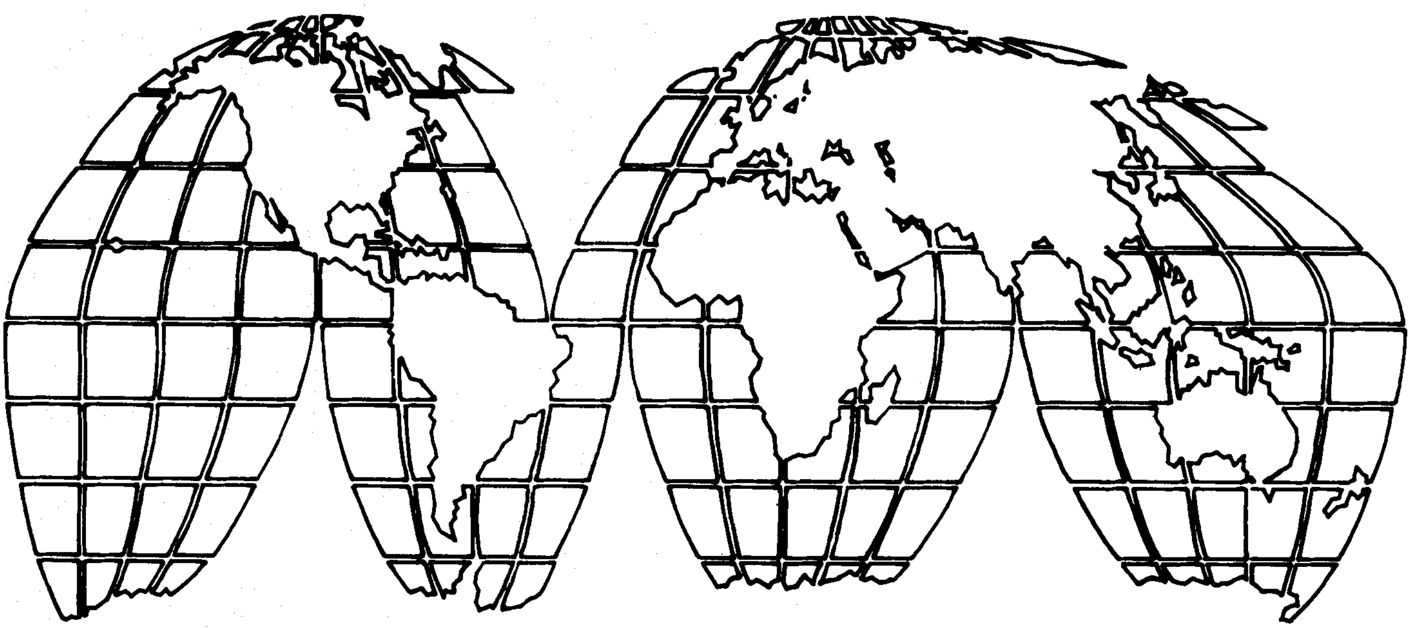
A.I.D. Evaluation Special Study No. 9

PRIVATE SECTOR: Costa Rica



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COSTA RICA PRIVATE SECTOR STUDY

A.I.D. Evaluation Special Study No. 9

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FOREWORD

In February 1982, the Administrator of the Agency for International Development (AID) requested that the Bureau for Program and Policy Coordination, through its Office of Evaluation, initiate a series of studies examining the contribution of past AID efforts to strengthen the role of the private sector in the development process. As part of the first phase of this effort, four countries--Malawi, Costa Rica, Thailand, and Cameroon--were selected for in-depth evaluations of the central issues surrounding this question. The development history of these four countries is, in a sense, unique. In a large measure, the economic history of Third World countries in the past two decades has not been a happy one. The remarkable economic performance of these four countries during this same period distinguishes them from many of their neighbors and from the developing world at large. The decision to examine success rather than failure was a purposeful one, and the studies need to be read in this light.

The country studies focus on two major areas of interest: the contribution of public policies to the development of private activity, and the impact of external assistance on the efficient functioning of internal markets related to capital, manpower, and information needs. The emphasis of these studies is not on private sector development as an end in itself, but as a means to AID's central objective of assisting recipient countries to meet the basic human needs of their poor majorities through sustained, broadly based economic growth. Thus, all components of the private sector are important, from large-scale industry to small enterprises, from external private capital to the poor smallholders in the rural areas.

Field studies in the four countries were conducted in June-July 1982. Synthesis reports comparing the central themes investigated in the country studies are available.

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SUMMARY

Costa Rica is in a state of economic crisis characterized most dramatically by a huge foreign debt which the country is unable to service. The current situation is also marked by a stagnant economy, rampant inflation, growing unemployment, and rapid depreciation of the currency. A synopsis of the crisis and its underlying causal factors are summarized in the figure on the next page.

Paradoxically, Costa Rica is a country that has shown remarkable progress in the last 20 years, achieving growth with equity. Given Costa Rica's good agricultural resource base, a homogeneous and well-educated population, political stability and a long-standing democratic tradition, a firmly established free enterprise system, a large middle class, and a more even distribution of income than in most LDCs, no one would have predicted the present outcome even as recently as five years ago when the country was enjoying an extraordinary coffee bonanza. Yet, serious structural problems were already undermining the future. When negative external factors coalesced in 1978-1980 to confront Costa Rica with falling export prices, higher import prices, rising interest rates, and adverse political conditions in Central America, the structural defects such as government deficit spending, an unresponsive nationalized banking system, and a protected industrial sector aggravated the situation to precipitate a crisis.

Since 1963, Costa Rica's economic development strategy has emphasized industrialization based on import substitution and participation in the Central American Common Market (CACM) while somewhat neglecting the traditional export-oriented agriculture sector. This strategy sought to attract private investment in industry by providing protective tariffs, tax incentives, tariff exemptions for materials and equipment, and a stable exchange rate. Donors, including USAID, provided extensive support in the implementation of this strategy by providing industrial credit, contributing to manpower development, and assisting with infrastructural development and regional integration. However, in spite of the relative success of the industrialization strategy pursued, Costa Rica's economy remained highly vulnerable to the terms of its non-CACM trade.

The industrialization strategy, complemented by continued if uneven growth in agricultural exports, was successful in fueling rapid economic expansion during the 1960s and 1970s. Real Gross Domestic Product increased an average of 6.1 percent per year between 1960 and 1978. Annual growth in the industrial sector averaged 9 percent between 1960 and 1968, 7.4 percent between 1968 and 1973, and 8.4 percent between 1973 and 1978, indicating a very positive performance in this sector.

Synopsis of The Costa Rican Crisis

<u>Principal factors contributing to present crisis</u>

Deterioration of terms of trade

Inflation and high interest rates (trading partners of Costa Rica)

Excess liquidity of the international financial system (large petro-dollar deposits to recirculate)

Fiscal deficit spending

Expansionary monetary policies--overvaluation of currency

Periodic reversal of basic economic policies

Political instability

Poor resource allocation

Capital-intensive investment

Continued fiscal deficits

Increased external dependence

Export disincentives

Disincentives to savings and capital formation

External

Internal

Import substitution policies

Bureaucratized banking system

Subsidies to capital

Temporary Current

Crisis

Structural

This growth was based almost entirely on opportunities in the local and regional markets.

The positive macroeconomic performance ignores some more disquieting aspects of this trend, including (1) the continued dependence on the export of a few traditional commodities whose prices have deteriorated in recent years; (2) the establishment of a relatively capital-intensive industry because of incentives to capital, and steadily growing payroll levies; (3) the development of relatively inefficient industries due to the protective policy framework; (4) the near exhaustion of import substitution opportunities; (5) the emphasis on industry at the expense, at least in part, of agriculture; (6) the heavy reliance on borrowed (often foreign) funds for investment capital as a result of Government financial policies; and (7) policies signaling a bias against exports principally through an overvalued exchange rate.

Another distressing characteristic of the economic picture has been the failure of the nationalized banking system to attract internal savings and provide adequate financial intermediation. While an increasing proportion of credit has been channelled to the public sector, private firms have suffered from poor service and inadequate financing such that they have increasingly had to look towards external sources of credit.

These negative trends have now culminated in a situation where a relatively inefficient and highly indebted industrial sector is forced to look for new export opportunities in the face of diminishing local and regional markets as well as sluggish markets in North America and Europe. Industrial and overall economic growth has virtually come to a halt. Not only is industry not in a position to turn to exports without first going through a painful shakedown period, but the necessary policy and support framework is not in place.

The other major element of public policy (besides industrialization/regional integration) has been the emphasis on equity and improvement of quality of life for low- and middle-income Costa Ricans. The implementation of this policy has brought major public investments in education, health, social welfare assistance, social security, and public services. It has also involved the establishment of price controls and subsidies for essential needs such as basic foods, public services, fuel, and selected other goods and services. Another major component has been the establishment of minimum wages with heavy payroll taxes to help pay for the social programs. Rapidly increasing public sector employment should also be seen as a part of this policy orientation.

The Government's equity-oriented policies have clearly had important results as measured by very positive performance of social indicators such as education and health, as well as by the development of a physical infrastructure to benefit all Costa Ricans. The average citizen is relatively well educated and protected with health, welfare, and social security systems.[1] Furthermore, middle income groups have been major beneficiaries of the growth experienced during the past years. However, it should be noted that the lowest income group has not improved its share of income nor has there been any significant redistribution of income during this period. Furthermore, Costa Rica entered the 1960s with a comparatively favorable pattern of income distribution that in part can be attributed to a relatively balanced distribution of land in the Central Plateau where most of the population is located, and the large number of small-scale business establishments present in the economy. This had been Costa Rica's unique heritage in the region, and successive governments of different political persuasions have done a good job at preserving and enhancing social equity.

Despite the positive results, the Government's social progress has come at a very high cost. A large bureaucracy (employing one out of five Costa Ricans in the labor force) has evolved to administer the programs. Moreover, a growing proportion of resources is dedicated to paying for public employees while benefits reaching the public decrease. Public administration has generally been inefficient. Because the cost of social programs has increased very rapidly, it exceeded the Government's revenues, particularly in years when traditional export earnings were down. This has had two consequences: (1) increased public borrowing in local capital markets, which in turn has squeezed out private sector borrowing (see Table 2); and (2) increased Government borrowing abroad, resulting in an unmanageable foreign debt.

The Government realizes that it is faced with a crisis of major proportions. Its strategy for recovery appears to be based on increased support for private sector initiatives and export development, while continuing to meet social welfare objectives.

From the perspective of the private sector, recovery and future growth will be facilitated by the following positive factors: an existing and underutilized industrial base (albeit somewhat inefficient); significant agricultural and

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[1]Although the extent of coverage provided by these systems is high relative to many other LDCs, it does not approximate the protection provided in the United States and most other industrial countries; unemployment compensation is especially noteworthy in this regard.

agro-industrial potential; a skilled, competitive, productive labor force and strong management resources (largely the result of social policies in education and health); a favorable geographic position that provides easy access to U.S. and Latin American markets; and an increased recognition of the need to export.

The principal constraints confronting the private sector include the acute shortage of foreign exchange, compounded by a confusing and unstable multiple exchange rate system; a severe credit squeeze (local and external), aggravated by a cumbersome and ineffective nationalized banking system; many industries that are noncompetitive in world markets; the limited technical and production management know-how for streamlining industry; the unfamiliarity with marketing know-how for penetrating foreign markets; an inadequate policy and programmatic support framework for exporting; and the cost of maintaining the social programs and the bloated public sector payroll. Furthermore, the country's extremely heavy debt service burden will seriously constrain economic recovery over the medium term.

PREFACE

The team was asked to evaluate the effects which public policy and donor interventions have had on the private sector and on economic and social development in Costa Rica since 1960. Costa Rica was proposed for inclusion in this four-country study because of its positive record vis a vis the private sector and significant economic and social progress during the period. The fact that Costa Rica is currently faced with a severe economic crisis which has halted its enviable growth pattern and threatens the validity of its cherished aspiration for upward mobility and elimination of poverty is purely coincidental. But the state of crisis added meaning to the task and led the team to explore the extent to which public policies and behavior of the private sector may have contributed to or, conversely, delayed the onset of crisis. Many less developed countries, extremely vulnerable to economic trends emanating from the industrial countries, are currently in trouble. However, Costa Rica appears to be worse off than most, at least financially. It was important to learn why. Our report includes a number of answers which most observers acknowledge as significant. Although we may not have discovered anything new, we hope that this presentation of our findings will be helpful to those striving to put Costa Rica back on course and to policy-makers facing similar decisions in other places.

The team concluded that public policies accelerated and enriched economic and social progress in the wake of general prosperity fueled by positive external economic factors during 1960-1975, neglected to prepare for the advent of adverse external conditions thereafter, and then failed to make essential, albeit difficult, adjustments as the pace of economic deterioration accelerated from 1978 to 1982. The private sector performed rationally all through the period, responding predictably to market and policy signals. Public policy, on the other hand, appears progressively irrational, having made a difficult situation worse. Donor agencies' record is mixed--major support for infrastructure with clear positive results, major support for agricultural and industrial credit with little positive policy effect, and support for social programs with positive results but at excessive cost.

These conclusions and the analyses upon which they are based were derived from information from many sources, both published and informal. We are extremely grateful to the many persons who shared their time and knowledge with us, whose names are recorded in Appendix E. Special recognition must be given, however, to a few people whose assistance was most crucial to completion of our task. Tim Mahoney, Bureau for Program and Policy Coordination, Office of Evaluation, had the unenviable job of explaining the assignment to us at the outset, over and over again until we finally understood it. Clarence Zuvekas, LAC/DP, provided valuable information in Washington before and after the field work. Eduardo Lizano, Ernesto Rohrmoser, and Juan Manuel Villasuso gave us extremely helpful insights into the 20-year economic history under study and, at the USAID, Bill Phelps, Bastiaan Schouten, Dan Chai, and John Curry shared their extensive knowledge and interpretation of events with us. The USAID also shared two of their secretaries with us, Mercedes Sciamsnelli and Beverly Roper, who typed many drafts of manuscripts under very tight time constraints and arranged numerous appointments, all with great skill and good humor.

GLOSSARY OF ACRONYMS AND ABBREVIATIONS

BANEX	Banco de Exportaciones (Export Bank)
BCIE	Banco Centroamericano de Integracio Economica (Central American Bank of Economic Integration)
BID	Banco Interamericano de Desarrollo (Inter-American Development Bank)
CABEI	Banco Centroamericano de Integracion Economica (Central American Bank for Economic Integration)
CACM	Central American Common Market
CAFEI	Central American Fund for Economic Integration
CAT	Certificado de Abono Tributario (Tax Credit Certificate)
CCSS	Caja Costarricense del Seguro Social (Costa Rican Social Security Fund)
CENPRO	Centro de Promocion de Exportaciones e Inversiones (Export and Investment Promotion Center)
CEPAL	Comision Economica Para America Latina (ECLA)
CIEX	Certificado de Incrementos de Exportaciones (Tax Certificate for Export Increases)
CNP	Consejo Nacional de Produccion (National Production Council)
CODESA	Corporacion Costarricense de Desarrollo (Costa Rican Development Corporation)
COFISA	Corporacion Costarricense de Financiamiento Industrial S.A. (Costa Rican Industrial Financing Co.)
Colones	Costa Rican monetary unit
ECLA	Economic Commission for Latin America (CEPAL)
FECAICA	Federacion de Camaras y Asociacion de Industriales de Industriales de Centro America (Central American Federation of Industrial Associations)
GDP	Gross Domestic Product

GOCR	Government of Costa Rica
IBRD	International Bank for Reconstruction and Development
IDB	Inter-American Development Bank
ICAITI	Instituto Centroamericano de Investigacion y Tecnologia Industrial (Central American Institute for Technical Research)
ICE	Instituto Costarricense de Electricidad (Costa Rican Electricity Institute)
IMF	International Monetary Fund
INA	Instituto Nacional de Aprendizaje (National Vocational Training Institute)
INCAE	Instituto Centroamericano de Administracion de Empresas (Central American Business Administration Institute)
INCOP	Instituto de Cooperativas (Cooperatives Institute)
JAPDEVA	Junta de Administracion Portuaria de la Vertiente Atlantica (Port Administration and Atlantic Development Council)
LDC	Less Developed Country
LIBOR	London Inter-Bank Offer Rate
MEIC	Ministerio de Economia, Industria y Comercio (Ministry of Economy, Industry and Commerce)
OFIPLAN	Oficina de Planificacion Nacional y Politica Economica (National Planning Office and Economic Policy)
PID	Project Identification Document
RECOPE	Refinadora Costarricense de Petroleo (State Refinery)
SIECA	Secretaria de Integracion Economica Centroamericana (Central American Integration Council)
SNAA	Servicio Nacional de Acueductos y Alcantarillados (National Water and Sewage Service)


Costa Rica
Guanacaste
Alajuela
Heredia
San Jose
Cartago
Limon
San Jose
Puntarenas

I. INTRODUCTION

A. Factor Endowments

Costa Rica is a small country with a land area of 50,400 square kilometers and a population of approximately 2.3 million persons. It has few resources beyond its fertile soil, ample water for both food production and power generation, and a well-educated, productive population. Until 1960, its economy had been based on the production and export of several primary agricultural products. Bananas and coffee continue to dominate Costa Rica's export trade, while beef cattle and sugar have increased in importance since the early 1960s. During the last two decades, agricultural expansion was facilitated by the availability of new land in San Carlos and the coastal plains, and to some extent in Guanacaste, and made economically viable by the virtual elimination of malaria, the expansion of road networks, and the extension of electricity to those areas.[1] In the process, provincial towns have become important market and service centers to support the expanded agricultural production in their respective areas allowing increased urbanization of the population while partially avoiding the overcongestion of the capital that has occurred in most other developing countries.

Buoyed by demand generated by the expanding agricultural sector and the advent of the Central American Common Market (CACM), industrial activity also grew rapidly during the 1960-1980 period based essentially on the processing of imported raw and semi-finished materials for the new expanded captive market. Thus, during the 1960s, Costa Rica was able to achieve a very satisfactory rate of economic development. During the next decade, this momentum was maintained principally by heavy borrowing from abroad, in the absence of efficient mechanisms to capture and channel internal savings.

Especially when looking into the future, the single most important factor endowment of Costa Rica is its strong human resource base. The country's heritage of concern with education and welfare and the considerable investments of the last two decades in furthering education and skill development, as well as in health and nutrition, have strengthened this resource

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[1]The geographic agricultural frontier has been reached, if not exceeded. Further expansion will be at a high social cost from negative ecological effects of deforestation. Further growth of agricultural output will have to result from productivity gains rather than land expansion, a more difficult proposition.

to levels comparable to those of the developed countries. Increased urbanization and industrialization have also contributed significantly to the development of managerial skill and entrepeneurial attitudes.

Parallel to these efforts to strengthen a sound human infrastructure, Costa Rica also invested heavily in physical infrastructure to access its agricultural and forest resources, harness its vast hydroelectrical potential, and connect with Central American and international markets through roads and ports.

Although heavily burdened by the external debt incurred in attaining these goals, these assets represent a solid foundation upon which to base a resumption of growth with equity.

B. Economic Performance

1. Production and Employment

Costa Rica's per capita Gross Domestic Product (GDP) grew at a very satisfactory rate over the past two decades, with the exception of 1975 (following the sharp rise in oil prices) and 1980. The annual rates averaged 3.2 percent between 1960-1980, exceeded 5 percent in 1972, 1973, and 1977, but declined by 1.9 percent in 1980. In constant (1970) prices, GDP grew from 3.4 billion colones in 1960 to 11.2 billion colones in 1980. In U.S. dollars (1970 prices) the real growth was from $633 million in 1960 to $1.9 billion in 1980. On a per capita basis, the GDP (in 1970 prices) grew from $512 in 1960 to $871 in 1980.

Economic performance during 1960-1970 was determined largely by the pace of primary product exports, fluctuations in export prices, and general developments in international markets. In addition, the rapid expansion of the industrial sector, which enjoyed an enlarged market (CACM), began to make a significant contribution. Negative effects of temporary declines in export volume or prices were mitigated by constantly rising public expenditures, which served to maintain the growth of the economy, but at the expense of budgetary and balance of payments problems and an increase of foreign debt.

The economy increased its dynamism during 1970-1975 with an average annual GDP growth rate of 7.5 percent. However, in 1974 the rate fell to 5.5 percent, and in 1975 it sank to 2 percent, which caused per capita output to decline. Nevertheless, in 1976 the economy resumed its previous growth rates and continued to show progress through 1978. Once again growth was mainly powered by exports (export prices, especially coffee, had improved) and heavy public spending, mostly with borrowed funds. In addition, the increased export earnings revitalized the construction and service sectors.

During the past two decades, economic performance was very impressive and the associated social benefits were considerable. However, these social benefits were obtained at a cost which increased rapidly between 1975 and 1980 as measured by the government's budget and current accounts deficits. The former grew from 428 million colones in 1975 to 3,371 million colones in 1979 (a sevenfold increase), while the deficit in the current account of the balance of payments almost tripled from $217.6 million to $684 million in 1980, despite the improvement in exports. Inflation became a problem in 1974-1975 with the oil crisis, but its effects were minimized between 1975-1978 by heavy imports. It reappeared as a serious problem when foreign exchange reserves ran low in 1979. As will be explained in detail below, these and other factors have resulted in an economic crisis of major proportions, such that economic performance is now negligible.

