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European Integration Model:  
Lessons for the Central American Common Market

**-Fernando Rueda-Junquera**



**Jean Monnet/Robert Schuman Paper Series  
Vol. 6 No. 4  
February 2006**

**This publication is sponsored by the EU Commission.**

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Miami European Union Center  
University of Miami  
1000 Memorial Drive  
101 Ferré Building  
Coral Gables, FL 33124-2231  
Phone: 305-284-3266  
Fax: (305) 284 4406  
E-Mail: [jroy@miami.edu](mailto:jroy@miami.edu)  
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**Fernando Rueda-Junquera \***

**The Jean Monnet Chair  
University of Miami  
Miami, Florida  
February 2006**

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\* Fernando Rueda-Junquera is Professor of International Economics and Vice-Dean of Institutional and International Relations in the School of Business and Economic Sciences at the Universidad de Burgos. He received his doctoral and master's degrees in Economics from the University of London, and a master's degree in Planning, Development, and Public Policy from the United Nations Economic Commission for Latin America and the Caribbean. Rueda-Junquera has worked as a consultant for the European Commission and for the Secretary of State for International Cooperation and Iberoamerica of the Spanish Ministry of Foreign Affairs. His most recent publications have focused on topics related to Latin American economies and processes of regional integration in Latin America. He teaches postgraduate classes related to his research agenda in the Inter-University Institute of Iberoamerican and Portuguese Studies at the University of Salamanca and at the Ortega y Gasset Research University Institute in Madrid.

## **European Integration Model: Lessons for the Central American Common Market**

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### **Introduction**

Under the stimulus provided by the formation of the European Economic Community in 1957, interest on economic integration spread particularly to less developed countries (LDCs) during the early 1960s. Most of the regional integration arrangements signed by then by these countries failed to match expectations. By contrast, regional integration efforts in Western Europe were in general more successful.

In the 1970s and early 1980s the slowdown in the European integration process and the failure of similar regional initiatives in the Third World led to a decline of integration theory and praxis. After this decline, regionalism has made an impressive comeback around the world. The increasing creation of formal structures of regional integration around the world has led to distinguish between the *new regionalism* of the present and the *old regionalism* of the 1960s.

Despite the problems raised in the past, recent economic policy debate in LDCs has been characterized by a renewed interest in subregional economic integration as a means of stimulating growth and confronting the challenges posed by the increased regionalism in world trading system. In Central America a new attempt has been made to revitalize the Central American Common Market (CACM) created in 1960 by Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua. The new integration scheme is still subject to numerous limitations hampering the effective encouragement of the Central American economic development. The objective of this paper is to compare the new CACM with the successful experience of economic integration in the European Union (EU), drawing lessons that may serve to overcome its current limitations.

The structure of the rest of the paper is as follows. The first section examines the theoretical basis of the European model of economic integration, identifying the main components which may contribute to explain the rationale of economic integration among LDCs under the old and new regionalism. The second section explores the major features acquired by this European model of economic integration in its implementation, paying particular attention to its legal and institutional system and its set of common actions and policies. After presenting the theory and praxis of the European integration model, the third section carries out a comparison between the EU and the new CACM, taking into account the prevailing structural differences between both regions. The fourth section ends the paper with the major conclusions drawn from that comparison.

## **The theoretical basis of the European economic integration: relevance to the rationale of regional integration among less developed countries**

Economic integration is a process aiming at abolishing discrimination between domestic and foreign goods, services and factors of production.<sup>1</sup> Typically this process runs through four stages: free trade area, customs union, common market and economic and monetary union. A free trade area involves the removal of tariffs between member countries on their reciprocal trade in goods and services, and the maintenance of the respective national tariffs towards non-member countries. When in addition to liberalize trade among member countries, these levy a common external tariff (CET) against third countries, a customs union is formed. A common market possesses all the elements of a customs union plus the free movement of the factors of production among the member countries. Finally, a common market in which the major micro- and macroeconomic policies of the member countries are harmonized under supranational control and in which a single currency is adopted, leads to an economic and monetary union.

The study of this process of economic integration has produced a substantial theoretical literature. Although integration schemes among LDCs have been the most numerous, the theoretical developments on economic integration have been biased largely towards the study of the problems of integration in the developed countries of Western Europe. This section provides an overview of the principal directions taken by this theoretical research, paying special attention to those contributions more relevant to understand the rationale of economic integration among LDCs under the old regionalism (the first part of the section) and the new regionalism (the second part of the section). As most economic integration initiatives in the Third World have not gone, at best, beyond an attempt of integrating the national markets of the participating countries without hardly harmonizing their economic policies, the theoretical literature reviewed in this section is that on product market integration, i.e. on customs unions.

### *Rationale under the old regionalism*

There is a consensus on crediting Jacob Viner's<sup>2</sup> pioneering distinction between trade creation and trade diversion with opening up the branch of the theory of international trade devoted to economic integration. By introducing the concepts of trade creation and trade diversion, Viner showed that it is not possible to generalize about the welfare consequences of a customs union. He accepted that its formation would augment trade between the member countries following the elimination of tariffs on their mutual trade, but he argued that no general judgment could be made as to whether this increased trade would improve or worsen welfare, since this depended on the source of that increased trade. Viner distinguished between two possible cases: trade creation and trade diversion. In the first case, there is a replacement of high-cost domestic production by lower-cost

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<sup>1</sup> See: Bela Balassa, "Economic Integration" in *The New Palgrave: A Dictionary of Economics*, ed. John Eatwell, Murray Milgate and Peter Newman, 43-47 (London: Macmillan, 1987).

<sup>2</sup> Jacob Viner, *The Customs Union Issue* (New York: Carnegie Endowment for International Peace, 1950).

imports from a partner country and hence, an increase in welfare. In the second case, the replacement is of low-cost imports from a non-member country by higher-cost imports from a partner country, and welfare is reduced. Accordingly, the net welfare effects of the customs union depend on the relative incidence of trade creation and trade diversion.

