Structural Adjustment Programs and Economic Stabilization in Central America

Eugenio Díaz-Bonilla
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Eugenio Díaz-Bonilla.

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Foreword

This document is one of a series reporting on policy seminars organized by the Economic Development Institute of the World Bank. Policy seminars provide a forum for an informal exchange of ideas and experiences among policymakers from different countries, leading experts in development, and World Bank staff with respect to major issues of development policy.

Policy seminar reports focus on issues raised during seminars that may be of interest to a wider audience. They are not intended to be comprehensive proceedings. They seek, however, to convey the essence of the discussion that took place and to bring out any principal areas of agreement or disagreement that emerged among those participating.

Christopher R. Willoughby
Director
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of The World Bank
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Overview

Since 1965 the countries of Central America have experienced different kinds of social, economic, and political shocks. It is little wonder that their economic performance has faltered along the way. This seminar was convened to help these countries define new development goals as they try to determine what structural adjustments and economic stabilization programs are required in the aftermath of these events.

The five countries of the region—El Salvador, Guatemala, Costa Rica, Honduras, and Nicaragua—are all classified as middle-income countries, but in the past 20 years their economies have grown at a slower pace than those of other countries in the group. Before the 1950s, the countries of Central America followed an export-led strategy of economic development based on tropical agricultural products, but in the 1960s they introduced an import substitution industrialization (ISI) approach under a protected Central American Common Market. In addition to the limits of the ISI strategy, population pressures, severe poverty, income inequity, deteriorating terms of trade, and civil strife eventually left the economic programs in a shambles, along with the political alliances and social structures supporting them.

These countries have now entered a period of profound change. The issues that they face with respect to economic stabilization, structural adjustment and growth, social progress, and their political economy are exceedingly complex. The difficulty in finding solutions is compounded by the guerrilla warfare and civil strife throughout much of the region. Each country’s policymakers are looking at hard choices.

How should El Salvador, for example, balance financial external support and the related negative trade balance, overvaluation of domestic currency, and continuing inflation? What sort of peace is desirable in the area, and how can it be achieved? Could the guerrillas be brought into the mainstream of political and economic life? If a national accord is reached, will this create new social expenditures?

How can widespread poverty be alleviated in Guatemala—particularly considering the Indian population, which makes up half the total population? How can the government reduce the enormous deficits in social services? Can tax increases be used to support stabilization programs without resorting to external financing? If the government does not develop support for its stabilization program, will it lose credibility and discourage investment? How can it consolidate the still-weak democracy and ensure social peace?

Although Costa Rica has succeeded in bringing down inflation from 80 percent to 11 to 15 percent a year and has reduced its fiscal deficit, can it maintain the level of social services required and still work out its debt overhang? Is the system of minidevaluations introduced to maintain external competitiveness adequately coordinated with measures to control inflation? How could the government balance—if at all—the development strategy based on a protected common market in the region with the expansion and diversification of exports? Which of its exports would be most competitive? Are there enough markets for these exports and can they be captured, at least in part, by encouraging a new entrepreneurial spirit among the small businesses of the country?

Now that Honduras is facing a dramatic reversal of external flows, should it consider devaluation to adjust to the new flows? Should the government purchase the country’s external debt? Is that an appropriate investment of public funds? What else can the government do to absorb at least part of the discount offered by the market valuation of the debt? Should the government expand domestic demand to reactivate the economy? Could it sustain such an effort, or would it inevitably lead to inflation and balance of payments problems?
What can Nicaragua do to put a lid on its soaring inflation—which hit almost 1,000 percent in 1987? What can it do to meet the food crisis and cope with the continuing lack of basic products? What can it do to correct the mounting imbalances in its external accounts? How can declining production be turned around? Are the monetary reforms introduced in 1988 sufficient to correct the disequilibrium? Can inflation be controlled by constraining demand to the subsistence level? Will forced savings, which have wiped out the working capital of some Nicaraguans, depress employment and production further? What can be done to alleviate the political problem and accelerate the recent advances in the political dialogue?

As the seminar participants debated these and other issues, four broad themes emerged as areas that require serious attention in all the countries of Central America in their search for appropriate development strategies.

First, there is a need for "general equilibrium" analysis, which can integrate the whole range of relevant economic variables and interrelationships and thus ensure that economic policies are well defined and consistent. Some have even suggested that "general equilibrium" be defined to include a larger socioeconomic dimension to the analysis, which would take into account political economy considerations and noneconomic goals such as peace, democracy, national reconciliation, and regional integration. Emphasis should also be placed on identifying the social alliance capable of carrying out the appropriate economic programs.

Second, there is broad agreement that production needs to become more outward oriented and strengthened so that it can compete internationally with increased and diversified exports. Exports are seen as the "engine of economic development" and the means of achieving a balance between international and domestic markets.

Third, external financing and democracy appear to offer considerable potential as facilitators of economic adjustment. Costa Rica, for example, has been able to ride over the rough economic waters without stirring up social violence, whereas the more rigid structures in some other countries in the region have been less successful in this regard. It has also made more headway in outward orientation of its economy and the export diversification drive, while attending to its social needs.

Finally, if it can be said that participants reached a general conclusion in their lively debates, which covered innumerable complex and diverse issues, it is this: Economic stabilization, adjustment and development in the countries of Central America are inextricably linked to political accord and reconciliation and regional peace and integration.

Kamlesh Gillespie
Introduction

This report covers the highlights of the Seminar on Structural Adjustment Programs and Economic Stabilization in Central America held in Alajuela, Costa Rica, from March 10 to 12, 1988. This was the third in a series of seminars on stabilization, structural adjustment, and development issues in the region, jointly organized by the Economic Development Institute and Instituto Centroamericano de Administración de Empresas (INCAE). The emphasis in this seminar was on individual experiences from five countries in Central America (El Salvador, Guatemala, Costa Rica, Honduras, and Nicaragua). The seminar also considered the lessons that could be drawn from three countries outside the region—Israel, Chile, and Bolivia whose stabilization and structural adjustment problems may shed light on particular issues. This report, however, concentrates on the problems that the countries of Central America have been trying to come to grips with.

The five Central American countries considered in the seminar are relatively small in size and population which ranges from 8 million in Guatemala to 2.6 million in Costa Rica. Their total population is about 23 million. The World Development Report 1987 classifies them as low middle-income on the basis of per capita income which in 1985 totaled US$1,300 in Costa Rica, US$1,250 in Guatemala, US$800 in Nicaragua and El Salvador, and US$700 in Honduras. However, these countries differ from other developing countries in the same category in several respects.

To begin with, the Central American countries have a greater average population density: 55 persons per square kilometer versus 42 in countries at a similar income level outside the region. The population density of El Salvador (229 persons per square kilometer), for example, exceeds that of China and is comparable to India and Haiti. Furthermore, the population has grown by more than 3% p.a. during the past 20 years, or about half a percentage point above the average for this income level. This increase plus the slow growth of GDP—which has been below the average of other developing countries in the same group—has caused a slow growth of per capita income. Thus between 1965 and 1985 Guatemala and Costa Rica posted very low growth rates (1.7 and 1.4 percent per year, respectively). Honduras reported almost no growth (0.4 percent), and El Salvador (-0.2 percent), and Nicaragua (-2.1 percent) showed a decline. Although these figures also reflect the heavy economic slump of the 1980s, the growth of per capita income was below average during the previous decades particularly in Nicaragua.

Although the share of agriculture production in GDP has declined since 1965, in line with the average for all the low-middle-income countries, industry has increased less in Central America and currently represents a smaller percentage of the GDP, than the average for that income group. In addition, government participation, as measured by general government consumption, seems to be slightly lower and has grown less than in comparable developing countries, except in Nicaragua, where government participation in the economy has increased more than threefold in the last decade. In contrast, Guatemala has kept the size of its government at about the same level since 1965, which is only half the average for other developing countries at the same income level.

In the area of trade, the countries of Central America experienced below average growth in exports during 1960 to 1985, and in the 1980s showed a greater decline than was the case for comparable developing countries. Primary products (other than fuel, minerals, and metals) represented about 80 to 90 percent of exports in 1965 and were still between 70 and 85 percent in 1985, well above the average for the income group. Although in 1965 the Central American countries were more open (as measured by the ratio of exports to GDP) than the middle-income
developing countries, their situation is now somewhat similar as a result of an increase in the average ratio outside Central America (from 16 to 23 percent) and a decline in Central American countries (from about 25 in 1965 to the current 23 percent). (The exception is Costa Rica, where the ratio rose from 23 percent in 1965 to 32 percent in 1985). This is still above the average for all developing countries and for the industrial market economies as well, although it is less open than the average for upper-middle-income developing countries.

All in all, the Central American economies have grown at a slower pace and experienced greater population pressures than other low/middle-income developing countries. Their sluggish agricultural production, below-average performance industry, and slow growth of government participation over the 1965 to 1985 period all point to an “informalization” of the economies in the region. Exports still consist largely of tropical agricultural products, which have experienced only small increases in demand, and the degree of openness characteristic of the Central American economies in 1965 has declined.