All during this 20-year period of sustained but uneven growth, open unemployment remained quite low. During 1960-1980, the rate ranged from 4 percent to 6 percent. The current labor force of approximately 725,000 persons is small, even though women have entered it at a rapid rate. Employment grew faster than the labor force during the latter part of the 1970s. The expanding public industrial and commercial sectors were able to absorb labor that left the lower-paying agricultural sector, where underemployment had always been significant.

Despite the consistently high employment rates and occasional labor shortages experienced by some industries in certain skill categories, wage rates remained generally competitive with, although somewhat higher than, Costa Rica's CACM partners. However, social changes mandated by the Government now impose a 26 percent surcharge on top of wages and benefits. These have increased steadily during the 20-year period and might have served to dampen somewhat the demand for labor in favor of more capital-intensive production methods.[2]

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[2]The subsidization of capital through consistently overvalued exchange rates and low interest rates from the nationalized banking system has probably intensified this trend. On the other hand, the fact that payroll surcharges and other revenues have gone to provide direct subsidies or funding for social services may have also contributed to lessen pressure for increased salaries and wages.

Labor productivity grew satisfactorily during 1963-1973, led by industry, agriculture, and utilities. However, the growth rates began to decline in 1973-1974 and registered negligible growth for the economy as a whole during 1973-1978. Productivity declined in industry by 0.3 percent, but the worst performer was the public sector, which declined by 4.2 percent during that period. Productivity has probably continued to decline through 1981.

2. Sectoral Distribution

The economy experienced significant sectoral changes between 1960 and 1980, especially with regard to the relative importance of agriculture and manufacturing. Agriculture's share of GDP fell from 26.2 percent in 1960 to 17.7 percent in 1980, whereas manufacturing rose from 11.3 percent to 22.2 percent during the period. The construction and service sectors remained remarkably stable over the years.

Growth in the various sectors was very uneven. Agriculture was affected by several exogenous factors including climatic and international market conditions. It maintained a 4.3 percent real rate of growth until the mid-seventies, after which it began to decline. As of 1981, the sector had not yet recovered its former dynamism, although performance in different crops has varied considerably. Rice and coffee production has continued to increase, assisted by strong Government support, but banana output has been hurt by strikes, while sugar output has declined and excessive slaughtering has adversely affected cattle breeding.

The industrial sector expanded at an average rate of 10 percent per year through 1977 despite suffering a serious setback in 1975 as a result of the world oil crisis. Food products and textiles (traditional consumer items) accounted for a large share of this expansion, but chemical, pharmaceutical, and metal fabrication industries also contributed significantly. The decline, which began in 1978, has continued through 1981, when the growth rate was a mere 1.1 percent, and is attributable to the high cost of imported industrial materials and contraction of the local and CACM markets.

Even though there are a large number of small- and medium-size establishments, Costa Rica's industrial structure is highly concentrated with a few establishments generating the major share of employment, output, and manufactured exports. In 1975, for instance, those companies that employed 200 or more persons (less than 2 percent of all manufacturing enterprises) employed about a third of the manufacturing labor force and generated about 44 percent of the sector's value added. At the other end of the scale, enterprises that employed less than 20 persons comprised over 80 percent of all establishments, employed 20 percent of the labor force, and produced only 10 percent of manufacturing value added. A recent study reports that those industrial subsectors that generate the largest shares of value added and employment are in fact dominated by the activities of one or two firms.

Despite the pronounced shifts in output and employment patterns, Costa Rica has actually proceeded along a fairly balanced development path. Industrialization has been somewhat emphasized over agriculture in Government policies, but agriculture continues to play a major role in development strategy and contributions to employment and income.

3. Private and Public Investment in Industry

The Costa Rican economy can be characterized as competitive and open in that there are no political or social barriers to entering into almost any type of economic activity or to competing with others for access to credit, labor, markets, or materials.

Although the limited data available (i.e., balance of payments series) only partially reflect the total level of private transactions for a given year, and not cumulative amounts, it is clear that the inflow of private capital from abroad increased substantially in the sixties. Net private capital transfers increased from $8 million in 1960 to $61 million in 1970, an average growth rate of 22 percent. Private capital continued to flow into Costa Rica throughout the seventies until 1978, when the net inflow changed to a net outflow, a sharp reversal of the trend.

Total investment flows, Costa Rican and foreign, also show a sharp decline between 1979 and 1981, from $317 million to $190 million. From 1976 through 1979, the private sector contributed 90 percent of total gross investment in the economy. Of this, a little over 17 percent went to industry. At the same time, the share of foreign investment in industry decreased from 45 percent of total private investment for 1976 to 15 percent for 1979. Unfortunately, the absence of cumulative figures does not allow for an assessment of the ownership structure in industry; that is, a comparison between private and public, and Costa Rican and foreign participation.

Published data based on extensive interviews carried out earlier this year show that foreign investors own a 50- to 100-percent share in those enterprises with any foreign capital participation. Foreign investment in Costa Rican industry comes largely from the United States and Mexico, followed by Japan and West Germany.

There has also been considerable Government intervention in the economy in terms of allocation of credit, price controls, and Government ownership of certain basic activities, including electricity, railroads, petroleum products, cement, insurance and, very prominently, banking, with its ensuing capacity to influence and control economic activities. In 1974, the Government established CODESA (Corporacion Costarricense de Desarrollo S.A.), an investment corporation, to buy majority shares in or initiate various businesses which it believed were needed for development purposes. Although the initial intention was to sell the shares off to private investors, they remain with CODESA, which has become a virtual holding company for Government-owned enterprises.

Public investment as a share of total investment in the manufacturing industry rose from approximately 16 percent in 1960 to 23 percent in 1970 and then increased sharply, with the advent of CODESA, to average 35 percent for the years 1976 through 1979 (see Section II-A for a discussion of CODESA).

4. Income Distribution

Costa Rica compares favorably with the rest of Latin America in its distribution of income and formation of a middle class. That group, represented as the middle three quintiles of families (as defined by average income), increased its share of total income from 34 percent in 1961 to 43.6 percent in 1974. Subsequent data are not available, although little change is thought to have occurred since then. That gain by the middle class was made mostly at the expense of the top 20 percent group. Unfortunately, however, the bottom quintile also lost some ground. In fact, the overall economic gains made during those 13 years were not shared, at least in comparative terms, with the bottom 10 percent of families, which continued in extreme poverty. In 1974, their income amounted to only 27 percent of the national average in that year. Eighty percent of that lowest income group lives in rural areas.

Although the cash income share of the lowest group may not have increased much since 1974, it is most likely that their standard of living has improved as a result of the substantial transfer to them of noncash resources of food, housing, health and nutrition services and, in some cases, cash payments through the Family Assistance Program. Real gains are evident from the significant improvement in social indicators.

The gains made by the middle income group are attributed to several factors: (1) upward mobility opportunities from industrial expansion; (2) improved education of greater numbers of people; (3) expanded public sector employment; (4) relatively wide distribution of ownership of industrial property with many small-scale enterprises; (5) prominence of middle-size farms in the overall land distribution pattern in the country; and (6) rapid decline of the population growth rate among the middle-income groups, thereby making them better able to improve their standard of living.

5. Balance of Payments and Foreign Debt

The total foreign debt of Costa Rica has reached an extraordinary level, estimated at over $4 billion, or nearly $1,700 per capita. The country has been unable to meet its obligations since 1981, and arrears on principal and interest continue to mount. Debt servicing in relation to exports increased substantially from an average of 10 percent between 1970 and 1977 to 24 percent in 1979, putting enormous pressure on the economy and on the ability of the manufacturing sector to reorient production. It is estimated that total principal and interest due from the last quarter of 1981 through 1982, plus arrears, would equal $927 million, equivalent to approximately 65 percent of projected commodity export earnings during this period.

The structure and terms of borrowing deteriorated steadily during the seventies, as the total debt climbed steeply. While loans outstanding to commercial banks (commercial terms) equaled the total from multilateral and bilateral sources (concessionary terms) in 1972, this ratio changed to 2:1 in 1979. The average interest rate for the total debt also doubled (from 6.8 percent to 15.1 percent) in the period, while average maturity terms shrank from 15.1 to 9.2 years.

The balance of trade, as a result of domestic policies and a deterioration in the terms of trade for Costa Rica's principal exports, began to produce negative numbers during the sixties and worsened during the seventies. During the 20-year period, exports grew at an annually compounded rate of 15.9 percent, but imports grew at the higher rate of 17 percent.

While in the earlier years of the last two decades a considerable but varying part of the imbalance in trade was compensated for by direct foreign investment, in recent years current account deficits have been met by a net loss in reserves and increased borrowing and refinancing. In the four years 1978-1981, Costa Rica experienced a loss of reserves of $358 million.

However, the de facto devaluation of the colon in late 1980 and during 1981 produced a considerable contraction of imports without a loss in net export earnings, thereby reducing the trade deficit from $539 million in 1980 to $220 million in 1981. However, the service of the external debt and other interest payments during 1981 amounted to $289 million,[3] equivalent to 70 percent of the current account deficit for that year.

As discussed elsewhere in this paper, the high level of foreign debt, while attributable in part to several structural factors (especially an import substitution policy not balanced by adequate export incentives and sound monetary policies), has as its most direct cause mismanagement of fiscal and monetary policies over the past decade.

C. Resource Allocation Goals and Policies

During most of the period under review, the Costa Rican Government's expressed philosophy has been to improve the living standards of the poorer segments of society--an equity-oriented, income redistribution philosophy. The Government's development strategy has emphasized programs that would support expansion of income-producing opportunities and provision of basic social services for the lower income groups, concurrent with investments and policies directed towards overall economic growth, such as basic infrastructure, education, and agricultural and industrial expansion.

The high level of concern for equity reflected in expressed policies and by heavy public sector investments may be attributed to the nature of the political system. The democratic process encourages participation of all citizens in the selection of political leaders and the debate of economic and social issues. In turn, political leaders must attempt to respond to the demands of the electorate. During the period under review there has always been an active, vocal opposition party or coalition on hand to debate every policy and implementing mechanism proposed by the Government. Since the executive branch must obtain legislative approval for most measures of any significance affecting the economy, the principal interest groups participate in the decision-making process. The free press has also been an important forum through which competing interest groups register their opinions on, and seek support for, issues of the day. Although impossible to quantify, there can be no doubt that the equity orientation of the

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[3] This is the amount actually paid and not the total owed.

crucial resource allocation decisions is the result of the participatory political process.

While the efficiency and long-term effectiveness in achieving these stated goals have been compromised by the burden of an enormous bureaucracy, the enthusiasm with which the political leadership subscribes to them has not diminished, even at this time of crisis. The fact that the considerable social and economic gains of the past two decades are now being undermined by the country's inability to repay the heavy foreign debt that had contributed towards making those gains possible has not yet permeated the electorate nor prompted the leaders to reappraise the means chosen to achieve the goals.

D. Public Sector Program Funding

As noted above, the public sector plays a large role in Costa Rica's economic and social development process. In striving to attain their ambitious social and economic development goals, successive governments have initiated numerous programs and built an elaborate array of public sector institutions to plan, administer, control, and/or conduct public- and private-sector activities. As is the case in many countries, programs and institutions take on lives of their own, and it becomes very difficult for the Government to modify or curtail their activities. Costa Rica's experience amply illustrates this phenomenon but reveals even greater difficulties with respect to the capacity to control the allocation of resources, growth of expenditures, and administration of many programs. Legislative and constitutional provisions, reinforced by natural laws of bureaucracies and prevailing political philosophy, cause extreme pressure for continued expansion of existing programs and creation of new ones, and cause implementation rigidities.

Until 1982, the central Government budget process did not attempt to exercise control over the annual budgets of the numerous autonomous or semiautonomous agencies that account for a very large proportion of public-sector expenditures.[4] The autonomous institutions' annual programs and budgets are determined by their boards of directors (appointed by the Government) and are supported by revenues from a great variety of sources: direct subventions from the central Government budget (often earmarked by law or the Constitution); revenues earned on taxes levied directly by the institution; issuance of bonds;

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[4]A consolidated public sector budget was introduced in 1982 to correct this deficiency.

or loans contracted with the national banking system, foreign commercial banks, or donor agencies. This process has resulted in excessive growth of some of those institutions as well as in costly financing practices, the effects of which are now being felt as a major part of the large public sector foreign debt.

A related problem that also limits the central Government's control over budget allocation is the extensive use of earmarked tax revenues. Approximately half of total tax receipts are earmarked for specific agencies and purposes. Once established, the implementing institutions become accustomed to the regular inflow of resources, and plan their operations around that supply rather than the real demand for services. If a new demand arises for public sector revenues, it becomes virtually impossible to obtain them by reducing some existing earmarked allocation. Consequently, serious distortions arise between the need for resources and their allocation.

E. Sociocultural Factors Affecting Entrepreneurial Activity

Costa Rica's population is very homogeneous, with a mostly Spanish heritage, and its history has been free of any significant social or cultural conflict. This cultural homogeneity and the relatively equitable distribution of land and income, particularly in the central plateau where the vast majority of Costa Rica's population has lived, has contributed to the evolution of a large middle class oriented towards productive activity and an absence of social or racial barriers to entrepreneurial pursuits. The historical importance of a large segment of small- to medium-scale farmers (coffee, sugar, dairy cattle) working for their own account, combined with the development of a large, well-educated, and culturally homogeneous middle class, may have fostered the entrepreneurial spirit that is evident today in the relatively large number of small-scale manufacturing, commercial, and service enterprises present in the economy.

The high levels of education and political sophistication encourage active popular participation in the country's political system. Although political differences are actively debated, there is widespread consensus and commitment to the political system and form of economic organization. Capitalism and the private enterprise system are highly prized by the vast majority, although tempered by a strong predilection for extensive public sector intervention and social welfare programs in pursuit of equity.

II. PUBLIC POLICIES

A. Public Investment

Since 1960 Costa Rican governments have invested heavily in physical infrastructure, agriculture, and social services. The pace of such expenditures accelerated steadily during the period with only a slight decrease in the rate of expansion during the administration of the Unification Party in 1966 to 1970. Although the positive impacts of these investments have clearly been great, the costs have been very high. As has become evident from the current financial crisis, these costs are considerably more than the country could afford. Investments in manufacturing enterprises were minimal until the mid-seventies when they began to grow rapidly with the advent of CODESA. That experience has added to the current dilemma.

1. Physical Infrastructure

With the financial assistance of multilateral and bilateral development assistance agencies (CABEI, IDB, IBRD, AID, and others) Costa Rica has built an impressive network of highways and feeder roads throughout the country, connecting agricultural areas with markets and facilitating efficient trade with Central America and Panama. An extensive electric power generation (hydroelectric) transmission and distribution network has been developed, providing relatively inexpensive power for production and consumer purposes. An efficient telecommunication system has also been installed. The two ports have been expanded and railroads at least maintained in good order. Most of the capital costs of these investments have been derived from foreign donor loans at favorable terms. Overall, Costa Rica's physical infrastructure investments have been well planned, executed, and financed. The engineers have done a good job.

2. Agriculture

The Government has not entered into direct production of agricultural products. It has left that entirely to the private sector but has provided producers with numerous forms of incentives, controls, protections, and technical support. The greatest investment has been in the form of subsidized production credit, particularly for coffee, although credit for beef cattle, rice, and diversified production by small farmers has increased steadily during the last decade.[5] The Ministry of Agriculture provides assistance to farmers through its research and extension services, with considerable collaboration from the University of Costa Rica. Also, farmer cooperatives receive technical and credit assistance from Government agencies, the Government Coffee Board regulates the marketing of coffee, and the Consejo Nacional de Produccion (CNP) maintains minimum prices for basic grains.

Although successive administrations increasingly have supported or regulated the agricultural sector, industry and urban interests have consistently received priority treatment at the expense of agriculture. For example, production of basic food products (e.g., corn and beans) has suffered because of price controls and inadequate support. Similarly, protective tariffs for industry increase the cost of agricultural inputs, which when combined with price controls results in deteriorating terms of trade for at least part of the agricultural sector. Within agriculture, traditional export crops have been favored relative to food crops, with the exception of rice which has received strong support.

3. Social Services

Costa Rica is noted for its extraordinary investment in the education of its people--"more school teachers than soldiers." Education is only one piece of the extensive system of social services provided. Others include health services through the Social Security or health clinics systems, and the family welfare assistance program (health, nutrition, housing, cash transfers). Although it is impossible to discriminate between the effects of these programs and the effects of the general increase in income, there can be little doubt that the social services programs have contributed significantly to the major social welfare gains achieved by Costa Rica during the past 20 years (as measured by literacy rates, life expectancy, number of university students, nutritional status, and child mortality). These gains have been a remarkable achievement for which the Government can be proud; but the costs borne by the taxpayers (past and future), and directly by employers and employees through payroll taxes, have been and will be great. It is questionable whether the services can be sustained at

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[5]Credit increased in real terms through 1978 but declined thereafter. In 1981 credit for crops represented only 75 percent of the 1978 level, and livestock received only 47 percent of the 1978 volume, all measured in real terms.

recent levels; in fact, some are now being cut back for lack of funds.

4. Manufacturing

Until the early seventies, the Government had not entered into manufacturing activities, with the exception of a few traditional monopolies--such as alcohol distilling. In the early seventies, the Government took over the Atlantic railroad from British owners who had been losing money. It also nationalized the oil refinery and petroleum products distribution services from various multinational firms, forming the state-owned Refinadora Costarricense de Petroleo (RECOPE) to handle the petroleum business.

Public investment in manufacturing enterprises increased rapidly between 1974 and 1980 after the creation of CODESA in 1974. The Government's role increased from less than 2 percent of total public investment prior to 1974 to more than 10 percent thereafter. As mentioned earlier, the initial rationale for CODESA was to apply its resources to new initiatives. CODESA was to be a true development bank initiating productive enterprises in concert with entrepreneurs and eventually leaving them to the private sector. This has not occurred; CODESA has become a holding company for mostly unprofitable ventures. It runs a huge annual deficit financed by the national budget and Central Bank. Although some of its enterprises compete directly with the private sector (cement, chocolate, sugar), most of these enterprises are in fields which investors would not enter (gasohol, aluminum production, urban bus transport). These enterprises exact their toll on the economy indirectly by competing for credit that has been allocated increasingly towards the public sector by administrative fiat.

B. Pricing Policies

Even though Costa Rica is basically a free market economy, prices are regulated for a range of goods and services associated with "basic needs." This pricing policy reflects Costa Rica's emphasis on equity-related objectives. The regulated commodities are those goods and services defined by the Government to be part of the basic consumer "basket," including: food items such as milk, cheese, rice, corn, tortillas, flour, bread, pastas, meat, chicken, fish, tuna, eggs, beans, edible oil, sugar, coffee, and salt; low-cost school uniforms and other selected apparel and shoes; utilities and services such as electricity, water, and public transportation; pharmaceutical products; selected household items; and some construction materials.

Prices for these items are set by the Government, based on its analysis of the purchasing power of the low-income consumer. In order to maintain these prices and still ensure an adequate supply, the Government provides subsidies (for example, for imported grains, transportation, electricity, etc.) or establishes quotas for products that must be sold locally at artificially low prices (coffee, sugar, meat). Since these last products could be exported, the quotas and regulated prices represent an important opportunity cost.

The Government also established minimum wages for labor. Although many small-scale enterprises probably ignore the minimum wage, the effective cost of labor to employers is considerably higher than the opportunity cost of labor.

The pricing of capital is discussed elsewhere. However, it should be emphasized here that through its interest and exchange rate policies, the Government has consistently under-priced credit and overvalued the colon. This has contributed to the development of capital-intensive industry.

Overall, pricing policies of the factors of production have not adequately reflected the scarcity value of resources. This, in turn, has contributed to many of the structural distortions that affect the economy and has helped to bring about the current economic crisis.

The current crisis has brought increased attention to the question of pricing policies. On the one hand, the Government has recognized the need to eliminate subsidies for transportation, utilities, and fuel. However, the very rapid increase in prices since 1979 (see Table 1) has resulted in intensive pressure on the Government to increase minimum wages, continue and strengthen price controls, and utilize a multiple exchange rate. Because of the Government's historic philosophy of protecting its low-income constituency, it appears likely to continue with these policies, despite the current crisis.

C. Trade and Industrial Policies

Since 1960 Costa Rica's basic economic strategy has been to expand industrial activity in order to absorb a growing urban labor force and reduce dependence on the export of traditional agricultural products, while simultaneously strengthening its agricultural sector. This has meant pursuing an import substitution/infant industry policy in concert with its Central American neighbors and, more recently, attempting to expand exports to other international markets.

Table 1. Consumer Price Index, 1960 Through June 1982
(1975 = 100)

Year	Index	% Annual Increase
1960	41.9	
1965	46.5	2.1
1970	52.7	2.6
1971	54.3	3.0
1972	56.8	4.6
1973	65.5	15.3
1974	85.2	30.0
1975	100.0	17.4
1976	103.5	3.5
1977	107.8	4.2
1978	114.3	6.0
1979	124.8	9.2
1980	147.4	18.1
1981	202.0	37.0
Through June 1982 (estimate)	306.0	51.5 (first 6 months)

Source: International Monetary Fund, International Financial Statistics, Supplement on Price Statistics, Washington, D.C. 1981, 1982. Counsel, Consultores Economicos y Legales, San Jose, Costa Rica, Mayo 1981.

