease would be to subsidize directly the production of new export products, something to which the Nicaraguan government seems to be ideologically opposed at the present time. The Honduran government has less clear positions in this respect. As developing countries with a GDP below US$ 1,000, Honduras and Nicaragua are exempted from WTO injunctions against export subsidies. These countries must use this space to design a temporary and moderate mechanism to support non-traditional exports to non-Central American markets.

A mechanism such as the 'simplified drawback' used by Chile with great success since the mid 1980s ought to be considered (see Agosin 1999, for a description).[12] The simplified drawback consists of a subsidy of up to 10 per cent of the fob value of exports which benefits all firms that export goods belonging to tariff lines whose total value of exports does not exceed US$ 20 million. The subsidy is granted in lieu of the regular drawback of duties paid on imported inputs used in the production of exports. When exports of a particular tariff line exceed the US$ 20 million threshold, all exporters of the good lose the right to the subsidy and must apply for a regular drawback.

As a minimum, Honduras and Nicaragua should implement a drawback on duties paid on imported inputs used by direct and indirect exporters.[13] By not having such benefits, exporters are being penalized artificially in favour of competitors from other countries.

As already noted, the *maquiladora* industry constitutes a potentially interesting new growth pole for Honduras and Nicaragua. However, its contribution to development is still weak. Governments have tended to see it mainly as a source of employment, rather than as part and parcel of a development strategy. The industry remains poorly integrated into the domestic economy, domestic value added representing only a quarter to a third of the value of exports. In addition, governments are not making efforts to target specific sectors and firms to attract to their EPZs. Products other than textiles, such as assembly of electronic and plastic goods, have greater potential for developing stronger linkages with the domestic economy, and their producers are less footloose than garment assemblers.

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

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[12] It should be noted that this instrument will be dismantled at the end of 2002 because it it is cosidered inconsistent with WTO rules. As less developed countries, Honduras and Nicaragua would not have legal inpediments to utilize an instrument of this nature.

[13] Indirect exporters are producers who sell inputs to exporters.

In order to transform the *maquiladora* industry into a true 'development pole', greater attention must be devoted to encouraging the growth of stronger linkages with the rest of the domestic economy. If countries are serious about the Common Market, this ought to be done at the regional level. For starters, EPZ legislation ought to be harmonized across countries. A uniform length for tax holidays of 5-10 years ought to be adopted by all countries.

Second, countries ought to sign double taxation treaties with the United States, the main home country of foreign investors in EPZs. As regards foreign investors in the industry, double taxation treaties with the United States (and, hopefully, other countries of origin) are probably just as useful as tax exemptions. Once such a treaty is in place, taxes paid in Central America would simply be credited to their income tax liabilities back home.[14]

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

So far, in other countries in Central America, backward linkages have been conspicuous by their absence. Thus the fourth element of a growth-oriented strategy toward the maquiladora industry is a deliberate effort to encourage the development of strong regional industries supplying inputs to the maquiladoras. One way of doing this is to institute a region-wide programme of tariff drawbacks for suppliers of inputs to the maquiladoras. There are other components of a policy to develop regional suppliers of intermediate goods. Useful policies in this regard could include setting up:

- special training and technology upgrading programmes for suppliers of intermediate inputs, and
- training programmes for skilled workers at the vocational and secondary school level targeted at the skill requirements of domestic firms producing inputs for exporters.

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

This approach also highlights the tight link that exists between successful global integration and investments in human capital and health. Thus, any attempt to use the EPZs as a key element in broad-based development must consider the need to increase very substantially the effort to improve the quantity and quality of health and education.

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14 This is true, of course, only if income tax rates in host Central American countries remain lower than in home countries, which is likely to be the case.

Finally, the problems of micro and small enterprises also need to be tackled aggressively. As already noted, a key problem is the unavailability of financing for these firms. In both Honduras and Nicaragua, financing for this segment of the enterprise sector is available only from NGOs and other not-for-profit organizations. It is time to convert these institutions into real banks, much as has been done in neighboring El Salvador (see Trigueros 2000).

The problem in Honduras and Nicaragua is that financial institutions operating in the sector are not allowed to take deposits form the public. They depend for financial resources on developed country donor agencies. Therefore, they do not make serious efforts to recover their money, and their loans tend to be viewed by recipients as one-time gifts. Research has shown that micro finance institutions can only be successful when they operate as banks offering a wide variety of financial services. When borrowers come to understand that they will be cut off from future access to finance if they do not service their loans in a timely fashion, non-performing loans tend to fall dramatically.[15] Therefore, simple reforms enabling the creation of banks specializing in servicing the financial needs of micro and small enterprises would be a move in the direction of easing these firms' financial constraints.

15 Existing micro finance institutions have handled the problem of missing collateral in a number of ways. See, for example, Morduch (1999) and Agosin (1999a)

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