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MANAGING ADJUSTMENT IN DEVELOPING COUNTRIES

Economic and Political Perspectives

Marc Lindenberg ▪ Noel Ramírez

INSTITUTO CENTROAMERICANO DE ADMINISTRACION DE EMPRESAS

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CONTENTS

List of Figures vii
List of Tables ix
Preface xvii
About the Authors xviii
Acknowledgments xix
Abbreviations xxi
Introduction xxiii

Part I: Understanding National Strategy 1

Chapter 1: Key Concepts for Understanding National Strategy 3
Marc Lindenberg

Chapter 2: Designing Short- and Medium-Term Economic Strategies 17
Noel Ramírez

Chapter 3: Managing Winners and Losers: Assessing the Political Impacts of Economic Strategies 35
Marc Lindenberg

Part II: Analyzing Short- and Medium-Term Economic Strategy 59

Chapter 4: Bolivia: Controlling Hyperinflation 1985–1986 61
Noel Ramírez and Marc Lindenberg

Appendix 63

Chapter 5: Costa Rica: Stabilization and Structural Adjustment 71
Noel Ramírez

Appendix 79

Chapter 6: Chile: An Economy in Transition 89
Noel Ramírez

Appendix 97

Chapter 7: Taiwan, 1961: The Search for a Viable Economic Strategy 107
Marc Lindenberg

Chapter 8: The Indonesian Oil Crisis, 1986 123
Naomi Goldstein

Part III: Formulating Industrial Strategy 137

Chapter 9: An Approach to Formulating Industrial Strategy 139
Marc Lindenberg

Chapter 10: Singapore: Switching to an Export Orientation 159
Marc Lindenberg

Chapter 11: Industrial Policy in León: The President's Industrial Policy Commission 173
Marc Lindenberg

Appendix 181

Chapter 12: Industrial Policy in Costa Rica: Import Substitution or Export Promotion 187
Iván Saballos

Appendix 199

Chapter 13: Taiwan, 1986: Choices for the Future 203
Edwin A. Winckler and George C. Lodge

Appendix 221

Chapter 14: Malaysia Planning Exercise: The Dilemma of Employment Policy 225
Marc Lindenberg

Appendix 227

Part IV: Designing Agricultural Strategy 237

Chapter 15: An Approach to Formulating Agricultural Strategy 239
Noel Ramírez

Chapter 16: Costa Rica: The Agricultural Sector and Structural Adjustment 257
Esteban R. Brenes

Appendix 267

Chapter 17: Rice Subsidies in Costa Rica 277
Roberto Artavia

Chapter 18: The Banana Industry in Costa Rica in 1985 285
Alice Howard

Appendix 297

Chapter 19: The Agricultural Sector of San Marcos 305
Francisco Leguizamón

Bibliography 315

Index 323

LIST OF FIGURES

Figure 1.1 Singapore: Political Map, 1966 8

Figure 1.2 Conceptual Framework for Review of National Economic Strategy 10

Figure 1.3 Effects of Country Scenarios on the Competitive Position of the Firm 16

Figure 2.1 Short-Term Economic Problems: A Framework for Analysis 19

Figure 2.2 Contrasting Economic Strategies of the International Monetary Fund and the World Bank 25

Figure 2.3 Contrasting Policy Packages of the International Monetary Fund and the World Bank 28

Figure A4.1 Bolivia: Political Map, October 1982 64

Figure A4.2 Bolivia: Political Map, 1985 65

Figure 7.1 Taiwan: Area and Resources, 1961 109

Figure 7.2 Taiwan: Political Map, 1961 111

Figure 7.3 Taiwan: Consolidated Government Revenues and Expenditures, 1951–1961 113

Figure 7.4 Taiwan: Changes in the Composition of Imports and Exports, 1952–1961 119

Figure 9.1 Import Substitution and Export Promotion: Four Dimensions of Industrial Strategy 142

Figure 9.2 Calculating Rates of Nominal and Effective Protection 144

Figure 10.1 Singapore and Its Neighbors 161

Figure 10.2 Singapore: Selected Data on the Expansion of the Manufacturing Sector, 1963–1967 170

Figure 11.1 León: Political Map, 1984 178

Figure A11.1 León: Socioeconomic and Political Situation, 1983–1984 185

Figure A11.2 León: Economic Situation, 1984 186

Figure A12.1 Costa Rica: Political Map, July 1984 202

Figure 13.1 Taiwan: Changes in Work Force Composition, 1961–Present and Projected 212

Figure 13.2 Taiwan: Major Trade Items, 1985 215

Figure 13.3 Taiwan: Growth in Trade Surplus and Foreign Currency Holdings, 1980–1986 217

Figure A13.1 Taiwan: Savings and Investment as Percentage of Gross National Product, 1975–1985 223
Figure A14.1 Malaysia: Geographic Zones of West Malaysia 236
Figure 15.1 Indexes of Real Exchange Rates and Exports of Agricultural Products in Ghana, Nigeria, Brazil, and Chile, 1961–1982 246
Figure 17.1 Costa Rica: The Rice System until 1985 280
Figure 18.1 Costa Rica: Main Areas of Banana Cultivation, 1985 286
Figure 18.2 World Banana Trade Routes, 1985 290
Figure 18.3 World Prices for Ecuadorian and All Countries' Bananas, 1950–1982 291
Figure 19.1 San Marcos: Organization of the Rural Public Sector, January 1977 308

LIST OF TABLES

Table 1.1 Trade Strategies and Actual Country Performances, 1963–1973 and 1973–1985 4

Table 1.2 Singapore: Country Performance Matrix, 1959–1965 7

Table 1.3 Singapore: Problem List, 1966 9

Table 1.4 Number of Reported Protests against Economic Adjustment Measures, by Type of Group Protesting in Three Central American Countries, 1982–1987 12

Table 1.5 Singapore: Potential Sources of Resistance and Support for a New Export Strategy, 1966 14

Table 1.6 Monitoring Changes in the Intensity and Cohesion of Opposition to New Economic Policies 15

Table 2.1 Composition of a Country's Balance of Payments 21

Table 2.2 Nicaragua: Budgetary Operations of Central Government, 1976–1978 21

Table 2.3 Nicaragua: Sources and Uses of Funds of the Banking System, 1976–1978 22

Table 2.4 Nicaragua: Balance of Payments, 1975–1978 23

Table 2.5 Calculating Imported Inflation (hypothetical example) 24

Table 3.1 Structural Adjustment Lending by the World Bank, 1975–1986 38

Table 3.2 Winners and Losers in Stabilization and Structural Adjustment According to Economic Theory 40

Table 3.3 Typology of Adjustment Policies in Ten Selected Countries 41

Table 3.4 Reported Protests against Economic Adjustment Measures, by Group Protesting, in Three Central American Countries, 1982–1987 42

Table 3.5 Reported Protests against Economic Adjustment Measures, by Issue Protested, in Three Central American Countries, 1982–1987 44

Table 3.6 Styles of Group Protest against Economic Adjustment Measures, by Issue Protested, in Three Central American Countries, 1982–1987 46

Table 3.7 Styles of Group Protest against Economic Adjustment Measures, by Group Protesting, in Three Central American Countries, 1982–1987 47

Table 3.8 Type of Group Protesting Economic Adjustment Measures, by Year, in Three Central American Countries, 1982–1987 49

Table 3.9 Summary of Type of Group Protesting Economic Adjustment Measures, by Year, in Three Central American Countries, 1982–1987 50

Table 3.10 Government Adjustment Policies and Levels of Social Conflict 53

Table A4.1 Bolivia: Inflation Rates, 1952–1985 66
Table A4.2 Bolivia: Monthly Inflationary Tax, 1981–1985 66
Table A4.3 Bolivia: Base for the Inflationary Tax, 1981–1985 66
Table A4.4 Bolivia: Interest Rate of the Central Bank, 1985 66
Table A4.5 Bolivia: Fiscal Accounts of the Government, 1979–1984 67
Table A4.6 Bolivia: Exchange Rates, 1982–1985 67
Table A4.7 Bolivia: Domestic Price of Gasoline, March–July 1985 68
Table A4.8 Bolivia: Tin Exports by COMIBOL, 1972–1983 68
Table A4.9 Bolivia: Growth of GDP, by Sector of Origin, 1979–1985 68
Table A4.10 Bolivia: Distribution of GDP, by Sector of Origin, 1978–1985 69
Table A4.11 Bolivia: Growth of GDP, by Expenditure Category, 1981–1985 70
Table 5.1 Costa Rica: National Accounts, 1980–1982 72
Table 5.2 Costa Rica: Nominal Growth in Domestic Credit, 1981–1982 72
Table 5.3 Costa Rica: Taxation Indicators of the Central Government, 1980–1982 72
Table 5.4 Inflation in Central America: Changes in the Consumer Price Index 72
Table A5.1 Costa Rica: Gross Domestic Product by Sector, 1977–1985 83
Table A5.2 Costa Rica: Aggregate Demand Components, 1977–1985 83
Table A5.3 Costa Rica: Central Government Financial Operations, 1977–1985 84
Table A5.4 Costa Rica: National Banking System, Monetary Picture, 1977–1985 85
Table A5.5 Costa Rica: Balance of Payments, 1977–1985 86
Table A5.6 Costa Rica: Growth Rate of Prices and Exchange Rate, 1977–1985 87
Table A5.7 Costa Rica: Rates of Growth in Unemployment and Wages, 1977–1985 87
Table A5.8 Costa Rica: Foreign Debt Indicators, 1977–1985 87
Table 6.1 Chile: Public-Sector Summary Account 91
Table 6.2 Chile: Average Rates of Growth, 1960–1979 91
Table 6.3 Chile: Tariff Structure Evolution, 1974–1979 91
Table 6.4 Chile: Evolution of Exports, 1970–1979 92
Table 6.5 Chile: Value Added, by Sector, 1970–1979 92
Table 6.6 Chile: Changes in Value Added per Worker, 1970–1979 92
Table 6.7 Chile: Investment Ratios, 1976–1979 93
Table 6.8 Chile: Evolution of Real Effective Exchange Rate Indexes, 1978–1982 94
Table 6.9 Chile: Total Indebtedness as Proportion of Sector's GDP, 1975–1981 94
Table A6.1 Chile: Shares of GDP by Industrial Origin, 1970–1987 98
Table A6.2 Chile: GDP by Industrial Origin, Real Growth Rates, 1970–1987 99
Table A6.3 Chile: Shares of GDP by Expenditure Component, 1970–1987 100
Table A6.4 Chile: GDP by Expenditure Component, Growth Rates, 1971–1983 101

Table A6.5 Chile: Balance of Payments, 1975–1983 102
Table A6.6 Chile: Exports of Merchandise by Product Type, 1971–1987 103
Table A6.7 Chile: Imports of Merchandise by Type of Goods, 1971–1987 104
Table A6.8 Chile: External Debt Evolution, 1975–1987 105
Table 7.1 Taiwan: Exchange Rates and Interest Rates, Official and Unofficial, 1949–1961 113
Table 7.2 Taiwan: Gross Domestic Product of Major Sectors at 1964 Prices 114
Table 7.3 Taiwan: Recovery of Key Products, 1938–1953 115
Table 7.4 Taiwan: Agricultural Employment, Production, and Development, 1952–1960 115
Table 7.5 Taiwan: Distribution of Farm Families and Agricultural Land, by Type of Cultivator, before and after Land Reform 116
Table 7.6 Taiwan: Terms of Trade for Industry and Agriculture 117
Table 7.7 Taiwan: Evolution of Controls over Imports of Manufactures, by Category, 1953–1960 118
Table 7.8 Taiwan: Percentages of Items Falling in Different Ranges of Tariff Rates in Four Tariff Schedules, 1948–1959 118
Table 7.9 Taiwan: Value Added and Employment in the Industrial Sector, 1952–1961 120
Table 8.1 Indonesia: Breakdown of Government Revenue and Expenditure, 1981–1987 124
Table 8.2 Indonesia: Origins and Components of Gross Domestic Product (GDP), 1985 125
Table 8.3 Indonesia: Selected Indicators of Economic Conditions during Period of Fixed Exchange Rate, August 1971–November 1978 127
Table 8.4 Indonesia: Performance Indexes of Nonoil Exports, 1969–1980 128
Table 8.5 Indonesia: Revenue Structure, 1969–1980 129
Table 8.6 Indonesia: Selected Trends in Aggregate Expenditure and Revenue, 1969/70–1979/80 130
Table 8.7 Indonesia: Economic Conditions after the 1978 Devaluation 131
Table 8.8 Indonesia: External Debt, 1980–1986 132
Table 8.9 Average 1986 Monthly Crude Spot Price for Indonesian Oil 133
Table 8.10 Value of U.S. Dollar in Indonesian Rupiahs and Japanese Yen, 1981–1987 134
Table 9.1 Shares of Production and Exports of Manufactures by Country Group, 1965–1985 140
Table 9.2 Comparative Industrial Policy Styles and Industrial Structures in Selected Countries, 1983 and 1985 146
Table 9.3 Selected Countries' Alternative Trade Strategies and Projected Economic Performance over a 20-Year Period 148
Table 9.4 Trade Strategies and Actual Country Performances, 1963–1973 and 1973–1985 148
Table 9.5 Selected Country Groups and Costa Rica: Average Annual Growth of GDP and the Industrial Sector, 1965–1985 149
Table 9.6 Composition of Value-Added Primary Market for Costa Rican Industrial Products, 1973–1985 150

Table 9.7 Costa Rica and Five Neighboring Countries: Assumed Factor Costs and Profitability in the Clothing Industry 151

Table 9.8 Examples of Strengths and Weaknesses Normally Attributed to Import Substitution and Export Promotion 152

Table 10.1 Singapore: British Military Withdrawal and Transition Plans, 1967 160

Table 10.2 Singapore: GDP by Sector, 1960 and 1966 160

Table 10.3 Singapore: Election Returns, 1959 and 1963, and Political Glossary 163

Table 10.4 Singapore and Its Neighbors: Examples of Comparative Costs and Other Data, 1966 164

Table 10.5 Singapore: Government Current and Development Revenues and Expenditures, 1960–1965 165

Table 10.6 Singapore: Money Supply, 1963–1967 166

Table 10.7 Singapore: Balance of Payments, 1963–1967 166

Table 10.8 Singapore: Distribution of Manufacturing Sales in Singapore and Foreign Markets, 1960–1965 169

Table 10.9 Singapore: Industrial Value Added and Employment in Selected Years 170

Table 11.1 León: Proposed Alternatives for Industrial Policy 174

Table 11.2 León: Companies in the Industrial Sector by Size, Market Size, Type of Capital, and Type of Project, 1984 176

Table 11.3 León: Terms of Trade in Agriculture and Industry, 1978–1984 176

Table 11.4 León: Support Price Policy and Agricultural Production, 1982–1983 177

Table A11.1 León: Composition of Industrial Production, by Value Added, Employment, and Percentage of Product Sold in Local Market, 1980 and 1984 181