Until about the 1950s, the countries of Central America had followed an export-led strategy of economic development based on tropical agricultural products. In the 1960s, in line with the prevalent ideas about economic development at the time these countries embarked on an import substitution industrialization (ISI) strategy, under a protected Central American Common Market (MCCA, in Spanish). Although regional exports and growth rates increased during the early stages of the ISI, this gave way to the by-now familiar pattern of stagnation once the “easy” part of the ISI was accomplished and some of the rigidities generated by this development strategy began to take their toll on economic performance. Then came the external shocks of the 1970s, which worsened the terms of trade of most of these countries and left them with less access to traditional markets. By the end of 1970s, these various factors, combined with the mounting population pressures and long-standing problems of poverty and income inequality (including skewed land-tenure patterns) that the development strategy had not solved, had begun to cast serious doubt on this strategy, as well as the political alliances and social structures that lay behind it. Consequently, economic adjustments that ensued (planned or unplanned, desired or not) were accompanied by some profound political changes.

The military regimes that had long dominated the political landscape of Central America (except in democratic Costa Rica, which eliminated the armed forces in 1948) seemed unable or unwilling to develop a broader social consensus in order to deal with the crisis of the 1970s. Painful economic decline and the continuing social, economic, and political grievances of old generated new violence, which in some countries escalated to guerrilla warfare and civil war. The dream of regional integration embedded in the concept of a Central American Common Market appeared shattered. As the countries mulled over new economic strategies, they also began the difficult task of defining new political and social alliances and the painful search for regional peace, hoping at the same time to revive the movement toward regional integration. In the minds of many people in Central America, as was clearly expounded during the seminar, economic stabilization, adjustment and development, political accord, and reconciliation are inextricably linked to regional peace and integration.

At the beginning of the 1980s Costa Rica invited INCAE to hold a series of “Dialogue Seminars” on some of these issues. The seminars were subsequently repeated in other countries in the region and three of the regional seminars were jointly sponsored by EDI. The specific issues discussed in this report must be seen as but one outcome of this ongoing process of defining a new economic strategy, with its related social structures and political alliances.

Before the “issues” are discussed, a word is in order about the participants. Those who attended the seminars came from both the public and private sector. In small countries, however, the roles of businessman, politician, and government official may converge to a greater extent than they do in larger countries, whose sheer size allows them to have a more “specialized” population.
Consequently, the seminar reflected not so much the views of the public versus the private sector as it did the views of different social and political groups, some of which happen to be affiliated with the government. The small size of these countries also adds a personal touch to economic policymaking: A high-level official is quite likely to be fully aware of who (specifically, by last name) may be hurt or stands to benefit from any particular decision. Even if those decisions are made only on the grounds of general welfare and national interest, it is very difficult to avoid charges of corruption when the person benefited belongs to the same political or family group, or claims of political and personal retaliation when the one who gets hurt happens to be a personal or political opponent.
El Salvador since 1979, El Salvador has been in the midst of a military conflict precipitated by external shocks, limitations of the development strategy, extreme population pressures, and long-standing social grievances related to widespread poverty and wealth and income inequalities. Successive military governments have tried to deal with the situation at three levels: (a) on the socioeconomic front, they initiated extensive agrarian reforms, nationalized the banking system, and put exports of traditional crops under state control; (b) at the military level, they increased the defense budget and initiated military action against an expanding guerrilla movement; and (c) at the political level, they took the first steps toward representative government. However, the social reforms and military outlays rapidly depleted public finances. External financing, as a result of growing concerns about widespread violence, violations of human rights, and the slow movement toward representative government, was not granted in the amount required to finance the economic adjustment. External accounts also deteriorated as a result of the unsettled internal conditions, and additional external shocks. The violence and sharp economic decline reinforced one another, and in the process precipitated large internal and external migrations.

Efforts to establish a representative government were then stepped up. A Constituent Assembly was elected in 1982 and an interim government appointed from 1982 to 1984. A stabilization program with IMF support was implemented and some of the main internal and external disequilibriums were at least partly corrected. In 1984 the Christian Democratic Party was elected to power with Jose Napoleon Duarte as president. Although the civil war continued to drain public funds, growing U.S. assistance, mainly on concessional terms, and workers’ remittances from abroad (as a result of the migration of Salvadoreans outside the country after the explosion of social violence) helped to improve the country’s fiscal position and its external accounts. A new stabilization plan with USAID financing was introduced in 1986, which included 100 percent devaluation of the official exchange rate and further reductions in the fiscal deficit. In October 1986, however, El Salvador suffered a severe earthquake, which put added strain on the economy. Although some headway has been made since then with respect to stabilization objectives, total GDP in 1987 was only 80 percent of the 1978 level, and it was not keeping pace with the population growth rate; in addition, unemployment levels were high and internal peace had not been achieved.

Stabilization, Structural Adjustment and Development

Fiscal Deficit

Some of the participants in the seminar mentioned their concerns about the negative trade balance, the overvaluation of domestic currency, and the continuing high levels of inflation (although it had declined from 35 percent in 1986 to 25 percent in 1987). Participants from the private sector tended to blame the fiscal deficit and its monetization for these problems and in discussing possible solutions cited the example of Israel (discussed during the seminar), where a significant component of the stabilization effort was to bring the fiscal deficit down from about 12 percent of the GDP to about 3 percent. Government officials countered that (a) the fiscal deficit had been already brought down to about 3 percent of the GDP (before the financing provided by foreign
grants), (b) the government was already relatively small, and (c) it had considerable difficulty attending to what the public sector officials saw as the interrelated tasks of providing social services and satisfying basic needs, on the one hand, and maintaining the level of defense-related expenditures, on the other (including the reconstruction of infrastructure destroyed during the war and the earthquake).

**External Inflows**

In general, the explanation of El Salvador's stabilization problems that focused on the fiscal deficit could be seen as part of a political tug of war between the government and the opposition. More analytical approaches during the seminar tried to place the discussion within a general equilibrium framework, in which the impact of the substantial inflow of foreign aid and workers' remittances (which amounted to about 6 percent of the GDP in 1987) had to be factored in. This explanation would emphasize the impact of a "dutch disease" linked to the inflow of external resources. The expanded amount of workers' remittances and net unrequited transfers from abroad (such as foreign grants received) represent an increased supply of dollars, which would lead to the "overvaluation" of the domestic currency. In its turn this alignment of the exchange rate would reduce exports and increase imports (i.e. the trade balance "deteriorates"). If imports are restricted (and therefore cannot go up by much), exports will have to drop further to restore overall macroeconomic equilibrium. Note 1 in the appendix gives a slightly more formal presentation of the argument, using accounting identities. And the greater the restrictions imposed on imports the greater would be the overvaluation. Any attempt to devalue the domestic currency under those circumstances could simply lead to greater inflation.

Of course, the final outcome would depend on what was happening to the balance between the public budget and private savings and investment. In this regard, workers' remittances and net unrequited transfers from abroad increase private savings and government receipts, and thus allow higher levels of private investment and government expenditures. However, as it was argued during the seminar, the country should direct these funds toward "sensible" investment and government outlays, which could help prepare the country for the time when those flows diminish (see appendix note 2). The way the country adjusts the current account is particularly important to direct those funds to adequate uses: If imports are compressed through protectionism and tariffs, that would give the wrong signals to the investment process, and inflationary pressures could mount.

**Inflation and Domestic Credit**

A related discussion during the seminar centered on whether the rate of inflation, already hovering at about 25 percent a year, is tolerable or whether it should be brought down further. And if inflationary pressures should be abated further, then the question discussed was how could this be done. A participant criticized the government for "not attacking monetization, the Government only reduced credit to the private sector". A government official replied that expansion of credit to the private sector was one cause of an increased money supply and controlling credit, money supply was also controlled in part.

In fact the discussion was over the distribution of domestic credit between the private and public sector. But, as already noted, the fiscal deficit in El Salvador is about 3 percent of the GDP and two points are financed through external grants. Therefore, given a money supply in line with projected
money demand, there does not seem to be much room to redistribute domestic credit between the two sectors (see appendix note 3).

_Agrarian Reform_

The discussion during the seminar also touched upon controversies surrounding the agrarian reform and, to a lesser extent, the nationalization of the international trade and banking system at the beginning of the 1980s. Some participants from the private sector argued that the agrarian reform failed, that it merely increased insecurity and uncertainty and consequently production declined. Government officials countered that the production dropped because of sharp declines in world prices of the main agricultural products, and a disease that attacked coffee—"roya"—which caused other countries in the region also to suffer declines in production. They also noted that guerrilla warfare was another important factor leading to decreased production in the cotton-producing area. Accordingly, the agrarian reform does not need to be reversed, so the argument goes; rather, technical and financial support should be given to the cooperatives that received land. A participant from the private sector noted that the agrarian reform, with all the shortcomings it may have had, addressed a grave political and social problem, which otherwise would have been far worse and would have generated far more violence.

