OCCASIONAL PAPERS
Number 21

PN-ABK-770
76229

ECONOMIC POLICY MAKING

Lessons from Costa Rica

Eduardo Lizano

INTERNATIONAL CENTER FOR ECONOMIC GROWTH

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An International Center for Economic Growth Publication

ICS Press
San Francisco, California

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Library of Congress Cataloging-in-Publication Data available.

Lizano Fait, Eduardo.
Economic policy making : lessons from Costa Rica / Eduardo Lizano.
p. cm.
"An International Center for Economic Growth Publication."
Includes bibliographical references.
ISBN 1-55815-117-6
1. Costa Rica—Economic policy. I. Title.
HC143.L583 1991
338.97286—dc20

90-28450
CIP

PREFACE

We are pleased to publish this essay by Eduardo Lizano as the twenty-first in our series of Occasional Papers, which presents reflections by scholars and policy makers on development issues.

Dr. Lizano discusses how Costa Rica recovered from unemployment, inflation, and foreign debt in the early 1980s. He focuses on the methods of the Costa Rican policy makers—how they selected policy objectives and how they designed a structural adjustment program to achieve their objectives—and the lessons they learned about formulating economic policy and implementing it.

This essay is Dr. Lizano's personal account of the policy-making process in Costa Rica during the early 1980s, when he was president of the Central Bank of Costa Rica. It is not often that we get to hear the account of someone directly involved in the policy-making process. This look at the process from an insider's point of view and the focus on the general themes of setting objectives and implementing policies make this paper valuable to policy makers everywhere.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

Panama City, Panama
January 1991

ABOUT THE AUTHOR

Eduardo Lizano is a professor at the University of Costa Rica and a research associate of the Institute of Economic Investigations of the School of Economics, University of Costa Rica. From late 1984 to mid-1990, he was president of the Central Bank of Costa Rica, a governor of the International Monetary Fund (IMF) and the Central American Bank of Economic Integration, and an alternate governor of the World Bank and the Inter-American Development Bank (IADB). During this time he was also a member of the economic council of the government of Costa Rica, the board of directors of the Council of National Production, the Budget Authority of Costa Rica, and the Central American Monetary Council (of which he was president in 1984 and 1990). Dr. Lizano has held visiting positions at a number of institutions, including the University of Geneva, Switzerland; the Institute for the Integration of Latin America (INTAL) in Buenos Aires; and the Central American Institute of Public Administration (ICAP) in San Jose, Costa Rica. He has published a wide variety of books and articles on economic integration and cooperation, structural adjustment, the role of agriculture in development, and external debt.

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EDUARDO LIZANO

Economic Policy Making

Lessons from Costa Rica

In Costa Rica in 1989, three major issues in the field of foreign trade were under discussion: entry into the General Agreement on Tariffs and Trade (GATT), a new system of export incentives, and cuts in coffee export taxes. All three were closely associated with the structural adjustment program. Four cabinet ministries—Treasury, agriculture, economy, and foreign trade—as well as the president's office and the central bank, were negotiating these issues. Opinions were divided as follows: on one issue, five in favor and one against; on another, four in favor and two against; and on the last, evenly divided three to three.

This is the case with nearly every policy issue in Costa Rica, ranging from wage policies to fuel prices. The final outcome is nearly always a combination of a few "carrots" built in through the continuing process of give-and-take (if I support you on this, you can support me on that); and a number of "sticks" (someone simply makes the decision, risking the annoyance of someone else). A great deal of time goes into trying to figure out what each participant thinks about each of the issues being acted on. Priorities, or the order in which the issues are discussed and decisions made, depend to a great extent on the number of "ayes" and "nays" counted, and on unsettled debts among the negotiators. Sometimes you need to press for coalitions, but other times you try to prevent certain "ayes" from allying themselves with certain "nays," in anticipation of future decisions to be made.

This is the daily exercise of developing and implementing economic policy. After nearly six years of navigating these troubled waters as president of the Central Bank of Costa Rica, I can only confess that perhaps the most important ingredient in economic policy is simple good luck. If this is true, then what is the importance of policy making? Well, good luck is nothing more than the coincidence of preparation with opportunity. Preparation is where policy making comes in—without it, all opportunities will be missed and no amount of luck can make a difference. So there is potentially a great deal to be gained from good policy making, and in this paper I will present an overview of a basic policy-making framework based on my experiences in Costa Rica.

We—meaning the economic policy-making team of the Costa Rican government—first began grappling with economic policy decisions in the middle of 1982, when the unprecedented economic crisis of the early 1980s had very serious economic and social consequences in Costa Rica: unemployment, inflation, and devaluation. It was obvious that something needed to be done about these conditions and quickly. The stabilization *cum* growth program was our response; it was a demanding and complex exercise in economic policy.

As president of the Central Bank of Costa Rica from the second half of 1984 through May 1990, I became deeply involved in economic policy decisions when the four most serious and pressing problems Costa Rica faced were the flawed development model, instability, foreign debt, and distortions.

The development model. The "inward looking" development model had outlived its usefulness. This was primarily due to the civil and military turbulence wracking a number of Central American countries, as well as to the limitations of the Central American Common Market, which had proven too small to provide an adequate basis for sustaining suitable economic development. It was therefore necessary to seek an alternative that would bring long-term growth to Costa Rica. The solution was, quite simply, an "outward looking" development model. We needed to raise our profile in the international economy, which is large enough to induce specialization, division of labor, and accumulation. In short, it could promote economic development.

Instability. We were faced with serious economic and financial instability owing largely to external events sparked by the second oil shock in 1978–1979. Particularly significant were increasing import prices, declining terms of trade, and rising interest rates on international financial markets. In this broader context domestic policy measures had been misdirected, intensifying problems instead of alleviating them. The situation grew worse, and imbalances became increasingly acute as the country registered unprecedented levels of inflation, unemployment, and exchange-rate instability.