Table A11.2 León and Four Neighboring Countries: Factor Costs and Profitability in the Apparel Industry 182

Table A11.3 León and Four Neighboring Countries: Factor Costs and Profitability in the Electronics Industry 183

Table A11.4 León: Structure of Industrial Tariffs 184

Table A11.5 León: Profits in the Apparel and Electronics Industries for Producers in Various Markets, 1984 184

Table 12.1 Costa Rica: Gross Domestic Product at Producer Prices, by Sector of Origin, 1979–1982 189

Table 12.2 Costa Rica: Selected Living Standards Indicators, 1979–1982 190

Table 12.3 Costa Rica: Value Added in Industrial Production, by Industrial Area, 1973–1982 191

Table 12.4 Costa Rica: Contribution of Consumer, Intermediate, and Capital Goods to Industrial Production 192

Table 12.5 Costa Rica: Destination of Industrial Exports, 1980–1983 192

Table 12.6 Central American Common Market: Nominal Protection Levels, 1959 and 1967 . . . 193

Table 12.7 Costa Rica: Loans of the National Banking System by Activity, 1978–1982 196

Table A12.1 Costa Rica: Capacity Utilization of Industrial Production, by Industrial Area, 1975–1981 199
Table A12.2 Costa Rica: Destination of Industrial Sales, 1980–1983 200
Table A12.3 Costa Rica and Five Neighboring Countries: Factor Costs and Profitability in the Electronics Industry 201
Table 13.1 Taiwan: Foreign Trade, 1980–1986 206
Table 13.2 Taiwan: Commodity Trade Balance, 1965–1986 206
Table 13.3 Taiwan: Shares of the United States and Japan in Taiwan's Foreign Trade, 1952–1984 207
Table 13.4 Taiwan: Source of Foreign Investment, 1953–1984 207
Table 13.5 Taiwan: United States and Japanese Investment in Taiwan, by Industry, 1952–1984 210
Table 13.6 Taiwan: The Contribution of Exports to Output Growth, 1956–1976 210
Table 13.7 Selected East Asia Countries: Comparative Monthly Wages in Manufacturing, 1984 211
Table 13.8 Taiwan: Exports and Imports, by Country, 1985 214
Table 13.9 Taiwan: Consolidated Public Revenues of All Levels of Government, 1981–1985 218
Table 13.10 Taiwan: Consolidated Public Expenditures of All Levels of Government, 1981–1985 219
Table A13.1 Taiwan: Growth of United States–Taiwan Commodity Trade, 1952–1984 221
Table A13.2 Taiwan: Changes in the Shares of Leading Industries in Manufacturing, 1952–1980 221
Table A13.3 Taiwan: Investment in the United States by Industry, 1959–1984 222
Table A13.4 East Asian Market (excluding China) in the Year 2000 222
Table A13.5 Taiwan: National Government Revenue and Expenditure, 1982–1985 222
Table A14.1 Malaysia: Country Fact Sheet 227
Table A14.2 Malaysia: Government Structures 228
Table A14.3 Malaysia: Ownership of Share Capital of Limited Companies in West Malaysia, 1969 229
Table A14.4 Malaysia: Racial Composition of Labor Force by Geographic Zone, 1970 230
Table A14.5 Malaysia: Political Parties, 1970 231
Table A14.6 Malaysia: Voting Data for the 1964 and 1969 West Malaysian Elections, by Party 232
Table A14.7 Malaysia: Employment of Malays and Other Groups in the Labor Force, the Manufacturing Sector, and in Manufacturing in the Southwest Zone, 1969 232
Table A14.8 Malaysia: Racial Composition of Manufacturing Firm Employment in the Southwest Zone, by Job Category, 1970 233
Table A14.9 Malaysia: Calculation of Alternative Employment Targets for Southwest Zone Manufacturing Activities by 1975 234

Table A14.10 Malaysia: Government Ministries and Their Duties, 1969 235
Table 15.1 Coffee: International Prices per Quintal, Production Profitability and Devaluation over Four Periods 240
Table 15.2 Nominal Protection Coefficients (NPC) for Producer and Consumer Prices of Selected Commodities in Industrial Countries and Regions, 1980–1982 241
Table 15.3 Costa Rica: Agricultural Strategies, 1900–1988 242
Table 15.4 Growth of Agriculture and GDP in the 1970s for Countries Where Agricultural Sector Exceeded 20 Percent of GDP 244
Table 15.5 Tanzania: Official and Unofficial Prices for Selected Crops in 13 Villages, 1979–1981 245
Table 15.6 Relative Price Incentives for Cocoa Farmers in Ghana, Togo, and the Ivory Coast, 1965–1982 247
Table 15.7 Protection of Agriculture Compared with Manufacturing in Selected Developing Countries, Selected Years, 1960–1983 249
Table 15.8 Import Substitution and the Terms of Trade between the Agricultural and Industrial Sectors 250
Table 15.9 Protection, Distortions, and Comparative Advantage 252
Table 16.1 Costa Rica: Gross Domestic Product (GDP) by Sector 258
Table 16.2 Costa Rica: Agricultural Employment 258
Table 16.3 Costa Rica: Evolution of the Agricultural Sector, Selected Indicators, 1974–1987 . . . 259
Table 16.4 Costa Rica: Local and International Prices of Basic Grains and Legumes, 1980–1985 260
Table 16.5 Costa Rica: Effective Protection and Net Effective Protection Rates for Staple Grains, 1980–1985 261
Table 16.6 Costa Rica: Agricultural Credit as a Percentage of Total Credit, 1975–1987 262
Table 16.7 Costa Rica: Average Real Costs of Production per Hectare, and Current Maximum Lending Allowance per Hectare, for Selected Agricultural Products, 1985 262
Table 16.8 Costa Rica: Costs and Benefits of Eliminating Protection for Staple Grains and Milk, 1983–1985 264
Table A16.1 Costa Rica: Comparison between Main Characteristics of Current and Proposed Tariff Schedules, 1985 268
Table A16.2 Costa Rica: Agricultural Exports, by Product, Compared with Industrial, 1970–1987 272
Table A16.3 Costa Rica: Agricultural Gross Domestic Product, by Subsector, 1974–1987 272
Table A16.4 Costa Rica: Agricultural Gross Domestic Product by Subsector and Selected Products 273
Table A16.5 Price of Powdered Milk in Costa Rica and Major Regions of the World, 1976–1984 274
Table A16.6 Costa Rica: Economic Policy in the Agricultural Sector, 1980–1987 275

Table 17.1 Costa Rica: Average Value of Farm Production, by Product, and of Cattle Raised, 1983–1985 . . . 278

Table 17.2 Costa Rica: National Rice Consumption and Actual Rice Consumption Needs, 1975–1985 . . . 278

Table 17.3 Costa Rica: Area Cultivated for Rice, by Size and Number of Individual Farms . . . 278

Table 17.4 Costa Rica: Area Planted, Production, and Yield per Hectare of Rice, 1975–1986 . . . 279

Table 17.5 Costa Rica: Distribution of Rice Production and Yield per Hectare, 1984–1985 . . . 279

Table 17.6 Costa Rica: Rice Prices to Industrialists, Wholesalers, and Retailers, 1975–1985 . . . 282

Table 17.7 Costa Rica: Local and Frontier Rice Price, 1975–1985 . . . 283

Table 17.8 Costa Rica: Rice Production Costs per Hectare, 1985–1987 . . . 283

Table 18.1 Costa Rica: Area Cultivated with Banana for Export, by Type of Ownership, 1976–1983 . . . 287

Table 18.2 Costa Rica: Area, Yield, and Production of Bananas for Export, 1976–1983 . . . 288

Table 18.3 Costa Rica: Comparative Value of Exports, by Product, 1978–1983 . . . 288

Table 18.4 Costa Rica: Direct Labor Utilized by the Banana Industry Compared with Total Labor Force, 1978–1983 . . . 288

Table 18.5 UPEB: Volume of Banana Exports, by UPEB Member Country plus Ecuador, 1974–1983 . . . 289

Table 18.6 Costa Rica: Monthly Prices for Costa Rican Bananas, FOB, in North America, 1977–1984 . . . 291

Table 18.7 FOB Value of 40-lb. Box of Bananas in UPEB Member Countries, December 1984 . . . 293

Table 18.8 Costa Rica: Export Taxes Collected on Banana Exports . . . 294

Table 18.9 Costa Rica: Revenues and Expenses of the Central Government, 1981–1983 . . . 294

Table A18.1 United Brands Company: Summary of Financial Results, 1982–1984 . . . 298

Table A18.2 Castle & Cooke Inc.: Summary of Financial Results, 1982–1984 . . . 299

Table A18.3 R. J. Reynolds Industries: Summary of Financial Results, 1981–1983 . . . 300

Table A18.4 Costa Rica: Annual Exports of Bananas, 1976–1983, by Exporting Company's Own Production and Purchases from Associate Producers . . . 301

Table A18.5 World Exports of Bananas by Country, 1973–1983 . . . 302

Table A18.6 Typical Port Costs for Banana Shipments in Selected Latin American Countries . . . 304

Table 19.1 San Marcos: Expenditure and Investment Budget for Rural-Sector Institutions, 1977 . . . 306

Table 19.2 San Marcos: Value of Agricultural Production by Principal Product, 1976 . . . 306

Table 19.3 San Marcos: Principal Agricultural Products by Principal Geographic Region of Production, 1976 . . . 307

Table 19.4 San Marcos: Number of Farms by Size and Region, 1976 . . . 307

Table 19.5 San Marcos: Number of Farms by Region and Form of Ownership, 1976 . . . 307

Table 19.6 San Marcos: Rural and Urban Population Distribution by Region, 1976 307

Table 19.7 San Marcos: Rural Public-Sector Agency Services, 1976 309

Table 19.8 San Marcos: Geographic Location of Personnel from Rural-Sector Institutions, 1976 310

Table 19.9 San Marcos: Distribution of the Development Bank (BAFOM) Portfolio among the Principal Geographic Regions, by Principal Crop, 1976 311

Table 19.10 San Marcos: Status of Basic Grain Production, 1976 311

Table 19.11 San Marcos: Agrarian Reform Program 1966–1976 312

PREFACE

The International Center for Economic Growth is pleased to publish *Managing Adjustment in Developing Countries: Economic and Political Perspectives* by Marc Lindenberg and Noel Ramírez, designed as a textbook for prospective decision makers and managers in developing countries.

While economics and politics are often treated as separate disciplines in academic settings, in the real world they are, of course, inextricably linked. To be successful, economic policy must reflect this reality. In *Managing Adjustment in Developing Countries,* Lindenberg and Ramírez offer an approach to economic decision making that takes account of the relationship between economic and political factors. As the authors point out, understanding the benefits and risks of a policy, as well as who supports and opposes it, can be essential in determining whether a policy will achieve its aims. After providing a framework for analyzing policy options, they present a number of developing-country case studies in which policy makers have had to take swift action or make crucial decisions under high pressure.

Both Lindenberg and Ramírez have advised leaders of developing countries on matters of national policy. Dr. Lindenberg has been rector of the Central American Institute of Business Administration (INCAE), one of the outstanding business schools in Latin America, and Dr. Ramírez is dean of INCAE's School of Economics. This volume, which resulted from a joint research project sponsored by the International Center for Economic Growth, should be a useful textbook in business and economics schools everywhere.

Nicolás Ardito-Barletta
General Director
International Center
for Economic Growth

Panama City, Panama
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Marc Lindenberg is a lecturer in public policy at Harvard University's John F. Kennedy School of Government where he received the Manuel Carballo Award for Excellence in Teaching in 1989. He is the author of numerous books on problems of international development, such as *Central America: Current Crisis and Future Prospects* (with Jorge Dominguez), *Managing Development: The Political Dimension* (with Benjamin Crosby), and *Public Budgeting* (with Fremont Lyden) as well as many articles. From 1981 to 1987 he was the rector of the Central American Institute of Business Administration (INCAE) in Costa Rica. He completed his B.A. degree in political science at Oberlin College (1967) and his M.P.A. and Ph.D. in comparative and development administration at the University of Southern California.

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We found President Monge's talents at coalition building during economic crisis unique, and appreciated his openness throughout the process. In fact much of our methodology for the economic strategy seminars was developed during our early collaboration with President Monge and the members of his economic team.

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Marc Lindenberg
Noel Ramírez

ABBREVIATIONS

ADB	Asian Development Bank
ADN	National Democratic Action party [Bolivia]
AID	Agency for International Development [United States]
ANEP	National Association for Private Enterprise [El Salvador]
ASBANA	National Banana Association [Costa Rica]
BCG	Boston Consulting Group
BIRF	International Bank for Reconstruction and Finance
CA	Central America
CAAP	Private Agricultural and Agroindustrial Council [Costa Rica]
CACIF	Consolidated Chambers of Private Enterprise [Guatemala]
CACM	Central American Common Market
CAT	Tax savings certificate
CBC	Central Bank of China [ROC]
CCP	Chinese Communist party
CCSS	Costa Rican Social Security Institute
CEMA	Centro de Estudios Macroeconomicos de la Argentina
CENPRO	Export and Investment Promotion Center [Costa Rica]
CIEX	International Center for Exports [Costa Rica]
CIF	Cost, insurance, and freight
CINDE	Costa Rican Coalition of Initiatives for Development
CNT	National Workers Confederation
COB	Bolivian Mine Workers Union
CODESA	Costa Rican State Development Corporation
COMAC	National Agricultural Committee of San Marcos
COMIBOL	Mining Corporation of Bolivia
CPF	Central Provident Fund [Singapore]
CPI	Consumer price index
DAP	Democratic Action party [Malaysia]
ECLA	Economic Commission for Latin America
EDB	Economic Development Board [Singapore]
EEC	European Economic Community
ERSO	Electronic Research Service Organization [Taiwan]
FEDEAGRO	National Federation of Agricultural and Farming Cooperatives [Costa Rica]
FMLN	Farabundo Marti National Liberation Front [El Salvador]
FOB	Free on board
FSLN	Sandinista National Liberation Front [Nicaragua]
GDP	Gross domestic product
GNP	Gross national product
HDB	Housing Development Board [Singapore]
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IICE	Economic Research Institute [Costa Rica]