_Trade Policy and the Central American Common Market (MCCA)_

During the discussion it was suggested that if the exports to the MCCA could be maintained then an additional export drive (over and above what was exported to the MCCA) would substantially improve the external accounts. This argument illustrates a not uncommon type of partial equilibrium thinking. First the approach does not take into account the possibility that protectionism related to the MCCA may make the expected additional exports less competitive in world markets. Second, if the exports were made competitive through fiscal subsidies, the countries need to consider the additional fiscal and economic costs related to selling cheaper what has cost more to produce. And finally, export promotion utilizing subsidies may face the constraint posed by possible external retaliation and limitations in access to markets due to these subsidies.

_Growth and Social Needs_

In the seminar different views were put forward as to the possible trade-offs between economic growth and the attention of social needs in El Salvador. Some participants argued that instead of trying to satisfy social needs through increased public expenditures which would require more taxing by the government, the approach to development should be reformulated to reduce protectionism and follow a labor-intensive export-led strategy, which would reduce unemployment and spur growth. Although the general thrust of the argument was accepted, some officials saw public spending related to education, health, and reconstruction of infrastructure destroyed by the civil war and the earthquake as unavoidable, which would require additional taxes anyway. However, participants from the private sector argued that a labor-intensive development strategy might broaden and increase the tax base, which, could lead to higher level of tax collection even with reduced marginal rates.

_Political Economy and Politics_

Many interventions during the seminar emphasized the importance of achieving peace in El Salvador because of humanitarian but also economic reasons. Among the economic considerations, it was mentioned the negative impact of war related to production lost due to the violence, decrease
in investment because of uncertainty, and the need to put some funds into rebuilding infrastructure and facilities destroyed during the armed conflict. However, not everyone in the seminar had the same idea about what sort of peace was desirable and how to achieve it. Some observers, particularly in the private sector, thought that the guerrillas were "outside the system" and should not be brought into the mainstream of political and economic life. The peace process initiated by the presidents of the region, of which the "Arias Plan" is part (and which earned its author, President Oscar Arias of Costa Rica, the Nobel Peace Prize), called for a negotiated settlement between the governments of El Salvador, Guatemala, and Nicaragua, on the one hand, and the armed groups fighting against those governments, on the other. The economic program and development strategies flowing from a national agreement with or without the groups contesting the power through military means would differ in line with the political actors involved in the settlement. Many in the private sector seemed to fear that a national accord including the Salvadorean guerrillas would lead to further agrarian reform, increases in various types of social expenditures, and possibly, wage concessions to workers' unions. Political considerations also account, in part, for their opposition to government deficits and the country's "external dependence" on U.S. foreign aid. In their view, the external donors supported the agrarian reform and their financial aid is one of the reasons the Democratic Christian government has been able to remain in office.
Guatemala

Guatemala is the largest country in the region (population, 8 million; population density 73 persons per square kilometer) and has more natural resources (including oil and tourist attractions) than the other countries of Central America. Although per capita income (US$1,250 per year) ranks second for the region after Costa Rica, the distribution of income and wealth is uneven, and poverty is widespread, particularly among the Indian population (descendants of the old Mayan civilization), which makes up about half of the total population. During the seminar a participant observed that Guatemala actually consists of two countries, one modern and relatively wealthy, and the other suspended in a bygone era, still living in fragmented linguistic groups and suffering from extreme poverty.

Like the other countries in the region, Guatemala has based its strategy on the export of agricultural products and an ISI under the protected MCCA. For reasons already discussed, this approach collapsed by the end of the seventies leading to social tensions and violence. Because population pressures were less intense and the country richer than El Salvador, however, open, armed conflict remained at lower levels than in El Salvador (some have cited ethnic composition and linguistic diversity as another reason). In any case, uncertainty related to the political violence limited Guatemala's access to international financial markets, and concerns about human rights and the slow movement toward representative government proved to be an obstacle to bilateral foreign aid and financing. Consequently, financing was not available to facilitate the process of economic adjustment. The transition toward a democratically elected government began to gain some momentum in 1986, and general elections were called, bringing the Christian Democratic Party of Mr. Cerezo into power.

The immediate concern of the new administration was to implement its stabilization plan, which called for devaluation of the local currency, a reduction of the fiscal deficit, dismantling of some protectionist structures, the introduction of price controls and higher interest rates. These measures helped to bring inflation down and to reduce the balance of payments and fiscal disequilibrium, but they also pushed unemployment up and real wages declined. Policymakers are currently concerned with reactivating the economy (GDP in 1987 was still below the levels of the preceding decade) and reducing the enormous deficits in social services. They also want to alleviate widespread poverty. The critical problem is how all this can be done without compromising the hard-won stabilization gains, in the context of very limited or null external financing.

Stabilization, Structural Adjustment and Development

Problems of Stabilization: Quasi-Fiscal Deficits and Fixed Exchange Rates

In general, Guatemala's stabilization program was favorably evaluated by the participants in the seminar, both from the public and the private sectors. It was argued that because the plan had a wide base of support that included the business community, economic activity did not decline much. Confidence in the plan sustained the levels of investment and led to some repatriation of capital, which was to help moderate the impact of restrictive policies on aggregate production and unemployment.

However, the effectiveness of the Guatemalan plan was also questioned during the seminar because of two problems in particular. First, although the fiscal deficit was reduced to less than 1 percent of the GDP, the quasi fiscal deficit (which developed when the Central Bank assumed the
exchange losses on external loans suffered by public entities after the domestic currency was devaluated) would have been substantially higher. The government officials responded that even so the total deficit (fiscal and quasi fiscal) is expected to be about 3 percent of the GDP, which is substantially less than the deficit before the stabilization program.

Second, the government was criticized for favoring fixed exchange rates (and thus losing an instrument of economic policy), which would reduce the incentives to exports and lead to increased imports. In fact a large imbalance in the trade account appeared in 1987. However, officials argued that the problems in external accounts were due to (a) depressed international prices; (b) a jump in imports following the relaxation of strict import regulations that had been in effect for some time; and (c) the fear of possible import taxes, which led to anticipatory inventory building.

**Money Supply and Domestic Credit Creation**

Another issue discussed during the seminar was the control of money supply as part of a stabilization program. Some participants argued that further restrictions in money supply were needed to control inflation, but in the same breath they called for increased domestic credit and low interest rates. Considering the consolidated balance sheet of the financial sector, it is obvious that both requests can be made compatible only under special circumstances (see appendix note 3). In fact, the debate really centered on the distribution of domestic credit between the private and the public sector rather than on the level of money supply side. But, as in the case of El Salvador, the room for restricting money supply and expanding private credit was rather narrow, given the already relatively small budget deficit.

**Tax Increases**

In Guatemala, during the months previous to the seminar considerable attention had also been focused on the government's plan to increase taxes. The government proposed to collect an additional 1 percent of the GDP in taxes to attend to the country's many social problems. The Guatemalan private sector resisted the tax increases and these complaints mounted into open protests. Then, the government decided to scale the whole package down to about 40 percent of what was originally envisaged. Exchanges among the participants in the seminar reflected the divergent opinions on this subject. Government officials argued that the tax pressure (and the size of the public sector) in Guatemala is one of the smallest among the developing countries and that there are numerous social needs to be attended. Those opposed to the idea of increasing taxes argued that the measure was merely a fiscal one, and that the budget deficit should be narrowed through reduction in expenditures. Beside the economic aspects involved, this discussion also had political implications as argued below.

**Financing Structural Adjustment**

During the seminar it was that mentioned one of the critical problems for Guatemala is the lack of external financing. Political and economic conditions in the region and the country have discouraged the flow of external resources. However, a positive counterpart to that problem is that the country is not heavily in debt. The renegotiation of the comparatively small external debt would not generate additional resources (but it would help to smooth out cash-flow requirements). And although some amount of financing will be provided by multilateral institutions it appears that the necessary resources to finance domestic investment will have to come from domestic savings. However,
many in the private sector are opposed to additional taxes and higher interest rates (they have been negative during the past few years), which poses severe problems for the mobilization of domestic resources.

**Financing the Provision of Social Services**

Another great problem for Guatemala, besides structural adjustment, is that of poverty. It is widely recognized that the country’s social needs require immediate attention. The Guatemalan government and the World Bank had given this problem high priority. During the seminar, a high level official of the Guatemalan delegation referred to the problem as a social debt (comparable to the external debt), which can be calculated as the difference between what the Latin American region has spent on average on social services (education, health and other services, especially in rural areas) and what Guatemala has assigned to those sectors, in percentage of the GDP, during the past 10 years. The government would like to increase taxes in order to pay that debt, but participants from the private sector in the seminar criticized the approach indicating that government does not know “whether to stabilize, grow, or distribute income”. These critics argue that Guatemala should grow first. However, government officials indicated that they did not believe “trickle down” approaches alone would work, given the extent of social problems existent.