1. Import Substitution

Much of this strategy has revolved around the common measures adopted by the five Central American countries through the Central American Common Market (CACM) mechanism. These policies and their impacts on Costa Rica are described more fully in Section III. A brief description of the principal measures adopted by Costa Rica, in concert with the CACM, follows.

Tariffs. Tariffs have been the key instrument by which the import substitution policy has been implemented. High protective tariffs apply to most imports of finished goods from outside the region, whereas imports of raw materials, semi-finished goods, and capital equipment required by the fledgling industries are exempted from tariffs if these goods are not produced in the region. Different levels of exemptions are negotiated for different categories of industry, depending on their economic importance to the economy.

Tax incentives. Priority industries have also benefited from tax holidays of 6 to 8 years on income taxes, and 4 to 10 years on net worth. The tariff and tax exemption were supposed to be discontinued at the end of prescribed periods but extensions have become the rule and no extension request had been denied as of 1978. The net result of the protective tariffs, combined with the tariff and tax exemption, has been a strong, effective stimulus for investment in manufacturing industries and a significant revenue loss for the treasury.

Exchange rate. The colon has been maintained artificially overvalued all during this period, as is further explained below in Section II.D. This policy has favored imports over exports and contributed at least as much as the CACM protection, and other incentives discussed above, towards the installation of excess capacity in some import substitution industries. Furthermore, capital-intensive production has been favored over the more intensive use of labor in a country where capital is relatively scarce and labor more abundant.

When multiple exchange rates have been employed (1960-1961, 1967-1969, 1971-1973, and 1981 to the present) exporters received colones in exchange for dollars earned at the less favorable official rates. Importers of finished consumer goods have been discriminated against by being forced to purchase dollars at the higher free rate. The inducement to import capital equipment and raw and semifinished goods duty free and to initiate protected import-substitution manufacturing enterprises was, therefore, very strong. On the other hand, these policies have discouraged investment in production of intermediate goods for which protection has often been negative.

Paradoxically, while the chosen industrial strategy was to replace imports by domestic production, manufacturing activity has become very import-intensive, substituting raw and semi-finished goods for finished products. This import intensity of manufacturing implies a significant rigidity in connection with balance of payments adjustment policy. The Government is forced to choose between continuing trade imbalances and the sectoral stagnation that would result if imports of inputs for manufacturing firms were constrained. The Carazo Government chose not to make the adjustment, preferring instead to increase foreign indebtedness at a rapid rate in order to avoid this tradeoff. Moreover, the granting of protection has been very permissive, in the sense that those activities which required the highest protection because of their lack of comparative advantages, were granted whatever protection was needed to make them competitive. As a result, little market discipline has existed within the manufacturing sector and the composition of its output does not reflect the sector's internal comparative advantages. In addition, the granting of protection has been very vulnerable to the political pressure of organized vested interests.

2. Export Promotion

By the late 1960s, recognizing that the CACM would not suffice as a market for Costa Rican manufactured goods, the Government began to take measures to expand nontraditional exports to markets beyond the CACM and thus build a broader export base for the future. A number of measures were taken during the next decade to promote such exports. The first step was to establish an export and investment promotion center (CENPRO) in 1969 to assist businesses to market their products or establish export-oriented businesses.

A series of financial incentives was created to make exporting more attractive. In 1973, a system of income tax credits equal to up to 15 percent of the f.o.b. value of non-CACM exports was instituted--Certificados de Abono Tributario (CAT). These credits have been used extensively, thereby making exporting more profitable, compensating at least in part for the negative effects of exchange rate policies. Many exporters have indicated that they could not profitably compete in world markets without this incentive. However, in 1978 the value of CATs issued amounted to only 79 million colones against exports of over 1 billion colones, indicating that this instrument was taken advantage of for only 7.7 percent of all exports, or half the allowable rate.

In 1978, another export tax incentive was introduced. The CIEX system provides a tax credit to firms that increase their exports from one year to the next. The effects of this mechanism could not yet be assessed because of its recent introduction, although initial indications show it to be less effective than the CAT in rewarding exporters. A drawback or re-export scheme initiated earlier provides import duty exemptions to firms that process imported inputs and export the total finished product. By the end of 1978, 34 firms had taken advantage of the scheme. This program has created new employment opportunities in the manufacturing sector, and it may be presumed that it has also contributed positively to labor productivity, although no figures are available. Nevertheless, it is thought that even more firms would take advantage of this program if administrative procedures were streamlined.

While the CAT, CIEX, and drawback schemes are all fiscal incentives for exports, Costa Rica has maintained several explicit fiscal disincentives as well. Most important, all exports are taxed, with the highest rates applied to the major traditional exports. In 1978, export taxes provided 17 percent of Government revenue.

In sum, the combination of high tariff protection for finished and semi-finished goods, an overvalued exchange rate, tariff exemptions, and tax incentives for import-substitution industry, together with the equivocable support for non-CACM exports, has caused structural distortions in the economy: cheap capital versus labor (especially in import-substitution industries), excess production capacity, sluggish exports, expensive consumer goods, and a generally inefficient economy. Financial/credit policies discussed in the following section aggravated the situation. On the other hand, the same trade and industrial policies have stimulated the development of a significant industrial base, at least part of which could survive in a less protected environment and contribute to the growth of a more export-oriented manufacturing sector.

D. Analysis of Policies That Affect the Formation and Use of Capital

The policies that have generally been applied and which significantly affect the formation and use of capital may be grouped into three general categories for analysis:

- -- Fiscal and tax policies (tariffs, incentives, etc.)
- -- Monetary policies (currency, foreign exchange rates, export receipts, capital export regulations, etc.)
- -- Credit and general banking policies (interest rates, guarantees, _topes_,[6] etc.)

Unquestionably the interaction and effects of one type of policy vis a vis the others make attempts at strict categorization an essentially academic exercise. It is equally difficult for the legislature or Government to harmonize these varied policies to assure that each regulation meets the intent for which it was created. Thus, regardless of their intent, policies should be evaluated and validated only on the basis of the results that they have produced, not separately, but in the context of the whole environment of policies and institutional

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[6] _Topes_ refer to a limit or quota placed on credit which banks are permitted to lend to specific sectors.

behavior of which they are a part. Nevertheless, when considering policy changes, each measure must be assessed separately to determine the feasibility of change.

In the case of Costa Rica, policies such as high tariff protection (on its own and as part of the CACM), investment incentives to profits and capital expansion (for manufacturing), and reliance on indirect taxation (tariffs, taxes on consumption, taxes on exports) have made capital relatively cheaper than labor and contributed to the accumulation of capital.

Monetary policies, which until late 1981 supported an overvalued colon, combined with low interest rates offered by the SBN, have encouraged the exportation of capital and savings and have rewarded the use of borrowed monies (generally from abroad) in place of accumulated earnings for the expansion of business.[7] Finally, the nationalized banking system, by policy design and by institutional behavior, in a contradictory manner, failed to mobilize domestic savings while it rewarded or subsidized the use of capital with low interest rates. At the same time, implicit policies limited access to credit to firms or persons with substantial assets by demanding high collateral or other forms of guarantees on loans.[8]

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[7]Low interest rates on colon savings deposits paid by the nationalized banking system (SBN) in contrast to the much higher interest rates on dollar deposits in Panama and elsewhere encouraged the conversion of colones to dollars at the overvalued exchange rates and the transfer of the funds to dollar deposits outside Costa Rica. At the same time, inflation in Costa Rica coupled to a fixed exchange rate significantly lowered the effective cost of borrowing abroad to import and produce for the Costa Rican market.

[8]An institutional evaluation of the Banco de Costa Rica by the IDB in 1975 restated the observation previously made in several studies that the bank's ability to evaluate projects (loan applications) and act on such evaluation was very limited, resulting in an over-reliance on guarantees and the borrower's reputation. In light of this conservative attitude on the part of the official banking system, it was particularly surprising to read in various reports that the real delinquent portfolio of the SBN stood in excess of 50 percent of loans outstanding even before the onset of the spiralling crisis. (For additional discussion of this topic see "Evolucion de la Capacidad Creditcia del Sistema Bancario Nacional," Claudio Gonzalez y Asociados, San Jose, 1982.)

A simplified summary of the results of past financial policies on the formation and use of capital can best be made by reference to Costa Rica's present critical situation, involving:

-- An immense (estimated in excess of U.S.$4 billion) foreign debt incurred by both the public and private sectors--largely the result of monetary policy (an overvalued colon), and the ineptness of the SBN

-- Excessive installed capacity in the manufacturing sector (and to some degree in agriculture and construction) because of implicit subsidies to the use of capital over labor (low interest rates, high tariff protection, tariff exemptions for imports of capital goods, overvalued colon, growing payroll taxes, etc.)

-- Relatively little direct foreign equity investment as opposed to heavy borrowing due to the overvalued currency and a lack of differentiated incentives which could have favored equity investment over loans, as well as the heavy emphasis on import substitution and the CACM

-- Significant export of capital and savings as a result of interest rate policies, overvalued currency, tax structure, and expansionary government budgets

III. IMPACTS OF POLICIES AND INTERVENTIONS

A. Evolution of Capital Markets and Financial Institutions

1. Introduction

From the perspective of the current crisis which precipitated so dramatically in 1980-1981 that financial (and credit) indicators appear not to bear any resemblance to the historical series 1960-1980, it would seem irrelevant to explore and analyze the evolution of the financial sector over the 20-year period for possible lessons to guide future actions. However, the opposite appears to be the case for an analysis of the Costa Rican economy generally, and it is certainly the case in the financial area. The crisis, by magnifying the problems, has facilitated the identification of underlying probable causes and the linkages between cause and effect. During a crisis, things happen so fast that the impact of policies and interventions can be evaluated better by isolating these events from other intervening factors.

Despite the temptation to focus exclusively on the specific current difficulties, we have attempted to examine the evolution of the financial sector over a 20-year span, focusing on structural problems and developments resulting from earlier policies and interventions that have influenced greatly the evolution of the private sector, specifically the private industrial sector.

2. General State and Condition of the Financial Institutions

The financial sector in Costa Rica has one singular characteristic that sets it apart from most other "free market" countries in Latin America, that is, the "official" (State-owned, Government-controlled) nature of its banking system with its absolute monopoly on demand and savings deposits. While other financial institutions have operated in the country over the period under study, their resources have either originated abroad (through loans and other forms of intermediation) or have been raised locally in the form of equity or the sale of bonds, savings certificates, and similar obligations.

Because of the absence of other formal mechanisms characteristic of capital markets or because of the negligible effect of existing mechanisms outside of the SBN and COFISA (Corporacion Costarricense de Fomento Industrial) in the channelling of capital to the productive sectors of the economy, this discussion of capital markets and financial institutions focuses on the SBN and COFISA.

The nationalized banking system has been characterized as slow, excessively conservative, and incapable of significantly contributing to the economic development of the country because of its implicit lending policies (see above) as well as its inability to mobilize internal savings to any significant degree. Interviews with private sector companies indicate that even applications for small loans take months to process while other banking services are very poor. The average loan size is very small, which when combined with the large number of people involved in processing the paperwork, results in a highly inefficient system. The absence of a profit motive and real competition in the banking sector is largely to blame for this situation.

As early as 1963, the USAID Mission in Costa Rica recognized this problem and assisted in the creation of a private finance institution, COFISA, in order to create an alternative for the private sector and stimulate Costa Rica's industrial development and its participation in the Central American Common Market (CACM).[9]

While COFISA can generally be characterized as a success story, it has not been totally immune to the problems arising from the structure, policies, and practices of the SBN, or from the more dramatic consequences of the Government's financial and monetary policies. As low-priced, long-term AID funds were used up, COFISA increasingly departed from its developmental (pioneering, risk-taking) role in favor of more commercial terms similar to those of the SBN, albeit processed with far greater agility and enormously superior results. Already in 1969, COFISA's short-term loan portfolio equalled its long-term portfolio and the average size of the loans made was only U.S.$24,600. By 1981, when the average size of the loans outstanding had increased to approximately U.S.$60,000 in current dollars, this represented a negligible increase in real terms, and almost the entire portfolio had terms of under three years and interest rates 1 to 3 points higher than LIBOR.

Barred from capturing internal Costa Rican savings by the effective monopoly of the SBN, favored by the Government's monetary policies supportive of an overvalued colon, and having created a network of clients, COFISA undertook to borrow from abroad for relending in Costa Rica. Through 1981 COFISA had multiplied by 25 times the $10 million that AID had provided with its two loans in the early sixties, becoming the country's single largest source of credit to the private sector.

The SBN is constituted by the Banco Nacional de Costa Rica, Banco de Costa Rica, Banco Anglo Costerricense, and Banco Credito Agricola de Cartago.[10] While formally there is no functional or geographical specialization, there are informal areas of concentration, as for example agricultural credit with Banco Nacional and industrial credit with Banco de Costa Rica. The latter's lending to the manufacturing sector has been

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[9]In 1968 a law was passed that allowed the creation of other private financieras, which are not permitted to accept demand deposits. Thus, by the nature of their funding, they are concentrated in very "high price" consumer financing and personal loans, and have had in the aggregate a very small impact on the development of industrial or agricultural production, or on the total volume of credit. Other mechanisms created later, such as the Bolsa de Valores (stock market), have also had little impact to date.

[10]Charter law of the National Banking System No. 1644 of September 26, 1953 governs the banking entities of the system.

supported by several loans and technical assistance from the Inter-American Development Bank (IDB).

In addition to the qualitative assessment that the SBN has been very slow, unresponsive to private sector needs, and non-developmental in its approach to lending, it has been determined that while COFISA was growing rapidly, the rate of growth of credit granted by the SBN slowed down and, in several years, even decreased in real terms (Table 2 and Figure 1). This problem has been further compounded by the freezing of a significant portion of the portfolio of delinquent loans which were almost automatically re-extended without a new disbursement of funds (Table 3). The exact amounts of overdue loans at any given period during the last 20 years cannot be determined given the "inadequate" accounting practices generally pursued in Costa Rica and specifically by the SBN. Some observers have estimated the aggregate value of the frozen portfolio to have reached a figure in excess of 50 percent of the total portfolio even before the present crisis. By contrast, COFISA's delinquent portfolio before the crisis never exceeded 1.5 percent of total loans outstanding.

The plight of private borrowers was exacerbated from about 1975 on by the growing encroachment of the public sector into the commercial credit markets to finance its deficits. In 1980, the private sector accounted for only 56 percent of total credit outstanding (Table 2) and only 31.4 percent of new loans extended in that year (Table 4).

3. Policies Specific to the Capital Markets and Financial Institutions

In our judgment, the two most important Government and Central Bank policies regarding the nature and evolution of the capital markets and financial institutions in the country have been the following:

1. The 1948 decision to nationalize the banking system for reasons and circumstances no longer relevant. Nevertheless, the system has been repeatedly reaffirmed, even by advocates of free market economics.

2. The decision to support the value of the colon and isolate the Costa Rican market from external inflationary pressures at the expense of international reserves and the possible expansion of the country's exports, while creating conditions favorable to the export of capital and savings (see Tables 1, 5, 6, and 7 and Figure 2 on exchange rates, monetary reserves, and consumer price indices).

Table 2. Credit From the SBN

Year	Total Credit[1]	Private Sector[1]	Total Credit[2]	Private Sector	Total Credit (percentage increase)
1960	878	766	900	784	N/A
1961	915	786	947	813	5.2
1962	970	854	987	869	4.2
1963	1,035	901	1,046	910	6.0
1964	1,195	1,037	1,185	1,027	13.3
1965	1,349	1,153	1,360	1,162	14.8
1966	1,429	1,168	1,418	1,159	4.2
1967	1,543	1,230	1,454	1,158	2.5
1968	1,638	1,282	1,492	1,168	2.6
1969	1,717	1,371	1,482	1,183	-0.6
1970	1,996	1,614	1,592	1,288	7.5
1971	2,500	2,068	1,919	1,587	20.5
1972	2,898	2,332	2,063	1,660	7.5
1973	3,205	2,646	1,805	1,490	-12.5
1974	4,663	3,746	1,900	1,527	5.3
1975	6,303	4,999	2,253	1,787	18.6
1976	7,856	6,153	2,619	2,051	16.2
1977	9,736	7,142	3,023	2,217	15.4
1978	12,435	8,864	3,529	2,516	16.7
1979	17,194	10,638	3,934	2,434	11.4
1980	21,679	12,049	4,080	2,268	3.7
1981	24,974	13,249	2,410	1,278	-41.0

[1]Millions of current colones.

[2]Millions of 1966 colones.

Figure 1. Total Real Credit From the SBN--End of Year Balances
(billions of 1966 colones)

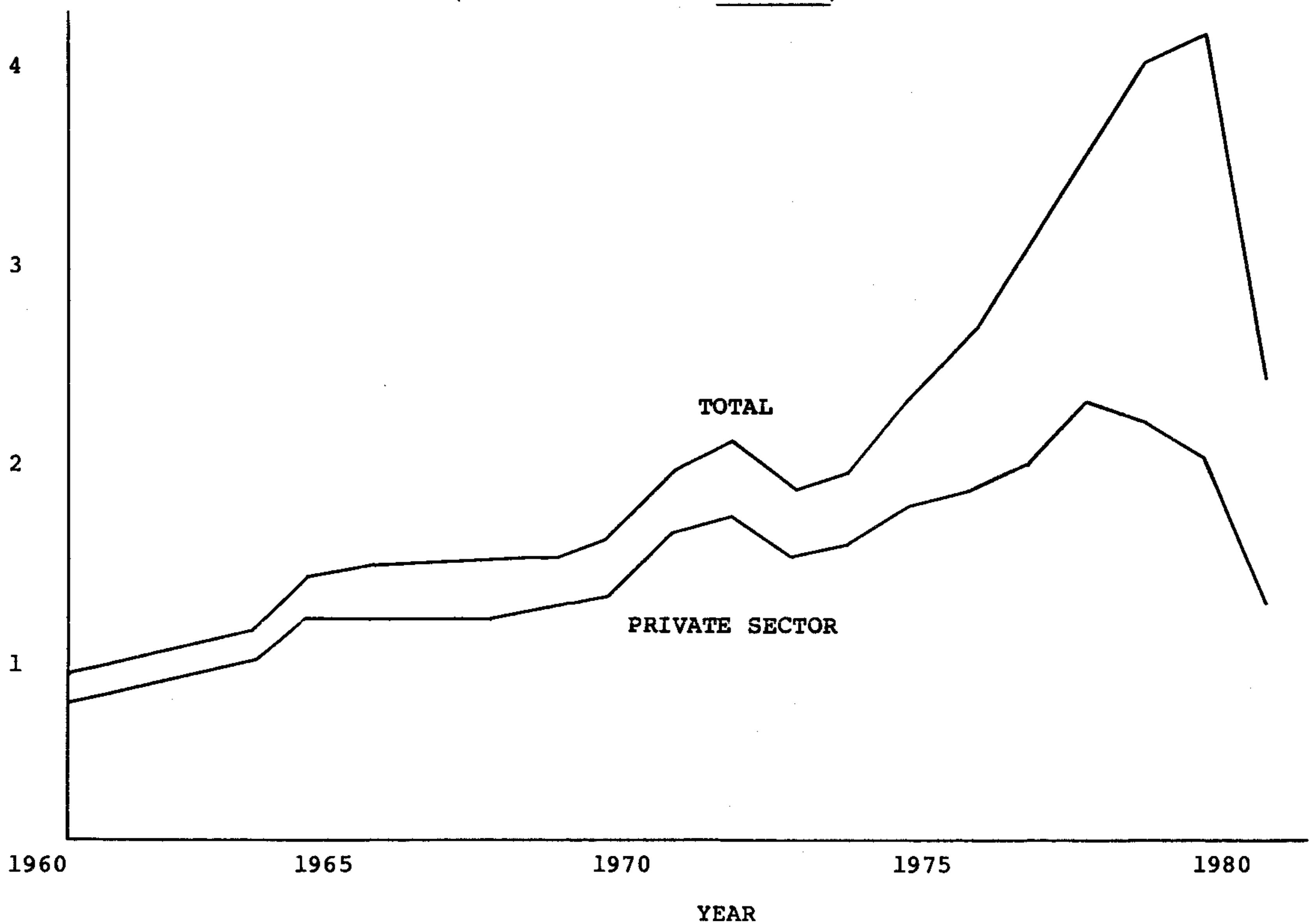


Table 3. Ratio of New Loans to Loans Outstanding, 1969-1980[1]
(in percentages)

Year	New Loans/Total Loans Outstanding
1969	79.8
1970	84.3
1971	90.5
1972	82.5
1973	84.6
1974	92.6
1975	90.0
1976	85.5
1977	79.0
1978	75.8
1979	67.5
1980	59.3

[1]The trend, particularly from 1974 on, reflects the reduction of the level of funds disbursed principally due to the increase in loan-delinquency rates.

Table 4. Private Sector Share of Yearly Increases of Total Credit
(in percentages)

Year	Private Sector Loans/Total Loans
1960	101.3
1965	73.0
1970	87.1
1975	76.8
1980	31.4[1]

[1]Caused by increased borrowing by the public sector, which succeeded to a large degree in "squeezing out" the private sector.