After Viner's fundamental breakthrough, however, economic integration theory has made only limited progress. The lack of a satisfactory framework for analyzing the dynamic effects of economic integration has undermined advance in this field. The recent incorporation of imperfect competition and product differentiation into economic integration theory has opened new possibilities and may contribute to a better understanding of integration in the contemporary economic context.<sup>3</sup>

The traditional theory of economic integration, centered on the static effects of resource reallocation of the customs unions, suggests that there is hardly scope for a beneficial process of economic integration among LDCs. The conditions found in the majority of these countries prior to integration –the Central American countries are a clear example– are precisely the opposite to those indicated by the theory for favoring trade creation: their external trade is important relative to their domestic production, the proportion of that external trade conducted with prospective partners is relatively low, their structures of production and resource endowments are similar,<sup>4</sup> and so on. In the light of these conditions, LDCs appear as the most unlikely candidates for membership of a welfare-increasing customs union.

The criteria for static welfare gains are of limited value to assess the arguments for economic integration among LDCs.<sup>5</sup> The circumstances of these countries are quite different from those ones prevailing in the developed countries of Western Europe, from which the orthodox theory of economic integration has evolved. While the LDCs are attempting to build up their industrial base and face serious structural distortions, the advanced European economies are already industrialized and suffer from much less distortions.

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<sup>3</sup> Useful guides to the development of the literature on customs union theory are provided by: Richard G. Lipsey, "The Theory of Customs Unions: A General Survey" *Economic Journal* 70 (1960): 496-513; Melvyn B. Krauss, "Recent Developments in Customs Union Theory: An Interpretive Survey" *Journal of Economic Literature* 10, no. 2 (1972): 413-436; Frank R. Gunter, "Customs Union Theory: Retrospect and Prospect" in *Economic Aspects of Regional Trading Arrangements*, ed. David Greenaway, Thomas Hyclak and Robert J. Thornton, 1-30 (London: Harvester Wheatsheaf, 1989); Robert C. Hine, "International Economic Integration" in *Surveys in International Trade*, ed. David Greenaway and L. Alan Winters, 234-272 (Oxford: Blackwell, 1994); Ali M. El-Agraa, "International Economic Integration" in *Current Issues in International Trade*, ed. David Greenaway, 174-221 (London: Macmillan, 1996).

<sup>4</sup> Those countries being initially competitive in production but potentially complementary, may give rise to a net trade creating customs union. The probability that this happens depends on the level of development of the economies involved. In the case of regional integration schemes among LDCs, most of the participating economies are competitive, but not potentially complementary. Their low level of development accounts for the low potential for sectoral changes towards complementarity in the short run.

<sup>5</sup> See: Tayseer A. Jaber, "The Relevance of Traditional Integration Theory to Less Developed Countries" *Journal of Common Market Studies* 9, no. 3 (1970): 254-267.

The basic rationale for economic integration among LDCs is a dynamic one. Regional integration arrangements are viewed as a means for accelerating the growth rates of the economies participating and for promoting their long-run development. In this dynamic context of growth and development, integration schemes may contribute to create economic conditions to overcome structural problems of the LDCs, primarily those ones hindering the change in the production structure from the primary to the secondary sector.<sup>6</sup>

Most of the integration initiatives launched in the 1960s in the Third World – among them, the CACM– aimed at encouraging industrialization through import substitution. When the domestic markets of LDCs proved to be too small to allow an efficient import-substituting industrialization (ISI), the establishment of a protected regional market –i.e. the formation of a customs union– was advocated as an effective alternative to reduce the costs of the ISI. These integration schemes were justified on the basis of the infant industry argument for protection applied at the regional level.

The customs unions among LDCs created to foster the development of import substituting industries are initially bound to be net trade diverting, since those industries supply a regional demand previously satisfied by imports from the rest of the world. The formation of these customs unions, however, is not irrational. Charles Cooper and Benton Massell,<sup>7</sup> and Harry Johnson<sup>8</sup> first provided an economic rationality for explaining them. LDCs consider industrialization as a rational social choice because they believe that it can give rise to substantial external economies or lead to an acceleration of economic growth. Given this social preference for industrialization, LDCs are willing to sacrifice some national income by not importing from the cheapest available source or/and by specializing in activities in which they do not possess static comparative advantages. Anything, such as the establishment of a customs union, lowering the cost of realizing the social preference for industrialization via import substitution, increases welfare and contributes to the countries' development. A policy of economic integration among LDCs can, therefore, be justified, even if the standard conditions for static trade creation do not exist.

To the extent that the limited size of the national markets constrains economic development in some LDCs, the market integration may become a useful instrument for

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<sup>6</sup> On the long-term dynamic rationale for economic integration among LDCs, see: Germánico Salgado-Peñaherrera, "Viable Integration and the Economic Co-operation Problems of the Developing World" *Journal of Common Market Studies* 19, no. 1 and no. 2 (1980): 65-76 (Part One) and 175-188 (Part Two); Peter Robson, *The Economics of International Integration* (London: Allen and Unwin, 1987), Ch. 11; Rolf J. Langhammer and Ulrich Hiemenz, *Regional Integration among Developing Countries: Opportunities, Obstacles and Options* (Tübingen: Mohr, 1990); Robert C. York, *Regional Integration and Developing Countries* (Paris: Organization for Economic Co-operation and Development, 1993).

<sup>7</sup> Charles A. Cooper and Benton F. Massell, "Towards a General Theory of Customs Union in Developing Countries" *Journal of Political Economy* 73, no. 5 (1965): 461-476.

<sup>8</sup> Harry G. Johnson, "An Economic Theory of Protectionism, Tariff Bargaining and the Formation of Customs Unions" *Journal of Political Economy* 73, no. 3 (1965): 256-283.

easing such constraint.<sup>9</sup> By encouraging a more rational division of labor among member countries and more optimum plants installations, the increased size of the regional market may facilitate the achievement of benefits based on intraregional specialization and on economies of scale. For the infant economies of the Third World, an intraregional division of labor within a customs union is expected to be more consistent with the comparative advantages of member countries without exposing their economies to the competition in world markets. Likewise, regional integration provides the opportunity for industries operating below optimum capacity to take advantages of economies of large-scale production made possible by the extended regional market.

Other economic arguments for regional integration arrangements among LDCs are included in the literature.<sup>10</sup> The most common ones maintain that economic integration may enable the joint production of public goods (physical infrastructure, public services, training and research, etc.), expand the volume of foreign private investment being more attracted to a regional market instead of several national markets, reduce the external vulnerability of LDCs dependent on commodity exports, and increase the collective bargaining power in the external economic relations.