**Political Economy and Politics**

*The Political Implications of Tax Incentives and Social Expenditures*

Some participants from the private sector argued that the national authorities must develop a consensus in support of the economic program. Otherwise the government might lose credibility, which could lead to capital flight and fiscal evasion and could discourage investment. Government officials countered that indeed a consensus had been reached and alliances have been built with different social groups in Guatemala, but that when invited to participate in the process the big private sector emphasized only one approach: to cut expenditures. This opposition to tax increases is, in part, based on economic reasons and on past occasions the private sector has successfully blocked similar initiatives, as it did when one of the military regimes tried to implement a stabilization program with IMF support.

But the discussion in the seminar showed that there were also political implications and that more than only 1 percent of GDP in taxes appeared to be at stake. An important component of the controversy appeared to be whether the ruling Christian Democratic Party might win (through the popular support, fostered by additional social spending financed by the tax increase) another turn in office. And some participants, representing large firms in the private sector and political sectors opposed to the current administration, seemed to fear more the political, rather than the economic, consequences of the small amount of additional taxes requested by the government. Consequently, any moves to alleviate poverty and attend social needs whatever the humanitarian or economic arguments behind them will also have inescapable political connotations.

*The Quest for Democracy and Social Peace*

Participants from the government also argued that the current Guatemalan administration wanted to consolidate the still weak democracy and to attain social peace. Government officials believed that the poverty and social problems had to be tackled as soon as possible to prevent guerrilla warfare from spreading and reaching the dimensions of the war in El Salvador. They defended an approach that would make the guerrilla problem disappear through community participation, democracy, economic development, and attention to social needs. But some participants from the
private sector seemed to believe that stability, growth, trickle-down, and military actions would suffice to defeat the guerrillas. These divergent opinions underscore again the point already made that social alliances and economic and political programs go hand in hand.
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Costa Rica

Like the other countries of Central America, Costa Rica followed a development strategy based on agricultural exports and a protected common market during the 1960s and 1970s. In this case, however, the political environment was different: Costa Rica had eliminated the armed forces in 1948 and thereafter a succession of elected governments ensured the continuity of democratic institutions. Costa Rica has also enjoyed less economic inequality and higher educational, health, and other social standards. Even so, the shocks of the 1970s hit hard. At first, Costa Rica tried to maintain the level of aggregate demand through expansive fiscal and monetary policies and extensive utilization of external financing. Nonetheless, its economic performance declined sharply in 1980 to 1982, in part because of the external shocks, but also because the development strategy was no longer appropriate and the initial policy responses did not address the causes of the crisis. Inflation, which for years had remained in single digits, now climbed to about 80 percent a year. The country’s economic problems mounted: GDP declined about 7 percent, unemployment jumped from 13 to 24 percent, the fiscal deficit reached 14 percent of GDP, and the external debt/GDP ratio skyrocketed to 149 percent, while the debt servicing costs escalated to more than 90 percent of exports. As an emergency measure, the country suspended debt service payments (except to multilateral banks), but then found itself cut off from international commercial lending.

From 1982 to 1985 Costa Rica implemented various stabilization measures (with IMF support), entered negotiations with international creditors, and undertook some structural adjustments (directed primarily at increasing exports). Subsequently, inflation fell to about 11 to 15 percent per year, the debt service/export ratio decreased to about 50 percent (mainly because of renegotiations of the term structure of the debt), the fiscal deficit shrank to about 2 percent of the GDP in 1985, nontraditional exports increased substantially (more than compensating, in current values, the exports lost because of the breakdown of the MCCA), and GDP growth and employment increased (although they did not return to the levels obtained before the crisis). Costa Rica’s greatest concern is how to successfully coordinate all of its goals—that is, how can it resume growth, continue on a path of structural adjustment, and maintain the level of social services, while sustaining the stabilization effort and working out the debt overhang? At the same time, Costa Rica feels menaced by the political instability along its two borders (Panama to the south) and Nicaragua (to the north), and in general by the levels of violence and internal strife in other countries in the region (especially in view of the fact that the country does not have an army). These concerns simply show that for many people in Costa Rica and in other countries in Central America the objectives of peace, democracy, and economic betterment throughout the region are inextricably linked.

Stabilization, Structural Adjustment and Development

Real External Shocks and Expansion of Nominal Aggregate Demand

As mentioned earlier, one of Costa Rica’s first reactions to the declining terms of trade in the 1970s, as was the case in many other developing countries was to expand aggregate domestic demand. This led to inflation and a balance of payments crisis. But after the stabilization effort of the first half of the 1980s, there is still a temptation to try to reactivate the economy via overexpansion of the domestic demand. It is widely agreed, however, that fiscal and monetary reactivation may reduce the trade surplus and, therefore, make it more difficult to service the
external debt. Moreover, excesses in domestic reactivation may lead to harsher stabilization efforts later, when inflationary pressures and balance of payment problems break out in the open.

**Minidevaluations**

Some participants have also raised questions about Costa Rica's decision to introduce continuous minidevaluations to maintain a competitive exchange rate. Those from countries with a tradition of a fixed exchange rate argued that Costa Rica's system of minidevaluations is inadequate, suggesting that in fact it had been instituted as part of the stabilization and structural adjustment programs at the behest of international organizations. But participants from Costa Rica seemed to think that although it was better to try to reduce inflation than to compensate for it with periodic changes of the exchange rate, if inflation was not completely controlled, the system of minidevaluations was an acceptable second-best policy.

**External Financing and the Debt Problem**

The debt problem complicates economic policymaking in Costa Rica. This country would have to have a net outflow of resources in order to pay its external debt. Relatively high real interest rates are in effect because of the internal and external transfer of resources associated with the external debt which cannot be serviced without increasing domestic savings and holding investment levels down (see appendix note 5). High interest rates also adversely affect the public budget, the financial sector and private enterprises in general. This painful adjustment is moderated by substantial levels of external aid (which may amount to about 7 percent of the GDP, according to some sources). That support has helped Costa Rica to maintain social services (and in the process, peace and democracy) and to finance a higher level of investment and the structural adjustment process that it hopes will generate growth. But besides the level of investment a key issue is its efficiency which depends on the development strategy and economic policies implemented by the government.

**The Development Strategy and Trade Policy**

A recurrent theme during the seminar was the need to replace the current development strategy which is based on a protected MCCA, with something that would help increase exports. How this may be done however, is a highly controversial issue in all the Central American countries.

One critical question for all these countries is whether they should emphasize tropical agricultural products, industrial products coming out of the ISI and directed to the protected MCCA, or nontraditional exports with which they might penetrate other nontraditional markets. Would it be possible to work with all these "engines of growth"? One problem, of course, is that protecting industrial production (under the MCCA) may make the nontraditional exports noncompetitive in world markets; moreover, protectionism would force those countries to export only those products that have an "extreme" competitive advantage (such as tropical agricultural products), and thus make them dependent on those export items.

A second question that must be resolved is how to achieve the desired expansion and diversification of exports. Governments in the region seem to have resorted more to fiscal incentives to export (and some corrections in exchange rates) than to eliminating protection. The fiscal approach to exports was criticized because of the budgetary problems that it may generate. Some participants opposed intervention with subsidies on selected exports because these may give the wrong signals to additional investments. Some suggested that countries like Costa Rica needed to define a clear program for opening up the economy that would reflect real costs and let investments flow wherever is profitable. The government, it was argued, should simply provide a stable macroframework and neutral incentives, as it did in Korea and Turkey, where more or less
neutral incentives across products and markets (internal and external) have led to substantial increases and diversification of exports. In any case the participants were divided into those who—thinking in general equilibrium terms—considered that it was wiser to eliminate or reduce protectionism in order to increase exports (because of the possible repercussion on the real exchange rate and the need for imported inputs) and those who would separate the import side (which would be under different levels of control) from the export side (which would be promoted through direct measures).

If Costa Rica decided to push exports that had a competitive advantage, which ones would it choose? Some argued that increase in international sales should not be based on depressed real wages, which would amount to “exporting poverty.” Others replied that countries should export whatever they have a competitive advantage in, given a stable macroframework and neutral incentives. If Costa Rica or other countries have an educated labor force with adequate levels of productivity, for example, exports should be based on products reflecting the underlying endowment of human and other resources. Yet some participants expressed concerns that in countries with non-democratic regimes, institutional and political arrangements might force wages below what would be simply indicated by the quality and quantity of a country’s endowment of human resources for given demand for labor.

One way out of the dilemma posed by exporting via fiscal incentives or via depressed real wages would be to increase productivity through technological innovation and adaptation. Some participants in the seminar suggested using the state’s buying power to support technologically innovative industries and increasing investments in education. This proposal again highlighted two different approaches to policymaking. The debate focused on whether the government in Costa Rica and the other countries of Central America should maintain a stable macroframework and neutral incentives, or become more directly involved in allocating support and subsidies (and therefore influencing more directly the investment pattern).