Table 5. Net International Reserves
(millions of colones)

Year	Year-End Balance	U.S.$ Equivalent
1960	91.5	13.8
1961	39.2	5.9
1962	73.7	11.1
1963	45.7	6.9
1964	27.9	4.2
1965	-22.5	-3.4
1966	-90.6	-13.7
1967	72.5	10.9
1968	139.6	21.1
1969	250.9	37.9
1970	172.5	26.1
1971	280.3	42.3
1972	328.6	49.6
1973	428.9	72.9
1974	332.5	38.9
1975	513.0	60.1
1976	1,065.2	124.7
1977	1,985.5	232.5
1978	1,639.3	191.9
1979	1,002.9	117.4
1980	NA	-95.0
1981	NA	-141.7

Source: Banco Central de Costa Rica, Anuarios Estadisticos.

Table 6. Exchange Rates
(colon/dollar)

Year	Official Purchase Price	Free Market Purchase Price
1960	5.60	-
1961	5.60-6.62	6.62
1962	6.62	6.62
1963	6.62	6.62
1964	6.62	6.62
1965	6.62	6.62
1966	6.62	6.62
1967	6.62[1]	7.00-7.55
1968	6.62[1]	7.32-8.22
1969	6.62[1]	6.62-7.27
1970	6.62	6.62
1971	6.62[1] (after 6/24)	6.62-8.22
1972	6.62[1]	8.57
1973	6.62[1]	8.54
1974	8.54 (after 4/24)	8.54
1975	8.54	8.54
1976	8.54	8.54
1977	8.54	8.54
1978	8.54	8.54
1979	8.54	8.54
1980	8.54	8.54

[1]Dual exchange rates, where some products were excluded from the use of the official rate.

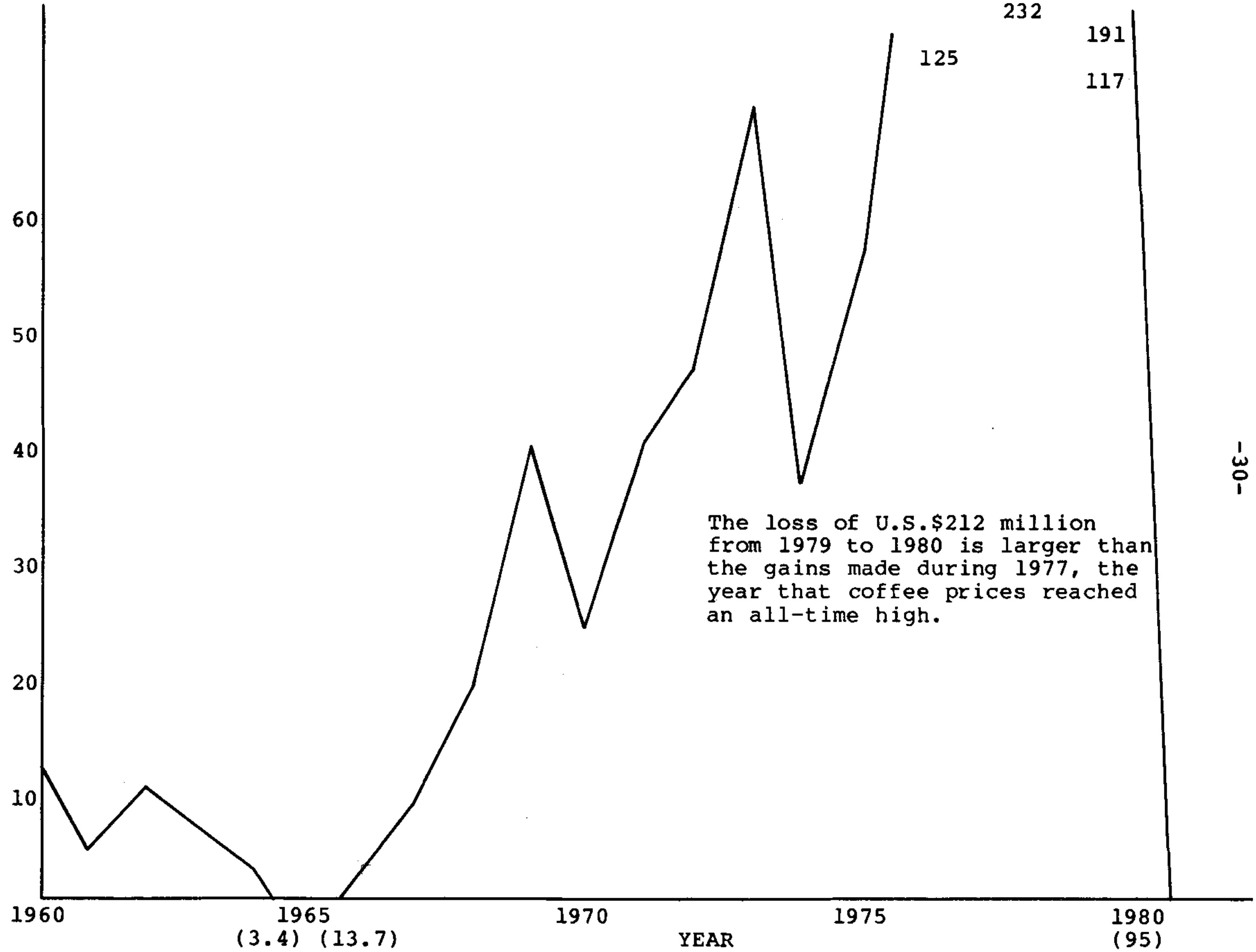
Source: Banco Central de Costa Rica.

Table 7. Exchange Rates, 1980-1981
(end-of-month quotation)

Month	Free Market (Bolsa de Valores) Exchange Rate, Colon/Dollar
1980	
January	8.54
February	8.54
March	8.54
April	8.69
May	8.68
May	8.69
June	8.81
July	9.06
August	10.40
September	10.60
October	11.27
November	14.09
December	14.64
1981	
January	13.28
February	14.04
March	17.29
April	18.83
May	18.92
June	19.30
July	20.84
August	22.99
September	26.33
October	36.66
November	37.40
December	38.00

Source: Counsel, Consejeros Economicos y Legales, San Jose, Costa Rica, Mayo 1982

Figure 2. Net International Reserves
(millions of U.S. dollars)



Among the many regulatory measures enacted over the years affecting the financial markets, the following deserve special attention because of their lasting impact on the behavior of the private sector:

-- The use of topes instead of market demand to allocate credit between various sectors of the economy (see Section III on the Central Bank of Costa Rica)

-- The arbitrary pricing of loans and low interest rates paid to depositors

-- High tariff protection for finished and semi-finished goods with exemptions for capital goods and selected materials imports

-- Ease of borrowing from abroad and of capital repatriation (or even net export of capital)

-- Emphasis on the CACM and import substitution policies for the economic transformation[11] of the private sector, even at the expense of traditional and non-traditional agricultural exports (which were the original creators of capital)

The results of these policies, as they affect the efficiency of the industrial sector, are discussed in several other sections of this paper. However, in terms specific to the capital markets and financial institutions, it may suffice to state at this point that Costa Rica has almost no formal capital market and a very weak financial system.

4. Donor Interventions

COFISA. The Costa Rican Industrial Finance Corporation was established in 1963 (with the assistance of a $5 million AID loan) as a private development finance company to help meet the capital requirements of the private industrial and agricultural

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[11]The stated intent of policies in the financial area was to support industrialization and benefit from Costa Rica's participation in the CACM, providing credit to the private sector in "developmental" terms (long-term, lower than market interest rates, high leverage, reduced guaranties and requirements, etc.). Preferential treatment for small- and medium-size enterprises was contemplated in donor interventions (IDB/Banco de Costa Rica, AID/COFISA) in order to broaden ownership and the private sector concept.

sectors. By 1968, it had made a total of 333 loans for fixed investment and working capital for new or expanding firms totaling $6.9 million.

COFISA received a second AID loan ($5 million) in 1969, the purpose of which was to support economic diversification, CACM industry expansion, and development of a domestic capital market to facilitate the investment of Costa Rican capital within the country. During the next five years, COFISA secured lines of credit from over 70 international banks and changed its focus from long-term to short- and medium-term lending, mainly for equipment imports and working capital.

In 1975, COFISA established an international subsidiary in Panama that would hold foreign currency deposits locally and reinvest in Costa Rica rather than sending remittances abroad or to international banks. In 1978, an AID-financed study concluded that COFISA was a healthy financial institution with "good management and consistent profitability" and recommended that AID permit COFISA to increase its debt-to-equity ratio to 10:1, which was done. By 1980, the company had increased its loan portfolio to $70 million, establishing itself as the foremost industrial financing institution in Costa Rica. In fact, it accounted for approximately one-half the total volume of industrial credit granted in the country.

Costa Rica's financial crisis began to take its toll on COFISA in 1980. By mid-1981, COFISA's borrower delinquency and default rate was on the increase,[12] and new lending activity had dropped and was limited almost exlusively to short-term uses. The Supreme Court's July 1981 decision to allow COFISA's clients to repay their dollar-denominated loans in grossly depreciated colones further exacerbated COFISA's financial crises. Many of the company's clients immediately paid off their loans at a loss to COFISA equal to almost twice its stock value. In April 1982, after a review of COFISA's situation and an Arthur D. Little analysis, the company's foreign creditors granted COFISA a one-year moratorium on its debts to them. Complete debt rescheduling negotiations were to be conducted in the summer of 1982.

AID intends to make a third loan to COFISA this year to assist its recovery from its current predicament and to help it resume its economically critical role as Costa Rica's foremost industrial lender.

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[12]From a historical low of under 1 percent.

Banco de Costa Rica. The Inter-American Development Bank (IBD) has made four loans[13] to the Banco de Costa Rica (BCR), one of the four commercial banks comprising the nationalized banking system (SBN), for relending to small- and medium-size industries. Although all four banks of the SBN lend for industrial purposes, the BCR has become more specialized in that field than the others.

The basic objectives of the loans were to help establish new industries or expand existing ones whose products would replace imports, increase exports, utilize domestic raw materials and/or provide new employment opportunities.

The IDB and BCR placed considerable importance throughout this program upon basing credit approvals on technical appraisal of projects' economic and financial merits as opposed to reliance on collateral for security. IDB provided technical assistance to train BCR staff in project appraisal techniques and required that certain measures be taken in that regard. In fact, clients were required to present to BCR the results of feasibility studies conducted by independent firms to support their loan applications. Unfortunately, the BCR has been unable to attract or retain sufficient staff adequately trained to evaluate the quality of such studies. Furthermore, firms complain of excessive delays and bureaucratic procedures in the loan application/approval process. Nevertheless, the demand for such credit was great during the period and all of the funds were disbursed as planned.

Central Bank. The Central Bank of Costa Rica (CBCR) is responsible for the determination and management of monetary, credit, and exchange rate policies. The credit policies are implemented through a complex system of differentiated interest rates and ceilings (topes) on the amount of credit that each commercial bank may extend to particular sectors of the economy.

By a 1970 amendment to its charter, CBCR was permitted to make loans for productive purposes directly to firms or indirectly via SBN member banks. Using foreign lines of credit, it financed equipment purchases in the industrial sector and administered the $9 million Export and Tourism Promotion Fund.

In 1978, IBRD made a $15 million loan to CBCR to assist the industrial sector to increase production, exports, employment, and manufacturing efficiency. To implement the project CBCR established a new branch, FODEIN (Industrial Development Fund), to make loans to SBN member banks to relend for industrial subprojects.

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[13]1962, $3.0 million; 1965, $4.2 million; 1970, $5.5 million; 1976, $8.6 million.

FODEIN's primary objective is to provide financing to export-oriented industries and to efficient import substitution industries with export potential. FODEIN's subproject evaluation criteria stress financial and economic soundness, balance of payments impact, and employment contribution. A major FODEIN goal is expansion of exports outside of the CACM. Local construction firms and tourism projects also receive priority attention.

The FODEIN financing is for 2 to 15 years, depending on the subprojects and cash flow of borrowers. The bulk of the funds are lent to the banks at 9 percent per annum for relending at a minimum interest rate of 12 percent. As an inducement for the banks to lend to smaller enterprises (equity plus sales not exceeding $150,000), FODEIN only charges the banks 8 percent, giving them an expanded interest spread of 4 percent.

Despite the importance of the role of the CBCR as a provider of credit to the private sector, by far its most important functions are the determination and management of monetary, credit, and exchange rate policies and the facilitation of government borrowing from the banking system. These functions are discussed in detail in other sections of this paper and are central to the team's analysis of the impact of policy on economic development and equity in Costa Rica.

5. Interaction Among Donor Interventions, Capital Markets, and Policy

The evolution of the Costa Rican capital market is best summarized in Tables 5, 6, and 7 and Figure 2. These figures indicate that the SBN failed to mobilize the internal capital market at a pace commensurate with the dynamic growth of the CACM and the Costa Rican private sector. Because the Government and the Central Bank consistently pursued, during a 20-year period, a policy of supporting increasingly overvalued exchange rates,[14] the Costa Rican private sector, and even the public sector, were in fact encouraged to go outside the country to seek financial resources to expand the productive infrastructure and later to meet current obligations, rapidly adding to a mounting foreign debt.

International financial institutions, flushed with very large deposits from oil exporting countries, especially during the mid-seventies, facilitated this process by providing credit

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[14] With the possible exception of the 1974 devaluation.

to Costa Rican borrowers without much apparent concern for long-term trends in the country.[15]

The results of the mutually reinforcing effects of a fairly inefficient banking system, an overvalued colon, the overprotected internal market, expansionist fiscal policies, an obvious loss of efficiency in the public sector, and the easy lending policies of international financial institutions have been a staggering foreign debt and the technical bankruptcy of the SBN and COFISA (and probably a significant portion of Costa Rica's private sector).

The intent of foreign donors was clearly to assist Costa Rica's private sector to expand its productive capacity and take advantage of market opportunities in the CACM and Third World countries. Yet, it is obvious from the results that these agencies failed to influence basic policies affecting trade or to encourage institutions through which their funds were channelled to finance primarily export-oriented industries. AID's second loan agreement with COFISA amd IBD's loan agreements with Banco de Costa Rica after 1970 emphasized the need to develop export (outside of the CACM) industries. However, no such emphasis is reflected in existing loan portfolios, obviously because private investors saw more profitable short-term opportunities in the local and CACM markets and developed projects towards this end. When local funds became scarce, private borrowers went outside the country, benefiting from favorable exchange rates and fiscal policies (incentives). The use of externally borrowed funds compounded the problem of export disincentives, further penalizing the balance of payments and increasing the spiralling pressures on an overvalued colon. Apparently, donor agencies found themselves in a position where they had minimal or no effect on basic Costa Rican Government economic policy, because their principal influence on policy, to deny condition credit, was ineffective since Costa Rica could find credit elsewhere. (See Section I-B.)

B. Evolution of Management and Skill Capacity

1. General State and Condition of the Labor Market

Skilled Labor. Costa Rica's private sector is a beneficiary of the country's longstanding commitment to universal education. That policy, although costly, has resulted in a highly

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[15]According to several interviewees, credit was actually "pushed" by the lenders.

literate, relatively well-educated labor force that adapted readily to changing technologies. We were assured by the business community that overall labor requirements are generally met satisfactorily. There have been shortages of certain types of skilled workers from time to time, but these have apparently not been frequent or persistent.

Labor relations have not posed a problem, especially for the industrial sector where unions have not been strong. Unions are most prominent in the banana industry and public sector. Government regulations set minimum standards for wages and benefits. The most common labor-related complaint concerns the high social payroll charges imposed by Government rather than wage rates per se, or labor availability, skills, or behavior.

Management. Management-level talent is considered adequate for the needs of the private sector. This positive situation is attributed to the large numbers of university graduates in general and business administration graduates in particular, the steady supply of 10 to 15 Central American Business Administration Institute (INCAE) graduates per year, and masters-level graduates from foreign universities. The good living conditions in Costa Rica also encourage Costa Ricans and foreign managerial talent to live and work in the country. Skills are said to meet the needs of the business community, with the exception of specialized knowledge of export procedures, markets, and financing.

2. Policies Related to Manpower Development

Skilled Labor. As part of its overall public education strategy, the Government has given high priority to providing vocational-skills training geared to the country's productive requirements as practical alternatives for youths who do not pursue more academic courses. The Ministry of Education operates an extensive network of colegios agropecuarios (agriculture high schools) and colegios vocacionales (vocational high schools) in which specific technical skills are taught in addition to a basic high school curriculum. It is felt that these schools have been an important source of supply of skilled labor and middle management for the industrial and agricultural sectors during the period.

At the lower end of the scale, the National Vocational Training Institute (INA), sponsored by the Ministry of Labor, trains approximately 220 youths per year[16] in a wide range of skills required by the agricultural, industrial, and construction sectors. INA receives very strong support from the Government, receiving the proceeds of a 1 percent payroll tax on all salaries in the country. It has been assisted by AID and other donors and is discussed more fully below.

Management. Strong Government support for the development of management skills is manifested by the policy of highly subsidized university education for all who qualify academically. This longstanding tradition has resulted in a great expansion of university enrollment during the past 20 years, albeit at a great cost to the national treasury. Evening classes in business and economics are very popular as a great many employed persons pursue university degrees in those subjects to upgrade their skills and earning potential. Graduate-level business administration courses are not available in the country but INCAE appears to meet the need together with returning graduates of foreign universities. Costa Rica has been a strong supporter and beneficiary of INCAE since its inception, as discussed below.

3. Donor Interventions

Foreign donor agencies have played a significant supportive role in the development of manpower resources available to the private sector. The most important contributions have been made for management training at INCAE in Managua and skilled labor training at INA in San Jose.

Management Training. INCAE was founded in 1964 in Managua, Nicaragua as a regional graduate-level business school. It was conceived at a 1963 conference of Central American Presidents as a means of accelerating the region's economic development through advanced education. It has maintained a close working relationship with the Harvard Business School since the outset; Harvard assisted the planning and development of the curriculum, and has provided faculty members to serve full time on INCAE's staff.

The Master's Program of Business Administration is considered equivalent to a U.S. graduate degree. The two-year course is unique in that it is geared toward the management needs of Latin American enterprises. Costa Rica's 155 INCAE graduates

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[16] Enrolled full-time in long-term (two- to three-year) courses. In addition to these students, INA trains several thousand persons per year in short-term courses.

constitute two-thirds of all MBAs currently working in the country. The average salary of Costa Rican INCAE graduates employed in the private sector is approximately $900 per month. The public sector pays considerably less, which is one reason why few INCAE graduates work there.

INCAE offers two other important programs. PAG (Program de Alta Gerencia, or Manager's Seminar) is offered for persons already occupying managerial positions. The six-week program, which charges $3,000 for tuition, focuses on business policy, all aspects of running a business, employee relations, and future planning, using the case-study method. INCAE data show that most PAG participants do not have advanced degrees. During the past 12 years, 182 Costa Ricans have participated in the courses, thus demonstrating the high value placed upon management skill building by the Costa Rican business community.

INCAE's three-day seminars ($450 tuition) have also been very popular throughout Central America. As of 1980, 10,382 persons had participated, of whom 2,264 were Costa Ricans. The seminars offer a range of special studies for business managers. Both the PAGs and seminars are given on a rotational basis among the member countries to facilitate participation. A significant proportion of management personnel in the companies visited by the team have participated in either the PAGs or the seminars.

INCAE has been assisted financially by AID/ROCAP since 1972. At that time, a $3.9 million loan was provided to expand the Managua campus. In 1980, a $1.8 million grant was made with final disbursements anticipated in 1982. Negotiations are now underway for a $3.5 million grant, of which $2.4 million would be for construction of a Costa Rican campus, with the remaining $1.1 million to be used for development of a regional private sector program and an export management course.

Serious consideration has been given recently to moving the INCAE campus to San Jose because of the unfavorable political situation in Nicaragua. The institute has had difficulty recruiting and retaining staff, the student population has been decreasing yearly, and private-sector donations to INCAE have been declining. (In San Jose, the opposite has occurred; a 100 percent increase in donations from the private sector has been recorded in 1982 thus far.)

Graduates of INCAE are considered by the industrial community to have strong managerial capabilities, and it is also felt that the seminars and PAG management courses have been beneficial in providing new insights for mid-career managers.

Skilled Labor Training. INA was established in 1965 as a semiautonomous institution for providing technical/vocational skill training in support of the country's industrial and agricultural development objectives. It began with industrial training programs in electrical installation, auto mechanics, refrigeration, air conditioning, heavy machinery, and electronics. The courses range in length from several months to three years. Requirements for these skills had grown rapidly due to the rapid industrialization of the country during the 1960s and 1970s. Approximately 3,000 young men and women have graduated from the long-term programs, receiving hands-on experience while working with excellent equipment, much of which was provided by foreign donors.

Rural development education is another of INA's areas of special interest. Four regional centers offer courses in agriculture, commerce, and service industries particular to rural areas. Mobile units go out from the regional centers to smaller communities giving mini-courses to persons unable to attend INA programs full time. These mobile units provide training in agriculture and small business practices, among other areas.

INA is 80 percent financed by the 1 percent social payroll contributions made by private firms employing more than five workers; the remainder of the operating budget is financed by the Government. Foreign donor agencies have played an important role in INA's development. The International Labor Organization (ILO) provided important planning and management assistance, and technical assistance for specialized purposes has been given by Israel, Switzerland, Germany, Holland, Austria, Great Britain, and France. IBRD has provided a $1.6 million loan for construction of classrooms, CABEI has contributed $4 million to build various specialty teaching centers, and BID has recently made a loan to INA for relending to graduating students to buy tools.