Foreign debt. The extremely high level of foreign debt hobbled Costa Rica's economic development. The service on the public external debt could not have been met under the original terms unless we transferred abroad so many resources, equivalent to a high percentage of gross domestic product (GDP), that economic development would have stalled, and serious social tensions would have ensued.

Distortions. The economic system was littered with examples of inefficient use and poor allocation of available factors of production, which was primarily, although not entirely, due to the high levels of tariff protection and other international trade barriers. Meanwhile, a number of distortions had gradually built up in response to demands by the many emerging pressure groups. The economy had become rife with distortions that prevented economic agents—consumers, producers, savers, investors—from making appropriate decisions and clouded the operations of the system. It was certainly difficult to quantify all the existing subsidies or simply to ascertain which group, activity, or sector was subsidizing which other group, activity, or sector.

Our economic policy needed to address all four of these problems simultaneously. While some of them were strictly circumstantial, deriving from current developments, others were structural, and all were closely intertwined.

The Assumptions

In order to address these problems, find solutions, propose alternatives, and design measures, we first needed to shape a theoretical conceptual framework. To be more modest, we had to juggle a wide array of assumptions that would undergird our decisions and action. Three particularly important assumptions involved the relationships between stability and growth, between equity and growth, and between foreign debt and growth.

Stability and growth. Initially, we had no choice but to insist on stability. Inflation had topped 80 percent per year, open unemployment hovered around 9 percent, the public sector deficit was gobbling up more than 15 percent of the GDP, and exchange-rate instability had pushed the cost of the U.S. dollar from ¢8.60 to more than ¢50.00. Under these circumstances we considered it essential to rectify these macroeconomic imbalances.

It soon became clear, however, that in order to ensure stability, we also needed to achieve a satisfactory economic growth rate. Growth would allow real wages to rise, business profits to expand, and public expenditures to increase, thus enabling the myriad groups in society to tolerate the initial sacrifice. If we succeeded only in maintaining stability, with no concomitant economic growth, the stability program could never last, and the political support we needed from workers, business, and politicians would quickly erode. Support would be relatively easy to garner in the beginning, but it would become increasingly difficult to consolidate unless growth rates were high enough to satisfy expectations within a reasonable period.

Equity and growth. We assumed that Costa Rica needed not only stability with growth, but also an equitable distribution of income. Our reasoning was that real wage levels basically depend on profit trends, not on changes in nominal wages. It has been a long and difficult task to explain this to union leaders. We have also found it necessary to convince business leaders that, just as wages follow profits, profits are dependent on real wages, not on price increases. This too was a difficult task. The following four relationships need to be clearly understood:

- Real wages follow profits. When profits are high, investment rises and the demand for labor intensifies, pushing up wages.[1]

- Profits depend on investment. When investments gather force, profits follow closely behind, as the new capital outlays introduce technologies that boost productivity.

- Investment, in turn, requires social stability. Business investment decisions are based not only on anticipated profits, but also on the relative security of assets and the probability that those assets will continue to work normally. In other words, investments depend to a large degree on the prevailing climate of social and political stability.

- Finally, stability depends on real wage levels. If real wages are satisfactory, it means that unemployment is low and workers enjoy an increasing purchasing power and relatively high standards of living. All of this is a key ingredient for providing an environment of social stability.

These four relationships can be visualized in Figure 1 moving clockwise from quadrant I. As profits rise from P to P′ to P″, unemployment tends to drop from U to U′ to U″. This means that wages are rising.

As unemployment declines and wages rise, social stability is enhanced, moving from S to S′ to S″. The investment climate becomes more attractive, pulling investments up from I to I′ to I″. In general terms, as the situation improves from ABCD to A′B′C′D′ to A″B″C″D″, stability is enhanced, and as a result, both real wages and profits are on the rise.

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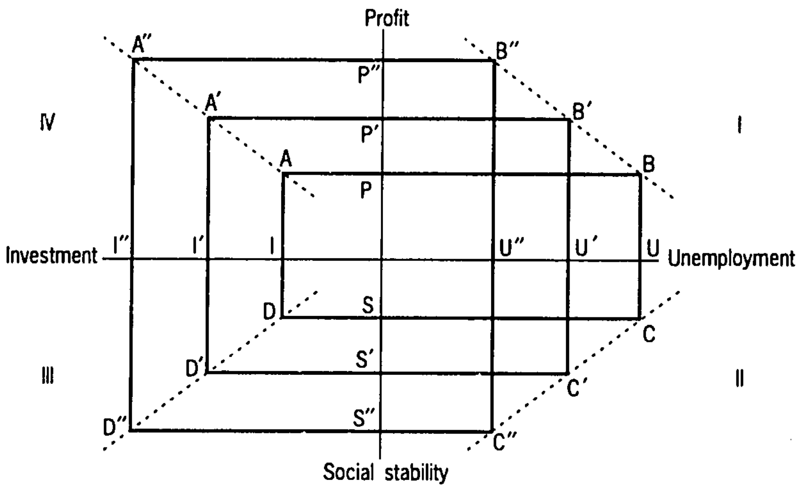
1. This point was clearly recognized by Alfred Marshall (1887, 216–17): "In the ordinary course of things the first benefit of an improvement in the demand for their wares goes to the employers; but they are likely to want to increase their output while prices are high, and make high profits while they can. So they soon begin to bid against one another for extra labour; and this tends to raise wages and hand over some of the benefit to the employed. This transfer may be retarded, though seldom entirely stopped, by a combination among employers, or it may be hastened on by the combined action of the employed."