All the analyzed arguments have not been modified substantially under the new regionalism. The basic long-term dynamic rationale for economic integration among LDCs remains the same, but the environment in which the new schemes have been launched is different from the one prevailing in the past. This fact has led –as it is shown next– to the arguments basing integration schemes to incorporate the new regionalism’s changes of emphasis with respect to the approach to economic integration. As a result of the changes in the development strategies pursued by LDCs, there has been a shift towards a more outward-oriented and market-driven approach to economic integration. Likewise, in a world trading system tending towards major blocs, integration schemes among LDCs are also viewed as an instrument for entering into regional trading arrangements with large developed countries to ensure future access to their markets.

### *Rationale under the new regionalism*

After a decline in the 1970s and the early 1980s, regionalism has reemerged as world wide phenomenon. Diverse developments in North America and Europe in the middle 1980s explain much of the upsurge of interest in integration initiatives. The United States (US), disappointed by the slow progress at the General Agreement on Tariffs and Trade (GATT) negotiations, decided to conclude a bilateral free trade agreement with Canada and to commence, together with this country, trade talks with Mexico for the completion of the North American Free Trade Agreement. The US also announced its intention to negotiate free trade areas with groups of other Latin American countries under the Enterprise for the

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<sup>9</sup> On this argument, see: Staffan Burenstan Linder, “Customs Unions and Economic Development” in *Latin American Economic Integration*, ed. Miguel S. Wionczek (New York: Praeger, 1966); F. Kahnert, P. Richards, E. Stoutjesdijk and P. Thomopoulos, *Economic Integration Among Developing Countries* (Paris: Organization for Economic Co-operation and Development, 1969).

<sup>10</sup> See: Langhammer and Hiemenz, *op. cit.*; York, *op. cit.*.

Americas Initiative. Alongside this, the European integration process started to widen and deepen. The conclusion in mid-1980s of negotiations to expand the European Community towards Portugal and Spain coincided with the laying of plans for the implementation of the Single European Market and the Maastricht Treaty.

The increased regional integration in the world's two largest trading areas and the failure in December 1990 to conclude the Uruguay Round of multilateral trade negotiations on schedule, led other countries to reconsider the regional alternative. While continuing to express support for the multilateral trading system, many countries began to explore options for increasing regional cooperation and integration as the way to meet the challenge posed by the developments in North America and Europe. As a result, in the early 1990s an increasing regionalization process of the world economy began,<sup>11</sup> continuing until nowadays.

In the case of Latin America and the Caribbean, this process of regionalization has led to the signing of two types of economic integration arrangements. Firstly, there exists a great number of plurilateral and bilateral agreements that only pursue to establish a free trade area in which goods and investments can circulate without restrictions. Most of them aspire to converge on a great hemispheric arrangement, the Free Trade Area of the Americas (FTAA).<sup>12</sup>

The second type of arrangements seeks to go deeply into the process of economic integration, beyond a simple free trade area. They aim at turning successively, into customs unions, common markets and economic and monetary unions. In this group four subregional integration arrangements are included: the CACM, the Caribbean Community, the Andean Community of Nations and the Common Market of the South. While the three first ones are a revitalization of integration schemes already existing, the Common Market of the South was formed in 1991 after the signing of the Treaty of Asuncion by the governments of Argentina, Brazil, Paraguay and Uruguay. All these subregional integration schemes are presently imperfect CUs.<sup>13</sup>

The proliferation of subregional trading arrangements around the world suggests that the world trading system may be evolving towards three major trading blocs built around the US (encompassing the Americas), the EU (encompassing most of Europe) and Japan (encompassing most of East Asia). Some view this development as a positive move towards a less fragmented world trading system. It is maintained that this new regionalism may speed up the global trade liberalization process as multilateral trade talks may be conducted better among a less number of negotiating parties. Others, on the contrary, fear that these

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<sup>11</sup> For a complete list of the regional integration arrangements signed in the early 1990s, see: Augusto de la Torre and Margaret R. Kelly, *Regional Trade Arrangements*, IMF Occasional Paper no. 93 (Washington, D.C.: International Monetary Fund, 1992), Tables 1 and 2.

<sup>12</sup> On this kind of agreements intending to be a part of the FTAA, see: Antoni Estevadeordal, Dani Rodrik, Alan M. Taylor and Andrés Velasco (eds.), *Integrating the Americas: FTAA and Beyond* (Cambridge, Mass.: David Rockefeller Center for Latin American Studies, Harvard University Press, 2004).

<sup>13</sup> See: Fernando Rueda-Junquera, "Integración económica latinoamericana: balance y perspectivas" *Boletín Económico de Información Comercial Española*, no. 2703 (2001): 17-25.

trading blocs may turn inward-looking undermining multilateralism. It is argued that once a trading bloc is large enough, the need to be open to extra-bloc countries is reduced.<sup>14</sup>

The question of whether new regionalism and multilateralism are conflicting or complementary processes is basically an empirical one. After the signing of the Uruguay Round agreement in April 1994 and the coming into force of the new World Trade Organization (WTO) substituting the GATT in January 1995, the protectionist danger seemed to recede. However, the last WTO ministerial conferences and the development of the Doha Round have revealed that the WTO capacity for ensuring that the new regionalism is open and supportive of multilateral liberalization still has to be tested.

In evaluating the recent wave of regional trading arrangements, it must be taken into consideration that the old regionalism of the 1960s was different from the new one in three important aspects.<sup>15</sup> First, the US was then firmly committed to promoting multilateralism and did not endorse regionalism except in the case of the European Economic Community. Second, the developing and communist countries embracing the integrationist approach, used it to encourage an inward-looking and state-led ISI strategy at the regional level. Third, economic integration arrangements involved countries with relatively similar income per capita levels, i.e. regional integration was of the North-North and South-South type.

Under the new regionalism the aforementioned features have changed. The US has commenced to support regional integration not only in North America, but also in a wider hemispheric and Pacific context.<sup>16</sup> Jagdish Bhagwati<sup>17</sup> argues that this US support is the single most important reason why regionalism is making a comeback and is likely to be more durable than the regionalism of the 1960s. On the other hand, development strategies in developing and communist countries have been radically reappraised in favor of outward-looking and market-led economies. Finally, the new regional integration initiatives have often taken the form of North-South schemes including partners from the developed and developing world.

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<sup>14</sup> The different views and arguments on this debate can be found in: Kym Anderson and Richard Blackhurst (eds.), *Regional Integration and the Global Trading System* (Hemel Hempstead: Harvester Wheatsheaf, 1993); Jaime De Melo and Arvind Panagariya (eds.), *New Dimensions in Regional Integration* (Cambridge: Cambridge University Press, 1993); Vincent Cable and David Henderson (eds.), *Trade Blocs ? : The Future of Regional Integration* (London: The Royal Institute of International Affairs, 1994); World Bank, *Trade, Regionalism and Development*, Global Economic Prospects 2005 (Washington D.C.: The World Bank, 2005).