IMAS . . . . . Mixed Institute for Social Assistance [Costa Rica]
IMF . . . . . International Monetary Fund
INA . . . . . National Learning Institute [Costa Rica]
INCAE . . . . . Central American Institute of Business Administration [Costa Rica]
INS . . . . . National Insurance Institute [Costa Rica]
ITRI . . . . . Industrial Technological Research Institute [Taiwan]
LDC . . . . . Less-developed country
MAG . . . . . Ministry of Agriculture [Costa Rica]
MCA . . . . . Malaysian Chinese Association
MCP . . . . . Malaysian Communist party
MEC . . . . . Ministry of Economy and Commerce [Costa Rica]
MIC . . . . . Malaysian Indian Congress
MIDEPLAN . . . . . Ministry of National Economic Planning [Costa Rica]
MINEX . . . . . Ministry of Exports [Costa Rica]
MIR . . . . . Movement of the Revolutionary Left [Bolivia]
MNRI . . . . . National Revolutionary Movement of the Left [Bolivia]
MOC . . . . . Ministry of Communications [Taiwan]
MOEC . . . . . Ministry of Economic Affairs [Taiwan]
MRN . . . . . National Revolutionary Movement [Bolivia]
NBER . . . . . National Bureau of Economic Research [United States]
NCBG . . . . . National Chamber of Basic Grains [Costa Rica]
NLP . . . . . National Liberation party [Costa Rica]
NOC . . . . . National Operations Council [Malaysia]
NPC . . . . . National Production Council [Costa Rica]
OECD . . . . . Organization for Economic Cooperation and Development
OFIPLAN . . . . . National Planning Bureau [Costa Rica]
PA . . . . . People's Association [Singapore]
PAP . . . . . People's Action party [Singapore]
PCB . . . . . Communist party of Bolivia
PDC . . . . . Christian Democratic party [Bolivia]
PKI . . . . . Communist party of Indonesia
PMIP . . . . . Pan Malaysia Islamic party
PPP . . . . . People's Progressive party [Malaysia]
PRC . . . . . People's Republic of China
PRD . . . . . Democratic Revolutionary party [Panama]
PU . . . . . Pueblo Unido [Communist party of Costa Rica]
PUSC . . . . . Unity Social Christian party [Costa Rica]
RECOPE . . . . . Costa Rica Oil Refinery
ROC . . . . . Republic of China
SAL . . . . . Structural adjustment loan
SAP . . . . . Structural adjustment program
SBN . . . . . National Banking System [Costa Rica]
SDR . . . . . Special drawing right
SIECA . . . . . Central American Economic Integration Secretariat
SIT . . . . . Singapore Investment Trust
SNE . . . . . National Power Service [Costa Rica]
STUC . . . . . Singapore Trade Union Congress
UCADEGUA . . . . . Farmers Union of Guatuso [Costa Rica]
UDP . . . . . Democratic and Popular Unity Coalition [Bolivia]
UMNO . . . . . United Malay Nationalist Organization
UNIDO . . . . . United Nations Industrial Development Organization
UPAGRA . . . . . Union of Small Farmers of the Atlantic [Costa Rica]
UPEB . . . . . Union of Banana Exporting Countries
USAID . . . . . United States Agency for International Development

MARC LINDENBERG AND NOEL RAMÍREZ

Introduction

The purpose of this book is to help future international managers and policy makers understand and participate in the definition of national economic strategies in developing countries. This is not a work for economic theorists. Instead, it attempts to make analytic frameworks and basic economic and political terminology accessible, and it provides case studies of situations in which decision makers have had to define national options.

The chapters and cases, developed and used extensively since 1980 to help the Central American presidents, their cabinets, business leaders, labor organizations, and political parties understand national policy issues, are intended to serve as a learning device for practicing the analysis of national policies. The cases are intended to be used as a basis for class discussion, not to illustrate the correct or incorrect administrative handling of an economic or political situation. In the United States, the materials are currently used at the John F. Kennedy School of Government, Harvard University, and by such consulting organizations as Arthur D. Little and Associates. They are also in use at the Central American Institute of Business Administration (INCAE), Costa Rica; in a growing number of overseas management institutes; and in seminars sponsored by the Inter-American Development Bank (IADB) and the World Bank.

The book proceeds from principle to practice in four parts. In part I, "Understanding National Strategy," conceptual frameworks are presented for organizing economic and political information about past policies, performance, and problems. Typologies for understanding the benefits and risks of new strategies are introduced, along with methodologies for determining which groups might perceive themselves to be winners or losers should governments attempt to implement these strategies.

Part II, "Analyzing Short- and Medium-Term National Strategy," uses cases from Costa Rica, Chile, Bolivia, Taiwan, and Indonesia to help readers study the dynamics and consequences of short-term strategies such as stabilization, and of medium-term strategies such as liberalization and structural adjustment. The cases permit the reader to apply the frameworks from part I in order to understand policy packages and speculate about their economic and political implications.

Part III, "Formulating Industrial Strategy," provides formats for evaluating key choices for the industrial sector, such as import substitu-

tion and export promotion, and the policies often associated with those choices. It uses cases from Singapore, Central America, Malaysia, and Taiwan to help readers understand different aspects of industrial policy and their consequences.

Finally, part IV, "Designing Agricultural Strategy," presents opportunities to review product and market choices in the agricultural sector. Through the use of cases from Latin America, it allows the reader to learn about policy options such as reducing agricultural subsidies and changing the agricultural product mix.

Our approach to this book reflects the assertion that successful strategies to increase growth, employment, and productivity in the world economy can be effectively developed not only for firms but also for countries. It is our contention that students of management and public policy can learn about policy options through the study of cases and conceptual frameworks. We believe the materials that follow can assist them in this learning process.

PART I

Understanding National Strategy

Part I, "Understanding National Strategy," outlines the frameworks that will be used to analyze country strategies throughout the rest of this book. The first chapter, "Key Concepts for Understanding National Strategy," introduces the four areas around which decision makers can organize their analyses: (1) reconstructing the past and understanding the present; (2) shaping the future: short- and medium-term economic options; (3) managing winners and losers; and (4) adjusting the organization to change. The following chapters, "Designing Short- and Medium-Term Economic Strategies" (chapter 2) and "Managing Winners and Losers: Assessing the Political Impacts of Economic Strategies" (chapter 3), explore these frameworks in detail and offer cases to provide practice with them.

Key Concepts for Understanding National Strategy

Societies like ours have no fat to spare. They are either lean and healthy or they die.

—Lee Quan Yew, prime minister, Singapore*

In our present state of development in Singapore, we are not rich enough to be able to set up a welfare state. Our first preoccupation should therefore be the accumulation of wealth through economic growth rather than more equal distribution of existing wealth and a proliferation of state welfare services.

—Goh Keng Swee, minister of finance, Singapore†

Within any developing country, what might a recently assigned manager of a multinational oil company, the newly elected president of the chamber of industries, the recently appointed housing minister, and the young head of a national labor union have in common? If they had lived in Singapore in 1966, when the future of that country's economic strategy was being hotly debated, each would have had to understand the government's viewpoint, as expressed in the quotes at the head of this chapter, and explain it to their constituents. Furthermore, they would have needed to analyze the implications of these government positions for their own organizations' strategies.

The ability to perform such an analysis would have been useful not only in Singapore during that critical period, but anywhere where current development options were—or are—under discussion. Multinational managers and civil servants, in fact, are assigned to a minimum of ten countries before their careers are completed, and have to understand the development strategy in each one of them. Local leaders similarly participate in countless changes of national strategy within their own countries during their professional lives.

Previous experience that new decision makers might have had as political organizers, technicians, or professionals often provides inadequate preparation for the problems they confront. The purpose of this chapter is to offer an overview of key questions and frameworks that have helped others develop a quick grasp of the dynamics of their economic and political environments, the national development strategies employed there, and many of the policy issues they have faced. This overview will be followed by a more detailed discussion of short- and medium-term economic strategy in chapter 2, and of the political management of economic change in chapter 3.

Underlying this approach are a few critical assumptions. First, the more than 126 countries listed in the most recent *World Development Report* are an important unit of analysis.[1] As with firms it is possible to identify strategies and performance characteristics at the country level. Understanding such characteristics is essential to the managers from both

* The *Mirror* (Singapore), July 25, 1966.
† Speech, May 1966.

sectors who want their organizations to remain competitive. Second, we have a particular interest in the more than 73 small countries, those with less than ten million inhabitants. We feel that their strategic problem is extremely difficult due to their economic openness and their vulnerability to external shocks from the world economy.[2] However, there are three reasons why we are convinced that size presents no special disadvantage in the quest for economic well-being: our own work in small countries;[3] the experiences of highly successful small countries like Singapore, Taiwan, and Hong Kong;[4] and the work of other professionals.[5] In fact some colleagues argue that their being smaller and more uniform ethnically and culturally than larger countries actually gives them a special advantage in building national consensus and maintaining more consistent development policies.[6] Third, the need for serious country analysis by managers has become even more urgent because of the global economic crisis of the early 1980s. Managers who did not pay careful attention to these recent changes in their environments ended in bankruptcy, and countries that did not adjust their national strategies continued in a downward spiral. Fourth, there are no guarantees that countries or firms can avert crisis during times of economic readjustment. However, both analysis and good strategy do make a difference.

National strategy may be defined as the ability to unite general objectives with the policies and practices needed to help achieve them. Such a vision is an optimistic one. It asserts that consciously designed national economic strategy can make a difference in a country's level of living.[7] The development experience since the end of World War II bears this out. For example, in 1987 the World Bank reviewed the economic performance of 41 developing countries between 1963 and 1985 based on the strategies they employed. These strategies were classified as strongly outward oriented, moderately outward oriented, moderately inward oriented, or strongly inward oriented (see table 1.1).[8] They

TABLE 1.1 Trade Strategies and Actual Country Performances, 1963–1973 and 1973–1985 (percentage)

Indicators	Strongly outward oriented	Moderately outward oriented	Moderately inward oriented	Strongly inward oriented
1963–1973[a]				
GDP growth	9.8	8.8	4.0	7.0
Real GNP per capita	6.5	5.0	2.0	4.0
Inflation	5.0	6.0	6.0	4.0
Gross domestic savings	13.0	20.0	15.0	22.0
Avg. growth in mfg. exports	14.0	16.0	5.0	10.0
1973–1985[b]				
GDP growth	7.0	4.5	3.0	5.0
Real GNP per capita	6.0	2.0	−0.4	2.2
Inflation	10.0	45.0	16.0	14.0
Gross domestic savings	32.0	20.0	18.0	23.0
Avg. growth in mfg. exports	14.0	14.5	4.0	8.0

a. In 1963–1973 the countries were the following: *Strongly outward oriented* (Hong Kong, Korea, Singapore); *Moderately outward oriented* (Brazil, Cameroon, Colombia, Costa Rica, Guatemala, Indonesia, Israel, Ivory Coast, Malaysia, Thailand); *Moderately inward oriented* (Bolivia, El Salvador, Honduras, Kenya, Madagascar, Mexico, Nicaragua, Nigeria, Philippines, Senegal, Tunisia, Yugoslavia); *Strongly inward oriented* (Argentina, Bangladesh, Burundi, Chile, Dominican Republic, Ethiopia, Ghana, India, Pakistan, Peru, Sri Lanka, Sudan, Tanzania, Turkey, Uruguay, Zambia).
b. In 1973–1985 the countries were the following: *Strongly outward oriented* (Hong Kong, Korea, Singapore); *Moderately outward oriented* (Brazil, Chile, Israel, Malaysia, Thailand, Tunisia, Turkey, Uruguay); *Moderately inward oriented* (Cameroon, Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Indonesia, Ivory Coast, Kenya, Mexico, Nicaragua, Pakistan, Philippines, Senegal, Sri Lanka, Yugoslavia); *Strongly inward oriented* (Argentina, Bangladesh, Bolivia, Burundi, Dominican Republic, Ethiopia, Ghana, India, Madagascar, Nigeria, Peru, Sudan, Tanzania, and Zambia).
SOURCE: World Bank 1988a: 83–85.

found that outward-oriented countries had higher growth in gross domestic product (GDP) and employment, and higher gross domestic savings. In fact the World Bank study showed as much as a 4.0 percent difference in average annual real GDP growth per capita over a 25-year period, depending upon the economic strategy selected. Such sustained differences can literally change the life opportunities for an entire generation in a developing country.

Finally, while success with national strategy is a cause for optimism, this should be tempered with a healthy dose of caution and realism. Since each country's cultural environment is different, no recipes for development can be passed blindly from one to another. Little is known about the complex social and political actions necessary to make national strategy work. However, there are some common questions that leaders can ask to arrive at answers that are appropriate to their special situations.

Managers and leaders stand a better chance of making national strategies realistic if they try to answer the following questions.

1. *Reconstructing the past and understanding the present.* What economic strategy has the country pursued in recent years and how successful was it? What current problems exist?

2. *Shaping the future: short- and medium-term economic options.* What short- and medium-term economic options might be viable for the country? What policies might be required? Which options might be the most attractive and why?

3. *Managing winners and losers.* Which groups might perceive themselves to be winners and losers in the scenarios developed? What tactics might be used to maintain support for new economic strategies?

4. *Adjusting the organization to change.* What organizational adjustments must be made should any of these scenarios become a reality?

Let us look briefly at some of the frameworks that have been useful in analyzing each of these questions.

Reconstructing the Past and Understanding the Present

Studying the recent past helps us see how we got where we are today and whether current trends may continue. Three frameworks have been particularly useful in providing "photos" of past and present country environments, strategy, and performance: (1) country performance matrices (see table 1.2), (2) political maps (see figure 1.1), and (3) problem lists (see table 1.3).

Country performance matrices. Country performance matrices enable a policy maker to organize information about the past rapidly. One of the most useful frameworks, presented by Bruce Scott and his colleagues (see table 1.2), divides critical information into three broad categories: (1) the international and domestic context, (2) country objectives, strategies, and policies, and (3) economic, political, and social results.[9]

Information about the context includes population size and ethnic mix, geographic descriptions, natural resource endowments, domestic and international economic and political conditions (such as tensions with other countries), internal conflicts, and market conditions during the period in question.

Data about objectives, strategy, and policy include broad information about governments' stated intentions for economic growth, employment, income distribution, and political participation; about the general strategies employed in aiming at those objectives (for example, an outward export orientation, a balanced trade orientation favoring neither production for export nor the domestic market, or an inward orientation focused more on domestic markets); about the choice of sectors to stimulate (for example, agriculture versus industry); and finally, about the packages of monetary, fiscal, trade, wage, and exchange-rate policies selected to provide incentives and controls for keeping the strategy on track.

Finally, performance information includes economic data on, for example, rates of gross national product (GNP) growth, sectoral growth, inflation, and unemployment. Social and political performance data include changes in life expectancy, literacy, health, and nutrition, as well as such evidence of discontent as violence levels, strikes, and documented human rights abuses.

All such information can be collected through the use of economic statistics from government agencies, especially the central bank and the minis-

try of finance or planning, as well as from national research institutes, opposition groups, and international organizations such as the International Monetary Fund, the World Bank, and the United Nations. Political and social data can be gathered not only through existing sources such as the World Health Organization, multilateral donor agencies, and Amnesty International, but also through government agencies and special studies.