INA has received mixed reviews from the industries interviewed. Many of the larger firms, especially those in the garment industry, have training agreements with the institute. The contracts provide for specific skills training aimed at the industry's needs. This form of training is thought to be beneficial. However, basic INA instruction is considered too general, with graduates needing retraining by their employers. Despite the criticism, INA appears to have made a positive contribution towards meeting Costa Rica's skilled-labor requirements. However, given the nature of our study, we are unable to judge whether the costs have been reasonable.

4. Interaction Among Donor Interventions, Manpower Development, and Policies

The relationships among donor agencies, the Government, and the private sector have been very productive over the past two decades. Government policies have been very supportive of the industrial sector's needs for trained management personnel and skilled labor, and donor assistance over the years appears to have made significant contributions in both fields. At the present time, complaints from businesses about INA do not suggest that its function is not important but rather that its curriculum should be more directly responsive to industry's requirements. Greater participation by the private sector in INA's management seems appropriate.

C. Evolution of the Availability of Economic Information

We have concluded that a manufacturing firm's felt need for economic (technical and market) information is determined to a large extent by prior decisions about what general market it will serve--Costa Rica, CACM, or non-CACM export. That decision, in turn, has been determined largely by the several basic policies adopted by the Government which have had a preponderant influence on profitability--e.g., import substitution policies, exchange rates, and credit policies. Those policies sent strong signals to entrepreneurs leading them into relatively easy import substitution activities. To pass up a protected CACM-oriented venture in favor of attempting to compete on the world market was very risky, except in special situations.

1. Market Evolution

Costa Rica's industrial development strategy has been largely based on the concept of expanding the country's markets through participation in the Central American Common Market (CACM). Instead of committing to an import substitution effort limited to the small Costa Rican market, the idea was to undertake a regional industrialization drive based on a common framework of protective tariffs and investment incentives.

In terms of its impact on the growth of the industrial sector, the CACM/import substitution strategy has succeeded. However, as will be seen in more detail below, the potential for further growth based on this strategy is limited, and recent declines in industrial performance will require a new emphasis on exports to non-CACM countries.

The impact of Costa Rica's CACM/import substitution strategy can be seen from trends in industrial production and regional exports. Industrial value added (in net terms) increased from $67.7 million in 1960 to $85.3 million in 1963, the year Costa Rica joined the CACM. By 1968, value added had reached $135 million, which represented an average of 9 percent annual growth between 1960 and 1968. Rapid growth continued at a 7.4-percent annual rate between 1969 and 1973, followed by an 8.4-percent growth each year between 1973 and 1978. By 1978, industrial value added had reached $370 million dollars (in 1979 dollars).

Industrial exports, and particularly those to CACM countries, showed similar growth during these years[17] (see Figure 3). In 1960, exports were limited to $2.4 million, almost all of which went to neighboring countries. By 1968, exports to the CACM amounted to $33.6 million, which represents a 39-percent annual growth rate, albeit from a small base. Annual growth in regional exports averaged 15 percent between 1968 and 1973, 17 percent between 1973 and 1979, and 48 percent between 1979 and 1980 (due to the Nicaragua situation).

Until very recently, industrial development in Costa Rica had depended almost exclusively on the domestic and regional markets. This can be seen from the fact that in 1968, 7 percent of industrial exports was directed towards non-CACM countries. By 1973, this figure had reached only 10 percent and in 1978, a somewhat higher 16 percent.

In the last few years, the limitations of import substitution, even with the larger common market, have become increasingly evident. Between 1978 and 1981, industrial value added increased at only 1.1 percent annually, while 1981 actually showed a decline in output. Similarly, in 1981, exports to the CACM region declined 11.9 percent.

Both short- and long-term factors have contributed to this sudden reversal in industrial performance. Short-term problems have included political and economic instability in the region, as well as the acute economic crisis in Costa Rica. However, several long-term factors have become increasingly important. Particularly significant is the saturation of the more obvious import-substitution opportunities. Most consumer products and many intermediate goods would not be economically viable in the region, even with Government support, because of the capital investment requirement and the limited size of the market.

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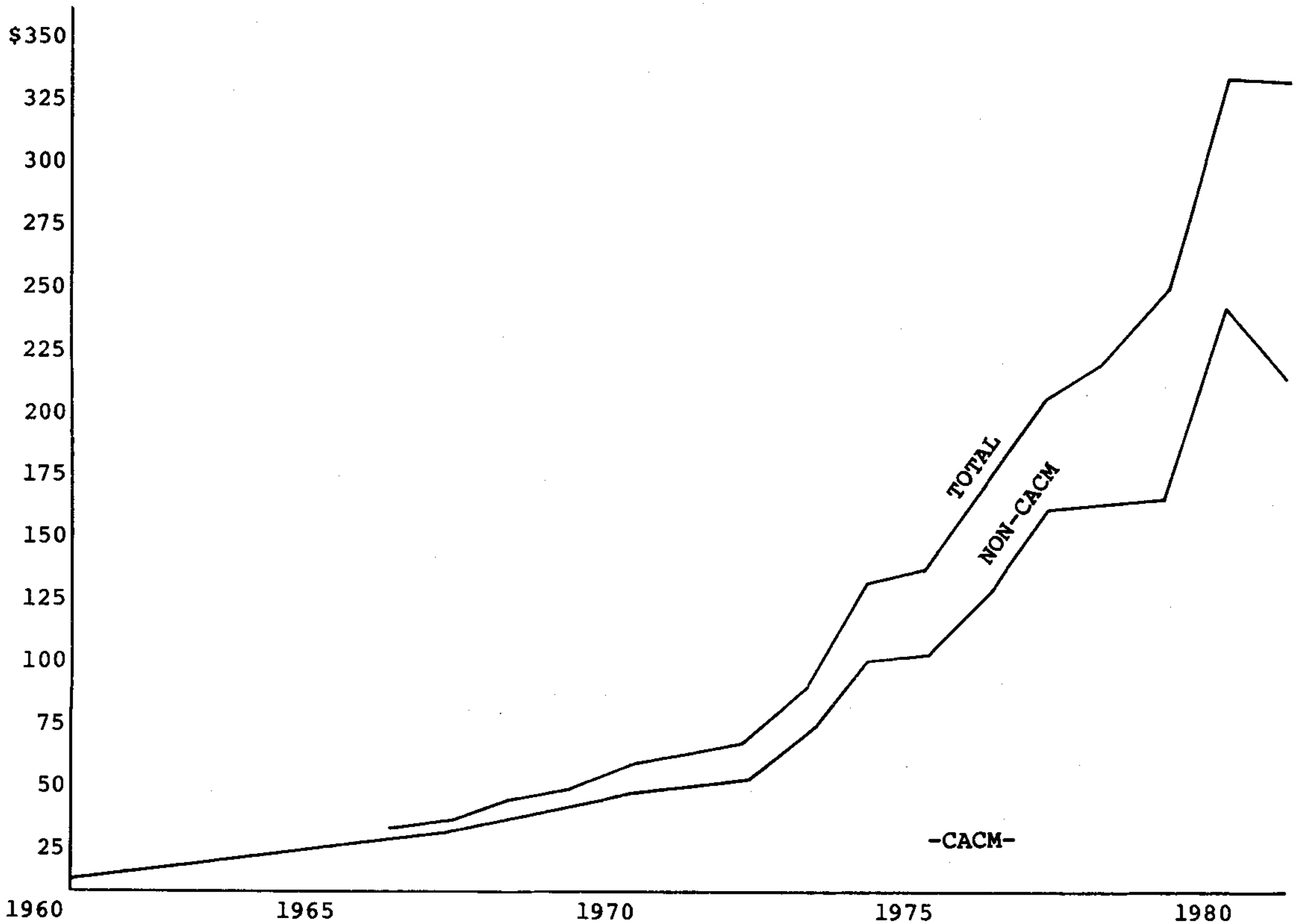
[17]The data reviewed here exclude sugar, coffee, frozen meat, and shrimp.

Figure 3. Exports of Industrial Products[1]
(millions of dollars)



[1]Excludes sugar, coffee, frozen meat, and shrimp.

As both the Government and industrialists began to realize the limits of the CACM, increasing attention was given to exports to non-CACM countries. Thus, these exports increased from $2 million in 1968 to $8.7 million in 1973 and $58.1 million in 1980. Growth has been particularly rapid in recent years as exports to the CACM have generally faltered. Although non-CACM exports have increased rapidly in percentage terms, the actual value is still relatively low.

2. Policies Affecting Information Availability

The principal policies associated with Costa Rica's import-substitution/common market strategy have been described elsewhere in this report. The most important policy instruments have been a common framework of protective tariffs, tariff exemptions for intraregional trade, exemptions on imports of raw materials and equipment, tax incentives, and monetary policies favoring industry.

Overall, this policy framework sent strong signals to potential inventors, both local and foreign, regarding the attractiveness of investing in industry. These policies provided the basis for most of the economic information required by industrialists. For example, potential inventors could easily determine market opportunities (from products being imported), assess the degree of competition (since the number of producers is usually small), and have a good sense of what the selling price and margin could be (derived from the level of tariff protection). Technical information was often provided by foreign partners or intermediate goods suppliers, and marketing in Central American was relatively easy because of cultural familiarity and numerous personal contacts throughout the region.

Policies affecting exports to non-CACM countries and the availability of economic information for potential exporters are much more limited. The principal policy instruments for export promotion include CAT (tax credits for exports) and CIEX (tax credit for increased imports). Information about the former is widely disseminated, and tax credits are generally requested by exporters. CIEX is generally well known or utilized.

Together, these policies do provide industrialists with an incentive to export. However, other policies have the opposite effect. These include taxes on exports, extensive paperwork and bureaucratic obstacles, the multiple exchange rate system, and exchange controls. Some exporters have to (or fear having to) redeem export earnings at a lower rate than they must pay for foreign exchange required to import their materials.

Information about international markets and their more demanding product and price requirements is much more difficult to obtain than for Central America. It can be very expensive to undertake seriously to penetrate the U.S., European, or even Caribbean markets. In recognition of this, the Government in 1969 established the CENPRO (the Center for Export and Investment Promotion), to provide the information, support, and orientation required to encourage exports and investment in export industries. Unfortunately, CENPRO's performance is considered to have been considerably below expectations. The private sector perceives it as being unduly bureaucratic and not providing the active support required to identify market opportunities, create a better "climate" for exporters, and generally help to expedite exports.

3. Donor Interventions

Donor agencies, and particularly USAID, have been very active in supporting a wide range of programs that have directly influenced the expansion of markets and the generation of economic information and "market signals" received by the private sector. The principal donor activities are briefly reviewed below.

CACM. USAID and other donors have played a major role in the development of the CACM and the principal institutions established for its implementation. In total, USAID has provided $232.2 million in loans and grants to the five principal integration institutions. The Central Bank for Economic Integration (CABEI) has received the bulk of USAID support ($204.6 million), which has gone towards industrial and export industry development as well as to infrastructure development. The Institute for Technological and Industrial Research (ICAITI) has benefited from $6.4 million in assistance which was earmarked for a wide range of specific studies of importance of the region's industrial development. The secretariat of the common market (SIECA) has used its $10.2 million in assistance for institutional development, economic and sectoral planning, and economic studies. Assistance to INCAP (a nutrition institution) and INCAE (discussed elsewhere) round out USAID's program to help develop the CACM.

CENPRO. The establishment of the Export and Investment Promotion Center (CENPRO) was supported by USAID, with technical assistance provided between 1969 and 1974. This effort was oriented towards institutional development.

BANIX. This private bank was established in 1980 to provide financing of exports, particularly nontraditional exports. In addition, a trading company subsidiary has been established to help in the marketing and distribution of these exports. The latter organization, which supports exporters with market studies, identification of potential customers, and the management of export sales, was required to meet the needs of potential exporters that are not being provided by other sources. USAID has given BANEX a major stimulus by lending it $10 million. The results of this effort are still not known because of its recent startup. However, many industrialists interviewed indicated their enthusiasm regarding the potential of BANEX.

4. Interaction Among Foreign Interventions, Information Availability, and Policies

The rapid growth of the industrial sector and of industrial exports to the region is evidence of the effectiveness of Government policies and donor interventions in this area. The private sector responded to the strong support provided for industrial development centered around the domestic and Central American regional markets. Although this policy and information framework has contributed to the development of a significant industrial base, the kind of signals received by the private sector has had other consequences, including the following:

-- The lack of any incentives to improve efficiency or production management given the relatively captive market and the protection provided

-- The development of capital-intensive industries which probably would not be economically viable in the absence of the protective policies

-- The evolution of an industrial structure which, for the most part, is not in a position to export to non-CACM markets because of high costs, poor quality, and the lack of an aggressive export policy.

The availability of incentives and information for promoting exports is generally inadequate. Many firms are turning to exports, not so much because of incentives and market information, but because they have no choice if they hope to continue to expand or even survive. Successful exporters interviewed during the course of the study indicated that new markets, and their capability to serve them, were developed entirely through their own initiative and perseverance. Unsuccessful exporters complained of the lack of institutional support in identifying marketing know-how, improving quality and efficiency, and expediting the export process.

IV. IMPACTS ON SPECIFIC INDUSTRIES

A. General State and Condition of the Food Processing and Apparel Industries

The implications of public policies and donor interventions for the private industrial sector can best be assessed by reviewing two case studies. The team selected food processing and apparel because together they represent a major segment of Costa Rica's industrial sector. The analysis presented below, which is based largely on interviews with representative firms, provides valuable insights into the impacts of policies and donor interventions. A guide used for the interviews is provided in Appendix D.

1. Food Processing Industry

The food processing industry consists of an estimated 1,200 establishments, excluding microenterprises which number approximately 1,500 establishments. Even without taking the microenterprises into account, the 1975 Census of Manufacturers indicated that food processing accounted for about 43 percent of the value of output in the industrial sector, 31 percent of sectoral employment, and 15 percent of manufactured exports (excluding sugar and meat).

The structure of the food processing industry, based on the 1975 Census of Manufacturers, is indicated by Table 8. These data, although incomplete, show that most food processing is oriented towards the domestic market while some, based on primary commodities such as sugar, milled products, and meat, are important export products.

The performance of the food processing industry during the past five years has been mixed. In 1977 and 1978, the volume of output (excluding meat, sugar, and coffee) increased 13.7 percent and 9.6 percent, respectively. After continuing to grow at a 6.3-percent rate in 1979, output decreased by 0.6 percent in 1980 and 3.6 percent in 1981.

The food processing industry can presently be characterized as being in a state of retrenchment. The originally rapid growth, centered around opportunities in the local market, has stagnated because of the following reasons:

- -- Reduced domestic demand caused by the economic crisis
- -- Inadequate credit for expansion or working capital

Table 8. Structure of the Food Processing Industry, 1975
(thousands of colones)[1]

Product	Number of Enterprises	Value of Production	Value Added	Fixed Assets	Imported Materials	Exports
Meat and Meat Products	25	250,085	82,838	47,073	1,119	151,871
Milk and Milk Products	17	249,402	35,885	67,590	4,991	23,189
Fruit and Vegetable Preservation	15	95,152	26,467	27,525	33,707	35,644
Vegetable Oils	5	74,615	33,577	34,819	-	3,244
Milled Products	192	1,017,704	320,270	241,441	172,875	372,884
Bakery Products	292	207,998	66,237	50,233	6,882	12,013
Sugar Milling and Refining	129	386,845	134,119	196,966	15,591	19,120
Cocoa, Chocolate, and Confectionary	11	29,250	10,933	23,815	7,452	4,432
Beverages	31	436,113	319,425	133,555	14,866	26,635
Tobacco	5	168,024	123,693	53,704	26,300	-
Other	84	235,645	58,494	49,496	29,228	15,800
Total	806	3,150,833	1,211,940	926,219	313,018	664,832

[1]¢8.60 = U.S.$1.

Source: IV Censo de Manufactura.

- -- Excess capacity (utilization was 40 percent in 1981)[18]
- -- Shortage of raw materials, due to inadequate financing and agricultural production
- -- Decreasing opportunities for import substitution
- -- Reduced exports to CACM countries because of political instability

2. Apparel Industry

The textile subsector in Costa Rica is defined to include spinning and weaving (textiles), apparel, leather goods, and footwear. Apparel was the focus of our interview program; however, a number of these enterprises were integrated to include spinning and weaving.

The textile and apparel subsector is of great significance to the Costa Rican economy. Although the 1975 Census of Manufacturers indicates that about 25 percent of industrial employment was generated in this subsector, employment is probably considerably greater since the Census would not identify many small, labor-intensive workshops. The largest share of this employment is generated by the apparel industry.

The apparel industry differs considerably from textiles, as is evident from Table 9. Not only are there many more apparel establishments, but these tend to be much more labor-intensive while textile production can be characterized as capital-intensive. Apparel is mostly produced for the local market, with about 15 percent exported to non-CACM countries, while textiles are exclusively produced for the local and regional markets. Many of the apparel exports are generated by "drawback" establishments producing only for export and using imported raw materials.

Growth in the textile and apparel industry has been very rapid until recently. Between 1957 and 1969, real growth of the value of output averaged 11.1 and 9.4 percent, respectively, for textiles and apparel. Rapid growth continued between 1969 and 1977 with average growth rates of 11.0 and 5.6 percent, respectively. After 1977, textile production experienced significant declines in 1978 and 1979, followed by limited growth in 1980 and 1981. In the case of apparel, rapid growth continued in 1978 and 1979, while 1980 and 1981 saw output stagnate and then decline.

---

[18]Measured on the basis of three shifts. Utilization would be 69 percent if management's perception of the optimum number of shifts were used as the basis for measurement.

Table 9. Structure of the Textile Industry, 1975

	Total	Textiles	Apparel	Leather (except footwear)	Footwear
Number of Establishments	734	84	476	77	97
Value of Production	707,696	418,262	207,114	42,203	40,117
Value of Materials	345,369	202,631	102,855	22,726	17,157
Value Added	362,327	215,631	104,259	19,477	22,960
Domestic Sales	483,108	272,031	144,966	33,856	32,255
Exports	189,886	134,891	45,415	3,366	6,214
-CACM	155,796	132,672	17,286	2,739	3,099
-Other Countries	34,090	2,219	28,129	627	3,155

Source: IV Censo de Manufactura.

The recent stagnation of the industry can be attributed to the following factors:

-- The exhaustion of most obvious import substitution opportunities

-- The sharp drop in local and regional demand

-- The U.S. recession which has affected drawback firms

-- Excess installed capacity

-- The lack of working capital

-- The lack of exporting and marketing know-how

As a consequence of these factors, capacity utilization (as measured by the normal standard of three shifts) was only 36 percent in 1981. Even when measured according to the number of shifts that producers consider optimal, capacity utilization was about 59 percent.

Despite the general malaise, some firms continue to do well through aggressive exporting to non-CACM countries, limited reliance on bank credit, and internal sources of financing.

B. Policies Affecting the Food Processing and Apparel Industries

1. Industrial and Trade Policies

Both the food processing and apparel industries can attribute much of their development to Costa Rica's import substitution policies. A package of policies involving the CACM protective tariffs, fiscal incentives, and tariff exemptions for raw materials have proved to be powerful instruments in encouraging private investment in these industries. Private investors have responded to the market "signals" provided by these policies. More specifically, the import substitution policies have involved the following:

-- Tariff protection (in 1972) averaging 148 percent for the food industry and 98 percent for apparel

-- A common system of tariffs for the CACM countries, providing food and apparel manufacturers with attractive regional markets

-- Tariff exemptions for imported raw materials and equipment not produced locally

-- Tax credits for new investment and reinvested profits

Export promotion policies (to non-CACM countries) have not been nearly as effective policy instruments, largely because of the primary emphasis given to import substitution. The principal mechanism for promoting exports has been the CAT system, which provides tax credits for nontraditional exports. On the other hand, most nontraditional exports pay an export tax of about 4 percent and must go through extensive paperwork in order to obtain the necessary export licenses.

In light of these considerations, most food and apparel manufacturers have found it easier and more profitable to focus on protected local and regional markets. A few exporters have been involved in the processing of certain agricultural commodities (meat, coffee, cocoa, fruit) or in reexport garment industries. It is only very recently that more firms have been turning to exports. The principal driving force has been the depressed local and regional markets, combined with the major devaluation of the colon. Even though the Government is encouraging exports, there is still no conscious effort to fully utilize policy instruments for export promotion; the policy framework is still oriented towards import substitution.

2. Pricing Policies

Although prices are uncontrolled in the apparel industry, the regulation of prices for many raw materials and finished goods has had a major impact on the food processing industry. In general, all products and ingredients that are considered basic consumer requirements have either controlled or subsidized prices. Some examples of pricing policies and their impacts on the food industry include the following:

-- Wheat can only be imported by the Government's Consejo Nacional de Producion (CNP), which turns it over to a nearby monopoly for milling. Flour is sold at subsidized prices to bakeries (the final price of bread is fixed), while flour for nonessential purposes such as cookies is often sold at prices above world market levels to help compensate for the subsidies.

-- Sugar and coffee are primarily export crops. However, a Government-mandated quota must be processed and sold domestically at fixed prices, which are usually below world market levels. Not only does this represent an opportunity cost, but food processors often lack sugar (an ingredient for 95 percent of all firms) because it is being smuggled out of the country.