<sup>15</sup> See: Vincent Cable, "Overview" in *Trade Blocs ? : The Future of Regional Integration*, ed. Vincent Cable and David Henderson, 1-16 (London: The Royal Institute of International Affairs, 1994).

<sup>16</sup> The US proposal for a hemispheric free trade area –the FTAA– was launched for the first time by President Bush in 1990 as the Enterprise for the Americas Initiative. After certain lethargy, this proposal reemerged in the first Summit of the Americas held in Miami, US, in December 1994 and it has been maintained in the subsequent Summits held in Santiago, Chile, in 1998, in Quebec, Canada, in 2001, and in Mar del Plata, Argentina, in 2005. Likewise, the US joined the Asia-Pacific Economic Cooperation proposal launched in November 1994, aiming at establishing a free trade zone in the Pacific basin.

<sup>17</sup> Jagdish Bhagwati, "Regionalism and Multilateralism: An Overview" in *New Dimensions in Regional Integration*, ed. Jaime de Melo and Arvind Panagariya, 22-51 (Cambridge: Cambridge University Press, 1993).

Two of these new features reveal a change of emphasis with respect to the approach to economic integration among LDCs. The basic rationale for LDCs economic integration remains a dynamic one, i.e. economic integration viewed as a means for accelerating the growth rates of the economies participating. However, integration schemes among LDCs have had to modify some of their old goals in order to adapt to the new conditions of growing economic globalization. Most of these schemes –including the new CACM–<sup>18</sup> no longer have as their primary objective the ISI and neither do they seek to be formed exclusively from partners with comparable levels of development.

The new initiatives at regional integration among LDCs go beyond a revival of the integration schemes launched in the 1960s to extend domestic ISI policies at the regional level. Most LDCs, as a part of their national stabilization and adjustment programs, have adopted similar trade liberalization and deregulation policies. This has led to a new outward-oriented and market-driven approach to economic integration. This approach aims at making integration policies compatible with, and complementary to, policies to enhance international competitiveness.<sup>19</sup> Economic integration can provide both demand-pull and supply-push mechanisms, i.e. it can contribute not only to expand domestic demand, but also to upgrade the sources of competitiveness of the participating countries' exports.

In addition to being an instrument for a more competitive insertion in the global economy, integration schemes among LDCs are now viewed as a means for ensuring future access to developed countries markets. LDCs have begun to fear that their access to world markets may be curtailed considerably if the three trading blocs indicated above become a reality and they are left out. For this reason, they are seeking to enter into regional integration arrangements with large developed countries. Many of the subregional processes of economic integration among LDCs, specially those ones among LDCs with little

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<sup>18</sup> On the new regionalism in Central America, see: Victor Bulmer-Thomas (ed.), *Integración regional en Centroamérica* (San José: Facultad Latinoamericana de Ciencias Sociales / Social Science Research Council, 1998); Fernando Rueda-Junquera, *La reactivación del Mercado Común Centroamericano* (Burgos: Servicio de Publicaciones, Universidad de Burgos, 1999); Klaus Bodemer and Eduardo Gamarra (eds.), *Centroamérica 2020: un nuevo modelo de desarrollo regional* (Caracas: Editorial Nueva Sociedad, 2002); SGSICA-CEPAL (Secretaría General del Sistema de la Integración Centroamericana – Comisión Económica de las Naciones Unidas para América Latina y el Caribe), *La integración centroamericana: beneficios y costos* (San Salvador and México: SGSICA-CEPAL, 2004); Fernando Rueda-Junquera, “Prospects for the Central American Customs Union” in *The European Union and Regional Integration: A Comparative Perspective and Lessons for the Americas*, ed. Joaquín Roy and Roberto Domínguez, 113-134 (Miami: Jean Monnet Chair University of Miami, 2005).

<sup>19</sup> For this reason, the United Nations Economic Commission for Latin America and the Caribbean designates this approach as *open regionalism* too; see: ECLA (United Nations Economic Commission for Latin America and the Caribbean), *Open Regionalism in Latin America and the Caribbean: Economic Integration as a Contribution to Changing Production Patterns with Social Equity* (Santiago: ECLA, 1994). For more details on the theory and praxis of new (open) regionalism in LDCs, see: De Melo and Panagariya, *op. cit.*; Cable and Henderson, *op. cit.*; Sheila Page, *Regionalism among Developing Countries* (London: Macmillan, 2000); IADB (Inter-American Development Bank), *Beyond Borders: The New Regionalism in Latin America, Economic and Social Progress in Latin America: 2002 Report* (Washington D.C.: IADB, 2002); Maurice Schiff and Alan Winters, *Regional Integration and Development* (New York: Oxford University Press, 2003); *World Bank, op. cit.*

bargaining power, are intended to be a part of larger integration efforts involving –unlike past initiatives– both developing and developed country partners. In the case of most Latin American integration schemes, their ultimate purpose is to sign a free trade agreement with the US.

### **The praxis of the European economic integration: major features of the European experience**

As it has been shown in the preceding section, the traditional theory of customs unions has been of limited value to assess the arguments for economic integration among LDCs. However, in the case of the European countries it has provided sound arguments for establishing a regional integration scheme in Europe. The effective implementation of this scheme has shaped the current European model of economic integration, through three essential components: the political commitment, the legal and institutional system, and the set of common actions and policies in favor of integration. Next, these three components are examined.

#### *Political commitment as a basic precondition*

The successful evolution of the European integration scheme suggests that the political commitment is a basic precondition which must be fulfilled in order for integration scheme to achieve the positive effects identified by the economic integration theory. Regional integration requires a strong political commitment on the part of the participating governments to advance towards common objectives. It is not enough to have a strong motivation in the initial stages, but the commitment must be sustained over a long period. It is worthwhile noting that the European integration process has been in construction for almost half a century now. The most remarkable feature in this regard has been the irreversible nature of progress accomplished thanks to that strong and sustained political commitment.