Figure 1 Real Wages and Profits



Thus it becomes essential—and this is the key point—both to ensure stability with growth and to provide for an adequate distribution of income. This fosters social stability, which in turn stimulates investment.

Foreign debt and growth. Another assumption focused on the links between foreign debt and economic growth. Under certain circumstances the relationship between the two can be positive. This occurs when payment on the debt gives the borrowing country access to resources greater than the amount actually being paid out. By meeting its foreign debt obligations, the borrowing country attracts new resources for development, and the relationship between debt payments and economic growth is positive. Frequently, however, this relationship is negative, and the debt payments steadily drain the resources available for economic growth.

In Costa Rica, we found ourselves in the latter situation. Payment of the foreign debt was clearly incompatible with any possibility of sparking economic growth, as was shown by Lizano, Kikut, and Arguedas (1989). This was due to several factors: First, Costa Rica's foreign debt was too large—it was one of the largest in the world relative to gross domestic product. Second, international private banks were, for obvious reasons, reluctant to provide additional loans to the public sector. Indeed, a full year before Mexico's default, Costa Rica had stopped making payments on either the principal or the interest of its foreign debt.

Third, Costa Rica's private sector had very little external debt. This is a crucial point: In other countries, such as Mexico or Brazil, the international private banks provide major cash infusions to private business. As a result, debtor governments need to avoid taking certain measures in dealing with the foreign debt because they cannot afford to have private banks cut off the flow of loans to the private sector. Business groups exert considerable pressure to prevent these governments from making risky decisions about their creditors. In Costa Rica, however, coffee growers were practically the only group that relied on external financing, and in any case, this particular sector was so profitable that private banks hastened to offer loans, even though Costa Rica was not meeting its foreign debt obligations on time. In this way, making debt payments did little to increase growth.

Fourth, meeting our foreign debt obligations would have demanded a fiscal effort that far exceeded our possibilities. Because most of Costa Rica's debt was associated with the public sector—central government, central bank, Costa Rican Electricity Institute, and other public institutions—the government needed to buy dollars to pay its debts and was therefore obliged to generate a large surplus of local currency. The only way to do this was to transfer substantial resources, in the form of new taxes or higher charges for public services, from the private sector to the public sector. If we had attempted to pay the debt under the original terms, this transfer of resources would have been staggering. Under the circumstances reigning at the time, however, we needed to keep resources in the private sector to reactivate the economy.

In view of all these factors, our final assumption was clear: Payment of Costa Rica's foreign debt was incompatible with the need for resources to reactivate production and promote economic development. Rather, we were operating under the premise that we would be unable to meet our debt obligations without economic growth. There was nothing new in this, as the thesis had already been expounded by then U.S. Secretary of the Treasury James Baker in Seoul at the 1985 annual meetings of the International Monetary Fund and the World Bank.

The Objectives

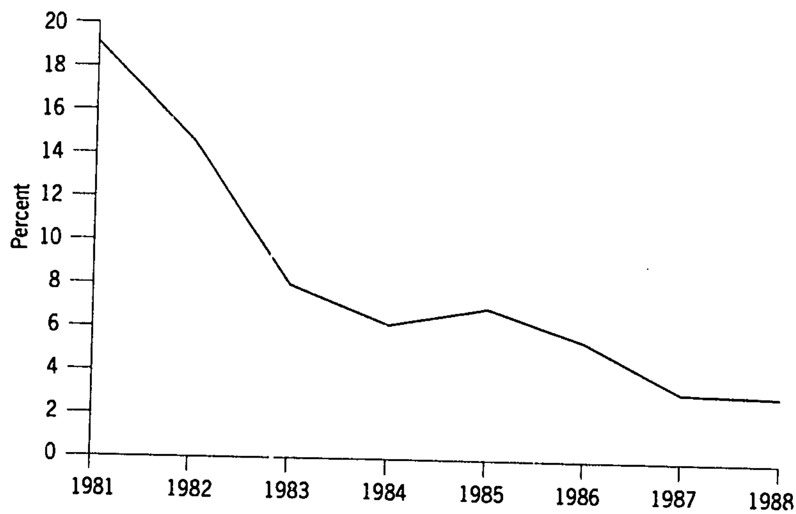
Given the problems described above and our three assumptions, we undertook to set concrete goals and specific objectives for economic policy. We decided to set four essential objectives and attempted to keep them as clear and simple as possible. One targeted public finances and attempted to reduce the consolidated public sector debt to zero. The second sought to open the nation's economy, and increase exports to 50 percent of GDP. The third focused on real wages, which were to be restored to 1978–1979 levels. The final objective addressed interest payments on the public foreign debt, which were not to exceed 4 percent of GDP.

Public sector deficit. We decided to eliminate the public-sector deficit, including the central bank's losses. At the peak of the crisis, the consolidated public-sector deficit topped out at about 19 percent of GDP, but we set about reducing it to zero and outlined a step-by-step program for this purpose (see Figure 2).

The goal of the first stage was not so much to reduce the deficit as to adopt noninflationary methods of financing it. We had to stop expecting the central bank to smooth over our problems by printing more money. Costa Rica had a deeply entrenched habit of seizing on the central bank whenever the government and the public sector had to cover their deficits. Examples include funding programs of the Development Agency (Corporación de Desarrollo, CODESA) and the National Production Council (Consejo Nacional de Producción, CNP). We proposed that the public sector deficit, while difficult to eliminate, should at least be financed in a "healthy" way. This could mean cutting expenditures, raising taxes, or selling bonds on the financial market.