Another issue discussed was whether there were enough markets to absorb expanded exports, and what would happen if everybody expanded exports? Some argued that if all the countries of the region expanded exports as well as imports, there would be enough markets and everybody’s welfare would be improved. However, public officials worried that, even if the opportunities exist “out there”, the private sector might not have the entrepreneurial spirit needed to take advantage of them, as it has been used to leaning on the state when faced with problems. If the big, traditional firms, used to protectionism, are too flabby and uncompetitive, what strategy should then be used? Views differed on this question. Some argued for letting the weaker protected industries die off, whereas others say the latter should be helped to reconvert. Others suggested that new agents be found by democratizing the economy, to help small firms and the cooperative movement produce new entrepreneurs and thus tap new sources of creativity and competitiveness. Korea and Taiwan were discussed as example of both approaches. Korea fomented large firms, whereas Taiwan’s export drive was based on small and medium firms. Interestingly, Taiwan currently has a higher per capita income than Korea and is a creditor country, whereas Korea faces a sizable external debt.

During the seminar it was also noted that the problem of export promotion and trade liberalization was closely linked to the workings of the Central American Common Market (MCCA). Some people felt that the MCCA has helped to develop entrepreneurial and managerial talent, absorb new technologies, and create a skilled labor force. Others argued that it was in fact meant to be a first step toward fostering exports, but the multinationals and domestic interest groups distorted the original intent and transformed it in a protectionist device. In any case, there was a general agreement that at present the MCCA lacked dynamism. However, discrepancies appeared among the participants as to the causes of its stagnation. Some argued that the current problems were an inherent part of the original import-substitution strategy and therefore the proper approach now was to look for dynamic markets elsewhere. Others believed that the current problems were
more of a political nature and, if they were solved, the MCCA could revive. The armed conflict throughout the region was said to be one of the main causes of the MCCA crisis, especially the struggle in Nicaragua, which cut off transportation lanes and impaired regional commerce across the isthmus. The war and related economic problems were also blamed for the breakdown of the system of regional payments among countries, which had substantially reduced Central American trade.

Some cautioned that countries thinking about liberalizing trade and reducing tariffs should remember that any action on these issues will affect all the countries of the region, and that if some of them decided "to go solo," the whole idea of regional integration embodied in the MCCA might crumble. The hope of an integrated Central America was a recurrent theme during the seminar. Some participants wondered whether any of the countries individually was viable. And many in the seminar saw the MCCA as the instrument for regional integration, although it was not always possible to differentiate protectionist sentiments from the legitimate aspiration of an integrated Central America. However, other participants suggested that there were different things that the countries could do together (such as negotiating oil purchases and restructuring the external debt, organizing regional transport systems and tourism) to keep the dream of integration alive even if the problems related to regional trade are not solved immediately. Whether all this would lead to political integration, free movement of labor across countries, and the like still remains to be seen. In any case it was thought that the regional conflict must be settled first.

**Institutional Reform and Financial Reform**

Participants from the Costa Rica government emphasized the need for institutional reform. They argued that many of the country's laws and administrative procedures were outdated and would prevent the government from operating efficiently and in particular from modernizing its management of public enterprises.

The reform of the financial system in Costa Rica was also discussed. While some argued for a prompt liberalization of the financial system others felt that financial liberalization should be coordinated with the rest of the economy because "you cannot have protectionism in agriculture and industry, financial liberalization and increases in money supply" without some undesirable side effects. It was mentioned that in Chile, for example, financial liberalization was not well coordinated with other institutional and macroeconomic policies, which along with other problems of internal design of that reform precipitated a grave economic crisis.

**Political Economy and Politics**

Different participants indicated that one of the great advantages that Costa Rica has enjoyed in shaping its economic program is societal consensus. Since the crisis at the end of the 1970s, different administrations in Costa Rica have strived to develop some broad national agreement on the economic and social policies needed to adjust to the crisis. Part of the costs of that adjustment were financed through commercial borrowing and official foreign aid. Although this approach generated the current debt problem, it also helped the country survive the instability and social unrest without experiencing more traumatic problems, as El Salvador and Guatemala did. Perhaps more important, that transition was also helped along by the country's more equal economic and social structures and its democratic system, which made it possible to reorient the development strategy and to move further in its implementation more than any other country in the region has done. And in the process the country managed to maintain social peace and democratic continuity.
Honduras has the lowest per capita income of the Central American countries and relies on agriculture more than the others do. Although it, too, has based its development strategy on a mixture of traditional exports of tropical agricultural products plus industrialization under protectionist measures, the latter has not advanced to the levels found elsewhere in the isthmus. As measured by the proportion of exports over GDP, Honduras did not move to a more closed economy, as almost all the other countries did (with the exception of Costa Rica, recently), and it has been less dependent on exports to the MCCA.

During the late 1970s and 1980s, growth was fueled by large public investments in infrastructure, financed primarily by international organizations. Thus, although the country grew at a relatively slower pace than its various neighbors during the 1960s and 1970s, Honduras’ economic activity did not decline as the rest did during the 1980s. And although population growth has been high, density is lower than in other countries of the region. The country began its movement toward representative government earlier than El Salvador and Guatemala, and this (together with the political and military developments on its border with Nicaragua) helped to keep foreign aid flowing. Taken together, these factors explain why Honduras, although it certainly suffered as much as the other countries of Central America, has been able, thus far, to muddle through without the type of political and military convulsion that has gripped El Salvador, Guatemala, and Nicaragua. One of the main problems the country faces now is how to cope with an ongoing external shock whose full effects are still working their way through the economic system: The flows of external capital are drying up or reversing, in large part because the loans with multilateral organizations, which financed the investment programs of previous years, are coming due, and U.S. foreign aid has been substantially reduced (and may disappear altogether in the near future). In fact, if the amount of the possible reversal in capital flows mentioned during the seminar takes place effectively, the shock could amount up to about 7 to 8 percent of the GDP. That would require a major stabilization and structural adjustment effort.

Stabilization, Structural Adjustment and Development

Inflation and the Financing of Fiscal Deficits

One of the peculiar traits of Honduras’ macroeconomic performance is that it has enjoyed far lower inflation rates (in the low single digits) than the rest of the countries in the region, and has been able to cling to a fixed exchange rate for years, while at the same time sustaining high fiscal deficits (during the last 3 to 4 years only Nicaragua’s deficit surpassed that of Honduras). As a percentage of the GDP, the deficit was above the 10 percent mark during much of the 1980s and still amounts to about 7 percent of the GDP. One reason for this outcome is that the fiscal deficit has been financed in great measure by external capital flows. Yet, El Salvador—with smaller deficits (about half the size of Honduras in percentage of GDP) and financed also in large part by external sources—has had inflation rates several times higher (for instance, in 1986 Honduran inflation was about 3 percent and El Salvador was 30 percent). The second reason—at least as important—is the higher domestic savings rate in Honduras (which has reduced domestic absorption) in comparison with the other Central American countries. And this may be traced to its higher real interest rates, which in turn seem to be related to a conservative monetary policy (and perhaps, to bond financing.
also, GDP grew at relatively higher rates in Honduras during the crisis of the 1980s than in the rest of the countries in Central America. Therefore, higher saving rates, external capital flows, and relatively stronger rate of growth of the GDP helped, ceteris paribus, to keep inflationary pressures down (see appendix note 5). And the low inflation allowed Honduras to maintain a fixed exchange rate. This situation is now changing dramatically, however, owing to the reversal of external flows, although the full impact may not have been felt yet.

*Adjusting the System of Fixed Exchange Rates*

The question of whether a devaluation was needed for Honduras to adjust to the new volume and direction of external financial flows sparked a vigorous debate during the seminar. Some argued that a fixed exchange rate is a matter of national honor and that a devaluation may bring social chaos whereas others pointed less dramatically to the impact of devaluation on expectations and the level of domestic savings. But other participants replied that the only people who have been benefiting from a fixed exchange rate are those taking their capital out of the country, and that overvaluation has worked against exports, including traditional agricultural products (the implication being that more people would benefit from the devaluation). Until the time of the seminar, the government had attacked the problem through import controls, but the subject of a devaluation was still being debated. In any case, it was suggested during the discussion that devaluation (or for that matter any other economic policy) should be consistent with the rest of the macroeconomic policies rather than being at cross purposes with them, as was the case with “compensated” devaluations in Nicaragua and other countries which were simultaneously implemented with a rise in nominal wages.

*External Debt Management*

Another question that was widely discussed is whether the government should purchase Honduras' external debt. That in turn brought up several related questions: Under what circumstances would that be an appropriate investment of public funds? What alternatives does government have for absorbing at least part of the discount offered by the market valuation of the debt? And finally, can the purchases be made within the context of the country’s monetary program?