An example of the utility of a country performance matrix as a photo for rapidly grasping a country's recent history is provided in table 1.2 for Singapore during the 1959–65 period. The matrix reminds us that Singapore is a small island country at the tip of the Malay Peninsula in Southeast Asia with no natural resources but with a good location along the sea lanes between Japan and Europe. While the international economy was expanding in the 1960s so was the escalating conflict in nearby Vietam. Singapore itself had problems with its two closest neighbors. The Sukarno regime in Indonesia, along Singapore's southern border, was engaged in a policy of confrontation. Malaysia, its northern neighbor and major market for industrial sales, expelled it from a multicountry federation. Within Singapore there were tensions between its three dominant racial groups, the Chinese, Malays, and Indians, as well as an uneasy political alliance among groups with competing ideological tendencies (described in the political map in figure 1.1, which is discussed below).

In the immediate postindependence period the government pursued a strategy of stimulating GDP growth through industrial import substitution, but with investments in education, health, and housing, and limited but expanding political participation. The role of government in the process was not simply to encourage private-sector investment with government incentives and the provision of infrastructure but also with coinvestment in new industries. Industrial import substitution of nondurable, labor-intensive goods was a priority along with investments in services and construction. Fiscal policy was quite conservative; in fact balanced budgets were achieved throughout the period. Furthermore, the country maintained relatively low levels of foreign borrowing.

The results of the early period were impressive. Real GDP growth between 1959 and 1965 averaged 6.0 percent. The dynamic sectors were industry, services, and construction. Gains were made in the health status of the population, in literacy, and in the availability of public housing. Unemployment was reduced. The country possessed a solid economic base upon which new initiatives might be built. But what about the levels of political support for the government?

Political mapping. Political mapping provides a quick photo of the relationships between key political actors and the government.[10] In a single page it is possible to look at the government's levels of support and opposition from domestic and foreign pressure groups, political parties, and social sectors (see figure 1.1). The purpose of the photo is to help decision makers determine whether the government's political base is solid enough to continue current policies as well as embark on new ones.

A quick review of relevant terminology is essential in preparing as well as interpreting the political maps that follow. "Pressure groups" are defined as organizations that mobilize their clientele through articulating and defending the specialized interests of their membership without an explicit desire to govern. "Political parties" mobilize and maintain their clientele through articulating and defending broader interests and with the explicit objective of gaining control of the state.[11] "Social sectors" are more general collections of urban and rural upper-, middle-, and lower-class actors that either withhold or channel their support to interest groups, political parties, and the government. "External sectors" are those foreign actors—countries, donor organizations, intelligence agencies like the CIA and KGB, and so forth—that also influence the government and other actors within a particular country.[12]

On the political map, all of the political actors are organized along a continuum based on their levels of support or opposition for the government. For example, the current government and the groups that support it most directly appear in the center in a category called the "central combination." Those groups whose support is the most solid are placed clearly in the center and those whose support is weaker are placed closer to the edges of the central combination. Groups that oppose the government but are willing to participate in the legislature and respect the constitution are placed in the "legal opposition," while those groups that use violence to demonstrate their opposition are placed under "antisystem." Finally, groups and social sectors that are apathetic are not placed on the political map at all. It is important to remember that they represent a large proportion of a developing country's population and that mobilizing them is an important task for most political actors. Groups that want a greater degree of state intervention than the actual government are placed to its left on the polit-

TABLE 1.2 Singapore: Country Performance Matrix, 1959–1965

International context
Vietnam War intensifies
Confrontation with Indonesia
Expelled from Malaysian Federation
Positive growth of world economy

National context
Internal power struggle
Heightened racial conflicts
Language differences
Strong work ethic
Honesty/efficiency

Objectives
Growth
- Maintain GDP growth ahead of population growth

Distribution
- Social investments

Strategies
Short-term
- More production

Medium-term
- Import substitution

Policies
Fiscal
- Balanced budget
- Domestic borrowing

Monetary
- 7 to 10% growth of the money supply

Commercial
- Incentives to industrial import substitution

Labor
- Wage hikes controlled

Exchange rates
- Fixed

Results
Economic (annual)
- GDP growth 6%
- Industry 15%
- Construction 13%
- Services 15%
- Inflation 10%

Social
- Unemployment down
- Health status improved
- More public housing built
- Literacy up

SOURCE: Based on Scott, Rosenblum, and Sproat 1980: 1–17.

FIGURE 1.1 Singapore: Political Map, 1966

	ANTISYSTEM	LEGAL OPPOSITION	CENTRAL COMBINATION	LEGAL OPPOSITION	ANTISYSTEM
EXTERNAL SECTORS	USSR N. Vietnam PRC	Indonesia	United Kingdom United States Hong Kong Taiwan	Malaysia	
REGIME			Lee Quan Yew Ministries Military		
SOCIAL SECTORS		Lower class All sectors	All sectors	Upper- and middle-class Chinese	
POLITICAL PARTIES		Barison Socialist party 33% (1963)	People's Action party 54% (1959) 49% (1963)	Alliance party 46% (1969) UPP/SPA 21% (1963)	
PRESSURE GROUPS		Singapore Trade Union Congress Mass organizations Media	Trade unions Block organizations Press and TV	Clans Business chambers Media	

SOURCE: Based on Lindenberg and Crosby 1981.

ical map while those that want less are placed to its right. A convenient measure of the degree of state involvement is public-sector expenditures as a percentage of GDP.

It is relatively easy to spot coalition problems in political maps by looking for absence of support (blank spaces) or imbalances (large clusters of groups) by comparing maps of the same countries over time. For example, governments with little pressure group or party support in the central combination are in a precarious position, as are governments whose primary support is solely from external actors. Countries with more and more groups moving toward antisystem positions also have difficult problems.

Finally, the maps can be used to help visualize which groups perceive themselves to be winners and losers as a result of recent economic policy and performance. Such analysis provides both a guide to problems and a forum for discussion of new strategies, tactics, and coalitions for both governments and other groups to accomplish their objectives. Data for political mapping come from interviews with country leaders and also from voting data, opinion surveys, media reporting, and academic studies.

Singapore's 1966 political map, as shown in figure 1.1, helps demonstrate some of the concepts and analytical uses of political mapping in general. For example, the central combination looks relatively solid. The regime has its own block organizations, official news media, unions, and political party, which got 49 percent of the vote in the last election. The regime has support from portions of all social classes and racial groups, but slightly more support from English-speaking Chinese and from lower-middle, middle-, and upper-class groups. It also has external support from the governments of the United Kingdom and the United States, but this is not as solid as the internal support it receives from certain trade unions, block organizations, and its own political party. The left side of the map has a cluster of strong and growing domestic opposition from the Barison Socialist party (which has gained an increasing percentage of votes), and from leftist trade unions, media, and external actors. A weaker cluster of business pressure groups, political parties, media, and foreign actors form the political opposition on the right side of the map.

The Singapore political map is useful in diagnosing problems. One problem is the loss of government support in the 1963 elections and the growing strength of groups on the left side of the map. A second problem is the lack of clear external support from key countries and specifically neighbors.

Problem lists. After an analysis of past country performance and political coalitions, it is important to ask whether any changes in context are significant enough to warrant revision of country strategy or policies. This can be done by listing the problems identified in the performance and political maps explained earlier in this chapter. Such problem analysis can be done on an individual basis or. to identify new problems, in group sessions with policymakers.

An example of this kind of problem analysis for 1966 Singapore appears in table 1.3. The table lists the changes in Singapore's context that policymakers believed threatened the viability of its strategy. For example, in that year the British announced closure of military installations in Singapore that generated 10 percent of that country's GDP and employed 40,000 people or around 5 percent of its labor force. In addition Singapore ran the risk of losing 20 percent of its industrial sales due to its deteriorating relationship with Malaysia. On the do-

TABLE 1.3 Singapore: Problem List, 1966

1. Changes in environmental conditions create incompatibility with economic strategy and policies of industrial import substitution.

International:

- loss of jobs due to closure of British military bases (40,000 jobs or 5 percent of all employment)
- threat of loss of Malaysian market for industrial products due to political tensions (10 percent of total industrial output)
- threat to transport lanes and raw material sources due to tensions with Indonesia and Malaysia

Domestic:

- increased opposition from political left

2. Serious question about whether import substitution will create enough jobs to make up for those lost by withdrawal of the British bases as well as to keep up with the growth of the labor force.
3. Will the government be able to maintain its political base of support in the absence of a new strategy to generate growth and employment?

SOURCE: Marc Lindenberg.

mestic scene, groups on the political left were expanding their political base. Analysts and foreign journalists questioned whether the industrial sector, a strong motor during the previous six years, could continue to generate high levels of growth and employment through a policy of import substitution in such a small domestic market.

The mismatch that emerged between certain new features of Singapore's environment and its economic strategy and policies forced leaders to consider new economic options—the next topic in our discussion of country analysis.

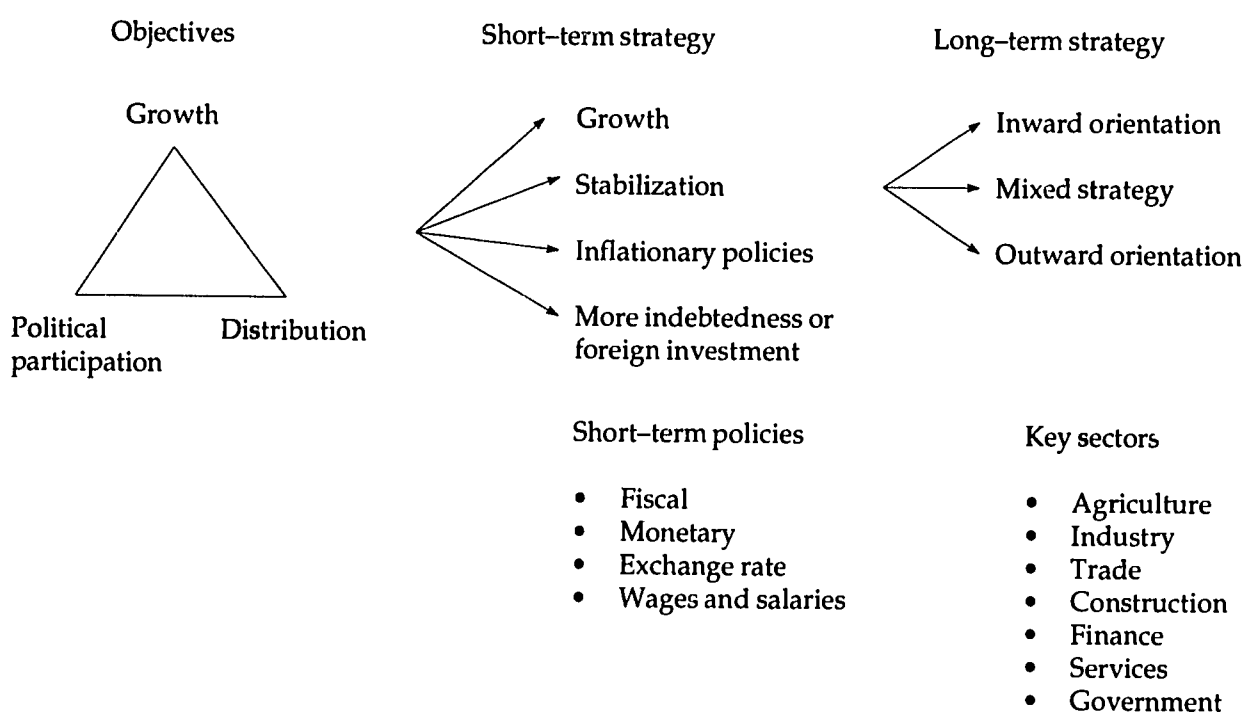
Shaping the Future: Short- and Medium-Term Economic Options

If current problems are serious enough, policy makers may be forced to reconsider both national objectives and short- and medium-term economic strategies and policies.[13] This may require changes in emphasis on particular sectors. Figure 1.2 provides a matrix that helps organize information about the short-term economic choices available to decision makers using the categories mentioned above. For example, shoring up domestic political coalitions may require a government to change the relative emphasis of national objectives on growth, distribution, and political participation. The country might have to alter its short-term economic strategy—the strategy it will follow for the next 12 to 18 months—to reverse an economic collapse or avert future problems.

Short-term options may be thought of as existing along a continuum. At one end of this continuum the government can attempt to expand production to generate new economic growth and employment through, for example, incentives or direct investment in new activities; at the other end it can try to temporarily reduce demand through, for example, stabilization programs.[14] In the middle of the continuum the government can postpone tough decisions about demand reduction or measures to encourage new production by looking, for example, for foreign resources to finance the same efforts, or by using such inflationary policies as increasing the fiscal deficit to keep the economy and employment growing temporarily.

In the case of Singapore in 1966, the country was forced to reconsider its medium-term economic strategy—its strategy for the next two to five years—and decide whether it could continue its inward orientation (growth through stimulating the domestic market) or whether it would have to make a

FIGURE 1.2 Conceptual Framework for Review of National Economic Strategy



SOURCE: Marc Lindenberg and Noel Ramírez.

transition to either an outward orientation (an emphasis on export-led growth) or a mixed strategy (growth through more balanced emphasis on both exports and the domestic market). Understanding this medium-range process of structural adjustment has been one of the most important and controversial tasks for development policy makers in the 1980s.[15]

Depending upon the strategic choices made, there is normally a reorientation necessary in fiscal, monetary trade, labor, and exchange-rate policies, as well as a redefinition of priority sectors—for example, more emphasis on export industry, tourism, or food production. (Chapter 2 is devoted entirely to the discussion of short- and medium-range economic choices for countries.)

Managing Winners and Losers

Sometimes economic scenarios may look so attractive to leaders that they lose sight of the political risks involved in implementing them.[16] Such economic myopia can be fatal to governments that, for example, ignore strong public reaction to stabilization packages or fail to get control of hyperinflation.[17] Although governments are usually not toppled when they pursue unpopular economic policies, the social cost of riots, national strikes, and slowdowns is high. Here are some steps that might be followed in considering the political feasibility of new economic strategies. (A detailed discussion of the analysis of winners and losers in policy change appears in chapter 3.)

Learning from others. There is a great deal to learn from the record of country success and failure in the management of economic change since the 1950s.[18] It is important that those involved in analyzing the feasibility of a new economic strategy consider which groups have normally supported or opposed it in other countries. For example, let us assume that Singapore had needed to embark on a short-term program of stabilization, followed by a medium-term strategy of outwardly oriented growth. (In fact Singapore in 1966 did not have to consider stabilization as an option; it did, however, begin to switch to outwardly oriented medium-range policies.) Policy makers might have looked at the kind of data that appear, for example, in table 1.4 to see who protested similar policy measures in other countries. They might also have asked (as is done in detail in chapter 3) why the political management of the change process went relatively smoothly in some countries but collapsed in others.