#### *Legal and institutional system*

Although the EU is a mainly economic regional integration process, it is necessary to point out that also this process is based on the law. After the Maastricht Treaty a clear distinction has been drawn between European Community law and EU law. While the former is highly supranational, the latter is considered much less supranational, since it also includes the areas pertaining to the EU's second- and third-pillar. The vast majority of EU activity –and particularly, the economics of the European integration (the EU's first-pillar)– is encompassed by the Community law, that is, it is subject to a supranational legal system.

Community law is characterized by two major features: its primacy and its direct applicability. The primacy on the national legal systems ensures that Community law

cannot be altered by national, regional or local laws in any Member State. The direct applicability to Member States means that Community law is binding on them. Having the force of law in Member States, Community law can be fully and uniformly applicable throughout the EU.

The two aforementioned characteristics explain that Community law has become an important mechanism of regional integration, since it has given rise to a gradual approach of the national legislations and at the same time, it has contributed to create a common legal system. This integration through law has been made possible because –and this is specially pertinent to the subsequent comparison with the Central American case– EU’s Member States have proceeded in accordance with the law, complying with the commitments signed in the Treaties (Primary Law) and introducing the binding rules (Secondary Law).

Not only the common legal system has supported integration efforts in Europe, but also the establishment of common institutions endowed with a supranational decision making power, a clear mandate and a certain amount of automatically available financial resources.<sup>20</sup> These institutions have helped the European integration scheme to pursue clearly identified regional interests rather than the sometimes conflicting interests of different Member States.

Common institutions have acquired a supranational nature thanks to the partial transfer of sovereignty from Member States to them, making possible that these institutions have operated appropriately. Both management and decision making powers have been transferred to these institutions, in such a way that a great part of their actions has binding character on the Member States. Therefore, operating common institutions has been a shared sovereignty exercise. This fact has led to these institutions have played an essential role in strengthening the integration process, since their operation have allowed consolidating the idea of supranationality.

The transfer of sovereignty has not been uniform in all the areas. While in some of them it has been far-reaching (e.g. in agricultural and monetary matters), in others it has been practically non-existent (e.g. in taxation and social issues). Institutions have had their scope limited to those powers assigned to them by the Treaty on EU or derived from its implementation.

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<sup>20</sup> On the legal and institutional system of the EU, see: A. Mangas Martín and D. Liñán Noguera, *Instituciones y Derecho de la Unión Europea* (Madrid: McGraw-Hill, 1999); D. Chalmers, “The Legal Dimension in EU Integration” in *The European Union: Economics and Policies*, ed. Ali M. El-Agraa, 49-71 (Harlow: Financial Times – Prentice Hall, 2001); J. Peterson and M. Shackleton, *The Institutions of the European Union* (Oxford: Oxford University Press, 2002); Francisco J. Fonseca Morillo, “Reformas de la arquitectura institucional y del proceso de toma de decisiones institucionales en el Tratado por el que se establece una Constitución para Europa” in *Logros, iniciativas y retos institucionales y económicos: la Unión Europea del siglo XXI*, ed. Isabel Vega Mocoroa, 33-59 (Valladolid: Lex Nova, 2005); Amparo Roca Zamora, “El sistema institucional de la Unión Europea” in *Economía de la Unión Europea*, ed. Josep M.<sup>a</sup> Jordán Galduf, 69-113 (Madrid: Thomson-Civitas, 2005).

The principle of subsidiarity has been useful in defining the mandates of the common institutions and dividing tasks between them and Member States. In line with this principle, the responsibility of dealing with an issue has been kept as close to the population concerned as possible. The responsibility has shifted to a higher Community level only if the issue has been able to be more effectively handled at that regional level. This has implied that common institutions have not been involved with matters which have been best dealt with by the Member States themselves.

In addition to create common institutions, the European integration scheme has financed them on a joint basis endowing them with a relative budget independence.<sup>21</sup> This has allowed them to reach a certain degree of autonomy, indispensable to carry out their activities without depending completely on the Member States' will.

Finally, it is worth highlighting that the legal and institutional framework for regional integration in Europe has been sufficiently flexible to allow adaptation to changing historical circumstances. This has made possible to accomplish advances on the integration process, which have been slow, but irreversible. The European process has just taken those steps being acceptable by all the Member States, while those decisions on issues without consensus have been postponed. It has never attempted to go faster than historical circumstances have permitted.

This European integration framework has not only allowed to agree what it was possible in each historical moment, but also it has taken into account the different speeds of progress at a subregional level. The European experience has showed that it is unrealistic to expect all the Member States to move along at the same pace, unless it is accepted that the pace is that of the slowest moving Member State. This situation has tended to become more complex as the number of participating countries has increased, making more difficult the process of achieving common policies.

The principle of *variable geometry* has enabled a limited number of Member States –which has been willing and able to advance further– to deepen integration process within the single institutional framework of the EU. The application of this principle involves the prior existence of a group of Member States with ability to take over the regional leadership of the integration process (e.g. the French-German Axis).

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<sup>21</sup> For detailed information on the EU budget, see: European Commission, Directorate General Economic and Financial Affairs, “Stable Money – Sound Finances” *European Economy*, no. 53 (1993); P. B. Spahn, *The Community Budget for an Economic and Monetary Union* (London: MacMillan, 1993); John Peet and Kitty Ussher, *The EU Budget: an Agenda for Reform?*, CER Working Paper (London: Centre for European Reform, 1999); Ali M. El-Agraa, “The General Budget” in *The European Union: Economics and Policies*, ed. Ali M. El-Agraa, 341-364 (Harlow: Financial Times – Prentice Hall, 2001); Ramón Barberán Ortí, “La hacienda pública de la Unión Europea” in *Economía de la Unión Europea*, ed. Josep M.<sup>a</sup> Jordán Galduf, 115-144 (Madrid: Thomson-Civitas, 2005).

### *Common actions and policies encouraging integration*

The final part of this section centers on the analysis of the common actions and policies developed by the EU in favor of the economic integration. The interest in economic aspects is due to three reasons. Firstly, the main objective of the paper is to know how regional integration can be made a successful instrument of social and economic development in Central America in the light of the European experience. Secondly, the economic dimension has been the prevailing one in the European integration process; so far, only the advances in the economic integration have managed to materialize in sound and permanent accomplishments. Finally, the European experience has showed how economic integration has been used as a direct means to achieve economic objectives and as an indirect means to deal with non-economic objectives of great significance in the European construction, such as the pacification after the Second World War and the gradual political integration overcoming destructive nationalisms.