*Reactivation via Expansion of Domestic Nominal Demand*

The fact that Honduras has experienced low inflation but high unemployment led some participants to suggest that the economy should be reactivated expanding domestic nominal demand. Other participants mentioned that similar policies have been adopted in Peru, and that there was concern about their “sustainability.” It was argued that growth generated this way may be short-lived and sooner or later may lead to inflationary pressures and balance of payments problems, which could force the country to reverse its expansionary policy and possibly even overadjust in the opposite direction. In any case, the sustainability of the experiment would depend on the magnitude of the stimulus, the level of unutilized installed capacity and unemployment, the marginal propensity to import, the level of imported inputs needed to sustain the expansion, and the pattern of income distribution and demand profile generated by this approach. Given the nature of the external shock facing Honduras, however, expanding domestic demand (which seems to be occurring in any event as the government has begun to monetize the fiscal deficit) would compound the problem.
Adjusting to the Shocks

Since the change in external flows will force the country to adjust anyway, some participants pointed out that it might be better to face the task in an orderly fashion rather than just let it happen in a potentially disruptive manner. Moreover, by having a well-defined program, Honduras would improve the chances of getting additional external support, which would address directly, and even mitigate, the problem forcing Honduras to make the adjustment in the first place. Whatever program the country considers, it should include reductions in the fiscal deficit, to make it compatible with the external (and perhaps domestic, through bonds) financing available and avoid further monetization. Some have also suggested that monetization that has already taken place should be sterilized through additional utilization of bonds. Another component of the suggested package would be a devaluation (perhaps through multiple exchange rates) plus other incentives to exports. Those measures should be made compatible with the wage policy. The efficiency of public enterprise was considered another area requiring improvement.

Political Economy and Politics

Some participants indicated that Honduras, like Costa Rica, seems to enjoy a comparatively greater internal consensus and to have advanced more in the consolidation of a system of elective government than other countries in Central America. Although other factors have certainly contributed, a case could be made that democratization, along with external financing, have helped the country muddle through the worst periods of the crisis of the 1980s without crippling social disruptions. How the current shock is going to be processed remains to be seen.
Nicaragua

Although Nicaragua followed the same general development strategy as the other countries of the region, it was the only one in which per capita income actually declined during 1965 to 1980. This was the result of poor GDP growth rates combined with high population growth. It should be mentioned, however, that Honduras, with even slightly higher population growth rates than Nicaragua, still managed to increase its average per capita income during that period. Different people inside and outside Nicaragua have concluded that besides the development strategy followed, an important cause of the weak economic performance during that period was its political system, based on the antidemocratic control of the country by one family. The external shocks of the 1970s merely intensified the seething social discontent. In July 1979, under mounting domestic and international pressures, Anastasio Somoza’s government was toppled. The country then entered a period of turbulent economic, social, political, and military change.

Between 1980 and 1986, real GDP growth was close to zero, and per capita income continued to decline during this period. In fact, the GDP in 1986 was only about 75 percent of the 1977 level and per capita income was still at about 1960 level. Different calculations put current real wages clearly below the levels achieved in the previous decade (even after the monetory reform of February 1988, which included wage increased and a new list of prices for basic goods). Inflation soared to almost 1,000 percent a year in 1987, and there seemed to be shortages of different types of food and basic products. As was pointed out during the seminar, the causes for this dismal economic performance are “multiple and the emphasis depends on the political and economic philosophy of the person expressing his views: terms of trade, war, inefficiency and distortions, commercial restrictions in USA, deficient economic policies, or distrust between the public and private sectors.” Some Nicaraguans in nongovernment political parties and the private sector participating in the seminar suggested that the economic problems were political in nature and thus called for a political solution. But also the economic aspects of the recent macroeconomic reforms were analyzed during the seminar and are reported below. The discussions about this country, like those about El Salvador and Guatemala, tended to be highly charged. As one Nicaraguan put it, the economic and political situation are “difficult to talk about when there are dead bodies in the middle.”

Stabilization, Structural Adjustment and Development

Expansionary Fiscal and Monetary Policies and Current Account Imbalances

During the 1980s, Nicaragua followed expansionary fiscal and monetary policies. Fiscal deficits ranged from 12 percent to 25 percent of GDP (with several years in the 20s). Domestic credit (especially to the public sector) and the money supply increased in real terms, at least until about 1983-1984. Until 1984 the official exchange rate was fixed. Current account imbalances increased, and during the past five years have been slightly more than 20 percent of GDP (the peak was reached in 1985, when the imbalance rose to 30 percent of GDP). The origin of the financing of those imbalances is reflected in the structure of import flows: Eastern European countries increased their proportion of Nicaraguan imports from almost zero in 1980 to about 42 percent in 1986, while countries of the European Economic Community (EEC) increased theirs from 13 to about 19 percent over the same period. Considering exports these two groups emerged as the main trading
partners as well, but the order was reversed: In 1986, 54 percent of Nicaraguan exports went to the EEC and 12 percent to the socialist block.

The Quasi-Fiscal Deficit

The Central Bank was adding to the quasi-fiscal deficit through two channels: (a) extremely negative interest rates (which, according to the Central American Monetary Council, were around -60 percent and -80 percent during 1985 and 1986, respectively) eroded Central Bank's (CB) assets, and to sustain the subsequent credit program the CB printed money to comply with the credit targets; (b) there was a differential exchange rate for exports and imports that before the monetary reform (see next section) had reached about 17:1 (5,000 cordobas (old) per dollar for exports and 300 cordobas (old) per dollar for imports). By buying at the export rate and selling at the import rate, the Central Bank incurred large exchange losses, which were monetized. The situation has deteriorated further in the past two years with inflation exceeding 1,000 percent a year, production declining sharply, and the imbalances in the external accounts soaring beyond any possible external financing.

The Monetary Reform

In February 1988 the government decided to implement a monetary reform (a stabilization program), which included some measures to also correct relative prices, which had become highly distorted. For example, owing to the different exchange rates, spare parts for a tractor were more expensive than the tractor itself; and in the official announcement of the monetary reform the minister of planning is quoted as saying, that because of “those crazy prices”, a watermelon could be exchanged for four bags of cement. The objectives of the monetary reform were to drastically reduce inflation from 1,300 percent to 100 percent; reduce distortions in relative prices; induce more efficiency in the productive system; stimulate exports; punish speculators and the armed opposition; and protect the workers' purchasing power. To achieve these objectives, the government (a) created the “new cordoba” to replace the old currency, which was to be traded at the rate 1,000 old cordobas per 1 new cordoba; (b) unified and devalued the currency so that the new exchange rate was 10 new cordobas (10,000 old cordobas) per 1 dollar (this was a huge devaluation of about 33 times for imports and about 100 percent for exports); (c) increased salaries and the spread between the maximum and the minimum from 8:1 to 15:1 (amidst government concerns about losing more professional functionaries); (d) increased the prices of basic goods and insisted that export products be paid the international price; (e) determined correction factors for the assets and liabilities of the financial sector; and (f) condoned the debts of about 23,000 families of sharecroppers.

One of the peculiar aspects of the monetary reform was that the new currency had to be exchanged for the old cordobas in a period of three days. In anticipation of the measure (which was not publicly known), the government ordered the banks to close for several days. When the banks reopened, they were allowed to exchange up to 10,000,000 old cordobas (US$1,000 at the new rate) in cash for 10,000 new cordobas. If someone came with more than that amount in cash, the difference was retained by the banks (according to a scale for different margins of excess cash) as forced savings for one or two years. By March 1988 the interest rate on those savings had still not been defined, and, according to a representative of the Central Bank, was still under discussion. This procedure applied to old cordobas held in cash. People with deposits in the banks could change without forced savings because of a 1986 regulation that mandated the opening of deposits in the banks and restricted the amount that could be held in cash outside the banking system to about US$500 (quantities in excess to that amount had to be authorized by the government). According to government spokesmen, the measure was intended to control the funds going to the armed opposition (the “contras”). But the private sector saw in the measure the possibility of
expropriation and chose to keep at least part of its money out of the financial system. The monetary reform was expected to attain two objectives: first, it would allow Nicaragua to substantially reduce overall liquidity eliminating a portion of high-powered money through the forced savings scheme; and secondly, with the short time to exchange the new for the old currency, the government believed that it could dry up funds utilized by speculators and the armed opposition, as outlined in its objectives.

The debate during the seminar about the monetary reform centered mainly on the following points:

- **Devaluation and wages.** One prominent concern was that devaluation accompanied by increases in nominal wages would act at cross-purposes, fueling inflation but not correcting the real exchange rate. A representative of the Nicaraguan Central Bank noted that the increases in nominal wages were smaller than the devaluation and therefore the real depreciation should take place. Some of the participants from the private sector had previously assailed the program on the grounds that it would actually reduce real wages and not defend workers’ salaries, as the Government claimed.

- **Aggregate demand and aggregate supply.** The standard criticism directed at IMF programs was also leveled against the Sandinista monetary reform. Some asked whether inflation was going to be controlled by constraining demand to the “subsistence level” the Nicaraguan economy would find itself in or rather by increasing production. According to this line of argument inflation was created basically by the drop in production and, consequently, the solution should be to increase production rather than to reduce demand (see appendix note 6).