The second stage has been a time of gradually reducing the deficit. In 1988 the consolidated deficit of the public sector was equal to approximately 3 percent of GDP, and as stated above, this includes the

Figure 2 Public Sector Deficit as a Percentage of GDP, 1981–1988

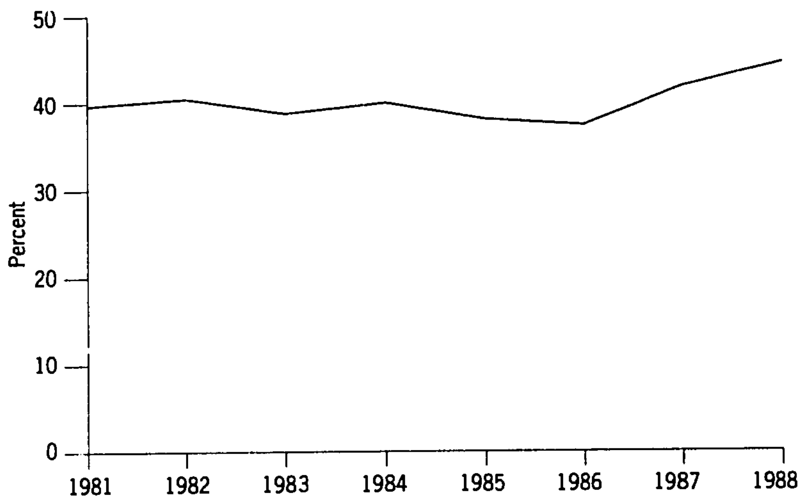


NOTE: Deficit includes the non-financial public sector plus the Central Bank of Costa Rica, in accordance with IMF standards.
SOURCE: Central Bank of Costa Rica, *Annual Report*, various years.

deficit of the central bank. It is important to bear in mind that the bank alone has a deficit equal to 3 percent of GDP, but this figure does not accurately reflect the inflationary pressures created by the deficit. Figures on the bank's deficit reflect the amounts the institution should pay, rather than what it actually paid. The bank's financial statements are based on the methodology of the International Monetary Fund, which requires that every year all the interest the central bank should pay in that year be recorded as a payment, whether or not it has been paid. From the standpoint of real demand and monetary policy, a more meaningful figure is the amount actually paid, which establishes the consolidated deficit of the public sector at even less than 3 percent of GDP. It is a figure that clearly reveals how much progress we have made toward meeting this objective.

Economic openness. We sought to achieve a more open national economy. We were interested in raising both exports and imports as a share of GDP. We hoped for maximum increases in production for

Figure 3 Goods and Services Exports as a Percentage of GDP, 1981–1988 (in 1986 prices)



SOURCE: Central Bank of Costa Rica, *Annual Report*, various years.

export, which in turn would allow us to import as much as possible. We felt that if Costa Rica were exporting, more factors of production would have to be allocated better, which would increase their competitiveness on the international market. Thus, as exports expanded, an ever-greater share of total factors of production would be able to compete in the world economy. Similarly, the more we imported, the more options would be available to our consumers and producers to meet their needs, whether for raw materials, intermediate goods, consumer items, or capital goods. The idea was to make the nation's economy more open and improve our standing in the international economy. We hope to achieve export levels in excess of 50 percent of total GDP. We have not yet achieved this goal, but we are moving in the right direction (see Figure 3).

The structural adjustment program has been the cornerstone for achieving this greater openness by making gradual but steady cuts in customs duties and lessening disparities in the tariff structure.

Wages. We tried to restore the real wage levels that had existed before the crisis of 1981–1982, thereby reclaiming gains achieved in

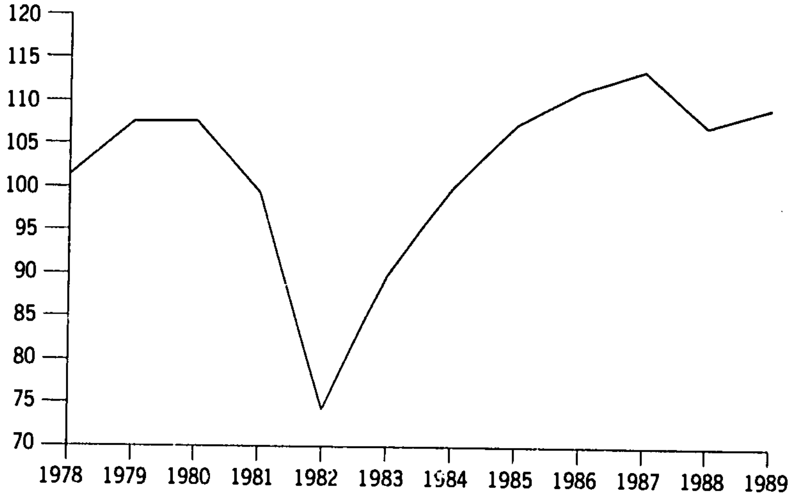
1978–1979. Real wages for the lowest income groups had declined only slightly, because economic policies had always protected the standards of living of these groups. Meanwhile, middle-class wages had plummeted, and the resulting loss of income could not be ignored. There was a real risk that low-income groups might spark an uprising and an equally real risk that the middle class might cause great social instability. The political decision was made to risk the latter and stave off the former. Neither event took place, but one of the most pressing goals of our economic policy was to restore real wage levels beginning with the lowest-paid social groups in the private sector.

It is also important to realize that real wages have already surpassed the precrisis level in the private sector (see Figure 4), but have yet to reach that level in the public sector. Real per capita GDP and real per capita consumption have also failed to reach precrisis levels (see Figure 5).

Our wage policy has produced satisfactory results. Open unemployment had reached 9.4 percent during the crisis, but it has subsequently declined to 5.5 percent, which is quite close to the traditional level (see Figure 6). This decline occurred even as large numbers of refugees entered the country and swelled the labor supply. It was also achieved despite the fact that public-sector employment has not expanded over the past two years; all the employment growth took place in the private sector.