The EU has pursued the social and economic development of the Members States by means of the integration of their national markets, the establishment of a single currency and the implementation of measures reducing the internal differences in the integrated market. Common actions and policies taken in this area has aimed at the economic liberalization (ensuring the free movement of goods, services, persons and capital), the introduction of the euro and the internal cohesion.<sup>22</sup> The singularity of this European approach to the economic integration arises from the fact that there has been an option for the economic liberalization as a way to boost welfare, but accompanied by redistributive policies intended for favoring the approximation of the levels of welfare.

### **Comparing integration schemes: implications for economic integration in Central America**

After presenting the main theoretical and practical characteristics of the European integration model, this section is devoted to compare the new CACM with the European model examined. The comparison is focused on three relevant issues: the political commitment, the legal and institutional system, and the common actions and policies.

#### *Comparing the political commitment*

Unlike the European experience, the regional integration process in Central America has been distinguished by its lack of a strong and sustained political

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<sup>22</sup> On the common actions and policies encouraging economic integration, see: Mike Artis and Frederick Nixon (eds.), *The Economics of the European Union: Policy and Analysis* (Oxford: Oxford University Press, 2001); Ali M. El-Agraa (ed.), *The European Union: Economics and Policies* (Harlow: Financial Times – Prentice Hall, 2001); Richard Baldwin and Charles Wyplosz, *The Economics of European Integration* (London: McGraw-Hill, 2004); Josep M.<sup>a</sup> Jordán Galduf (ed.), *Economía de la Unión Europea* (Madrid: Thomson-Civitas, 2005).

commitment. This has usually arisen from actual or perceived conflict between national and regional objectives. When this has happened, the Central American governments have given priority to the former. The political will to implement agreed measures, share sovereignty, accept the short-term costs of integration and allocate financial resources to burden-sharing mechanisms has been quite insufficient. To face this situation it is necessary to renew political commitment in the region and maintain political will for integration.

### *Comparing the legal and institutional system*

The Central American Integration System (*Sistema de la Integración Centroamericana*, SICA) is the new institutional framework created by the 1991 Protocol of Tegucigalpa to reactivate the CACM. Compared with the EU's legal and institutional system, this new framework presents five major limitations.<sup>23</sup>

Firstly, the institutional scheme develops immersed in a remarkable legal disorder. There are no homogeneous and compulsory deadlines for the national ratification of the agreements signed, what causes delays in their entry into force or the partial entry into force for only some member countries. For example, Costa Rica has not ratified the 1986 Constitutive Treaty of the Central American Parliament. Likewise, Costa Rica, Guatemala and Panama have not ratified the 1992 Statute of the Central American Court of Justice.

Secondly, the essentially intergovernmental conception of the new institutional framework makes that the decision taking power is concentrated on the Summit of Central American Presidents, which is the SICA highest ranking organization. The high political commitment level of the Presidential Summits is decisive in the first years of an integration process, but it can limit its deepening. The political consensus of the governments will be strongly conditioned by each member country's specific political situations, which can slow down and hinder the regional integration process.

If the consolidation and deepening of the new CACM is wished, facing an increasing number of conflicts in trade matters as well as in harmonization and production factors movement issues, will be inevitable. In this context, it will be necessary to provide the regional integration scheme with supranational institutional mechanisms having sufficient decision-making and financing capacity to remove rapidly obstacles arising on the path towards a greater integration.

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<sup>23</sup> More complete information on the new legal and institutional framework can be found in: PNUD (Programa de las Naciones Unidas para el Desarrollo), *Segundo informe sobre desarrollo humano en Centroamérica y Panamá* (San José: PNUD-Proyecto Estado de la Región, 2003), Ch. 4; SGSICA-CEPAL, *op. cit.*; SELA (Sistema Económico Latinoamericano), *La institucionalidad de la integración en América Latina y el Caribe: posibilidades de articulación y convergencia* (Caracas: Secretaría Permanente del SELA, 2005).

Thirdly, the construction of the integration process from the political encouragement of the Central American presidents has been carried out without existing a clear group of countries with effective ability to take over the regional leadership of the integration process. Although El Salvador and Guatemala have tried to play this role, they have not had a substantial impact on the regional integration dynamics.

Fourthly, governments have hardly complied with commitments signed in the Presidential Summits. This fact has slowed down the integration process, subtracting its credibility and legitimacy in the civil society.

Finally, the fifth limitation of the new regional institutional scheme lies in its excessive complexity and high number of institutions, as a consequence of a formal integration process with overambitious objectives. This not only has conditioned institutions' effectiveness, but also has ended up causing a serious funding problem.

The aforementioned limitations have brought about an important legal and institutional weakness, which hampers the advance in the regional integration scheme. Therefore, it is required to carry out a profound rationalization and reinforcement of the common Central American institutions.

#### *Comparing the common actions and policies encouraging integration*

The European experience has showed that a regional integration process has costs and benefits, but as a whole the net effect can be potentially positive. In order that this potentially positive effect materializes in practice, sensible backing policies are required (such as trade, macroeconomic and sector policies); otherwise, the potential benefits of regional integration can be reduced or removed.

It is worthwhile noticing that the *net* benefits of integration are those ones becoming positive, that is, it is admitted that there will be winners and losers in the process. To a great extent, the magnitude of these redistributive effects will depend on the type of intraregional trade created after the beginning of the integration process. If that trade creation has a high component of intraindustry trade, the productive structure adjustment will be relatively costless and its effect on income distribution will be less severe. In case of predominance of this trade, member countries have only to bear the cost of eliminating some firms from some industries, without having to abandon entirely those industries. By contrast, interindustry trade involves the whole elimination of some industries in some member countries due to their moving to other member countries where comparative costs for these industries are the lowest in the regional market.

The European integration scheme has proved that the gains can be sufficiently significant as to offset for the losses. The fact that the overall effect has been positive, it

has ensured the feasibility of compensatory policies. The standard way to carry out this compensation has been through financial solidarity materialized in the Structural Funds and the Cohesion Fund. By these Funds, a part of the Member States' contributions to the EU budget have been transferred to the less favored social groups and regions. In the current 2000-2006 Financial Perspectives, the aforementioned Funds account for the third part of the EU budget.

The backing and compensatory policies have been keys to success at the European model of economic integration. By contrast, the lack of these policies in the new CACM has accounted for most of its limitations. Unlike the European case, the new CACM has not been able to implement completely the basic backing policies to restore the customs union in the region and coordinate their members' macroeconomic policies. As regards compensatory policies, these hardly exist in the new Central American integration scheme.