- **Aggregate supply and working capital.** Another discussion centered on the possible negative impact of stabilization programs on firms’ working capital and its financing. Given the importance of working capital to sustaining and expanding production, a stabilization plan, in trying to restrict aggregate demand, might also affect—through different channels—aggregate supply, negating the impact on inflation control and possibly producing “stagflationary” results. Participants from the private sector indicated that in several cases the forced savings had almost wiped out their working capital, and that they saw employment and production going down because of that (see appendix note 7).

- **High-powered money, money supply and domestic credit.** Although the “burning out” of high-powered money seemed an important step in controlling money supply, other policies the government was considering, especially those related to domestic credit and interest rates, did not appear to be analyzed as part of the whole macroeconomic program and no indication was given that they would be consistent with each other. What to do with the fiscal deficit was also being debated within the government but it did not appear to have been explicitly coordinated with the monetary reform. These may be some of the reasons why, only a couple of weeks after the strong February devaluation, the dollar in the parallel market was reported to have again achieved a substantial spread with respect to the official exchange rate.

*The Development Strategy and the Role of the Public and Private Sectors*

Although much attention during the seminar was focused on monetary reform and stabilization in Nicaragua, growth and development issues also received attention. The government has belatedly recognized that price distortions do matter and has attempted to correct at least the most obvious misalignments, such as the multiple exchange rates. However, the problem of the uneasy balance between the private and the public sector in the Nicaraguan economy remains.

The private sector does not feel safe from possible government attempts to further increase the productive sector controlled by the public sector (altogether the public sector accounts for almost
half the GDP). To date the private sector has perceived different economic measure as a potential threat of future enlargement of areas controlled by the state. In turn, the Government has suspected that part of the private sector, whose most conspicuous representatives are also members of the legal political opposition, provided a cover for the activities of what the Sandinista government considered (at least before the recent Sappoa accords) the illegal armed opposition. And the government has blamed speculators for the outbreak of inflation. Hence, the financial punishment of speculators and armed opposition has been embedded in the monetary reform.

Whatever the validity of the Government’s diagnosis, it seems that the reform has merely helped intensify the distrust and uncertainty. As one participant during the seminar commented, this was a no-win situation, because if the government was consistent in its attempt to have a fully planned and controlled economy, it should be developing the administrative and institutional mechanisms to operate it (which in his opinion the government was not doing). According to this argument, the government has taken a hostile attitude toward the private sector but has not built a functioning alternative to it, thus causing the worst possible outcome for the economy, manifested in ever decreasing levels of investment and production.

*Development Strategy and Its Financing*

One of the participants who had technical responsibilities in the early phases of the new government after the overthrowing of the Somoza regime, recalled, with retrospective self-criticism, that “we had a free-lunch mentality”. The government thought that it could first satisfy social basic needs that went unmet in the previous decades, then increase investment, and finally expand defense expenditures simply by printing money. It is clear that part of the lunch was financed from abroad and that it did not come free. And now Nicaragua is having to undertake structural reforms (including a more outward-oriented strategy) for the same reasons that other countries in the region are considering them: the flow of external resources is declining and may dry up.
Final Comments

Four broad themes emerged from the discussions during the seminar on structural adjustment and stabilization in Central America: (a) the need for a “general equilibrium” analysis in economic and sociopolitical terms; (b) the contribution of external financial flows to the attainment (or not) of stabilization, structural adjustment, growth, and development objectives; (c) the appropriate development strategy with exports as an “engine of economic development” and the balance between international and domestic markets in that context; and (d) the importance of democracy as a facilitator of economic adjustment.

General Equilibrium Analysis and Consistent Policies

The call for a “general equilibrium” framework in the analysis of the stabilization and structural adjustment issues discussed during the seminar was prompted by the need for an overall diagnostic encompassing the whole range of relevant economic variables and interrelationships, and the requirement that the economic policies suggested be consistent. The country experiences discussed during the seminar provided different examples of partial equilibrium analysis and inconsistent policies. Some of those examples may have been the result of faulty analytical frameworks, but others could have simply reflected conflicting pressures on a government that was trying to placate different social groups or to build political alliances across them.

Consequently it is important to go beyond economic general equilibrium analysis and to adapt a truly general view of the whole socioeconomic process, which would take into account political economy considerations and plain politics. This political emphasis would have at least two dimensions. One has to do with the objectives considered, which would include noneconomic aspirations such as peace, democracy, national reconciliation, and regional integration. The second is related to the fact that beyond defining an adequate set of economic policies, a crucial aspect of implementation is to consider the social alliance capable of carrying out the economic program. Different social alliances usually imply different economic programs.

In summary, the need for economic general equilibrium analysis cannot be emphasized enough. But it should be placed in the context of the overall sociopolitical framework for the same reasons that economic general equilibrium analysis is to be preferred to partial approaches: Important links and feedbacks may otherwise be overlooked.

External Financial Flows and the Stabilization and Structural Adjustment Programs

Another recurrent theme during the seminar was the composition and volume of external financial flows and their influence on both short-run macroeconomic equilibrium (stabilization) and medium- to long-term structural adjustment, growth, and development.

*El Salvador* and *Nicaragua* showed positive inflows of external funds (certainly from different sources), which allowed them to sustain important trade deficits (especially in the case of Nicaragua). Those inflows also helped maintain levels of domestic investment and government expenditures higher than what would have been possible otherwise. As it was emphasized during the discussions, countries with substantial inflows should use those funds wisely, preparing themselves for the time when “Santa Claus “gifts” disappear. In general, there was some broad agreement on the concept that such preparation implies developing a productive structure that is
more outward oriented and able to compete internationally with increased and diversified exports. But at the same time, other participants appeared less willing to accept a general equilibrium proposition, which would normally hold under relatively general conditions, stating that if in the presence of those external financial inflows, imports are compressed by protectionist measures, then the domestic currency would be more overvalued, exports would drop further, inflationary pressures would be higher, and signals to the investment process would be more distorted, than in the absence of the protectionist structure.

Costa Rica, at the beginning of the 1980s, resorted to debt to finance the adjustment. This approach helped Costa Rica to get through its period of economic and political instability without the traumatic upheavals suffered by other countries in the region. But now the country is faced with the need to generate a positive outflow of resources, to pay the external debt accumulated. Foreign aid has helped to reduce that outflow, and in recent years, Costa Rica has managed to reorient its productive structure by increasing the participation of nontraditional exports. Yet, according to some opinions voiced during the seminar the growth pull generated by these activities may not have been as strong as expected (which the proponents of the outward orientation would blame on the tentative nature of the export drive rather than on weaknesses of the approach itself).

Honduras and Guatemala provided somewhat different examples of the problems and opportunities created by the presence (or absence) of external financial flows. Analytically, the simplest case is Guatemala. Compared with the other countries in the region, it has gone through the adjustment period so far without much external financial support from commercial or bilateral sources. The fact that Guatemala also suffered the greatest decline in per capital income in the region during the period 1980 to 1987 may be more than simply a coincidence. And it seems that it should not expect much in terms of additional financial flows in the future, either. Therefore only mobilization of domestic savings (helped by some financial support coming from multilateral organizations) could sustain the levels of investments and government expenditures needed to pursue its economic and social programs. And this would require higher interest rates and taxes than the private sector seems to be prepared to accept (although current interest rates are negative and the tax burden is small). Perhaps more important, the current government sees the alleviation of widespread poverty as an important objective (the World Bank concurs), while the influential big (although small in number) private sector appears to oppose this approach. They seem to fear they would pay the tab while the government, which is based on a social alliance they dislike, would harvest the political dividends. As for Honduras, until recently it enjoyed a positive inflow of external resources, but now those flows appear to be reversing themselves, so that Honduras is moving away from El Salvador's case and beginning to look more like Costa Rica's. Loans with multilateral organizations (which financed the important infrastructure program of previous years) are coming due and bilateral flows seem to be declining. Part of the solution here lies in the design of the economic program and the generation of a steady stream of projects capable of sustaining a net flow of financing from the multilateral organizations. But the adjustment to the new situation would also require politically more controversial measures aimed at reducing a high public deficit and correcting an overvalued domestic currency. The latter, after many years of an exchange rate fixed in nominal terms, seems to be a particularly sensitive political issue.

The Development Strategy

Another large group of issues revolves around what was referred to during the seminar as "engines of development." One aspect of this discussion was the importance of increasing exports. And the second was the balance between domestic and world markets in the development strategy followed by the countries in the region.
Although there was widespread agreement on the need to increase exports, positions differ on how to do it. In terms of the possible markets, many considered the possibility of reactivating the MCCA an important objective which they generally saw as part of a “mixed strategy” that included trying to penetrate other world markets. The obvious question here is under what circumstances (if any) would the strategies of a protected MCCA and fostering nontraditional exports be additive? In turn, this issue is related to the question of the possible mechanisms that could be used to increase exports.