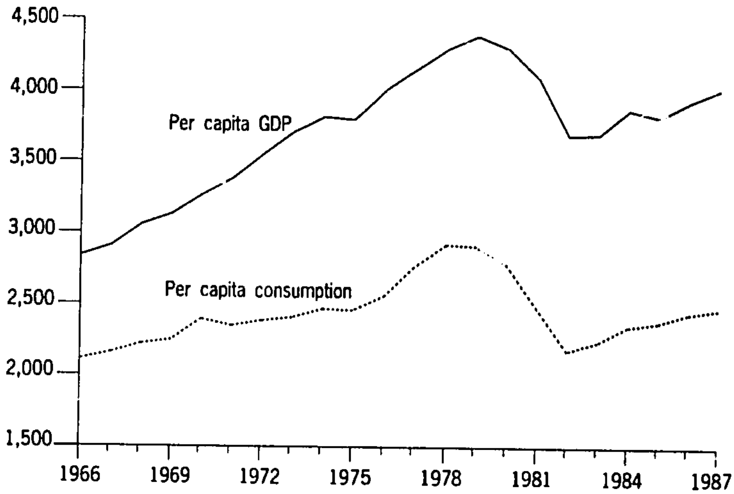
Interest payments on the foreign debt. We attempted to limit interest payments on the public foreign debt to 4 percent of GDP. This target figure encompassed all credits from commercial banks and multilateral agencies, as well as bilateral loans. At the same time, Costa Rica expected to receive donations each year worth approximately 2 percent of GDP. If we succeeded at meeting this objective, the interest payment burden would not exceed 2 percent of GDP. Again we tried to keep this objective not only rudimentary, but also specific and easily quantifiable. Considerable difficulties have arisen in reducing interest payments on loans to multilateral agencies. The bulk of the adjustment was therefore made on interest payments to bilateral sources and commercial banks. Over the past three years, the latter have received actual payments of 3

Figure 4 Index of Private Sector Real Wages, 1975 Colones (1984 = 100)



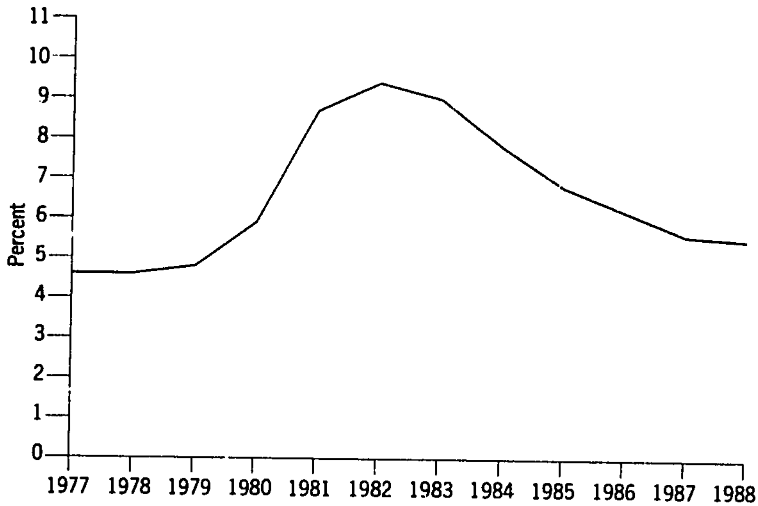
NOTE: Data are for July of each year. 1989 figures through April.
SOURCE: Based on monthly reports from the Costa Rican Social Security Fund.

Figure 5 Per Capita Gross Domestic Product and per Capita Private Consumption (1966 Colones)



SOURCE: Central Bank of Costa Rica, *Cuentas Nacionales*, yearly report, several years. Cited in Victor H. Céspedes, Claudio Gonzáles, and Ronulfo Jiménez, *Costa Rica frente a la Crisis, Políticas y Resultados*, Academia de Centroamérica, 1990, p. 102.

Figure 6 Unemployment, 1977–1988



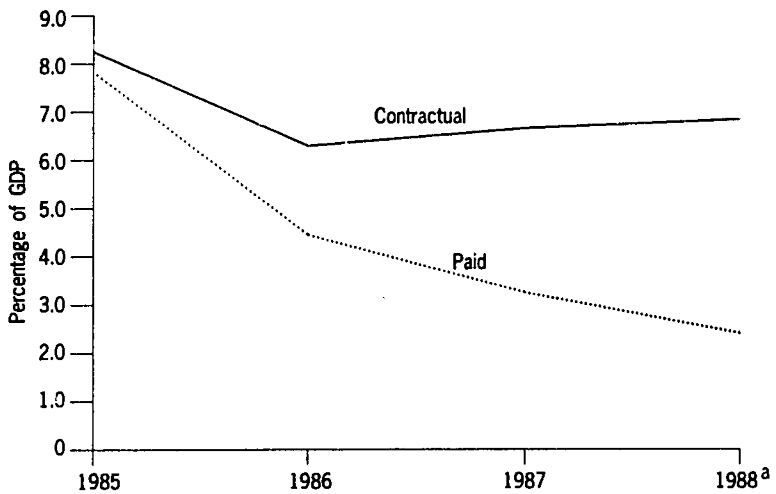
NOTE: Data are for July of each year except 1988, which refers to March.
SOURCE: Ministerio de Trabajo y Seguridad Social, Dirección General de Estadística y Censos, *Encuesta Nacional de Hogares, Empleo y Desempleo*, reports of several years. Cited in Victor H. Céspedes, Claudio Gonzáles, and Ronulfo Jiménez, *Costa Rica frente a la Crisis, Políticas y Resultados*, Academia de Centroamérica, 1990, p. 247.

percent interest per year (see Figure 7). This has moved Costa Rica very close to meeting its established objective of limiting real interest payments on the total public external debt to 4 percent of GDP.