Identifying actual supporters and opponents. Potential winners and losers in new economic scenarios can be identified with the help of the political maps discussed earlier. Using the maps an analyst can identify the potential sources of support for and resistance to particular policy packages. For example, an analyst considering potential support for and opposition to a new industrial export-promotion strategy in Singapore in 1966 might have come up initially with the list shown in table 1.5.

Opponents of the new strategy might include, for example, industrialists involved in import substitution who benefit from current high levels of effective tariff protection, subsidized interest rates, overvalued exchange rates, and other incentives. Such groups may fear that they will not be able to compete in their own domestic market should the government open the economy, and that they might not be able to adjust their firms rapidly enough to compete in the international market either. Union leaders from this same industrial import-substitution sector might fear loss of jobs through the closure of noncompetitive industries and the flood of cheap foreign products. In contrast, members of the chamber of commerce might favor such a new strategy because opening the economy to imports might reduce their levels of competition with importers' black market goods. Potential exporters might view the new policy focus very favorably as well.

Such initial hypotheses can be confirmed by individual interviews with business and labor leaders, by group meetings with business chambers or unions, and by opinion surveys.

Monitoring support and opposition. Once decisions are taken to embark on a new strategy, support and opposition can be monitored by further meetings and surveys and by analyzing the actual responses of groups. For example, early warning systems can be designed to anticipate serious problems by looking for changes in the intensity and cohesion of opposition as policies are implemented (see table 1.6). By watching, for example, the number and type of protest incidents over time it is possible to detect changes in the intensity of opposition as groups move from simple public statements to strikes, seizures of installations, and finally terrorist actions. At the same time, one can look for changes in the level of the opposition's cohesion as incidents cease to involve single isolated groups and become multisector actions like national strikes. Such observation can be buttressed by frequent preparation of political maps to see how the government's base of support might be changing during the policy imple-

TABLE 1.4 Number of Reported Protests against Economic Adjustment Measures, by Type of Group Protesting in Three Central American Countries, 1982–1987

Group protesting	Reduced public services	Wages and benefits	Public sector layoffs	Consumer price hikes	Producer subsidy reduced	Tax hikes	Trade and tariffs	General govt. policies	Against IMF/WB program	Total	Percent
	Economic measures in Costa Rica										
Urban labor	2	1	0	1	0	0	0	0	0	4	5.6
Rural labor	4	6	0	2	0	0	0	1	0	13	18.1
Popular groups	7	0	0	9	0	0	0	0	1	17	23.6
Teachers and students	1	3	1	2	0	0	0	0	1	8	11.1
Public employees	0	14	2	0	0	0	0	0	0	16	22.2
Business chambers	0	1	0	0	2	1	1	0	0	5	6.9
Political parties	0	0	0	1	0	0	0	1	0	2	2.8
National labor	0	1	0	0	0	0	0	0	1	2	2.8
National business	0	0	0	0	0	0	1	0	0	1	1.4
National popular	0	1	0	0	0	0	0	0	0	1	1.4
National public sector	0	0	0	0	0	0	0	0	0	0	0.0
Multisector (no private)	0	0	0	0	0	0	0	0	2	2	2.8
Multisector (with private)	0	0	0	0	0	0	0	1	0	1	1.4
Total	14	27	3	15	2	1	2	3	5	72	100.0
Percent	19.4%	37.5%	4.2%	20.8%	2.8%	1.4%	2.8%	4.2%	6.9%	100.0%	
	Economic measures in Guatemala										
Urban labor	1	5	1	1	0	0	0	0	0	8	12.9
Rural labor	1	0	0	0	0	0	0	0	0	1	1.6
Popular groups	3	0	0	3	0	2	0	0	0	8	12.9
Teachers and students	0	2	0	1	0	0	0	0	0	3	4.8
Public employees	0	5	2	0	0	0	0	0	0	7	11.3
Business chambers	0	0	0	1	2	0	1	3	0	7	11.3
Political parties	0	0	0	0	0	0	0	1	0	1	1.6
National labor	0	4	0	1	0	0	0	0	0	5	8.1
National business	1	0	0	0	0	4	2	4	0	11	17.7
National popular	0	0	0	0	0	0	0	0	0	0	0.0
National public sector	0	1	1	0	0	0	0	0	0	2	3.2
Multisector (no private)	0	0	0	3	0	0	0	0	0	3	4.8
Multisector (with private)	0	0	0	3	0	3	0	0	0	6	9.7
Total	6	17	4	13	2	9	3	8	0	62	100.0
Percent	9.7%	27.4%	6.5%	21.0%	3.2%	14.5%	4.8%	12.9%	0.0%	100.0%	

continued on next page

TABLE 1.4 *continued*

Group protesting	Reduced public services	Wages and benefits	Public sector layoffs	Consumer price hikes	Producer subsidy reduced	Tax hikes	Trade and tariffs	General govt. policies	Against IMF/WB programs	Total	Percent
	Economic measures in Panama										
Urban labor	1	15	0	0	0	0	0	0	0	16	19.5
Rural labor	2	4	1	0	0	0	0	1	0	8	18.1
Popular groups	2	0	0	0	0	0	0	0	0	2	23.1
Teachers and students	3	2	0	0	0	0	0	0	1	6	11.1
Public employees	1	7	7	0	0	0	0	0	0	15	22.2
Business chambers	0	0	0	0	0	0	0	0	0	0	6.9
Political parties	0	0	0	0	0	0	0	1	0	1	2.8
National labor	0	4	0	1	0	0	0	0	4	9	2.8
National business	0	0	0	0	0	0	0	1	2	3	1.4
National popular	0	0	0	0	0	0	0	0	0	0	1.4
National public sector	0	2	2	0	0	0	0	0	0	4	0.0
Multisector (no private)	0	2	2	0	0	2	0	2	0	7	2.8
Multisector (with private)	1	0	0	0	0	0	0	5	5	11	1.4
Total	10	36	12	1	0	2	0	10	12	82	100.0
Percent	12.2%	43.9%	14.6%	1.2%	0.0%	2.4%	0.0%	12.2%	14.6%	100.0%	
	Economic measures in all three countries										
Total	30	80	19	29	4	12	5	21	17	216	
Percent	13.9%	37.0%	8.8%	13.4%	1.9%	5.6%	2.3%	9.7%	7.9%	100.0%	

SOURCE: Prepared by Marc Lindenberg and Maria Larraz de Quant, based on content analysis and rating of all reported protest news items in *Inforpress* (Guatemala) between 1982 and 1987. Number of news items may not reflect actual number of protests.

TABLE 1.5 Singapore: Potential Sources of Resistance and Support for a New Export Strategy, 1966

Potential sources of resistance	Key problems or issues
Import-substituting industrialists	Loss of tariff protection Fear of inability to compete in both domestic and international markets
Unions in import-substituting sector	Fear of job loss Fear of erosion of levels of living
Barison Socialist party	Desire for more state intervention than government will permit
Unions	Wage controls
Potential sources of support	**Key benefits**
Chamber of commerce	Lowered tariffs Less competition from black market goods Better-quality goods
Foreign capital	New investment opportunities
Industrial exporters	New investment opportunities
Singapore unemployed	New employment opportunities
Right political parties	New coalition possible
Consumers	Less expensive and higher-quality goods

SOURCE: Marc Lindenberg and Noel Ramírez.

mentation process. If protests start turning serious, governments can evaluate the risks as well as benefits of continued implementation.

Adjusting the Organization to Change

For those in the private and public sector who must live with the consequences of new national strategies, it is useful to study the implications of various scenarios for their organizations. Since there is an excellent literature on competitive strategy and business policy, it is not the purpose of this book to focus on analysis at the firm level or the level of the public organization.[19] However, two frameworks are worth mentioning here. First, a simple analysis of organizational internal strengths and weaknesses and of the external threats and opportunities posed by the new scenarios has proven to be extremely useful to businessmen in developing countries. This can be combined with financial analysis to show how changes in exchange rates, interest rates, and wage policies may affect the firm's profitability, liquidity, and solvency. Other useful concepts have been developed by Michael Porter for looking at the firm's strategy and its competitive position in relation to suppliers, substitute products, competitors, and markets (see figure 1.3). Managers can ask how each new scenario might change the relationships in Porter's framework and either threaten or improve the firm's competitive position.

Summary

The crisis in the world economy during the 1980s has made country analysis for managers and policy makers who work in the developing world more important than ever. These decision makers can organize such analysis around four basic areas: (1) reconstructing the past and understanding the present, (2) shaping the future: short- and medium-term economic options, (3) managing winners and losers, and (4) adjusting the organization to change.

TABLE 1.6 Monitoring Changes in the Intensity and Cohesion of Opposition to New Economic Policies

	Low intensity			High intensity		
	Public statements	Strikes	Demon-strations	Seizure of institutions	Road blocks	Terrorism
Low group cohesion						
Single-group actions						
Two or more groups from the same sector						
Multisectoral coalitions						
High group cohesion						

Less serious problems for the government

More serious problems for the government

SOURCE: Marc Lindenberg.

Notes

Works cited only by author and date are fully listed in the bibliography at the end of this book.

1. See World Bank (1988c).

2. See, for example, Marc Lindenberg (1988a), B. Jalan (1982), and the special 1980 issue of *World Development*, vol. 8, no. 12 (Dec.) called "Islands."

3. Between January 1984 and June 1987, at the request of private-sector leaders and the presidents of Costa Rica, Honduras, El Salvador, Guatemala, and Panama, the Central American Institute of Business Administration (INCAE) conducted 73 seminars to promote dialogue between business, labor, the military, and the public sector: 20 in Guatemala, 10 in Honduras, 16 in El Salvador, 8 in Panama, and 9 in Costa Rica. These seminars explored the problems of country strategy in small, open, export economies.

4. Among the more interesting materials on these transformations are those by Shirley Kuo et al. (1981) and Lawrence Lau (1986).

5. See for example, Joan Nelson (1988), Peter Katzenstein (1986), Boris Blazic-Metzner and Helen Hughes (1982), and Gustav Ranis and Louise Orrock (1985).

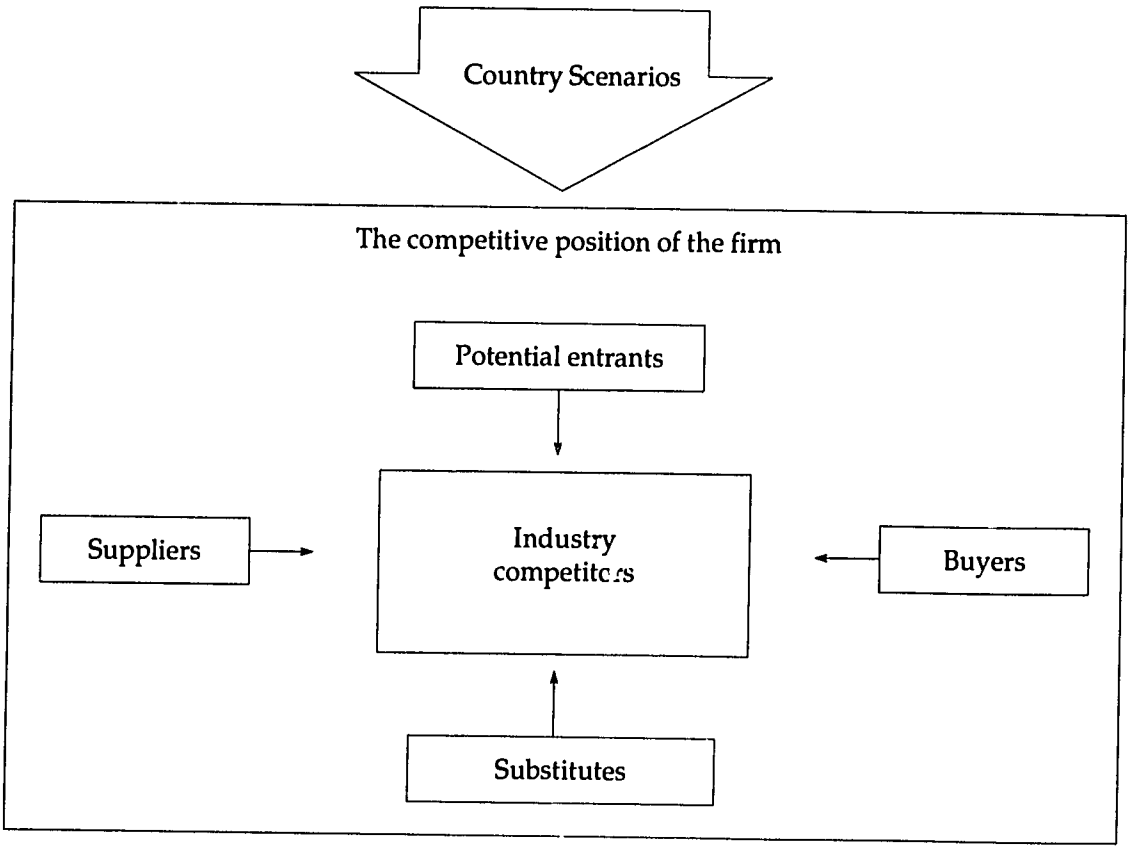
6. Blazic-Metzner and Hughes (1982) as well as Katzenstein (1986) make this point effectively.

7. The role of strategy and creating dynamic advantage at the country level is effectively presented by Bruce Scott and George Lodge (1985, particularly chs. 1, 2, and 14); see also Michael Porter (1986). Robert Reich (1982, 1983) also presents interesting views about dynamic comparative advantage.

8. See also World Bank (1988a: 82–94).

9. Development of this matrix came out of the materials design process in the Harvard Business School's courses on business, government, and the environment and is most effectively presented in

FIGURE 1.3 Effects of Country Scenarios on the Competitive Position of the Firm



SOURCE: Adapted from Michael Porter, *Competitive Strategy* (New York: Free Press, 1980), p. 4.

Bruce Scott et al. (1980: 1–18).

10. For literature on the origins of this approach and its uses, see Marc Lindenberg and Benjamin Crosby (1981) and Warren Ilchman and Norman Uphoff (1969).

11. For more comprehensive definitions refer to the glossaries in Ilchman and Uphoff (1969).

12. Ibid.

13. For an interesting source that makes ideas on short- and medium-term economic strategy and policy accessible to policy makers from developing countries, see Noel Ramírez (1987b).

14. One of the most useful sources on the objectives of stabilization and structural adjustment is Constantine Michalopoulos (1987); see also William Cline and Sidney Weintraub (1981).

15. For a good discussion of the problems and prospects of structural adjustment, see Armeane Choksi and Demetris Papageorgiou (1986); for a less optimistic view, see Giovanni Andrea Cornia et al. (1987).

16. See, for example, Joseph Ramos (1986) and Benjamin Crosby (1987). The Overseas Development Council has a book on the politics of structural adjustment forthcoming in 1989. See also Joan Nelson (1987).