-- Most basic foods, as well as the agricultural ingredients, have regulated prices. These Government-mandated margins tend to create safe investments, protect inefficient firms, and discourage production by farmers.

3. Financial Policies

The rapid growth in the 1960s and 1970s of both the food and apparel industries was greatly stimulated by easy access to relatively cheap credit. Interviews indicated that any firm with a reasonable reputation could borrow extensively through personal guaranties. One of the consequences may well be overinvestment and excess capacity. In contrast, tight credit is now widely believed to be the key constraint affecting many firms, since they are unable to obtain necessary working capital. For example, one apparel firm could not accept a large export order because it could not finance the additional raw materials required.

4. Public Investment Policies

Direct public investment in the food processing industry has been limited to four ventures owned by CODESA involving the production of chocolate, processed fruit, sugar, and shrimp. All compete with private firms and are relatively unsuccessful. There is no public investment in apparel.

C. Donor Intervention

Interviews with representative firms in the food processing and textile industries suggest that the most successful donor interventions have been channeled through the private sector. Efforts related to CACM are perceived fairly positively, while those associated with public-sector programs are viewed as being generally ineffective.

One donor intervention receiving very positive support from manufacturers is COFISA. Several firms indicated that loans extended by COFISA played a major role in the development of the company. Others indicated that what the country needed was more institutions like COFISA. The quality service provided by COFISA was contrasted to the National Banking System, which most interviewees saw as one of the principal constraints affecting their respective industries. Criticisms included poor service, such as several months' delays in approving working capital loans, the need to use political leverage to obtain a loan, and the lack of responsiveness to industry needs.

Banex is a very recent donor intervention that is already receiving positive feedback. The purpose of this private institution is to provide export credit. However, it is responding to the need of many firms for assistance in developing export markets. For example, recent agreements with two firms to develop exports for cookies and coffee essence have already generated positive results

On balance, several donor interventions associated with CACM have been perceived positively. CABEI has provided credit for a number of industrial projects, particularly in the food processing industry; this credit has helped these firms to overcome the shortcomings of the National Banking System. INCAE has produced managers for a few of the companies interviewed. More important have been the short management programs offered by that institution, providing specialized training for a significant number of managers.

CENPRO is the donor intervention in the public sector that has received the least favorable comments. This institution is perceived as bureaucratic and paper-shuffling in nature rather than dynamic and actively supportive. The problem has been that CENPRO provides general market information or access to fairs and exhibits, but is not able to meet the principal needs expressed by firms interested in exporting, particularly assistance in marketing know-how, market identification, and production management.

A number of firms have training agreements with INA. The perception of this institution, however, is relatively negative. The common complaint is that the training provided is often not tailored to meet the requirements of a specific firm. The greatest success is reported by firms that have been actively involved in designing and monitoring on-the-job training programs.

D. Implications of Policies and Donor Interventions

The principal conclusion regarding the implications of policies and donor interventions is that firms are highly responsive to the signals that these policies and interventions generate. More specifically, the following observations can be made:

-- The development of both industries can largely be attributed to the Government's import substitution/infant industry strategy, complemented by the CACM regional development initiative. The combination of protected markets and fiscal incentives stimulated investment in the development of a significant industrial base in these two industries.

-- Easy access to artificially cheap credit in the 1960s and 1970s was one of the principal factors contributing to the industry's rapid growth. However, it also led to excess capacity, heavy reliance on borrowed capital, and relatively capital-intensive and labor-saving industry. For example, the textile industry, which is characteristically capital-intensive, may never have become established without these policies.

-- Regulated prices have had a major impact on the food industry. Investment decision, competition, and efficiency have been greatly influenced by controls on the supply, distribution, and pricing of key raw materials and final products.

-- One of the implications of the primary policy emphasis on import substitution has been that nontraditional exports to non-CACM countries have been of secondary importance. Despite some fiscal incentives to export, firms have acted rationally in focusing on the safe and profitable local and regional markets. It is only now, with the severe contraction of these markets, combined with the need to generate foreign exchange to meet foreign obligations, that firms are being forced to look to exports.

-- Both the food processing and apparel industries represent important opportunities for Costa Rica as sources of foreign exchange and employment. In the case of food processing, export opportunities could be developed on the basis of Costa Rica's important agricultural potential. Apparel manufacturing could be competitive in world markets, based on the country's low cost and productive labor, and the country's proximity to U.S. and Caribbean markets.

-- There are a number of constraints limiting the realization of this potential. In food processing, poor integration between agriculture and industry, pricing policies, lack of working capital and credit to procure raw materials, inadequate supplies of basic raw materials, and a lack of exporting know-how must be addressed. An export-oriented apparel industry is constrained by the inefficiencies of most firms and the lack of export marketing know-how.

-- Government policies and programs, as well as donor interventions, are not adequately addressing these constraints. For example, CENPRO does not provide the marketing and production management know-how needed for export development. The availability of credit and foreign exchange for exporters is not adequate, while controls and regulations are often punishing rather than rewarding exporters. In order for the food and textile industries to be substantially reoriented from import substitution to exports, the basic policy and program orientation must be changed.

V. CONCLUSIONS AND LESSONS LEARNED

In 1960, Costa Rica was in an enviable position among Third World nations, having inherited the fruits of a number of positive historical, political, economic, social, and geographic factors. Its policy-makers took good advantage of those assets, encouraged investments in human and physical capital, and achieved an enviable record of broadly based economic growth during the next 20 years, facilitated by a growing world economy.

Ambitious income distribution goals were not being met through private-sector employment, even though unemployment was very low. Therefore, public-sector transfer payments were increased during the period to supplement the functioning of the marketplace. Unfortunately, the public-sector supplements, having grown so large that they could no longer be supported by the domestic economy, relied upon borrowings from abroad. When that source dried up, the domestic contraction was that much greater.

Lesson 1: Growth with equity can be achieved. However, over the long term productive employment must be the prime distributor of wealth. Public-sector transfers must not be permitted to overburden productive sectors or to rely on external borrowing.

The import substitution policies initiated in the early 1960s in the context of the Central American Common Market to encourage economic diversification and development of an industrial sector had a very positive impact on growth and employment during that decade. However, the strong incentives to capital investment and high tariff protection for this purpose led to installation of excess, high unit cost, capacity. The measures, intended to be temporary, were maintained too long. A transition to exporting manufactured goods to world markets was never made. It is clear that implementation of import substitution policies was deficient, perhaps inevitable once vested interests became entrenched. Transition any time during the process would have been difficult for many producers. Now it may be impossible for many.

Lesson 2: An import substitution strategy, particularly with an enlarged common market, can provide the impetus for rapid growth and the development of an industrial base. However, over the long term, excessive protection results in inefficient firms that are unable to compete successfully in world markets when local opportunities are exhausted.

Lesson 3: Because the limitations imposed by size and natural resource endowment can best be circumvented through trade, restrictions on trade, such as import substitution policies, should be temporary and gradual to avoid costly long-term distortions to the economy.

Labor was put at a disadvantage by policies which raised its price relative to capital. This was done by the imposition of a number of taxes on payrolls to support social welfare programs and by subsidies to capital for industrial investment promotion purposes. Although total unemployment was never a serious problem until recently, it could be that the high level of public sector employment merely disguised a real problem. Policies which raised the price of labor created pressures to expand the public payroll which in turn contributed to fiscal deficits, put pressure on credit markets, and so on.

Lesson 4: Excessive payroll taxes distort the relative price of labor versus capital, exacerbating the effect of existing subsidies to capital.

The country's balance of payments was affected severely by the compounding effect of tariff, monetary, exchange rate, and credit policies pursued. High tariff protection and import substitution policies were a disincentive to exports while total imports continued to grow rapidly because most manufacturing activity required a high proportion of imported raw and intermediate materials. Maintenance of an overvalued exchange rate was a significant disincentive to exports. Maintenance of low interest rates was a disincentive to savings and capital formation. Business was forced to borrow abroad because the banks did not have funds to lend and those persons with excess funds were forced to place them abroad where they could obtain world market rates. Administrative control of the allocation of credit has caused economic distortions and sectoral imbalances.

Lesson 5: Attempts to control administratively the cost and availability of money in contradiction of market forces leads to economic distortions and misallocation of resources. Prudent management of macroeconomic factors should be given high priority.

Throughout the period, Costa Rican businessmen managed and invested their resources rationally, responding or reacting to market and policy factors in ways calculated to maximize profits while minimizing risks. The CACM import substitution strategy offered numerous profitable, relatively low-risk opportunities and substantial amounts of domestic capital (profits from traditional agriculture and commerce) were therefore invested in manufacturing enterprises. Because few remunerative financial investments were available as a result of the restricted capital markets, persons or firms with excess funds were encouraged to invest them abroad, thereby reducing availability of investment capital in the country. Overvalued exchange rates reinforced this tendency as well as encouraged heavy borrowing from abroad, in effect, to replace the funds placed there.

Lesson 6: Investors respond rationally to market and public policy signals in predictable ways. Private-sector reactions to most policy measures which either support, or attempt to contradict, market forces should be anticipated and factored into long-term plans. Governments should avoid measures which attempt to contradict market forces.

Donor agencies have made major contributions towards Costa Rica's development in many sectors--physical infrastructure, agriculture, industry, and human resources. However, it appears that they had little effect on major macroeconomic policies that have been discussed in this report. It is not clear whether this was due to lack of concern for policy matters which were not of direct project concern, lack of appreciation of their potential consequences, or unwillingness to connect their projects to policy issues.

Lesson 7: Donor interventions should be coordinated to achieve maximum synergism and effectiveness in influencing the design and implementation of policy. Donor support of specific projects should take place only after they have been proven consistent with the overall objectives and strategy of the public sector, and conversely, only after careful determination that public policies will not frustrate attainment of project objectives.

The public policy which was pursued most consistently throughout the 1960-1980 period was the high priority placed on human resource development. The investments made have paid generous dividends in terms of improvement of quality of life and in producing the most important asset available to the private sector, a literate, healthy, productive labor force. Although public expenditures for this purpose grew large and added to the fiscal and monetary problems which in turn contributed to the current crisis, the team concluded that this factor by itself was not the primary cause of the crisis, and that social goals should not be sacrificed in the name of economic recovery.

On the other hand, the team concluded that fiscal measures used to finance many programs were inappropriate, too much autonomy was granted to some programs with insufficient central control, and programs became overstaffed--problems of management, not of purpose.

Lesson 8: Substantial public-sector investments in human resources are a necessary element of a long-term economic and social development strategy but good management of those investments is required to preserve public-sector fiscal integrity.

APPENDIX A

METHODOLOGY

METHODOLOGY

The team consisted of six persons, three consultants and three AID staff members, assisted by a Costa Rican special consultant. A macroeconomic analysis of the period under study was initiated by one consultant several weeks prior to the team's assembling in San Jose to begin the work on-site. This analysis, which was then completed in-country, served as a useful starting point for the entire team. Sections I and II of this report draw heavily from that analysis. Sections II and III were developed principally from published and unpublished studies prepared by Costa Rican economists and international agencies and from interviews with numerous persons in the public and private sectors.

Dr. Claudio Gonzalez Vega, our special consultant, assisted by obtaining certain data to complete our analysis, and provided his analysis of economic events and policy measures. Dr. Clark Joel provided valuable analyses of the CACM impact on Costa Rica and of major factors that affected the development of the private sector, based on his extensive experience as ROCAP senior economist and on interviews with Costa Rican businessmen. He spent one week with the rest of the team in Costa Rica.

Section IV was based on a series of interviews with industry association representatives and managers of food processing and textile/apparel industries. It was not designed as a quantitative analysis but rather as a largely qualitative assessment of the impacts of policies and donor interventions on these industries. The interviews were based on the outline in Appendix D.

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APPENDIX B

CHRONOLOGY

CHRONOLOGY

Year	Presidents Elected	Important Events	Economic/Financial Indicators	Social Indicators
1982	Monge (PLN)		FX ¢ 61.00[1] CPI--202	
1981		BANEX	FX ¢ 38.00 Coffee--$1.13[2]	Population--2.3 million
1980			FX ¢ 15.00 Coffee--$1.57 Per Cap. Inc--$871[3]	
1979			CPI--125 Per Cap. Inc--$888	Life Expectancy--70 yrs Child Deaths[4]--3/1000
1978	Carazo (U)		Coffee--$1.65	Secondary School Attendance--46%
1977		CIEX	Coffee--$2.14 CPI--108	Population Per Physician--1390
1976			Coffee--$1.09	
1975			CPI--100 Per Cap. Inc--$777	
1974	Oduber (PLN)			
1973			FX ¢ 8.54	Population--1.9 million
1972		CAT		
1971			FX ¢ 8.22	
1970	Figueres (PLN)	San Jose Protocol	FX ¢ 6.62 CPI--53 Per Cap. Inc--$653	
1969		CENPRO	FX ¢ 7.27	
1968				
1967			FX ¢ 8.22	
1966	Trejos (U)			
1965		INA	CPI--47 Per Cap. Inc--$548	

CHRONOLOGY (cont.)

Year	Presidents Elected	Important Events	Economic/Financial Indicators	Social Indicator
1964		INCAE		
1963		CACM, COFISA		Population--1.4 million
1962	Figueres (PLN)			
1961			FX ¢ 6.62	
1960	Echandi (U)(58)		CPI-42 Per Cap. Inc--$512	Life Expectancy--62 yrs Child Deaths--9/1000 Secondary School Attendance--21% Population Per Physician--2,700

[1] Foreign exchange rate is number of colones per one U.S. dollar.
[2] Coffee price is U.S. cents per pound.
[3] Constant 1970 U.S. dollars.
[4] Ages 1-4.

APPENDIX C

STATISTICAL TABLES

Table C-1. National Accounts

Item	1960	1965	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981[1]
GDP at Market Prices 1970 ¢ (million)	3,393	4,658	6,525	6,967	7,537	8,117	8,568	8,748	9,230	9,945	10,541	11,052	11,190	10,787
Gross Dom. Product at 1970 Prices ¢ (million) Factor Cost	3,222	4,137	5,799	6,192	6,699	7,215	7,615	7,775	8,204	8,893	9,361	9,823	9,945	9,587
Gross Dom. Product at 1970 Prices $ (million) Factor Cost	633	813	1,139	1,217	1,316	1,418	1,496	1,528	1,612	1,737	1,839	1,927	1,950	na
Gross Dom. Product Real Rate of Growth/Average Rate		5.1	7.0	6.8	8.1	7.8	5.5	2.1	5.5	7.7	5.9	4.8	1.2	3.6
Per Capita Income, $ at Constant 1970 Prices	512	548	653	684	721	757	780	777	801	842	867	888	871	na
Per Capita Income, Real Rate of Growth		1.4	4.0	3.9	5.4	5.0	3.0	-0.4	3.1	5.1	3.0	2.4	-1.9	na

[1]Preliminary figures.

Source: Commission Economica Para America Latina, Anuario Estadistico, 1979.
International Monetary Fund, Financial Statistics, 1982.

Table C-2. Sectoral Accounts
(GDP at factor cost, 1970 prices)

	1960	1965	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981[1]
Agriculture														
% Share in GDP	26.2	23.8	25.0	24.5	24.0	23.4	21.8	22.0	20.9	19.8	19.6	18.2	17.7	19.0
Rate of Growth		3.2	8.0	4.6	5.4	5.6	-1.7	3.0	0.5	1.5	5.0	1.2	-1.2	2.3
Manufacturing, Mining														
% Share in GDP	11.3	13.6	15.1	15.3	15.7	16.0	17.6	17.3	17.3	18.2	18.4	22.0	22.2	22.6
Rate of Growth		9.2	9.3	8.1	10.5	10.2	12.7	3.2	5.8	13.0	7.0	2.7	0.8	1.1
Electricity, Gas, Water														
% Share in GDP	1.3	1.5	1.9	2.1	2.1	2.1	2.2	2.2	2.2	2.2	2.2	2.2	2.3	2.6
Rate of Growth		9.9	16.2	13.1	9.4	6.0	9.3	2.3	8.7	5.4	7.0	5.1	11.8	8.3
Construction														
% Share in GDP	5.2	5.4	4.7	5.2	5.8	5.6	5.7	5.9	6.8	6.9	7.0	5.7	6.2	4.7
Rate of Growth		6.5	4.7	17.2	21.9	3.1	7.8	5.7	20.8	8.5	8.5	19.3	-9.4	-21.5
Finan. Inst., Insurance, Trade, etc.														
% Share in GDP	22.2	22.7	22.4	22.2	22.1	22.4	21.9	21.4	21.8	22.6	23.0	22.6	18.1	21.6
Rate of Growth		6.2	7.7	5.5	7.9	8.9	3.4	-0.6	7.9	11.6	7.6	4.1	-1.2	16.3
Transportation, Communications														
% Share in GDP	4.9	4.5	4.8	4.6	5.1	5.5	5.9	6.2	6.2	6.2	6.1	6.8	7.0	7.4
Rate of Growth		3.4	9.5	11.2	11.6	15.9	14.1	6.2	5.8	6.5	5.8	6.2	5.2	1.2
Ownership of Dwellings														
% Share in GDP	10.6	9.8	8.4	8.2	7.8	7.8	7.8	7.9	7.7	7.4	7.2	4.2	6.8	7.2
Rate of Growth		3.6	3.9	5.0	3.2	7.2	5.1	3.4	3.1	3.1	2.9	4.1	2.0	1.7
Other Serv. (soc., communal, bus.)														
% Share in GDP	5.7	6.2	5.6	5.5	5.4	5.2	5.2	5.0	4.9	5.0	4.8	4.4	4.5	4.3
Rate of Growth		7.4	4.4	4.7	5.7	4.7	5.3	-1.2	3.3	9.8	2.0	4.4	2.1	-4.8
Public Administration														
% Share in GDP	13.6	13.1	12.0	12.1	12.1	11.9	12.4	12.5	12.3	11.6	11.4	9.9	10.0	10.6
Rate of Growth		4.3	5.6	8.2	8.1	5.6	9.9	3.2	3.8	1.2	4.5	5.9	3.6	1.5
Total														
(million of 1970 ¢)	3222	4136	5799	6192	6699	7215	7615	7775	8204	8839	9361	9823	99459587	

[1]Preliminary figures.

Source: CEPAL, Anuario Estadistico 1979; COUNSEL, Repertorio Economico, 1982, San Jose.

Table C-3. Population, Labor Force, and Development

	1963	1973	1976	1977	1978	1979	1980	1981
Population (000)	1379.8	1871.8	2017.9	2070.6	2125.6	2183.6	2245.4	2306.0
Population 12 Years and Older (000)	822.4	1209.2	1346.3	1393.5	1442.3	1492.9	1543.7	1593.0
Total Labor Force (000)	408.1	584.9	658.9	688.5	726.7	753.3	768.1	796.0
Labor Force Employed (000)	379.9	542.2	617.4	656.8	693.3	716.4	722.8	726.7
Agriculture %	49.7	38.2	34.8	33.0	30.3	28.7	27.4	27.8
Industry %	11.7	12.9	14.6	15.8	15.2	16.3	16.3	15.6
Construction %	5.5	6.9	6.5	6.4	7.4	7.7	7.8	6.8
Basic Services %	4.8	5.5	5.6	5.5	6.1	5.7	6.6	5.7
Commerce %	9.9	14.7	16.3	17.5	17.8	17.7	18.1	18.1
Personal Services[1] %	18.4	21.8	22.2	21.8	23.2	23.9	23.8	26.0
Annual Increase								
Employment %	2.4	3.6	4.5	6.3	5.6	3.3	0.9	0.5
Agriculture %	1.8	0.9	1.3	0.8	-3.1	-0.2	-3.7	2.0
Industry %	2.8	4.6	9.0	15.1	1.5	10.8	0.9	-3.8
Construction %	4.5	6.0	2.5	4.7	22.1	7.5	2.2	-12.3
Basic Services %	4.0	5.0	5.0	4.5	17.1	-0.3	16.8	-13.2
Commerce %	4.3	7.8	8.2	14.2	7.4	2.8	3.1	0.5
Personal Services[1] %	2.8	5.4	5.0	4.5	12.3	6.5	0.5	9.8
GDP/Economically Active Population (1966 prices)		12,789	12,770	13,074	13,161	13,366	13,412	13,137
Employment of Labor Force								
Private Sector	329.4	459.2	513.7	541.2	563.7	583.9	580.5	584.3
Public Sector	50.5	83.0	103.7	115.6	129.6	132.5	142.3	142.4
Central Government			48.8	54.5	56.8	56.6	62.8	63.9
Autonomous Institutions			54.9	61.1	72.8	75.9	79.5	78.5

[1]Personal services and government.

Source: Academia de Centro America.

Table C-4. Savings
(percentages, current colones)

Year	Net Nat'l Savings / GDP	Net Nat'l Savings / Net Investment	External Savings / Net Investment
1960	7.5	60.7	39.3
1965	2.1	15.6	84.4
1970	6.4	45.2	54.8
1971	6.8	37.7	62.3
1972	6.8	42.6	57.4
1973	10.0	54.4	45.6
1974	4.8	22.2	77.8
1975	5.2	32.0	68.0
1976	9.9	54.2	45.8
1977	11.8	61.6	38.4
1978	7.9	43.4	56.6
1979	6.3	31.6	68.4
1980	5.8	29.0	71.0

Source: Banco Central.