The Structural Adjustment Program

One of the most influential factors in the formulation and implementation of economic policy during this period was the structural adjustment program. What do we mean by structural adjustment? What is the relationship between structural adjustment and economic growth? For this discussion, structural adjustment consists of those policies that tend to optimize the use of available factors of production. In an economy that lies within the bounds of a production possibility curve, the idea of a structural adjustment program is to shift to a situation nearer the curve or, if possible, right on the curve. By contrast, an economic growth program is designed to increase the total supply of factors of

Figure 7 Foreign Debt Owed to Commercial Banks: Contractual and Actual Interest Payments, 1985–1988 (as a percentage of GDP)



a. As of July.
SOURCE: Central Bank of Costa Rica, *Yearly Report on the Balance of Payments*, several years.

production. It attempts to shift the production possibility curve itself to the right. In theory we can draw a distinction between a structural adjustment program and an economic growth program. The former leaves factors of production constant, but raises national production by increasing factor productivity. The latter increases national production by increasing the factors of production.[2]

2. It is important to understand that a situation far removed from the production possibility curve might arise from at least two different causes. In one scenario it occurs because demand is inadequate. This is the typical case of a highly developed economy during a downturn in the economic cycle. In the other scenario this distancing is due to underdevelopment—i.e., an inappropriate allocation of factors of production resulting from the presence of distortions in both the factor market and the goods market.

The question of whether or not a structural adjustment program can be launched depends largely on the initial conditions of the economy. If the economic growth rate is satisfactory, the program may not attract enough support to make the effort worthwhile or to justify the major costs accompanying the program. On the other hand, a situation of economic stagnation or even crisis greatly favors the possibility of introducing a structural adjustment program. Under such circumstances the country is already forced to make a special effort, external conditions are generally discouraging, and factors of production have become difficult to obtain. A structural adjustment

Distortions. A closely related matter is the question of why the economy does not spontaneously settle right on the production possibility curve. Why are deliberate policies needed to push the economy toward the curve? The answer can be found in so-called distortions. Over time the government and other public-sector entities have introduced a full array of decrees, rules, regulations, and prohibitions that hinder the appropriate allocation of factors of production. These measures, known as distortions, force the economy farther and farther away from the production possibility curve. The structural adjustment policy is designed to reduce or eliminate these distortions and enable the nation to produce more without increasing the factors of production.

Many if not all of these distortions arise in response to the action and pressure of special-interest groups such as producer associations, labor unions, political parties, and government bureaucracy. Each of these groups furthers its own interests and cultivates its clientele. The result is a broad field of activities that is not directly productive, and its impact on the allocation of factors of production needs to be analyzed.

It should not be forgotten that it is a complex and difficult task to eliminate distortions. This difficulty is due to the pressure groups, which are unwilling to sacrifice the benefits they derive from these distortions and vigorously oppose any move to reduce or eliminate them. When distortions disappear, other problems crop up. The simple act of removing a distortion does not necessarily bring the economy any closer to a position on the production possibility curve. In fact, it could well move the economy even farther away from the production possibility curve, in response to the well-known "second-best" theory (Lipsey and Lancaster 1956–57).

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program is generally adopted when the economic situation is precarious. Unfortunately, this hampers efforts to acquire needed funding for the program and increases the pressure on the government to show tangible benefits so that political support can be sustained.

The size of the economy has a major impact on the success of the structural adjustment program. A small economy experiences greater distortions than a large economy because unit costs of production are relatively high. In fact, the smaller the market is, the greater are the effects of distortions, so even large distortions often fail to bring sizable benefits to producers. If the unit costs of local production are relatively high because the national market is small, then producers may find themselves making little profit, even in the presence of high tariffs. Consumers nevertheless have to shoulder high costs.

Any discussion of distortions opens debate on the role of the government and the market in a structural adjustment program. It is clear that government action is an essential requirement if the economy is to function as it ought to, and it is equally important that the market function well. There is no need to take an ideological stance; rather one must recognize that concrete action can facilitate the appropriate allocation of factors of production. A balance between government activity and market operation is desirable, but in reality, this is very difficult to achieve.

Timing. An important consideration is how quickly such a program should be set in place. This topic was hotly debated in Costa Rica at the time our program went into effect. The fundamental reason why speed is an issue is that the process itself involves costs. If the adjustment program were cost free, no one would oppose it, but in fact, the implementation of the program can prove truly burdensome. The best response to this concern is to put the structural adjustment process into effect as quickly as possible. There are four reasons for this.

First, if the process moves too slowly, program benefits will remain in the hands of the few business people who were involved in the program from the start. Workers will get their fair share of the benefits only if businesspeople are unable to retain the surplus for themselves. Benefits will begin to spread to workers and low-income consumers only if the labor supply becomes relatively inelastic. This happens when investments increase quickly, production rises, and real wages begin to climb. The upswing in real wages serves to redistribute part of the surplus generated by the structural adjustment program. If the program moves too slowly, production, employment, and wages will fail to increase rapidly. Thus, a structural adjustment program that advances at a slow pace will inevitably concentrate its benefits in the hands of producers, and this is not the purpose of the program.

Second, if the program moves too slowly, benefits will be limited, and as a result, the needed political support either will not be forthcoming or will quickly erode.

Third, a program that advances slowly is addressing only a few distortions at a time. It is quite probable that this unbalanced removal of distortions will only worsen the economy. A program that moves rapidly, however, has targeted many distortions at the same time, and there will be a much better chance that the negative impact of removing any one distortion will be offset by measures to remove another.

Finally, it should be understood that the costs of a structural adjustment program are generally felt sooner than the benefits. It is essential to move beyond this first stage as rapidly as possible. Only a structural adjustment program that advances rapidly will soon produce benefits that outweigh the costs.