17. A growing literature is beginning to emerge on the political reaction to the economic strategies of the 1980s; see, for example, R. Bernal (1984) and James Petras and Howard Brill (1986).

18. See, for example, Nelson (1987, 1988), as well as the forthcoming book by the Overseas Development Council. See also Thomas M. Callaghy (1987).

19. See Michael Porter (1980, particularly chs. 1 and 2).

-11-

Designing Short- and Medium-Term Economic Strategies

As soon as it was apparent that Gen. Augusto Pinochet had been refused eight more years in power in a plebiscite last Wednesday, Chilean opposition groups quickly reassured businessmen that many of his economic policies would be maintained once democracy returns here. The reaction was understandable. . . . General Pinochet constantly reminded Chileans of the country's recent economic growth—running at about 5.7 percent per year for the past three years—and warned that economic chaos would follow his defeat.

—*New York Times*, October 10, 1988

Economists are not naive and do not need textbooks to be convinced about the complexity level involved in the economic development process. They know there is no magic formula; that there is no combination of one or two or even ten or twelve policy instruments which, once applied in the right order, can ensure economic growth.

—Arnold C. Harberger *

As the above report from Chile indicates, public and private sector managers must think carefully about the changing economic conditions in which they operate and the policies they might face under different regimes. Those who cannot cope with economic change create serious risks for their organizations. Unfortunately, as Arnold C. Harberger says, there are no recipes for the development of economic policy. Even during the relative stability of the 1960s and 1970s. the task of anticipating economic policies and adapting organizations to change was not an easy one. Since the world economic collapse of the 1980s, this job has become even more difficult.

However, there are frameworks that may help managers organize information about the possible causes of economic problems and the probable short- and medium-term strategies and policies their governments might pursue. The purpose of this chapter is to provide readers with further exposure to general frameworks, introduced in chapter 1, to help them assess the implications of these difficult issues for their organizations.[1]

A Framework for Analyzing Economic Strategies

Characteristics of the economy. Both the relative size of their economies and the relative importance to them of world trade help to explain some of the

* *World Economic Growth* (San Francisco: ICS Press, 1984), p. 427.

differences in economic behavior among countries. Large and relatively closed economies like the United States may respond positively to certain economic policies, while these same policies may lead to opposite results in the more than 70 small countries with more open economies, such as Honduras, Zambia, and Hong Kong.[2]

During the period between the Great Depression and the 1950s, world economic thought was dominated by the ideas of John Maynard Keynes.[3] Few economists, until quite recently, were interested in understanding some of the differences in the way small and relatively open, developing-country economies respond to economic policy. Keynesian theory did influence the design of national economic policy in many developing countries. However, the financial imbalances experienced by many of the small open economies that had applied Keynesian policies prompted professionals from the International Monetary Fund and such institutions as the University of Chicago to develop new perspectives based on what is now called the "monetary approach to balance of payments."[4]

Using the new frameworks economists noted, for example, that large and relatively closed economies responded to expansionary monetary and fiscal policies quite differently than their smaller and more open neighbors. Keynesian theory had made the general case that monetary policy could be used to offset economic cycles in the following manner. During a decline in economic activity, the money supply could be expanded. The increased liquidity would then help reduce interest rates, encourage domestic demand, and—without generating inflation—stimulate economic recovery until full capacity was reached. However, the same countercyclic monetary policy in the open economies of developing countries produced different results, depending upon the level of sophistication of the small country's financial market. For example, in small and open economies with relatively well-developed financial markets, excess liquidity generated through expansionary monetary policy also helped reduce domestic interest rates. However, instead of responding to the stimulus of lower interest rates to increase domestic investment, many third world businessmen simply moved their capital out of the country in search of higher profits elsewhere.

In small and open economies with poorly developed financial markets, the results were even more perverse. Expansionary monetary policy helped create excess liquidity in the hands of the public. This new purchasing power was translated into a growing demand for goods that could not be produced internally. The result was often additional imports, which could be financed without inflation—until the country's international reserves were used up.

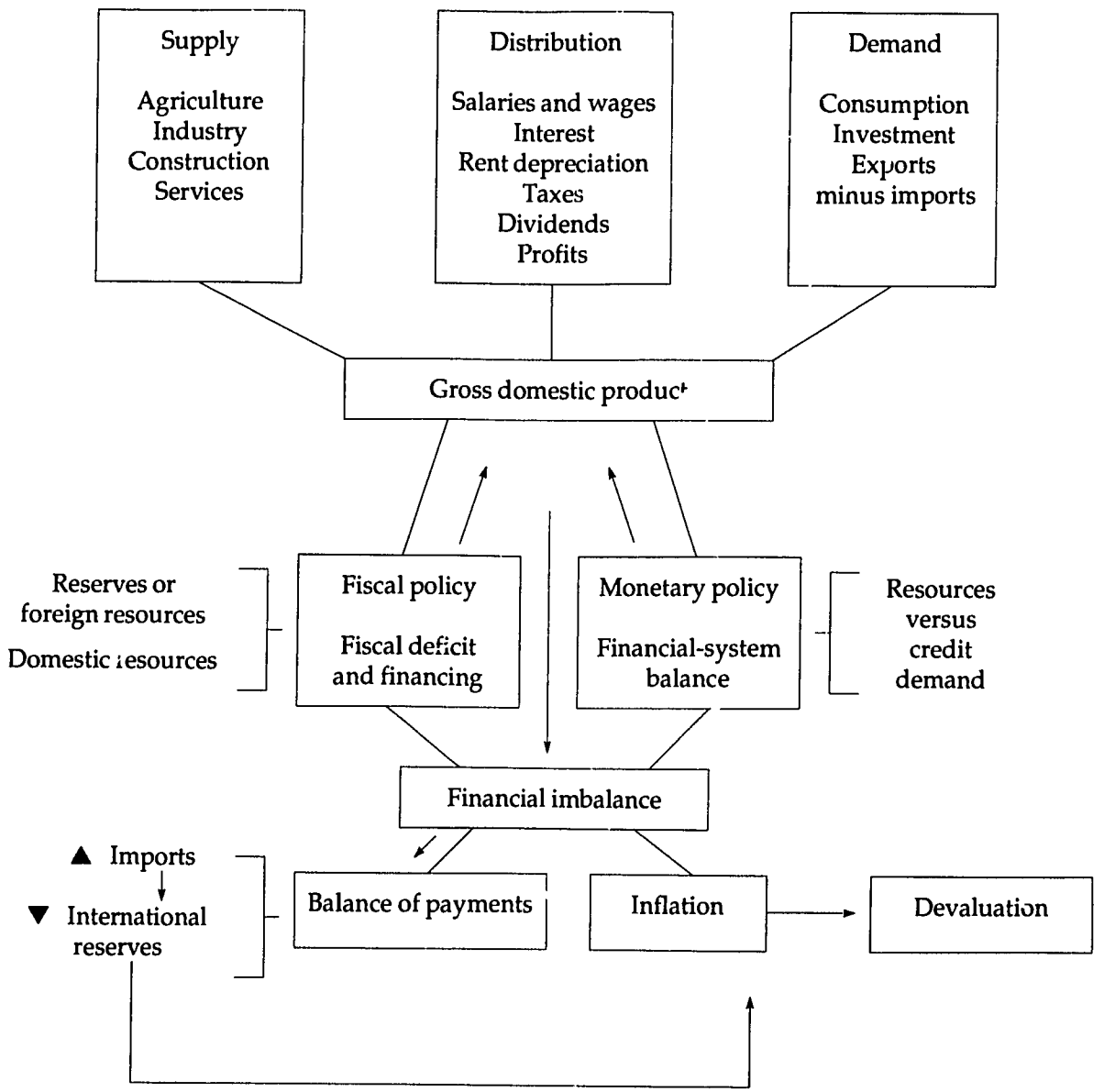
Economists also noted that the sources of economic imbalances were often different depending upon a country's size and degree of economic openness. For example, while large and closed economies were hardly immune to imported inflation, their smaller, more trade-dependent neighbors imported even more inflation because their total imports were an even larger percentage of total gross domestic product (GDP). In the larger and more closed economies, more frequently than in the smaller ones, the causes of inflation were found in domestic policies to stimulate demand.

Finally, certain policies appeared to have a more immediate impact in small, open economies than in large and closed ones. For example, since small and open economies had little influence on the world price of their exports, devaluation became a short-term policy alternative to restore export-sector profitability, since international price increases did not compensate quickly for the inflation created by financial imbalances.

A framework for diagnosing short-term economic problems and policy responses. The effects of short-run economic problems and the policy responses to correct them in small and open economies can be traced with the assistance of a framework based on four elements: production, fiscal policy, monetary policy, and balance of payments. Production and balance-of-payments levels reflect the performance of the economy, whereas fiscal and monetary policies show the types of involvement available to the state to influence the behavior of the first two elements.

While this framework overlooks many economic variables, it can provide a quick assessment of the way in which problems like inflation might jeopardize exchange-rate stability and lead to financial and economic collapse. The framework (summarized in figure 2.1) requires information from the following sources, published periodically in most countries by the central bank or the ministry of planning: (1) national accounts showing the performance of GDP and its components; (2) public-sector revenues and expenditures; (3) the monetary picture showing the performance of the national financial system; and (4) balance-of-payments data recording

FIGURE 2.1 Short-Term Economic Problems: A Framework for Analysis



NOTE: ▲ means rising; ▼ means declining.
SOURCE: Noel Ramírez.

the country's trade and financial operations with the rest of the world.

Gross domestic product (national accounts). GDP data are used to observe changes in a country's levels of economic activity. GDP is typically measured either at current prices, that is to say, when price-level changes are taken into account; or at constant prices, for instance "at 1950 prices," where real production levels are shown without the distortions due to price changes. For example, if a country produced 100 tons of wheat in 1986, when the unit price was 2 pesos, and in 1987 earned an income of 400 pesos with the same production level, then GDP

growth at constant prices was zero, although it increased 100 percent at current prices.

GDP can be reported from three different, though complementary, perspectives. The supply-side approach measures the net contribution generated by each sector of the national economy (agriculture, industry, construction, and services). The demand-side approach measures how national production is used (public and private consumption, plus public and private investment, plus the result of exports minus imports). Finally, GDP can be measured by calculating its distribution among factors of production (wages, rent, interest, and profits) and returns to the state in the form of taxes.

Each measure of economic activity offers a different perspective. For instance, supply-side calculations permit observation of rates of economic growth by sector and identification of specific sectoral problems. Demand-side observations allow a review of the mix of resources allocated to future growth through more current investment versus higher current levels of consumption.

Fiscal policy. Analysis of fiscal policy provides an overview of the structure of public spending and taxation, the size of the fiscal deficit and, more important, how this deficit is financed. Fiscal deficits are normally calculated as a percentage of GDP at current prices. The idea is to avoid confusing the growth of the deficit in absolute terms with changes in the real burden a nation may accumulate if the deficit actually increases as a percentage of GDP. Such deficits can be financed either with foreign resources directly contracted by the government—for example, loans from international commercial banks to the ministry of finance—or with domestic resources, such as those received from the national banking system.

According to the monetary approach to the balance of payments, fiscal deficit financed with foreign resources are not a source of price instability. The reason given is that the deficits could finance additional imports to face increased demand, leaving domestic prices unaffected. On the other hand, should the deficit be financed by increasing the money supply, this increase in domestic demand could unleash an inflationary process, since there would not be an equivalent increase in the supply of goods.

Monetary policy. In a closed economy the monetary authority controls liquidity through open-market operations, legal reserve requirements, and portfolio ceilings. The same tools can be used in open economies. However, according to the monetary approach, only credit can be controlled and, through it, the level of foreign reserves, since liquidity is determined by the general public. The financial system can sustain a specific level of domestic credit by making use of foreign debt, international reserves, domestic resources backed by national production, and monetary emission. In this approach, only the last source of financing is thought to be inflationary.

In order to know for sure what type of resources have been used to finance a fiscal deficit, it is necessary to take a look at the overall monetary picture, including the borrowing practices of the central bank. The monetary picture reflects the general credit policy being implemented.[5]

These data can be observed through studying a balance sheet for the financial system. The system's assets typically include private and public credit balances; its liabilities are comprised of both foreign and domestic resources. Domestic resources include both money, consisting both of cash and of highly liquid demand deposits; and quasi-money, which includes time deposits, bonds, and any other relatively illiquid securities existing in the marketplace. Money and quasi-money combine to form liquid assets, that is to say, the total domestic liquidity existing in an economy at a given time. The total demand for domestic credit can be sustained not only by domestic resources but also by a country's international reserves.

While domestic resources are the soundest source of financing a country's economic activity, they can also generate financial instability. For example, if nominal credit grows at a faster pace than GDP, the consequences often are: (1) a higher level of foreign indebtedness; (2) a loss of international reserves; or (3) a squeeze at the domestic price level (inflation), once alternatives 1 and 2 have been resorted to. These inflationary results are one of the reasons why countercyclic monetary policy does not appear to be an efficient tool to offset economic cycles in small and open economies.[6]

Foreign sector. The last element in the framework is the foreign sector, whose behavior is reflected in the country's balance of payments. The balance of payments, as shown in table 2.1, is made up of three parts: (1) the "current account," recording the country's imports and exports of goods and services; (2) the "capital account," which includes the net movement of public and private capital (withdrawals minus amortizations); and (3) changes in

TABLE 2.1 Composition of a Country's Balance of Payments

1. Real portion ("current account")	Imports and exports
2. Financial portion ("capital account")	Net capital movement (official and private capital)
Errors and omissions	
3. Change in net international reserves	Real portion + financial portion

SOURCE: Noel Ramírez.

net international reserves. If the first two accounts generate a surplus, then international reserves increase. In the opposite case, reserves are reduced by an amount equal to the existing deficit.

Economic strategies and policies aiming at offsetting a country's financial imbalances through the balance of payments, leaving domestic price levels unaffected, cannot be implemented indefinitely. Once reserves are depleted and more foreign borrowing is not feasible, the government faces the following dilemma. Either it must implement a stabilization program—which will safeguard the country's financial and exchange-rate stability at the expense of slower economic growth and more unemployment—or it can continue the expansionist policies that depleted its reserves, and spark an inflationary process that will maintain employment in the short run at the expense of the country's medium-term financial stability. Neither choice provides an effective long-term solution.

Using the analytical framework: Nicaragua 1976–1979. To illustrate how the framework can help trace the impacts of economic problems and policies, let us observe some interesting economic changes that took place in Nicaragua during the last three years before the Somoza government fell as a result of the Nicaraguan revolution. Table 2.2 shows the budgetary operations of the Nicaraguan government in the years 1976 through 1978.