During the debate at least two different approaches emerged in this regard. On the one hand, it was suggested the possibility of developing an outward orientation based on appropriate exchange rates, reductions in protectionism (which would have an impact on the real exchange rate and the availability of imported inputs), and a neutral system of incentives. According to this line of thought, the development strategy based on a protected MCCA would be flawed in economic terms and its current problems would bear witness to this indictment.

An alternative approach would be to separate the import side (which would be kept under different levels of control) from the export side (which would be expanded and diversified through more active participation of the state in designing and administering fiscal and other incentives). Also, in this approach, the problems faced by the MCCA would be mainly political ones, emerging from the social unrest and armed violence ravaging different countries in the region, rather than from a flawed economic conception. Again the economic and political dimensions of the current discussion about Central America crossed each other in a complicated mix.

Another important question debated in the seminar has to do with the balance between the internal and external aspects of the aggregate demand and supply equations. Several participants have suggested that economic growth needs to be reactivated through expansionary policies aimed at increasing domestic aggregate demand. Either they considered that the export drive was not robust enough to sustain the levels of growth and employment they wanted or the pattern of economic growth thus generated would not address different social needs they perceived as important. In the case of countries like Costa Rica, doubts were also voiced about whether the export effort was predicated upon its better prospects for attaining sustainable growth or on the need to pay external debts (which some argued are unpayable). But economic reactivation via expansion of the domestic aggregate demand was also criticized on the grounds that it may not be sustainable in the medium term. It was argued that in many cases those experiments led to additional inflationary pressures and/or balance of payments problems, making it even more difficult to work out the debt overhang and finally resulting in harsher stabilization measures. And in any case, if the source of the shock is a real external cause, the country would not normally be able to sustain economic activity through the expansion of nominal domestic demand. Yet some appeared to think that even though the lunch may not be free, they would rather have it today and wait for the bills to arrive in the future.

**Representative Governments and Economic Adjustment**

A final question to consider is how important are democratic political, social, and economic structures to the process of adjustment? A case could be made that democracy has helped Costa Rica to confront the economic crisis of the 1980s far better than would otherwise have been possible. On the political side, Costa Rica was able to withstand the difficult times without giving up democracy and did not suffer outbreaks of social violence. In contrast, the more rigid and unequal structures in some other countries in the region did not seem to be able to adjust peacefully and experienced different levels of violence and are still struggling for political democracy. As for its development strategy, Costa Rica also seems to have made more headway in the outward orientation of the economy and the export diversification drive, while trying to attend social needs.
Relatively more egalitarian economic and social structures and a democratic system allowed it to reorient its development strategy in a way that enabled it to proceed further than other countries in the region, which are still debating these issues. And in doing so Costa Rica was able to maintain social peace and democratic continuity.
Appendix

El Salvador

Note 1. Some of the main points of the discussion can be illustrated using the balance of payments equation:

\[ (1) \ X - M - i^*D + W + NTR + dD = dF, \]

where

- $X$ (exports) minus $M$ (imports) is the trade balance;
- $i^*D$ is the payment of interests at a rate $i$ on a stock of foreign debt $D$;
- $W$ are workers' remittances from abroad;
- $NTR$ are net unrequited transfers from abroad (i.e., foreign grants received);
- $X - M - i^*D + W + NTR$ can be thought of as the current account;
- $dD$ is the increase in the external debt (an inflow of capital if positive);
- and $dF$ is the change in assets denominated in foreign currency held by the country (then $dF - dD = dNFA$, the change in the country's net foreign assets); all variables (except $i$) are nominal, denominated in domestic currency.

If $NTR$ increases (because of foreign grants), if $W$ increases (because of increased remittances from workers abroad), and if $i^*D$, $D$ and $F$ do not change much, and "equilibrium outcome" is that $M$ has to go up compared to $X$ (the trade balance "deteriorates"). In addition, if imports are restricted (and therefore $M$ cannot go up by much), exports will have to decrease further to restore overall macroeconomic equilibrium. On the financial side, this amounts to an increased supply of dollars which leads to the "overvaluation" of the domestic currency, required to reduce exports and increase imports. And the greater the restrictions imposed on imports, the greater the overvaluation. Any attempt to devaluate the domestic currency, in the presence of that structure of international financial flows, could lead to greater inflation. Certainly the final outcome depends on what is happening in the "background" with the balance between private savings and investment, and the public budget (see next paragraph).

Note 2. The increased financial inflow (represented by higher $W$ and $NTR$) also allows higher levels of investment and public expenditures than would otherwise have been possible. This is shown by the well-known rearrangement of the national income identity:

\[ (2) \ (S - I) + (T - G) = X - M - i^*D + W + NTR, \]

and recalling that

\[ (3) \ S = Y - C - T \] where $Y$ is Gross National Income, $C$ is private consumption, and $T$ represents taxes, and that

\[ (4) \ Y = GDP \ (Gross \ Domestic \ Product) - i^*D + W + NTR; \]

then (2) can be written (assuming $W$ goes to the private sector and $NTR$ to the government and that the debt is private)

\[ (((GDP - i^*D + W) - C - T) - I) + (T + NTR - G) = X - M - i^*D + W + NTR \]

Therefore, if $W$ and $NTR$ increase, then $S$ will increase (if the sum of the marginal property to consume and the marginal income tax is less than one) and government receipts will go up (including an increase in $T$ to the extent that there is a direct tax on incomes), allowing more investment ($I$) and government expenditures ($G$).

Then the point is to use wisely the increased levels of $I$ and $G$ allowed by the stepped-up flows of $W$ and $NTR$. In particular, the way the country adjusts the right-hand side of the equation (the current account) is important: if $M$ is compressed by protectionism and tariffs, (a) that would give the wrong signals to the investment process, and (b) inflationary pressures would be higher than otherwise.
El Salvador and Guatemala

Note 3. The table below shows the consolidated balance sheet of the financial system and can be utilized to evaluate claims such as the need “to control money supply and increase domestic credit.”

Consolidated Balance Sheet (simplified)

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>NFA (net foreign assets)</td>
<td>M (money supply)</td>
</tr>
<tr>
<td>DC (domestic credit)</td>
<td>Wb (capital and other accounts)</td>
</tr>
</tbody>
</table>

Public

Private

or, in equation form,

\[ \text{NFA} + \text{DCPu} + \text{DCPr} = \text{M} + \text{Wb} \]

If \( \text{NFA} \) and \( \text{Wb} \) are unchanged, \( \text{M} \) can be reduced and \( \text{DCPr} \) increased only if \( \text{DCPu} \) is reduced further. But in the case of El Salvador and Guatemala, the margin to do so seemed very narrow given the already relatively small budget deficit. However, in the case of El Salvador, \( \text{NFA} \) could have been expanding owing to the inflow of foreign grants and worker's remittances, which if not sterilized and given the restrictions on imports, could lead to an expansion in money supply and added inflationary pressures.

Costa Rica

Note 4. Using the equation

\[ (S - I) + (T - G) = (X - M), \]

the payment of the debt requires \( (X - M) \) to be positive, and with \( (T - G) \) negative, \( (S - I) \) has to be even more positive to free resources to pay the debt. And this may require higher interest rates even if national income is growing. One of the problems that have been pointed out within this framework is that if the external debt is mainly publicly held, the generation of private savings through this mechanism does not necessarily put the resources needed to pay for the external debts in the hands of the government (except that one believes that the government can capture domestic savings through domestic bond financing of the deficit and it is prepared to default on its internal debt in order to pay the external one, while, surprisingly, the domestic private sector is not perceiving what is going to happen).

Honduras

Note 5. Using the equation

\[ (P \times Y) - (C + I + G) = X - M, \]

where \( P \) is an appropriate price index, \( Y \) is real GDP, \( (X - M) \) is redefined accordingly, and \( (C + I + G) \) is domestic absorption in nominal terms. It is clear that if domestic absorption exceeds the
value of GDP, the country would suffer inflationary pressures ($P$ goes up), and/or balance of payments problems ($M > X$). In the Honduran case, because (a) external capital flows sustained a higher domestic absorption than otherwise; (b) the existence of relatively high domestic savings; and (c) $Y$ increased in real terms, overall macroeconomic equilibrium was achieved without too much additional pressure on the price level ($P$).

Nicaragua

Note 6. In the diagram below aggregate supply ($AS$) has dropped to “subsistence level” ($AS'$), for reasons that are assumed to be unrelated to the level of aggregate demand ($AD$) which has been left unchanged. This increases the price index from $P1$ to $P2$. Reducing aggregate demand (from $AD$ to $AD'$) would control inflation ($P$ would decline back to $P1$), but the economy would be at its subsistence level. The alternative would be to increase aggregate supply.

Diagram 1

Note 7. In the diagram below, measures aimed at reducing aggregate demand (e.g., from $AD$ to $AD''$) through restrictions in domestic credit could, through the working capital channel, also affect aggregate supply (for instance, making it drop from $AS$ to $AS''$). The result may be stagflation: less production, and greater inflation (from $P3$ to $P4$).
Diagram 2

Price Level

P4

P3

Aggregate Supply, Demand

AS''

AS

AD''

AD
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