Table C-5. Balance of Payments
(million $)

Current Account	1960	1965	1970	1975	1976	1977	1978	1979	1980	1981
Trade Balance	-14.6	-49.7	55.7	-134.3	-103.1	-97.3	-185.5	-315.1	-374.3	-62.5
Exports, f.o.b.	85.2	111.7	231.0	493.0	592.4	827.8	863.9	942.1	1000.9	1029.7
Imports, f.o.b.	99.8	160.9	-268.8	-627.3	-695.5	-925.1	-1049.4	-1257.2	-1375.2	-1092.2
Services (net)	-8.2	23.9	-24.1	-935.0	-111.9	-144.0	-194.3	-255.2	-304.2	-337.3
Tourism	1.8	0.3	9.4	16.8	13.0	10.9	10.8	10.4	24.5	47.5
Net Investment Income	-3.9	-13.4	-13.6	-60.9	-71.0	-76.9	-110.4	-146.0	-216.2	-300.1
Other	-10.3	-10.8	-19.9	-51.2	-53.9	-78.0	-94.7	-119.6	-112.5	-84.7
Unilateral Transfers	4.4	5.9	5.9	10.0	13.6	15.7	16.6	12.1	14.6	26.4
Current Account	-18.9	-67.2	-74.0	-217.8	-201.4	-225.6	-363.2	-558.2	-663.9	-373.4
	17.0									
Capital Movement (net)										
Private Long-Term		10.9	38.0	115.1	100.3	125.8	137.8	24.0	61.6	7.8
Direct Investment		0.0	26.3	69.0	60.7	63.1	47.1	42.3	48.1	45.6
Loans		10.9	11.7	46.1	39.6	62.7	90.7	-18.3	13.5	-37.8
Private Short-Term		10.5	22.7	-41.9	50.7	49.1	14.1	-45.0	69.9	-117.7
Official		24.3	11.1	132.3	128.9	178.5	216.8	425.9	402.5	360.4
Long-Term		24.2	10.6	134.3	128.0	172.3	202.3	358.9	340.5	158.4
Short-Term		0.1	0.5	-2.0	0.9	6.2	14.5	67.0	62.0	202.0
Errors	-0.8	14.0	-9.5	33.2	-13.8	-19.2	-46.4	78.9	-68.2	76.1
Changes in Reserves	2.7	7.5	11.8	-20.9	-64.7	-108.6	40.9	74.4	198.1	46.8

APPENDIX D

PRIVATE ENTERPRISE INTERVIEW GUIDE

PRIVATE ENTERPRISE INTERVIEW GUIDE

I. DEVELOPMENT OF THE ENTERPRISE

A. General Description

-- Product(s)
-- Size (Employment, Sales, Fixed Investment)
-- Markets
-- Value Added
-- Raw materials and source of materials
-- Technology and source of technology and equipment
-- Use of skilled labor and managers
-- Form of enterprise (sole proprietorship, joint stock, etc.)

B. Establishment of the Firm

-- When was the firm established?
-- What was the opportunity perceived at the time of establishment?
-- What factors were responsible for creating this opportunity?
-- What was the initial source of capital?
-- What constraints were encountered in establishing the firm? (credit/capital, project approval/red tape, labor, management, marketing)
-- Was any outside support received for establishing the firm? (banking system, financieras/COFISA, CENPRO, etc.)
-- How important were government incentives? (tariffs, CAT, etc.)
-- What was the source(s) of information regarding markets?
-- What was the source(s) of information regarding technology?

-- How important was the CACM in the firm's initial plans?

C. Growth of the Enterprise

-- How has the company grown since being established?
-- What can the growth be attributed to?
-- How have the company's products, markets, quality, technology changed?
-- What have been the principal constraints to growth?
  - Financing (fixed asset and working capital)
  - Labor (skilled and unskilled)
  - Management
  - Marketing and markets
  - Materials
  - Government red tape
-- What has been done to deal with the factors above? (i.e., obtaining credit, labor, managers, technology)

II. IMPACTS OF POLICIES AND GOVERNMENT INTERVENTIONS

A. Policies

-- What government policies have had the greatest impact on your firm?
  - Tariffs and protection
  - Price controls
  - Credit policy
  - Social policies
  - Export incentives
  - Regional integration
-- What are some specific examples of the impacts of these policies?

B. <u>Donor Intervention</u>

-- Have you received support from any of the following:

- COFISA
- Banco Nacional de Costa Rica
- Other banks
- Fondo de Desarrollo Industrial
- INCAE
- INA
- CENPRO
- ICAITI

APPENDIX E

PERSONS CONTACTED

PERSONS CONTACTED

Marco Arabon, Production Manager, Pozuelo, S.A.
Enrique Araya, President, Interfashion Industries
Seymour Arnold, General Manager, Lovable Brassiere
Ernesto Luis Aviles, President, Costa Rica Cocoa Products
Carlos Bulgarrelli R., Assistant Manager, INA
John Curry, Economic Officer, U.S. Embassy
Guillermo Castro Echeverria, General Manager, Costa Rica, INCAE
Roberto Falca, Sales Manager, Reyco
Oscar Gomez, Deputy General Manager, COFISA
Carlos Lachner, General Manager, Lovable Brassiere
Eduardo Lizano, Economist, Academia de Centroamerica
Roberto Lobo A., Executive Director, Centro de Promocion de Exportaciones
Rodrigo Madrigal Nieto, Former President of the National Assembly
Rodrigo Mora S., Marketing and Sales Manager, Union Regional de Cooperativas de la Provincia de Cartago
Carlos Alberto Oreamuno, Executive Director, Camara de Industria Alimentaria
Rodrigo Oreamuno, President, Costa Rica Bar Association
Benjamin Piza Carranza, President, Camara de Industrias de Costa Rica
Bruce Porter, Commercial Officer, U.S. Embassy
Jorge Quiros Saenz, President, Aromas y Sabores Tecnicos, S.A.
Rodrigo Rivera Bianchini, General Manager, Union Regional de Cooperativas de la Provincia de Cartago
Ernesto Rohrmoser, General Manager, COFISA
Ligia Sanchez, Planning Officer, INA
Harry Valverde, General Manager, Comerico
Fernando L. Villalobos V., Sales Manager, Pozuelo, S.A.
Juan Manuel Villasuso, Director, PRODESARROLLO

Eduardo Yamuni, President, Leonisa de Centroamerica

Laureano Rodrigo, IDB

Odalier Villalobos, Vice Minister, Ministry of Industry and Commerce

Otto Kikut, Economic Studies Department, Banco Central de Costa Rica

Rafael Trejos, PRODESARROLLO

Mario Vedova, PRODESARROLLO

Clarence Zuvekas, LAC/DP, AID/W

APPENDIX F

IMPACT OF THE CENTRAL AMERICAN COMMON MARKET (CACM) ON COSTA RICA

I. Introduction

I will first briefly describe the basic legislation establishing the Central American Common Market (CACM) and its major institutions. I will then examine trends in the following key parameters since the establishment of the COFISA in 1960: exports of manufactured goods, value added by manufacturing industry, private investment and net private capital inflow. Finally, I will review the benefits accruing to the region and to Costa Rica from integration according to the exhaustive SIECA/Brookings study.

II. THE BASIC LEGAL AND ORGANIZATIONAL FRAMEWORK OF THE COFISA

The formal establishment of the Central American Common Market dates from the signing of the General Treaty for Central American Economic Integration in Managua on December 13, 1960. In that basic document, the five Central American countries agreed to do the following:

-- Establish a common market or free trade area within a period of five years. Goods originating in any one of the CA countries would be permitted to move freely within the region.

-- Establish a common external tariff applying to all goods entering the region. The national tariff schedules would be harmonized over a five-year period. Sales taxes would not discriminate against goods originating in another Central American country.

-- The central banks would cooperate closely to prevent currency speculation, maintain convertibility of currencies at stable exchange rates and, under normal conditions, guarantee freedom of foreign exchange transactions.

-- The countries agreed to adopt all the provisions of the agreement on the Regime of Central American Integration Industries, which is designed to promote the equitable distribution of manufacturing industry throughout the region to promote the region's "balanced" development.

-- The countries also agreed to harmonize fiscal incentives to prevent competition among them in granting tax concessions to foreign enterprises. To this effect, they agreed to sign a special protocol harmonizing the national fiscal incentives laws.

-- To administer the General Treaty, the countries created the Central American Economic Council, comprised of the Ministers of Economy of the five countries, which is in charge of supervision and policy formulation; an Executive Council consisting of the Vice Ministers of Economy in Charge of Integration; and a Permanent Secretariat with responsibility for preparing the basic studies required for policy determination and with day-to-day administrative matters "to ensure the proper application of the integration treaties and the implementation of the resolutions adopted by the Central American Economic Council and the Executive Council."

While a large number of other instrumentalities were created to administer the provisions of the General Treaty, only two others will be mentioned here because of their cruicial importance: The Central American Bank for Economic Integration (CABEI) and the Central American Monetary Council.

CABEI's Charter was adopted at the same time as the General Treaty (on December 13, 1960) for the purpose of "promoting economic integration and the balanced economic development of the member countries." The Bank has been instrumental in raising substantial sums to provide long-term loans for the Central American countries, primarily for the development of public infrastructure (roads, ports and airports, tourism infrastructure) and, to a lesser extent, housing and industrial development. Recently, the Bank has also begun to become active in other areas, such as agribusiness and the financing of private manufacturing activities through national financial intermediaries. AID has been a major contributor to CABEI's resources with cumulative loans amounting to $200 million since its inception.

Monetary cooperation has been another important aspect of the CACM and deserves special mention because the Central American Monetary Council is one of the few integration institutions that is continuing to meet at regular intervals even today, in spite of political tensions in the region. The Central American Monetary Council, consisting of the presidents of the five central banks, was set up in February 1964 as part of the Agreement for the establishment of a Central American Monetary Union. This Agreement has as its primary purpose to promote the coordination and harmonization of the monetary, foreign exchange, and credit policies of the Central American countries and to progressively establish the basis for a monetary union. The Agreement directed the central banks to harmonize their foreign exchange systems, achieve stability and convertibility of the Central American currencies, strengthen the Central American Clearing House, provide mutual financial assistance to help correct balance of payments disequilibria, and generally establish a permanent system of information and consultation to harmonize legislation and policies in the monetary area.

With the help of a $10 million AID loan and an initial $10 million capitalization, the five central banks set up the Central American Monetary Stabilization Fund in 1970 to provide mutual balance of payments assistance to any country in the region facing serious balance of payments difficulties. As of May 1981, the Fund's capital had grown to $63 million, while total loans granted by the Fund to its members (mostly for one-year terms) has an outstanding balance of $124 million. Along with the Central American Clearing House, the Central American Monetary Stabilization Fund constitutes one of the two major instrumentalities administered by the Cental American Monetary Council.

III. MAJOR REGIONAL DEVELOPMENTS SINCE 1960

Before discussing the impact of the CACM on Costa Rica, we will briefly review trends in some key macroeconomic variables in the region as a whole following the establishment of the COFISA. Basic growth trends in intraregional and total exports, private investment spending, value added by manufacturing, and real GDP are presented in Table F-1. Note that total intraregional exports increased from only $30.3 million in 1960 to $1,156 million in 1980, an average annual increase of 20 percent. As a proportion of total exports, intraregional exports increased from only 7 percent in 1960 to 25 percent in 1980.

Note that the most rapid growth of the CACM countries occurred during the eight-year period 1960-1968. During that period, intraregional exports increased at an average annual compound of 30 percent; private investment spending increased in real terms by 7.6 percent; and value added by manufacturing (also in real terms) at 8.7 percent (see Table F-1).

Beginning in 1969, the CACM growth slowed. Over 1968-1975 the annual growth rate of real GDP declined from 6 to 5 percent, while the annual growth rate of private investment declined from 7.6 to 4.9 percent. Value added by manufacturing fell from 8.7 to 5.8 percent.

The reduction in the growth rate after 1968 may be attributed to a combination of the following factors:

a. The establishment of the CACM was followed by a spurt of investment spending as many firms established themselves in the region to take advantage of the CACM

Table F-1. Trends in Intraregional Trade in Relation to Total Exports, Private Investment, Value Added by Manufacturing, and GDP Over 1960-1980

	(1)	(2)	(3)	(4)	(5)	(6)
	In Millions of Current Dollars			In Millions of Constant 1960 Dollars		
Year	Total Intraregional Exports	Total Exports	(1) as % of (2)	Private Investment Spending	Value Added by Manufacturing	Real GDP (millions of constant 1960 U.S.$)
1960	30.3	440.1	6.9	275.0	379.4	2,700.9
1965	132.1	761.3	17.4	426.2	578.2	3,690.5
1968	246.9	947.3	26.1	495.9	739.5	4,314.5
1972	204.7	1,328.8	22.9	548.6	933.7	5,270.3
1975	536.4	2,298.7	23.3	691.4	1,095.4	6,070.1
1978	862.7	3,855.3	22.4	949.4	1,352.2	7,179.1
1980	1,156.0	4,641.8	24.9	887.6(1979)	1,350.8	7,327.1
	Average Annual Compound Growth Rates					
	%	%	%	%	%	%
1960-1968	30.0	10.1	-	7.6	8.7	6.0
1968-1975	11.7	13.5	-	4.9	5.8	5.0
1975-1980	16.6	15.1	-	6.4[1]	4.3	3.8
20-Year Period						
1960-1980	20.0	12.5	-	6.4[2]	6.6	5.1

[1] For the 4-year period 1975-1979.
[2] For the 19-year period 1960-1979.

Sources: SIECA, VI Compendio Estadistico Centroamericano, 1975; SIECA, Series Estadisticas Seleccionadas de Centro America y Panama, Guatemala, November 1980; and SIECA, Estadisticas Macroeconomicas de Centro America, 1970-1980, July 1981.

protective umbrella. Such investment spending could not continue at the same rate indefinitely.

b. A gradual reduction in easy import-substitution opportunities.

c. The outbreak of the Salvador-Honduras war in 1969, followed by Honduras's departure from the CACM free trade area (though Honduras remained an active participant in the regional integration institutions), and the closing of the Pan American highway through Honduras to all traffic to and from El Salvador.

d. The impact of the increases in the price of petroleum in 1973 and following years, which gave rise to serious balance of payments difficulties.

e. Beginning in 1979, the region experienced additional severe shocks, including civil war in Nicaragua followed by the overthrow of the Somoza government; a coup d'etat followed by civil war in El Salvador; and the development of greatly increased political tensions in the region between Nicaragua on the one hand and Honduras, Guatemala, and El Salvador on the other.

The development of the crises in the Central American region since 1979 is reflected by the data in Table F-2. Note that between 1979 and 1981, the regional balance of payments deficit on current account increased from $744 million to $1.9 billion; the overall balance of payments deficit increased from $320 million to $744 million; latest available data on net international reserves show that they are negative by some $550 million; the budget deficits of the five CA central governments over 1979-1981 increased from $640 million to $1.5 million; the regions' real GDP is now declining by some 3 to 4 percent; while inflation has become a major problem in both Nicaragua and Costa Rica (Table F-2).

IV. IMPACT ON TARIFF RATES

A careful examination of the impact of the CACM on the height of the tariff schedule in each of the Central American countries was undertaken by the Secretariat for Economic Integration of Central America (SIECA) in close collaboration with the Brookings Institution .[1] The results for industrial

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[1]William R. Cline and Enrique Delgado, Editors, Economic Integration in Central America, The Brookings Institution, 1978.

Table F-2. Selected Key Macroeconomic Indicators
(In millions of current U.S. dollars as of March 1982)

Country	(1) Deficit (-) or Surplus (+) on Current Account				(2) Overall Balance of Payments Deficit				(3) Net International Reserves			(4) Gross International Reserves Including Gold[1]		
	1979	1980	1981 (Proj.)	1982 (Proj.)	1979	1980	1981 (Proj.)	1982 (Proj.)	Dec. 31, 1979	Dec. 31, 1980	Latest Date	Dec. 31, 1979	Dec. 31, 1980	Latest Date
Guatemala	-206	-163	-601	-583	-15	-250	-423[2]	-305[3]	691.6	413.1	70.0 (Feb. 28, 1982)	718.4	466.8	104.3 (Feb. 28, 1982)
El Salvador	132	-86	-227	-344	-108	-196	-59	-237[4]	126.3	-69.9	-128.5 (Dec. 31, 1981 projected)	161.7	99.5	95.6 (Jan. 31, 1982)
Honduras	-192	-321	-299	-354[5]	-17	-61	-97	-76[5]	116.2	55.2	31.9 (Aug. 31, 1981)	210.0	150.8	101.0 (Dec. 31, 1981)
Nicaragua	124	-387	-293	(-293)	-80[6]	-172[6]	-10[7]	(-10)	-192.6	-362.8	(-363.0)[8]	87.3	81.0	NA
Costa Rica	-602	-661	-511[9]	-526[10]	-100	-456	-155[6]	-150[10]	117.0	-95.3	-163 (Mar. 31, 1981)	154.6	199.5	141.6 (Feb. 28, 1982)
Total	-744	-1618	-1931	-2100[11]	-320	-1135	-744	-778[11]	858.5	-59.7	-552.6	1332.0	997.6	523.5[11]

[1] Gold is valued at the old official price of $42.22 per ounce. Source for gross international reserves: IMF, International Financial Statistics, December 1981.
[2] Counts as part of the 1981 deficit, the assistance received from the IMF and the CA Monetary Stabilization Fund, and commercial bank borrowing by the Bank of Guatemala.
[3] Assumes a 4% decline in imports in real terms; hence, is consistent with some decline in the real GDP.
[4] Assumes no significant change in real imports between 1981 and 1982; and excludes (in 1982) all IMF and US/ESF assistance.
[5] Assuming zero real GDP growth in 1982. The current account deficit corresponding to a 3-4% real GDP growth assumption in 1982 is estimated at $398 million; and the overall balance of payments deficit (on that same assumption) at $121 million.
[6] Excludes most debt service charges estimated at some $500 to $600 million in 1980. These were simply not paid in 1979 and "renegotiated" in 1980.
[7] Assumes a 20% decline of imports in real terms, and interest payments of $127 million.
[8] No data for Nicaragua are available. Net international reserves were assumed to be same as at the end of 1980 in summing.
[9] Assumes a 14% decline in 1981 imports in real terms, no net private capital flows and no repayment of arrears. Since this deficit most likely cannot be covered, imports may have to decline by more than 14% in real terms.
[10] Assumes an increase in imports (in current prices) of only 4.6% in 1982, which means a reduction of 4-5% in real terms. The overall deficit figure abstracts from private capital inflows and repayment of arrears.
[11] In totalling, it was assumed that the 1982 figure for Nicaragua is the same as for 1981.

Table F-2. Selected Key Macroeconomic Indicators (continued)
(In millions of current U.S. dollars as of March 1982)

Country	(5) Central Government's Overall Budget Deficit (-)				(6) Real GDP Growth Rate			(7) Debt Service Ratio[12]	(8) Estimated Annual Inflation Rate	
	1979	1980	1981 (Proj.)	1982 (Proj.)	In 1979 %	In 1980 %	In 1981 (Proj.) %	1980	Mid-1980 %	Mid-1981 %
Guatemala	-148	-368	-698	-453	4.5	3.5	1	4.2	15	12
El Salvador	-24	-199	-191	-297	-1.5	-9.6	-9.5	4.0	20	13
Honduras	-74	-193	-196	-352	6.7	2.4	0 to -2.0	15.1	15-20	10
Nicaragua	-125	-189	-275[13]	NA	-24.0	10.7	5-7[14]	37.7[15]	35	20
Costa Rica	-269	-328	-105[16]	-109[17]	4.9	1.2	-3.6	25.6	18-20	35-40[18]
Total	-640	-1,277	-1,465	-1,411[19]						

[12] On external public debt. Ratio of interest plus amortization payments to merchandise exports. Data used are for 1981 (if available) or for 1980.

[13] At the official exchange rate of ¢$10 to $1.

[14] The Government of Nicaragua claims real GDP growth rate of 7% in 1981, but that claim is questionable.

[15] After debt renegotiation.

[16] Converted into dollars at ¢20 to $1. Note that the Central Government's budget deficit contracted significantly in real terms between 1980 and 1981.

[17] Converted into dollars at the free market rate of ¢40 to $1 (for 1982).

[18] The Consumer Price Index in CR increased by 21% over the first quarter of 1982 alone. The increase in the wholesale price index during the first quarter was 27%.

[19] Nicaragua's 1982 deficit was projected at $200 million in totalling, though no data for Nicaragua are available at this time.

products are summarized in Table F-3. Part A of the table shows the average height of the tariff weighted on the basis of import value, while part B shows the average tariff ratio based on the value of consumption of industrial products. I consider B to be more meaningful because, when import value is used as the basis for determining weights, results are distorted to the extent that high tariff rates discourage imports, and hence may depress total tariff receipts and lower the ratio of duties collected to import value. Note, however, that regardless of the concept used in weighting, Costa Rica's average tariff on manufactured products declined significantly between 1958 (pre-CACM), 1968, and 1972. This outcome is true for all countries of the region with the exception of El Salvador (Table F-3).