In Nicaragua the fiscal deficit grew rapidly between 1977 and 1978. The increase of over 700 million cordobas in current government expenditures was the consequence of mounting pressure on the Somoza government to maintain itself in power while the revolution was in progress. However, in 1977 the government managed to secure the resources needed to finance the deficit from foreign sources. Due to the difficulty in getting foreign resources in 1978, the deficit for that year had to be covered with domestic financing. An analysis of the balances of the national banking system for 1976–

TABLE 2.2 Nicaragua: Budgetary Operations of Central Government, 1976–1978 (millions of cordobas)

Item	1976	1977	1978
Ordinary revenue	1,527.3	1,795.7	1,621.3
Current expenditures	1,210.2	1,539.1	1,979.4
Current savings	317.1	256.6	-358.1
Capital expenses	813.1	1,301.0	825.7
Deficit (–) or surplus (+)	-496.0	-1,044.4	-1,183.8
Financing	496.0	1,044.4	1,183.8
Foreign net	369.1	978.8	69.1
Withdrawals	470.4	1,151.8	381.6
Amortization	-101.3	-173.0	-312.5
Domestic net	126.9	65.6	1,114.7
Central bank net	42.7	16.4	636.3
Income tax retention	36.0	39.8	103.7
Floating debt	45.9	28.1	318.2
INSS [a]	25.0	29.0	39.0
Other	-22.7	-47.7	17.5

a. Instituto Nicaragüense de Seguridad Social (Nicaraguan Institute for Social Security).
SOURCE: Central Bank of Nicaragua.

TABLE 2.3 Nicaragua: Sources and Uses of Funds of the Banking System, 1976–1978 (millions of cordobas)

Item	1976	1977	1978
Sources			
Cash	639.4	701.2	896.2
Demand deposits	1,036.0	1,084.7	1,001.6
Time and savings deposits	1,076.2	1,147.9	991.2
Deposits of other financial institutions in the central bank	46.8	48.8	39.5
Capital and reserves	525.1	538.6	587.9
Government credit	60.2	61.4	61.4
FED (credit net)[a]	106.3	170.4	249.7
Foreign resources			
Short-term	712.3	1,096.6	2,072.6
Long-term	456.1	396.4	399.8
Other	8.9	65.1	72.3
Subtotal	4,667.3	5,311.1	6,372.2
Uses			
Domestic credit			
Central government (net)	75.7	145.1	724.1
Official entities	19.0	22.4	55.4
Other financial institutions	51.7	59.2	492.7
Private sector	2,971.3	3,539.1	3,877.0
Other assets (net)	458.9	391.5	656.1
Gross reserves	1,109.7	1,153.8	566.9
Subtotal	4,667.3	5,311.1	6,372.2

a. Fondo Especial de Desarrollo (Special Development Fund).
SOURCE: Central Bank of Nicaragua.

1978 reveals that domestic credit increased by over 1,900 million cordobas (see table 2.3). While this could have fueled an inflationary process, it was basically financed by foreign resources and international reserves so that, in 1978, inflation in Nicaragua was only 4 percent.

As table 2.4 reveals, Nicaragua had a trade surplus of US$92 million in 1978 but also lost approximately US$224 million in international reserves. The main cause of this loss of reserves was private capital flight. This case hints that the crisis reflected in the balance of payments apparently did not stem from excess demand, and consequently from excess imports, but from a political crisis, the Nicaraguan revolution.

Imported inflation. To complete our discussion of the framework, it is necessary to recognize that imported inflation is often a major source of financial instability in small and open economies.[7]

When the source of a country's financial instability is largely imported, but the solutions applied are relevant only to control domestically caused inflation, policy makers can unwittingly choke economic growth. For instance, if inflation has been brought about by a rise in oil prices, and policy makers restrain domestic credit, they run the risk of bringing the country to a standstill. Thus it is useful to have a simple framework available to help trace the impacts of imported inflation as a source of financial instability.

Imported inflation is determined by three basic elements: (1) the "import basket," that is, the percentage of the total being imported from each particular country or region; (2) the domestic inflation existing in each import-supplier country; (3) U.S. dollar fluctuations with respect to third-country currencies. Table 2.5 provides an example of how to calculate imported inflation, which in this hypothetical case reaches 15.6 percent.

If an economy's total inflation is 10.0 percent, we should estimate how much of the 15.6 percent imported inflation is contributing to that 10.0 percent. An approximate answer is found by multiplying imported inflation—let us call it 15.0 percent—by the ratio of imports to GDP. That is to say, if imports

TABLE 2.4 Nicaragua: Balance of Payments, 1975–1978 (millions of U.S. dollars)

Item	1975	1976	1977	1978
A. Goods, services, and donations	–184.1	–38.7	–182.0	25.0
FOB exports	374.9	541.8	636.2	646.0
FOB imports	–482.2	–485.0	–704.2	–553.3
Trade balance	–107.3	65.8	–68.0	92.7
Service income	89.3	91.8	105.4	131.5
Freight and insurance	15.2	12.8	16.3	14.9
Travel	26.3	23.8	33.9	25.3
Profits and interest	8.2	11.2	9.7	7.6
Reinsurance	6.1	3.8	8.6	45.2
Other	33.5	35.9	36.9	38.5
Service outlays	182.8	197.5	230.6	258.5
Freight and insurance	29.1	27.1	40.4	31.2
Travel	32.3	35.1	46.3	59.8
Profits and interest	61.3	78.0	78.0	101.2
Other	60.1	57.3	65.9	66.4
Balance of services	–93.5	–105.7	–125.2	–127.1
Donations (net)	16.7	10.2	11.2	9.4
B. Private capital movement	44.5	26.8	–67.1	–282.5
Direct investment	11.0	12.9	10.0	7.0
Withdrawals on loans	10.0	15.0	16.0	13.9
Amortizations	–6.4	–6.0	–9.0	–16.8
Commercial credit and other	29.9	4.9	–84.1	–286.6
C. Official capital movement	112.2	65.3	196.4	43.2
Withdrawals on loans	159.4	74.7	245.3	101.5
Amortizations	–20.3	–40.5	–50.2	–52.2
Other	–26.9	31.1	1.3	–6.1
D. Errors and omissions	–4.3	–13.7	–3.9	–10.0
E. Total balance (A+B+C+D)	–31.7	39.7	–56.6	–224.3
F. Change in net international reserves[a]	31.7	–39.7	56.6	224.3

a. A (–) sign indicates an increase in reserves, and no sign means a decrease.
SOURCE: Central Bank of Nicaragua.

accounted for 50.0 percent of GDP, imported inflation should have contributed 7.5 out of 10.0 percent total inflation. This information is extremely critical, since it lets one know how significant imported inflation is as a source of the financial instability the country is suffering, and hence how to provide an adequate solution to the inflationary problem.

General considerations of the framework. The framework also helps to show the dangers of inconsistencies in macro policies. For example, if policy makers try to stimulate domestic demand with expansionary fiscal and credit policies while restraining imports, and if there is also a shortage of foreign exchange, an inflationary cycle may be generated because the total supply of goods available to the economy will not match demand. This does not mean it is irrational for policy makers to try to ration foreign exchange when there are shortages. It simply underscores the need for symmetry between economic policies affecting domestic demand and those having an impact on supply.

Now that a framework for tracing the causes of financial imbalances in small and open economies has been presented, let us review the different national strategies governments might implement in the short and medium term.

National Economic Strategies

General definitions. While some governments define their economic policy objectives with more clarity than others, most stress one or more overall

TABLE 2.5 Calculating Imported Inflation (hypothetical example)

	(A)	(B)	(C)	(D=B+C)	(E=AxD)
Countries we import from	Percentage we import	Domestic inflation by country	US$ fluctuation with respect to other currencies	Total effect	Total weighted effect
USA	50	10	—	10	5.0
Japan	30	12	10[a]	22	6.6
Others	20	20	—	20	4.0
Total	100	—	—	—	15.6

a. Devaluation of the dollar with respect to the yen by 10%.
SOURCE: Noel Ramírez.

objectives such as economic growth, more even income distribution, or broad versus narrow participation in economic and political processes. The emphasis given each will guide national strategy in one direction or another. For example, from 1965 to 1969 the government of Malaysia emphasized rapid economic growth. Its policies were relatively consistent with this overall objective and it had a great deal of success. After the race riots in May 1969, however, it altered its focus to combine growth and income distribution as major objectives. In contrast the Pol Pot regime's emphasis on a program of radical income redistribution at the expense of economic growth in Kampuchea (Cambodia) in the 1970s, led it down a path of economic collapse and ostracism by many nations in the international community. Finally, Sri Lanka in the 1970s emphasized participation, growth, *and* income distribution. These broad choices, even when they are not made explicitly, help to structure the policy package that follows. Thus, managers must try to identify them.

Once a general strategic direction is identified, managers might look at the fiscal, monetary, trade, wage, and exchange-rate policies governments use to try to implement the proposed strategy. While consistency among macro policies and between short- and medium-term strategies is one of the keys to a regime's success, it is by no means the norm. For example, it would be inconsistent for a government to encourage an export-promotion program in the medium term while implementing inflationary policies that lead to an overvalued exchange rate—a disincentive to the export sector in the short run. However, for political reasons some governments prefer short-term regime survival to long-term policy consistency. Managers need to be critically aware of how governments view their short- and long-term strategies as well as what their own time horizons are. They need to be able to identify inconsistencies in policy and what these imply for their organizations.

Short-term strategies. In the short term, that is to say, within 12 to 18 months, a government might implement either of two economic strategies: on the one hand, growth through stimulating domestic demand together with incentives to produce for the domestic or export market; or, on the other, when there is a lack of growth, a stabilization program to correct economic imbalances. However, when governments are capable neither of promoting growth nor of implementing stabilization to correct imbalances, they often resort temporarily to foreign borrowing and, in absence of this, to inflationary policies.

Economic growth. GDP growth is attained by expanding overall national production, increasing factor productivity, or substantially improving terms of trade.[8] Depending on the size of the economy, and the productive sector's capacity to respond to economic policies encouraging production, this strategy may turn out to be extremely beneficial. However, in many countries, the capacity to increase production levels in the short term, even when installed capacity exists, is relatively limited by low productivity, lack of business confidence, and world market conditions.

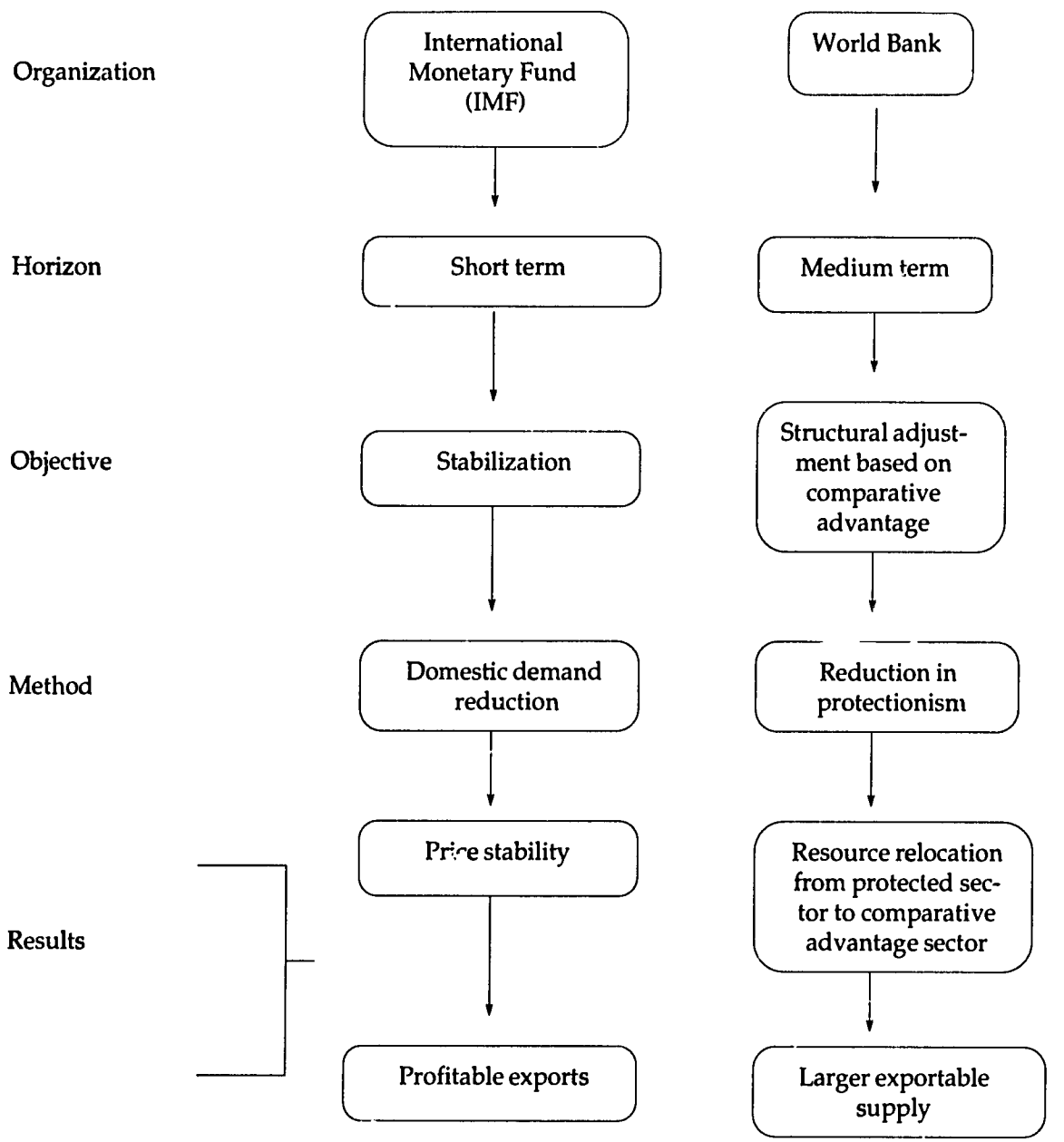
Stabilization programs. In the face of lack of growth, economic imbalances, and hyperinflation, many governments in the 1980s resorted to stabilization programs.[9] The objective of stabilization is usually to correct economic imbalances, preserving the country's financial stability and providing the foundation for eventual economic recovery. Stabilization is often distinguished from structural adjustment, which is a medium-term effort to reorient the

economy based on its increased productivity and competitiveness in the world economy.

Both the International Monetary Fund (IMF) and the World Bank have played expanding but different roles in stabilization and structural adjustment.[10] IMF programs are aimed primarily at remedying short-term problems; they have the common objective of reaching price stability, which is attained through cuts in domestic demand, without paying much attention to the problem of reallocating country resources to increase supply. Conversely, the World Bank focuses more on structural adjustment problems that can be solved only in the medium term through better utilization of a country's resources. (See figure 2.2 for a review of the roles and policies of these organizations.)