Intraregional trade – an essential element for reactivating the customs union– remains limited within the total trade of the CACM. In the 2000-2004 period intraregional exports were not able to represent on average more than 26.7 per cent of total exports, while intraregional imports did not exceeded 13.5 per cent of total imports. These percentages are still far from those ones observed in the EU, where intraregional trade –measured by both the export and import side– accounts for more than 60 per cent of total trade.<sup>24</sup>

The dominance of extraregional trade explains why the economic policy of Central American governments has given priority to extraregional economic relations and in moments of conflict, has not favored the interests of the Central American integration scheme. If intraregional trade is wished to acquire more significance for the economic development of Central America, it is necessary to adopt measures favoring its expansion. Thus, measures such as the removal of the non-tariff barriers and the effective liberalization of intraregional trade in primary products and services can help to achieve this objective.

The creation of a customs union also involves the adoption of a common trade policy, since all the customs union members are bound to apply the same CET against third countries. Besides the existence of the CET compels that trade negotiations are carried out jointly, providing a potential benefit to the customs union members stemmed from the greater regional bargaining power.

In customs unions made up of LDCs, as it is the case of the CACM, the possibility of using the greater regional bargaining power is singularly important because it allows taking part in better conditions in international trade relations. However, the Central American countries have scarcely used this power. They have tended to negotiate bilaterally their free trade agreements, eroding the common dimension of the tariff protection guaranteed by the CET. Even when the Central American countries have

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<sup>24</sup> Rueda-Junquera, *Prospects for the Central American Customs Union*, *op. cit.*, 122.

negotiated free trade agreements en bloc –as it was done with the Dominican Republic and the US–, harmonized joint agreements were only reached regarding procedures, while the tariff concessions were negotiated bilaterally, taking into consideration the peculiarities and the sensitive products of every country.

The absence of a real common trade policy not only has prevented CACM members from taking advantage of the potential regional bargaining power, but also it can endanger progress made in the CET harmonization. The problem arises when simultaneously establishing a CET with a series of bilateral free trade agreements including different tariff concessions. The entry into force of the US – Central America Free Trade Agreement (CAFTA) will give clear proof of this problem, since it will not take place in a homogeneous way in all the Central American countries. Tariff concessions were negotiated bilaterally, what means that the schedule of tariff exemption in the CAFTA will be different in every country and therefore, the CET will not be applied in its entirety by all the countries during the period of tariff exemption. The fact that the US is the principal trade partner of the CACM, providing around 40 per cent of its total imports,<sup>25</sup> converts to the CET exceptions originated by the CAFTA implementation, into a potential disturbing factor of the Central American customs union. The potentiality of this disturbance will become effective if governments do not come to an agreement to harmonize the differences in the CAFTA tariff concessions and to make them compatible with the establishment of the CET.

Likewise, the weakness of the common trade policy in the CACM can hinder the conclusion of the current process of CET harmonization. If the aforementioned problem on CAFTA coming into force is left aside, the current percentage of the tariff universe remaining to be harmonized is small (5.4 per cent).<sup>26</sup> Nonetheless, its harmonization can be complex because tariffed agricultural products are included. For this type of products, a renegotiation both in the list of products and in the tariff levels, as well as in the quotas, could be required within the framework of the WTO. In other words, it would be necessary to renegotiate commitments assumed by every country as part of its admission into the WTO, for what it would be advisable to rely on a regional bargaining power.

Along with the common trade policy, the common customs administration is another element inseparable from the formation and operation of a customs union. Not only the CET has to be applied against third countries in equal terms by all the CACM members, but also it has to be collected and administered jointly. The CET collection is a source of community revenues, which can be allocated to the financing of common policies consolidating and deepening the economic integration process.

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<sup>25</sup> SIECA (Secretaría de Integración Económica Centroamericana), *Unión aduanera centroamericana en cifras* (Guatemala: SIECA, 2005), 26.

<sup>26</sup> The member countries of the CACM have made substantial progress in the harmonization of tariffs applied by every country against third countries, in such a way that there is a harmonized CET for most of the products. At the beginning of 2005 there were 332 tariff lines remaining to be harmonized and 5,861 tariff lines already harmonized, which represent 94.6 per cent of the total of tariff lines. For more details, see: SIECA, *op. cit.*, 79-87.

For now, the advances in the setting up of a customs administration strictly common are limited, what can be conditioning the effective establishment of the customs union. Progresses are only perceived in the binational customs between Guatemala and El Salvador. Nevertheless, it is still necessary to eliminate all the intraregional customs, keeping only the peripheral customs model until becoming the type of customs which is typical of a customs union.<sup>27</sup>

Given the budgetary restriction of the Central American governments, a significant issue is to delimit the use of the revenues collected in the peripheral customs, once intraregional customs are removed. These revenues include both the tariff incomes and the domestic taxes on imported goods collected at the customs. That is why it is important to find suitable mechanisms of tax harmonization as well as of collection and distribution of the CET revenues received by the peripheral customs. A coherent proposal would be that such revenues financed a community budget from which common policies could be developed. Nonetheless, for the time being the Central American governments are reluctant to this idea.

Macroeconomic stability is another requirement for laying down a customs union on a sound basis. A way of contributing to this stability is the coordination of the major macroeconomic policies of the countries participating in the customs union. Besides, this coordination is fundamental to avoid that the measures adopted by every member country to adjust to the international economy changes, end up affecting unfavorably on the rest of the partners.

The empirical evidence suggests the fulfillment degree of the macroeconomic convergence criteria established by the Central American Monetary Council has been modest in the new CACM.<sup>28</sup> In the 1997–2004 periods the average fulfillment degree did not exceed 34 per cent in Honduras and Nicaragua, was around 50 per cent in Costa Rica and Guatemala, and reached almost 66 per cent in El Salvador.<sup>29</sup> Although all the CACM

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<sup>27</sup> The CACM has four customs administration models. These models have been designed to test out the different forms in which trade in the region might be managed in order to gradually advance towards a customs union. The customs models which have been put into practice, are the following: three of intraregional character –integrated, juxtaposed and trinational–, and one of peripheral character. On these customs models, see: INTAL (Instituto para la Integración de América Latina y el Caribe), *Informe centroamericano N° 2* (Buenos Aires: BID-INTAL, 2004), 17-18.