Coverage. It is also necessary that the structural adjustment program form a broad front, tackling many production sectors simultaneously. Indeed, the structural adjustment program needs to encompass nearly every sector of the economy at the same time. Unless this is done certain sectors will fall behind and hamper the progress of all others, thus reining in the structural adjustment program. The agricultural sector has no hope of getting ahead if the industrial sector fails to produce high-quality manufactured inputs at competitive prices. Similarly, the industrial sector cannot hope to make any progress unless the agricultural sector produces the necessary high-quality inputs on time and at competitive prices. In the same way, the structural adjustment program can make no headway in the financial field unless public finances are set in order.

Costs. Fast implementation and simultaneous action are important, but the costs of the structural adjustment program must be considered too. Although costs do appear before benefits, the key point is that they are generally more visible. The costs are felt more quickly because they tend to affect the better-organized groups of producers, who are quick to respond. Benefits, by contrast, are spread thinly over a large mass of consumers, who are not well organized and therefore are unable to respond.

There are occasions when the structural adjustment program runs the risk of becoming a political orphan. When the distortions that favor particular groups of producers are removed, these groups react swiftly if the benefits have not yet accrued or have yet to be perceived by the mass of consumers or the other groups of producers.

Lessons Learned

There are six basic lessons we learned in this process of policy making. They can be divided into two groups—those applicable to *formulating* economic policy and those applicable to *implementing* it.

Formulating economic policy. The formulation of economic policy includes the need to be realistic, to think big and act small, and to stay the course.

Be realistic. The first part of this important lesson is to avoid being overly ambiticus. Economic realities are extremely complex, and if we strive to comprehend them in their entirety, we risk paralysis and inaction. Theoretically, it is almost possible to conduct a detailed study of the full array of causal relationships. We could examine the myriad options available and project the possible outcomes of each one. Finally, we could pinpoint the deciding factors whereby each option might eventually take place. If we attempted all these things, we could easily become so entangled in our theories and arguments, undeniably all very interesting, that we would be unable to make decisions. Very real constraints must be overcome in drafting an economic policy, and the time constraint is one of them. The hours available for framing an economic policy cannot be occupied in study. Decisions must be made, even when useful information is lacking and needed studies are unavailable.

A second major handicap is personnel. We simply cannot bring in Nobel laureate Paul Samuelson to help out at the central bank. Financial constraints are a third problem. Our budget is limited, and we do not have unrestricted funds to spend on acquiring know-how or hiring staff.

Fourth, we need to accept certain limitations in terms of the amount of knowledge available. There are many areas—such as causal relations, effects, and outcomes—about which we still have much to learn.

In the face of all these constraints, decisions must be made. In our case, we chose to set a small number of objectives, refusing to let them proliferate. Similarly, we preferred to work with only a few instruments. The extensive body of literature headed by Tinbergen and enriched by Meade suggests that a single instrument must be assigned for meeting each objective.[3] Thus, if we have a given number of objectives, we will have the same number of instruments. This is why we chose to simplify as much as possible by setting few objectives and selecting the same number of instruments. Obviously, the result of this approach is a simple, unsophisticated, even rudimentary economic policy.

All things considered, we still operate under conditions of extreme uncertainty, and risks are very high. We are not wandering entirely in the dark or throwing ourselves from an airplane without a parachute, but uncertainty is high, and the risks we run are very serious. In short, our first lesson is not to take on too much—to avoid biting off more than we can chew.

Think big, act small. Although it is necessary to think on a large scale, action takes the form of many small steps. It is crucially important to develop a general conceptual framework, similar to that developed earlier in this paper, that will serve as a compass for steering the ship. What we believe, what we want, and where we are going all need to be clearly stated. When we sit down to design an economic policy, however, we must keep in mind that real progress is generally marginal. Forward motion occurs in a series of small steps, and massive change is nearly always impossible. The comprehensive plan plays a major role, telling us where each of these small changes should take place and showing us how they are related to one another and how they fit into the big picture. If we did not have a point of reference, we could very easily lose our way.

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3. James Meade's views on this issue have undergone an interesting evolution (1978, 426–27): "My subsequent education in the rudiments of the theory of the control of dynamic systems suggested to me that this was not the best way to have proceeded. One should not pair each particular weapon off with a particular target as its partner, using weapon A to hit target A, weapon B to hit target B, and so on. Rather one should seek to discover what pattern or combination of simultaneous use of all available weapons would produce the most preferred pattern or combination of simultaneous hits on all the desirable targets. With this way of looking at things no particular weapon is concentrated on any particular target; it is the joint effect of all the weapons on all the targets which is relevant." He continues: "I am now, however, in the process of having second thoughts and of asking myself whether the idea of trying to hit each particular target by use of a particular weapon or clearly defined single armoury of weapons is really to be ruled out. This onset of second childhood is due to a consideration of the political conditions in which economic policies must be operated."

If we attempt to lay out or impose large-scale changes very rapidly, at least two problems come to the fore. First, most of the public has difficulty understanding even the small steps; how great, then, would the general confusion be if we came out with very broad, relatively comprehensive policy statements? Second, large decisions spark much stronger reactions, both pro and con, than small decisions.

Thus, as this exercise unfolded, bit by bit we began to see the need, very complex indeed, to maintain a degree of balance between the general and the specific. The more general the goals, the less controversial they will prove to be. When we propose to the president or to the general public that we will strive for economic growth, there is no opposition. Such broad objectives, however, are of little use in designing specific economic policies. On the other hand, if we go public with very specific objectives, such as increasing fruit exports by 15 percent over the course of the next year, we provoke immediate opposition from special interest groups. Everyone who disagrees that fruit exports should have this priority will speak out. This is why articulating objectives is a complicated task. The goals should be neither so general that they become useless as guidelines for formulating economic policy, nor so concrete and specific as to hinder policy formulation.