Of greater relevance than the "legal tariff" is the "adjusted tariff" which calculates the weighted average tariff after allowance for exemptions on the importation of raw materials and intermediate goods. Note that for Costa Rica, the adjusted tariff, with weights based on the value of consumption, declined from 59.4 percent in 1958 to only 19.8 percent in 1972. In evaluating these rates, the SIECA/Brookings Study notes that "in terms of general level of protection, these tariffs appeared quite modest--especially the rates adjusted for exemptions. In 1972, legal tariff rates on the order of 30 percent and adjusted rates on the order of 12 percent in the region represented very modest protection compared with that typical for most developing countries."[2] The study attributes the sharp drop in the adjusted tariff between 1968 and 1982 to the incidence of exemptions which had only a limited impact in 1958, but a very substantial one by 1972 "when actual tariff collections were between one-third and one-half of the legal duties hypothetically due in the absence of exemp tions."[3] The SEICA/Brookings study also notes that "legal tariffs converged from their 1958 level among the five countries to a uniform common intermediate level by 1968; the tariffs were reduced substantially in the process for Guatemala and Costa Rica."[4]

The "effective rate of tariff protection" is a more meaningful concept than either the legal tariff or even the adjusted tariff because effective rates of protection measure the degree of protection given to a particular manufacturing process as a percentage of total value added domestically, after taking full account of the degree of protection given to

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[2]Cline, p. 80.

[3]Cline, p. 81.

[4]Cline, p. 79.

Table F-3. Weighted Average Industrial Tariffs, 1958, 1968, and 1972
(percentages)

Tariffs	1958	1968	1972
Based on Import Value Weights			
Legal Tariffs			
Guatemala	53.8	28.1	27.9
El Salvador	25.2	28.9	26.2
Honduras	34.4	28.5	36.0
Nicaragua	30.7	25.5	34.5
Costa Rica	52.9	28.9	28.1
Adjusted Tariffs			
Guatemala	48.8	19.5	10.4
El Salvador	13.3	23.4	12.6
Honduras 28.7	22.9	14.2	
Nicaragua	15.4	14.9	12.0
Costa Rica	47.4	15.2	8.5
Based on Consumption Value Weights			
Legal Tariffs			
Guatemala	79.5	59.6	60.9
El Salvador	27.7	57.4	53.0
Honduras 56.7	60.4	59.3	
Nicaragua	52.5	54.9	61.9
Costa Rica	69.5	54.8	58.1
Adjusted Tariffs			
Guatemala	70.8	36.7	15.6
El Salvador	10.3	49.3	23.5
Honduras 45.2	49.1	27.7	
Nicaragua	34.8	39.0	16.6
Costa Rica	59.4	40.7	19.8

Source: W.R. Cline and Enrique Delgado, Editors, Economic Integration in Central America, The Brookings Institution, 1978, Table No. 4, p. 80.

both the finished and intermediate goods involved. The adjusted rates of effective protection for all five Central American countries are presented in the first section of Table F-4. Note that average rates of effective protection are higher for Costa Rica and Honduras than for the other three countries, particularly in relation to Guatemala and Nicaragua. Note also that by far the highest rates of protection are provided for the "traditional products," i.e., mostly finished consumer goods that compete with products produced in the region. In Costa Rica, this category enjoys about 85 percent of effective protection (after adjustment for exemptions). A comparison of Tables F-4 and F-5 shows that the level of effective protection in Central America is much lower than that prevailing in some other LDCs, including Argentina, Brazil, India, and Pakistan; is roughly in line with the Philippines; and is significantly higher than in Mexico and Taiwan.

Finally, it should be noted that while the establishment of the CACM has resulted in some degree of harmonization and convergence of the five national tariffs, this harmonization is far from complete. A study undertaken by H. Brewster[5] notes that the tariff structures of the five CA countries still differ substantially owing to a multitude of tariff exemptions which not only differ among products but also among countries for the same products; the haphazard application of the San Jose Protocol (30 percent imports surcharge) of 1968; the importance of specific duties prevalent in the CACM tariff structure; and a rather important list of excluded goods. Still, the weight of the evidence supports the conclusion that for all countries of the region except El Salvador, the level of protection declined significantly between 1958 and 1982.

V. TRENDS IN MAJOR MACROECONOMIC FACTORS SINCE 1960

In this section, we shall analyze basic trends in Costa Rica's key macroeconomic variables, including exports of industrial products to the CACM and to outside the region, GDP, private and public investment, value added by manufacturing, and net private capital inflow. The analysis does not suggest that these growth trends are attributable to the establishment of the CACM. Obviously, a number of other factors, including changes in the prices of Costa Rica's export products and of POL and other imports, improvements in technology and trends in capital formation that would have occurred in the absence of

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[5]"The Choice Between Efficiency and Industrial Balance: Protection and Employment in the Central American Common Market," mimeographed (Guatemala City, SIECA, 1972).

Table F-4. Effective and Nominal Protection Rates for Selected Countries, Adjusted Rates

Sector	Guatemala	El Salvador	Honduras	Nicaragua	Costa Rica
		Adjusted Rates of Effective Protection			
Dynamic	23.76	27.90	42.41	20.64	20.48
Traditional I	23.57	59.75	64.00	34.59	84.53
Traditional II	24.23	61.30	64.85	35.05	86.31
Intermediate	21.56	25.49	49.90	21.68	20.00
Metal-Mechanic	26.77	30.40	13.03	14.74	21.14
Total Sector	23.64	48.78	56.89	31.06	58.61
		Nominal Final Protection			
Dynamic	16.29	20.23	14.97	13.17	12.08
Traditional I	17.65	39.11	45.88	26.78	54.98
Traditional II	18.15	40.07	46.89	27.02	56.29
Intermediate	15.34	19.88	15.69	13.87	12.09
Metal-Mechanic	15.99	16.89	9.43	10.30	11.30
Total Sector	17.18	32.61	35.70	23.34	37.63
		Intermediate Protection			
Dynamic	6.70	10.57	6.50	3.75	4.19
Traditional I	10.01	19.24	25.75	15.32	29.48
Traditional II	10.18	19.53	26.27	15.40	30.19
Intermediate	6.93	11.89	6.13	3.64	4.76
Metal-Mechanic	4.97	4.25	6.82	4.32	2.69
Total Sector	8.87	16.25	19.41	12.39	19.25

Source: Cline, Table K-4, p. 703.

Table F-5. Rates of Effective Protection in Selected Countries

Goods	Argentina	Brazil	Mexico	India	Pakistan	Philippines	Taiwan
Consumption	164	230	22	NA	883	94	NA
Intermediates	167	68	34	NA	88	65	NA
Capital	133	31	55	NA	155	80	NA
All Sectors	162	118	27	313	271	49	33

Source: Cline, Table K-6, p. 705.

the CACM, and external shocks such as the El Salvador-Honduras war, had a profound impact on Costa Rica's general economic situation. The SIECA/Brookings study that will be summarized in Section V attempts to isolate the welfare effects resulting from integration from these other factors. In the present section, no attempt to establish a simple cause and effect relationship between the CACM and these growth trends will be made. However, we believe that the impact of the CACM on Costa Rica's foreign trade, investment, and capital inflow is substantial--and apparent--particularly during the decade of the 1960s.

A. Trend in Exports of Manufactured Products

Costa Rica's exports of manufactured products to the CACM increased from a mere $2.4 million in 1960 to $33.6 million in 1968, an average annual rate of growth of 39 percent during this eight-year period (see Column 1 of Table F-6). Growth slowed considerably thereafter to 15 percent over 1968-1973, then rose slightly to 17 percent over 1973-1979. A surprising 48 percent growth rate occurred between 1979 and 1980, almost entirely as a result of a substantial spurt of exports to Nicaragua fueled by that country's substantial reconstruction needs and by the generous credits provided to Nicaragua by Costa Rica, Guatemala, and other countries and donor institutions. A 12-percent decline in Costa Rica's intraregional exports occurred in 1981 as a result of the general contraction in the level of real income of the Central American region.

The impact of the establishment of the CACM is certainly apparent in the 14-fold expansion of Costa Rica's exports to the region during the formative years of 1960-1968 (see Table F-6). The growth of intraregional exports is particularly significant because of its impact on the development of the manufacturing sector. An analysis of the composition of intraregional trade recently undertaken by ROCAP shows that about 87 percent of the region's (and Costa Rica's) total intraregional exports consists of manufactured goods (see Table F-7).

The last two decades also witnessed a tremendous explosion in Costa Rica's exports of manufactured products to new extra-regional markets (see Column D of Table F-6). However, while the period of rapid growth for intraregional exports was the decade of the sixties, the explosion of Costa Rica's exports to the rest of the world took place in the seventies. In 1969, Costa Rica's total exports of manufactured products to the rest of the world only totaled $2.5 million. This increased by nearly 800 percent by 1975 (to $22.3 million) and to $80.3 million by 1981 (Column D of Table F-6). Thus, over the 11-year period 1970-1981, exports to outside the region increased

Table F-6. Exports of Industrial Products by Economic Area in Costa Rica[1]
(in millions of dollars)

Year	(A) Central America	% Increase	(B) Panama	% Increase	(C) Central America and Panamà	% Increase	(D) Rest of world	% Increase	(E) Total	% Increase
1960	2,421.0									
1966	23,365.5		2,106.2		25,471.7		2,013.4		27,485.1	
1967	25,377.0	8.6	3,320.1	57.6	28,697.1	12.6	1,205.1	0.6	29,902.2	8.8
1968	33,638.3	32.5	4,547.9	37.0	38,186.1	33.1	2,063.4	71.2	40,249.5	34.6
1969	35,479.6	5.5	4,169.5	-8.3	39,649.1	3.8	2,491.3	20.7	42,140.4	4.7
1970	44,014.3	24.1	6,258.4	50.1	50,272.7	26.8	3,198.7	28.4	53,471.4	26.9
1971	44,217.6	0.5	6,592.2	5.3	50,809.8	1.1	7,795.7	143.7	58,605.5	9.6
1972	48,394.8	9.4	9,359.2	42.0	57,754.0	13.7	6,781.5	-13.0	64,535.5	10.1
1973	66,463.5	37.3	11,868.1	26.8	78,331.6	35.6	8,652.0	27.6	86,983.6	34.8
1974	98,622.4	48.4	15,101.9	27.2	113,724.3	45.2	16,883.5	95.1	130,607.8	50.2
1975	99,949.5	1.3	14,398.7	-4.7	114,348.2	0.5	22,276.5	31.9	136,624.7	4.6
1976	125,065.1	25.1	17,621.2	22.4	142,686.3	24.8	30,362.1	36.3	173,048.4	26.7
1977	161,603.1	29.2	19,970.0	13.3	181,573.1	27.3	26,157.3	-13.9	207,730.4	20.0
1978	162,833.1	0.8	25,599.6	28.2	188,432.7	3.8	35,710.8	36.5	224,143.5	7.9
1979	166,850.0	2.5	33,104.4	29.3	199,954.4	6.1	52,556.6	47.2	252,511.0	12.7
1980	247,751.6	48.4	38,117.3	15.1	285,868.9	43.0	58,119.9	10.6	343,988.8	36.2
1981[2]	218,120.2	-11.9	43,141.8	13.2	261,262.0	-8.6	80,256.3	38.1	341,518.3	-0.7

[1] Excluding the exports of sugar, coffee, refrigerated meat, and shrimp.
[2] Preliminary figures from the Departmento de Transacciones Internacionales.

Source: Direccion General de Estadisticas y Censos.

Table F-7. Composition of Intraregional Trade for Selected Countries

Country	Manufactured Products[1] Traded Intraregionally as Percentage of Total Manufactured Exports in 1978	Manufactured Products[1] Traded Intraregionally as Percentage of Total Intraregional Trade in 1978
Guatemala	67	85
El Salvador	84	93
Honduras	26	83
Nicaragua	64	82
Costa Rica	60	87
All Central America	63	87

[1]Only 35 percent of the gross value of foodstuff production was included under "manufactured products" in view of the high proportion of value added by agriculture in this category (which should not be credited to the manufacturing sector).

Source: Detailed computer printouts for 1978 provided by SIECA.

at a stunning average annual compound rate of 34 percent! Of particular interest is the fact that in 1981, while Costa Rica's industrial exports to the CACM declined by 12 percent, its exports to the rest of the world increased by 38 percent,[6] a truly astounding performance in light of recession abroad and the foreign exchange, credit, and confidence crisis that Costa Rica went through during this period. These data suggest that, given provision of foreign exchange credits for the importation of essential raw materials for the export manufacturing sector and some easing of domestic credit to provide working capital depleted by Costa Rica's crushing debt servicing requirements,[7] the country's manufacturing sector is likely to continue to expand its exports to outside the CACM, though probably not at the rate experienced in recent years.

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[6]Based on data in Table F-6.

[7]As a result of the substantial devaluation of the colon which greatly increased the cost of servicing debt contracted abroad.

B. Trends in GDP, Investment, and Value Added by Manufacturing Industry

Growth trends in GDP, private and public investment, and value added by manufacturing industry expressed in constant dollars are presented in Table F-8. The private net capital inflow (expressed in current dollars) is presented in Table F-9. Note the following:

1. The period 1960-1968 is the period of most rapid growth. Costa Rica's real GDP increased at an average annual compound rate of 6.8 percent during this period. It declined to 5.4 percent over 1968-1978 and to only 1 percent over 1978-1981 (Table F-8). The 1960-1968 period is also the period of most rapid growth for private investment (which increased at an average annual rate of 6.9 percent in real terms) and of value added by manufacturing industry (annual growth rate of 9.0 percent). Public investment also increased rapidly during this period (average annual rate of 8.5 percent), though it increased even more rapidly during the following five-year period 1968-1973 (see Table F-8).

2. During the decade of the sixties, Costa Rica also experienced a substantial increase in net private capital inflow from abroad. The latter increased from only $8 million in 1960 to $61 million in 1970, an average annual growth rate of 22 percent (see Table F-9). While the growth rate of net private capital inflow slowed considerably during the 1970s, it continued to grow and reached a peak of $175 million in 1977 (see Table F-9).

3. A dramatic turnaround in growth trends occurred after 1978 (see Table F-8). The average annual real GDP growth rate over 1978-1981 fell to only 1.0 percent. In 1981, GDP is estimated to have actually declined by 3.6 percent. A decline of 1.2 percent was experienced by value added in manufacturing industry. Over the three-year period 1978-1981, private investment declined at an average rate of 12.4 percent. Between 1979 and 1981, private investment fell from $317 million to $190 million, or by nearly 40 percent (Table F-8). The net private capital inflow which had grown so rapidly over 1960-1978 turned negative in each of the three following years, climaxing at minus $187 million in 1980 (Table F-9).

Table F-8. GDP, Private and Public Investment, and Value Added by Manufacturing Industry in Costa Rica, 1960-1981

Year	GDP	Private Investment	Public Investment	Value Added by Manufacturing Industry
		In Millions of Constant 1960 Dollars		
1960	417.6	66.3	12.9	67.7
1963	501.2	83.6	20.5	85.3
1966	617.9	87.7	30.8	112.0
1968	706.1	112.7	24.7	135.0
1973	910.5	150.9	51.7	193.2
		In Millions of Constant 1970 Dollars		
1970	984.8	148.0	43.7	179.9
1973	1,225.2	181.8	71.5	236.7
1976	1,393.2	218.2	121.4	290.7
1978	1,612.3	282.6	130.4	354.2
1979	1,691.9	315.1	161.0	363.2
1980	1,721.1	224.1	-	370.0
1981 Proj.	1,659.1	189.8	-	365.9
		Average Annual Compound Growth Rates		
	%	%	%	%
1960-1968	6.8	6.9	8.5	9.0
1968-1973	5.2	6.0	15.9	7.4
1973-1978	5.6	9.2	12.8	8.4
1978-1981	1.0	-12.4	-	1.1

Sources: For 1968-1970, SIECA, VI Compendio Estadistico Centroamericano, 1975, Table 198. For 1970-1980, SIECA, Estadisticas Macroeconomicas de Centroamerica 1970-1980, July 1981, Table 12. For 1980-1981 private investment figures, I used rates of change based on unpublished data from Central Bank. The GDP for 1981 is based on the rate of change estimated by COUNSEL, Repertorio Economico, May 1982.

Table F-9. Costa Rica: Private Net Capital Inflow in Costa Rica, 1960-1981
(in millions of current dollars)

Year	Capital Inflow
1960	8.1
1965	20.4
1970	60.6
1975	73.2
1976	151.0
1977	174.9
1978	151.9
1979	-20.9
1980	-186.8
1981	-17.0
Average Annual Compound Growth Rate	
1960-1970	22.3%
1970-1975	3.8%
1975-1978	27.6%
1978-1981	Sharply negative

Sources: For 1960-1965, SEICA, VI Compendio Estadistico Centroamericano, 1975, Table No. 187. For 1966-1979, SEICA, Estadisticas Macroeconomicas de Centroamerica, July 1981, Table 18. For 1980-1981, unpublished and preliminary estimates by the Central Bank of Costa Rica.

In conclusion, there is little doubt that the formation of the Common Market played a significant role in contributing to Costa Rica's rapid growth during the 1960s. A significant slowdown occurred during the seventies as a result of the various factors described in Section III. The magnitude of the crisis that Costa Rica has been traversing since 1978 is dramatically reflected in the macroeconomic indicators presented in Tables F-8 and F-9. That crisis is attributable to a combination of factors, including the sharp adverse shift in the terms of trade, the cut-off of foreign credit lines, cessation of foreign investment, depressed market conditions both within and outside the CACM, the impact of successive devaluations on the working capital of Costa Rica firms, and the high external debt that Costa Rica is no longer able to service.

VI. BENEFITS FROM INTEGRATION

The SIECA/Brookings study found that the major welfare benefits resulting from integration were the following:

1. "Trade creation" which results directly from the elimination of tariffs on imports from partners, thus enabling all countries of the region to increase their total level of imports and attain a higher standard of living.

2. A "labor opportunity cost effect" which results from a fuller and more effective utilization of underemployed labor as a result of expanded exports and opportunities for specialization generated by the CACM.

3. An "economies of scale" effect, because greater specialization, resulting in lower costs, can be achieved as a result of the expanded market.

4. A "foreign exchange savings" effect resulting from the fact that the region as a whole saves foreign exchange (i.e., convertible or "hard" currencies) to the extent that it is able to increase its exports to partners at no expense to its exports to the rest of the world, and while replacing goods imported from the rest of the world with goods supplied by its CACM partners.

In addition to the above effects, which the study described as "static," there is a significant "dynamic" effect associated with the expansion of real investment taking place in the CACM to take advantage of the expanded market and the increased availability of investment funds.[8]

The study concludes that the welfare effects from these various sources are substantial. Total welfare effects from integration for the region as a whole were estimated to fall between 3 and 4 percent annually of Central America's GDP.[9] Half of this impact is attributed to the "dynamic" effect which was found to be particularly important. In the case of Costa Rica, the total welfare impact of integration as a proportion of GDP was found to be significantly less than for the region as a whole--i.e., 1.3 percent for Costa Rica versus 3 to 4 percent for the region as a whole. Still, the integration benefits to Costa

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[8]For a full description of these effects, see pages 62-70 of the SIECA/Brookings study cited above.

[9]Cline, p. 110.

Rica must be considered significant, amounting to some $15 to $16 million annually by 1972.[10]

VII. CONCLUSIONS

The weight of the evidence suggests that the creation of the Central American Common Market has contributed significantly to the economic development of the region--particularly to its manufacturing industry and infrastructure. Substantial welfare benefits accrued as a result of establishment of a free trade area which promoted specialization according to comparative advantage, the fuller utilization of the labor force, savings in foreign exchange and "dynamic" benefits resulting from the substantial acceleration of both private and public investment expenditures. Formation of the CACM induced a substantial inflow of private capital while the formation of the Central American Bank for Economic Integration attracted a significant amount of capital from the United States and, to a lesser degree, from the IDB, to finance the development of the region's infrastructure, particularly the regional road network. AID's cumulative loan contribution to CABEI amounted to $200 million. In the case of Costa Rica, establishment of the CACM led to a significant expansion of exports of manufactured products to the CACM during the sixties, and resulted in a substantial acceleration in the growth of real GDP and of private investment during the decade. The 1960s also witnessed a substantial increase in value added by Costa Rica's manufacturing industry and in the country's net private capital inflow.

Annual welfare benefits by 1972 were estimated by the SIECA/Brookings Institution at a substantial 3 to 4 percent of the GDP for the region as whole. For Costa Rica, annual welfare benefits were estimated to be a much more modest but still significant 1.3 percent of the 1972 GDP.

In view of the importance that intraregional trade has assumed (it now amounts to about 25 percent of the region's total exports), and particularly because of the close interrelationship between intraregional trade and value added by the manufacturing sector (some 85 to 90 percent of intraregional trade consists of manufactured products), the region has an important stake in maintaining the Central American Common Market and to prevent a further reduction in the level of intraregional trade. Still, most observers agree that the region must depend for much of its future growth on exports to

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[10]Based on Table 16, page 111, of SIECA/Brookings report.

outside the CACM and on the investment that such exports would generate. This conclusion is equally valid for Costa Rica. The ninefold expansion of Costa Rica's exports of manufactured products to outside the CACM registered between 1973 and 1981 suggests that Costa Rica has the potential to produce and market its manufactured products outside the region if only it can surmount the obstacles arising from the present crisis. These consist primarily of the acute shortage of foreign exchange for the purchase of essential raw materials, intermediate, and capital goods, and in the decapitalization of Costa Rican firms aggravated by the general shortage of bank and supplier credit.

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