<sup>28</sup> The criteria of macroeconomic convergence established by the Central American Monetary Council are the following eight: first, the growth rate of Gross Domestic Product (GDP) must achieve or surpass 5 per cent (nevertheless, due to the economic slowdown in the last years, growth rates exceeding 4 per cent were regarded as satisfactory); second, the rate of inflation must not go above 6 per cent; third, the index of real effective exchange rate with the US has to be placed between 95 and 105; fourth, the rate of real passive interest must not pass 5 per cent; fifth, the ratio of Central Bank's net international reserves to monetary base has to be greater than or equal to 100; sixth, balance of payments' current account deficit does not have to surpass 3.5 per cent of GDP; seventh, public sector deficit must not be above 2.5 per cent of GDP; and finally, the eighth criterion is that total public debt must not exceed 50 per cent of GDP. The fulfillment degree of these eight parameters takes values varying between 0 per cent (null fulfillment) and 100 per cent (full fulfillment). For more information, see: SECMCA (Secretaría Ejecutiva del Consejo Monetario Centroamericano), *Informe económico regional 2004* (San José: SECMCA, 2005), 25-26.

<sup>29</sup> Rueda-Junquera, *Prospects for the Central American Customs Union, op. cit.*, 131.

members have been applying similar macroeconomic stabilization and structural adjustment policies, the degrees and speeds of implementation of these policies have been different in each country, what explains the disparity in the macroeconomic convergence?

The real possibilities that this limited macroeconomic policies coordination will be extended and deepened appear to be still very reduced, since regional commitments continue occupying a secondary position among governments' national priorities. In the medium term it is not predictable that a political commitment at the regional will be undertaken to coordinate macroeconomic policies and fulfill convergence criteria.

In sum, the little relative importance of intraregional trade, the absence of a real common trade policy, the lack of a common customs administration and the limited coordination of macroeconomic policies explain why the economic integration process in Central America has not been accompanied by the appropriate backing policies. In this context, the prospect that the potentially positive effect of the new CACM materializes in practice, is very scarce.

As to compensatory policies, these are practically non-existent in the new CACM despite the presence of important intraregional asymmetries. The empirical evidence points out that the relatively more developed Central American countries –that is, Costa Rica, El Salvador and Guatemala– are in better conditions to enjoy the potential benefits from the consolidation of the new CACM. Most of the growth in intraregional trade and in its intraindustry component has been explained by the aforementioned three countries.<sup>30</sup>

If the new regional integration scheme is to endure in Central America, it must be perceived to be equitable by all the member countries, specially by Honduras and Nicaragua. Without additional measures paying attention to specific needs of the relatively less developed countries, it is almost inevitable that these countries begin to question their participation in the new CACM. It would be appropriate to design mechanisms that enabled that the potential winners of the Central American customs union creation compensated the potential losers of the same. The European experience on intraregional solidarity could be adapted to the peculiarities of the Central American case, giving rise to some kind of structural and social cohesion instrument. For the present time, the interest of the Central American presidents in this type of mechanisms to

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<sup>30</sup> Empirical evidence on the distributive problems of costs and benefits in the new CACM can be found in: Rueda-Junquera, *Prospects for the Central American Customs Union, op. cit.*, 124-127. The presence of intraregional asymmetries and the need to search for a mechanism facing them, have been a constant in the process of Central American integration from its inception in the 1960s. The lack of a suitable mechanism to tackle the specific problems of the relatively less developed countries, was one of the main factors that contributed to the slowing-down of the integration scheme in the 1970s and to the withdrawal of Honduras in 1971, as well as to the crisis of the 1980s. On the problem of the intraregional asymmetries in Central America, see: Jorge Nowalski, *Asimetrías económicas, laborales y sociales en Centroamérica: desafíos y oportunidades* (San José: Facultad Latinoamericana de Ciencias Sociales, 2002).

distribute more equitably the costs and benefits of integration, has been more formal than real.<sup>31</sup>

## Conclusions

The European model of economic integration has become an unavoidable reference for any project of regional integration. Nevertheless, in the case of projects involving LDCs –as the CACM– it is advisable to use the European reference with caution, since there are important structural differences between both regional groupings. Furthermore, the theoretical basis of the European model is of limited relevance to assess the CACM as it refers to a theoretical framework which has been biased largely towards the study of the problems of economic integration among developed countries.

Despite this, some features of the praxis of the European economic integration provide useful guidelines for the new CACM. In this regard, it is worthwhile highlighting that the European experience suggests that:

- a) The political commitment is a basic precondition which has to be fulfilled in order for economic integration to advance.
- b) The legal and institutional system is an important mechanism of economic integration. In the European case the Community law has given rise to a supranational legal system, which has allowed a gradual approach of the national legislations in economic matters. Likewise, the common institutions endowed with a supranational decision making power, a clear mandate and a certain amount of automatically available financial resources, have helped to pursue clearly identified common interests rather than the sometimes conflicting interests of different Member States.
- c) The backing policies –such as trade, macroeconomic and sector policies– and the compensatory policies –such as structural funds and social cohesion instruments– are keys for the potentially positive net effects of economic integration to materialize in practice.
- d) Flexibility in the process of regional integration is essential to adapt it to changing historical circumstances, as well as to take into account the different speeds of progress at a subregional level.

The evolution of the new regionalism in Central America differs substantially from this European experience. The new CACM has been reactivated without a strong

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<sup>31</sup> In the Presidential Summit held in Belize in December 2003, the Central American Bank for Economic Integration was instructed to submit “a financial mechanism to create a Social Cohesion Fund to mitigate possible impacts derived from the customs union and to promote its benefits ” (Point 6 of the Declaration of Belize, on December 19, 2003). Although the project for a financial mechanism of intraregional solidarity was proposed, the Central American governments did not approve it.

and sustained political commitment and with a weak legal and institutional framework. Likewise, the new CACM has not been able to implement completely the basic backing policies to restore the customs union in the region and coordinate their members' macroeconomic policies. As regards compensatory policies, these hardly exist in the new integration scheme. Without additional measures paying attention to specific needs of the relatively less developed Central American countries – that is, Honduras and Nicaragua–, the potential benefits from the new regionalism will be concentrated on the relatively more developed ones, aggravating the intraregional asymmetries.

All these factors account for the serious limitations of the new CACM. If these limitations are not overcome by implementing sensible economic and institutional policies such as the ones suggested in the paper, the new CACM will not be able to contribute effectively to the process of economic development in Central America.