Stay the course. Objectives should be not only simple and few but also unalterable: we must stay the course, come hell or high water. When we change objectives, we create an atmosphere of confusion. If we waver in our objectives, we convey a sense of uncertainty. It is most unwise to give the impression that objectives are frequently up for reconsideration. The practice of winding up—taking a step back in order to jump farther ahead—means nothing but trouble in economic policy. Every step back sends the wrong message to economic actors, politicians, and the general public. Certainly, we feel free to speak our minds in meetings, we invite dialogue in seminars, we take part in roundtable discussions, we smile and laugh, we tell jokes, and we even act very nice. Underneath this smiling facade, however, we stand unshakable on our few selected objectives and never think twice. The iron fist is always there, neatly encased in its kid glove. In economic policy, unlike military strategy, bridges must always be burned.

Implementing economic policy. Implementing economic policy includes the need to build consensus, to establish leadership, and to keep the public informed. If policy formulation seems a quagmire of serious problems, policy implementation is equally plagued with difficulties.

Build consensus. The first difficulty arises from the need to forge consensus. This is perhaps the bitterest pill to swallow for one who comes out of academia and begins to work in economic policy. Academia teaches us to destroy truths. Knowledge advances as we break down provisional truths, replacing them with new ones, themselves provisional, which will in time be dismantled and replaced. Instead of seeking consensus, we attempt to refute arguments. Instead of finding ways to agree with one another, we search for arguments and evidence to test our provisional truths. All these truths stand inviolate until they are invalidated. Thus, academia is an ongoing process of creative destruction.

When we set about implementing economic policy, the opposite occurs. The opinions of many different people and the interests and pressures of diverse groups must be taken into account. The only way to get anything done is by making concessions and engaging in the give-and-take that builds consensus. We descend from the clouds of theory and sit uneasily in the world of power struggles. Only with a major change of attitude will we succeed in leaving behind the endless process of destroying and creating provisional truths and taking on the task of consensus building. It is an uphill struggle for an academician. This new attitude feels like a waste of time and tends to become terribly boring. But that is how the real world operates.

The first reason for the change of attitude is that we confront real time constraints. In economic policy, unlike academia, we cannot spend endless days, nights, and weeks discussing the logical structure of a given model and then examine whether or not the empirical evidence bears it out. In the central bank, it is necessary to move quickly, albeit under conditions of uncertainty due to insufficient knowledge or inadequate information. The second reason for the change of attitude is that we must answer to a large number of people. The central bank works closely with the executive branch, political groups, business groups, and union organizations.

They all have opinions, to a greater or lesser degree, and discord often reaches the boiling point. As if that were not enough, it is necessary to keep a close eye on relations with external parties—international organizations, foreign governments, and creditors. Forging the consensus needed for taking action is an exercise in the art of concession, of building alliances, of compromise; in short, it is a power game.

The most diverse techniques of negotiation must be developed and practiced. If four are needed, eight must be requested, because during the negotiations three of the original eight must be given up; of the five offered, one will eventually fail to materialize. The end result is the four you needed in the first place.

Many accords are vaguely implicit. If *B* is required, do not set out after *B*, but go for *A*. This is not because the issues have been confused; quite simply, *B* can be obtained only through *A*. Although *A* must be obtained to get *B*, the other negotiating parties do not entirely understand why *A* is so important. At times the ground seems rocky, issues complex, and the rules of the game neither fixed nor predetermined. Inside every head is an entire universe! Everybody has a different way to skin the proverbial cat. Essentially this political game is a relatively painful learning process.

Establish leadership. Although the economic policy process demands consensus, it also requires leadership. Someone has to lead the wagon train, push things along, and see that anyone who gets out of line or blocks the way either gets back in line or is shoved aside. This someone, the trail driver of the executive suite, forges ahead, sweeping aside everything blocking the path, until, one fine day, the trail driver comes face to face with the president of the republic. The trail driver may lead the wagon train on a trail with many unfriendly, even hostile, encounters. Experience has shown that this is not necessarily bad. Instead of leading a single wagon at a time, it is preferable to lead several. In this way the wagons can be drawn into a defensive circle; many wagons together can be defended better than one alone. For example, when restrictive measures need to be taken, and the effects will be distasteful, it is important to adopt them in such a way that many different groups will be affected. Thus, I am not the lone victim of the measure; my neighbors are also feeling it. If for some reason it becomes necessary to hold down real wages, workers need to understand that owners' profits are equally affected, as are public budgets managed by politicians. In other words, when belts need to be tightened, everyone loses weight, not just a few. Whether workers are willing to accept the measure depends largely on what they see happening to other groups of society.

Keep the public informed. Another complicated issue to consider is that the public needs to be informed. Everyone needs to understand what objectives have been set, why they were selected, what policy tools will be used, and what measures will be taken. The next question, then, is how many details of economic policy need to be communicated to the public. Certain elements of economic policy would be harmful if they were published in full, specific detail. For example, in introducing our crawling peg, we gave the public enough information so that economic actors could determine, with a reasonable degree of certainty, which way the wind was blowing. Certain details have been released about the frequency and magnitude of exchange-rate adjustments and about the procedure used for calculating them. We have not, however, revealed how much each devaluation would be, or when it would take place. A delicate balance must be struck: On one side of the ledger are the demands of a democratic society in which information should be available to the public, economic actors, and politicians so they can exercise their rights and make their own decisions. On the other side we find information that, if it were released, would prove counterproductive to the community and interfere with the implementation of economic policy. This balance frequently proves to be very difficult.

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