Stabilization programs require difficult political and economic decisions, since they typically lead to increased unemployment, short-term reductions in real wages, and cuts in government programs and

FIGURE 2.2 Contrasting Economic Strategies of the International Monetary Fund and the World Bank



SOURCE: Noel Ramírez.

employment. In many instances, they require deep devaluations and sharp declines in national liquidity, which reduce the population's purchasing power.

Orthodox stabilization programs follow the guidelines promoted by the IMF. But many countries with severe imbalances implement these programs without the IMF's resources and technical support. Unorthodox stabilization programs have been introduced by some governments in an effort to alleviate the social cost of traditional adjustment and to manage the adjustment in a more controlled fashion. Such programs are designed not only to bridge the fiscal gap but also to protect high-risk poverty groups with special fast-disbursing programs of food assistance or small business loans. In addition, they aim to break the inflationary inertia by instituting regulatory mechanisms for more gradual changes in wages, interest rates, consumer prices, and exchange rates.[11]

Some countries have rejected both orthodox and unorthodox programs. They have tried to achieve economic stabilization merely through strong price controls and fixed exchange rates to freeze imported product prices. Often, however, the desired adjustment has not been reached, and later they have had to adopt more orthodox programs.

Using foreign resources. When the above choices are not feasible, policy makers sometimes rely on foreign resource inflows, whether from borrowing, donations, or a greater infusion of foreign investment.[12] While geopolitical factors sometimes make it possible to have easy access to foreign resources, eventually limits are reached and a country's access is restricted. Furthermore, foreign resources have their political price and carry the risk of greater foreign dependence—a risk that must be balanced against the potential for generating growth and employment.

Managers should bear in mind that different types of resources—bilateral versus multilateral aid flows, commercial versus concessional loans, more foreign investment versus less—carry different risks and benefits. These differences usually turn out to be very important in determining whether a government's short- and medium-term economic strategies will be feasible.

Inflationary policies. If production cannot be increased in the short term and the country is unable to implement an adjustment program or to secure enough foreign resources, governments sometimes resort to inflationary policies that jeopardize both financial and political stability.[13] By and large, inflationary policies are based on political and social arguments about maintaining employment or stimulating demand to achieve rapid economic recovery.

Often such policies degenerate into spiral hyperinflation, as occurred in Bolivia (1983–1984) and Nicaragua (1987–1988), or earlier in Argentina (in the 1970s). Such economic collapse has often forced governments to revert to stabilization programs.

Short-term economic policies. Economic strategies are accompanied by specific fiscal, monetary, trade, labor, and exchange-rate policies. Before looking at overall policy packages, a brief overview of these terms will be provided.

Fiscal policies relate to the size and composition of public current and capital expenditures and revenues, and to the distribution of costs and benefits of government spending and taxation. Fiscal policy makers concern themselves with the size of fiscal deficits and how to finance them. They also make decisions about the size, productivity, and profitability of state-owned enterprises.

Monetary policy determines the growth of liquidity in the economy and its relation to the overall growth of production. Through monetary policy, decisions are made about the total magnitude of national credit and its distribution between the public and private sectors. In countries where the central bank sets interest rates, decisions are made about whether to encourage saving or consumption and whether to subsidize credit for specific sectors.

Trade policy determines the way in which a country's goods and services will be valued in relation to imports. Trade policy makers decide whether they will regulate the flow of goods and services in and out of the country through quotas and export incentives or tariffs. Where tariffs are used, policy makers fix rates of nominal and effective protection. Finally, trade policy may include decisions about price controls in the domestic market and the extent to which there will be support prices and subsidies for local products.

Labor policies include not only decisions about the generation of public and private employment

but the rules for provision of wages and benefits. Options for fixing minimum wages and for salary increases are usually reviewed on the basis of such factors as inflation indexes or productivity increases.

Exchange-rate policy fixes the relationship between local and foreign currency as well as the rules for access to both. Policy makers decide whether to maintain a fixed exchange rate or a floating rate, that is, one based on market conditions or pegged to a single currency or to a basket of currencies. They also determine whether to maintain a single exchange rate for local producers or multiple exchange rates based on government priorities. Finally, they prioritize access to foreign exchange and decide how this process will be managed.

The economic policies described above are often combined to produce the short-term policy packages described in the next section.

Short-term economic policy packages. *Stabilization policy packages.* The objective of a stabilization program is to control inflation and correct financial and economic imbalances.[14] Typically, this objective is achieved by designing a policy package aimed at reducing domestic demand through a series of policy measures.

In both orthodox and heterodox programs, policy makers try to reduce fiscal deficits through cuts in public capital and current expenditure, service reductions, employee layoffs or hiring freezes, improvements in efficiency, tax increases, increases in user fees, and the sale and divestiture of state-owned enterprises. Adjustment programs that rely only on strong price controls and fixing the nominal exchange rate make little effort to reduce fiscal deficits.

Stabilization programs are normally accompanied by a reduction of monetary expansion through reducing levels of public- and private-sector credit and of public borrowing (especially from foreign sources). In orthodox programs this reduction in monetary expansion is reflected in real interest rate increases, while in unorthodox programs interest rates are managed within the boundaries set by the monetary authority. When stabilization is pursued merely through price controls, monetary expansion will continue. It often generates more inflation and a reduction in real interest rates. When this is accompanied by controls on exchange rates, expectations about future devaluations encourage capital flight and the use of credit for speculative purposes. This often leads to further increases in interest rates.

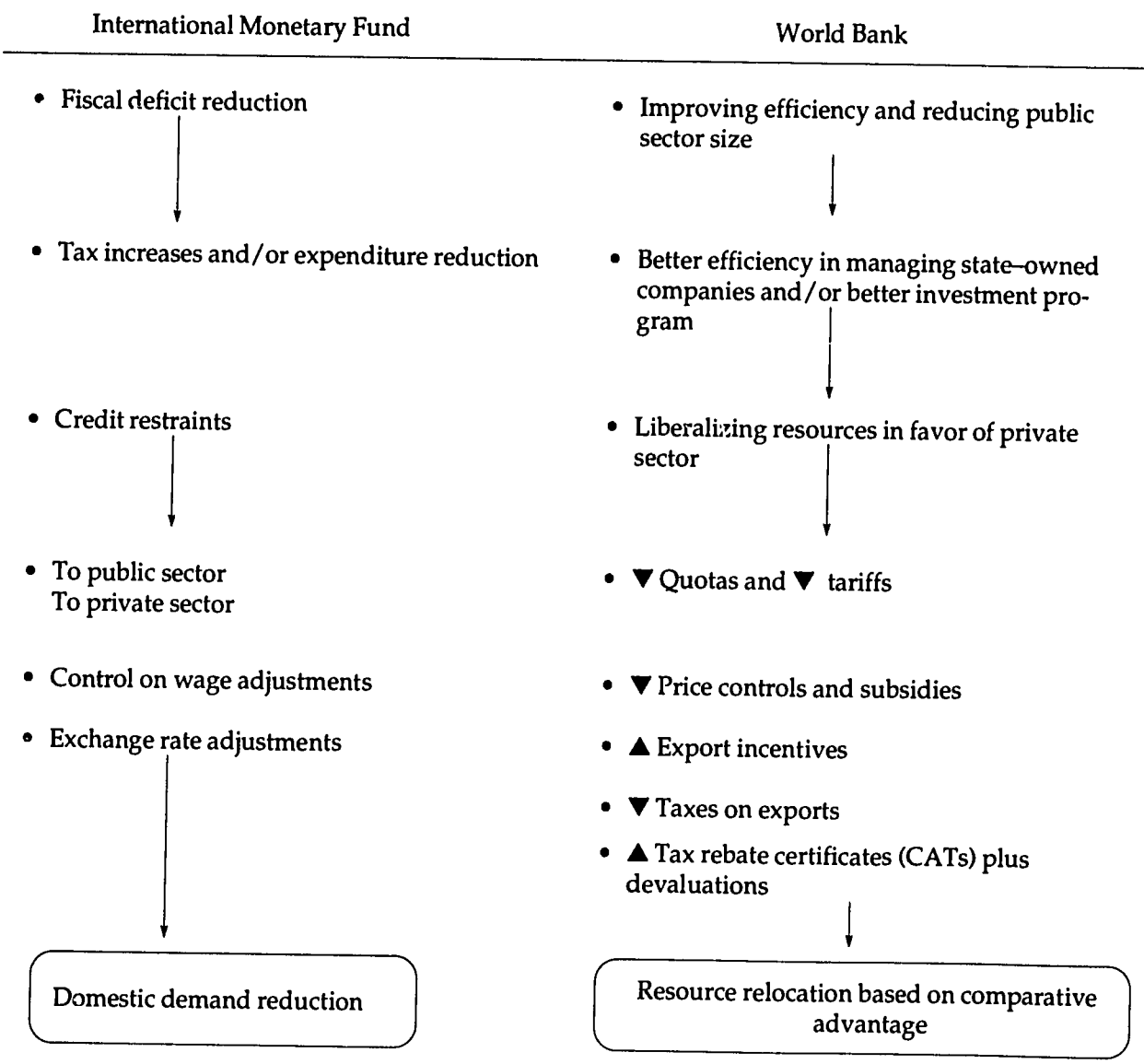
In the area of trade policy, stabilization programs attempt to reduce consumer and producer subsidies. One of the major differences between orthodox and unorthodox programs is that the latter programs attempt to regulate key prices—food and transport prices, for example—to reduce the adjustment cost to poverty groups. Stabilization programs normally do not attempt to reduce rates of nominal or effective protection or to change from quotas to tariffs. These later policies often occur in the more medium-term structural adjustment programs. Advocates of the third approach recommend generalized price controls, which, in turn, often lead to product shortages in official markets and thriving black markets. Furthermore, exchange-rate controls during an internal disequilibrium often cause a drop in export-sector profitability and a resulting decline in exports. Imports often become cheaper and their volume increases. Much of this stems from a failure to reduce the price inflation of nontradeable goods.

During stabilization, wage adjustments are rejected or at least controlled. This leads to sharp declines in both real wages and employment levels in the case of orthodox programs, and to attempts to maintain freezes within socially and politically acceptable limits in the case of unorthodox programs. Changes in labor codes and in the overall structure of labor relations are often left for the more medium-term structural adjustment process.

Finally, correcting overvalued exchange rates has been a key element in most stabilization programs. Devaluations may be thought of as a tax that benefits the export sector and the government at the expense of the rest of the economy. Orthodox programs often attempt large and infrequent devaluations or, through a crawling peg system, more frequent "minidevaluations." Heterodox programs often set temporary fixed exchange rates with periodic adjustments that can be normalized through minidevaluations or through a table of preannounced adjustments called *la tablita* in Latin American countries. (See figure 2.3 for a review of policies.)

While stabilization programs help correct imbalances, reduce domestic inflation, and recover export competitiveness, there are many risks that accompany the process. For example, if the source of a country's disequilibrium is not excessive growth of domestic demand, but rather a deterioration in the terms of trade, stabilization can create an unnecessary recession in the national economy. Sec-

FIGURE 2.3 Contrasting Policy Packages of the International Monetary Fund and the World Bank



NOTE: ▲ means rising; ▼ means declining.
SOURCE: Noel Ramírez.

ond, while stabilization can provide the basis of economic recovery, short-term unemployment may increase substantially due to reductions in domestic credit and public spending. Finally, public expenditure cuts usually take place in social services, and such cuts place a special burden on high-risk, low-income groups. Finally, adjustment, particularly in Latin America, has been achieved by a virtual paralysis of public investment. This begins a cycle of deterioration in the public-sector infrastructure.

Inflationary policy packages. When governments have little success in generating economic growth and little access to foreign resources, instead of opting for stabilization they often choose inflationary policies that maintain them in power on a short-term basis.[15] Through this process, they maintain short-term employment by monetary emission and increased fiscal deficits while leaving the more serious consequences of their actions to future governments. Thus they create excess domestic demand

through increased public expenditures, expanded credit, wage increases indexed to inflation, and maintenance of the current structure of consumer and producer subsidies. During the process the exchange rate frequently becomes overvalued.

The choice of inflationary policies is not a long-term solution since, at any rate, the employment thus created will be transient rather than productive. Often governments prefer to avoid the social costs of adjustment while neglecting the social costs of not making it. Specifically, in many instances an exchange adjustment is delayed in view of the inflation-induced social costs that would be generated by this measure, while no attention is paid to the costs derived from an overvalued exchange rate in terms of unemployment in the export sector and in the import-competing sector.

If nominal interest rates are not adjusted to reflect inflation, real interest rates may even become negative. Debtors become better off and creditors often go bankrupt. All of this causes a serious deterioration in financial intermediation and fuels inflation further. The public has little incentive to save. Increases in the consumption of durable and even nondurable goods take place. The public switches preferences from time deposits to more liquid financial instruments. The domestic resources of the financial system decline in real terms, although they might grow nominally. The financial system's capability to finance investment projects declines, and this exacerbates the imbalances between supply and demand for goods and services. Thus, the attempt to avoid the cost of adjustment through inflationary policies may lead to more serious costs later.

Policies for the use of foreign resources. In the 1970s it was common to hear that, when a country's debt-service payments reached more than 20 percent of its exports, it had exhausted its capacity for additional borrowing. In the 1980s the debt crisis and political considerations have made such rules of thumb obsolete. While a burden of foreign debt service above 20 percent of exports is a serious one, it does not necessarily stop governments from borrowing when foreign resources are available or from finding creative means to reschedule or repay debt in order to receive additional foreign resources. Policy makers who look for more foreign resources reason that, if they are used rationally, they will generate future GDP growth. Consequently, repaying this debt will be much less costly economically and politically than stabilization or inflationary policies.

To understand a government's policies about foreign borrowing, managers must recognize that countries do not go bankrupt nor are there foreclosure proceedings. While in the early 1900s, foreign powers seized defaulting countries' customs houses to gain control of tax revenues, overt foreclosures are very uncommon in the 1980s. The risks of nonrepayment today are poor credit ratings, reduced new financial flows, and financial and trade embargoes. Instead of foreclosures, a series of new initiatives has been proposed: debt equity swaps; limiting debt service to a fixed proportion of exports; negotiating regional or bilateral agreements to lessen debt burdens; special treatment for high-risk poverty countries; debt rescheduling; and outright defaults. There is to date little consensus about the effectiveness of these measures or any clear sense of which will predominate. Once governments obtain foreign resources, the short-term impacts look like those seen when production is increased, since foreign resource inflows play a role similar to the net gain obtained from a positive change in terms of trade. However, governments are expected to convert this inflow into more self-sustaining growth.

Policies to stimulate economic growth. Sustainable growth with substantial new employment is one of the most desirable alternatives a country can achieve. During the last 25 years, as we saw in chapter 1, some countries reached this goal through an import-substitution process, while others attempted export-led growth. While governments must begin to generate growth either with short-term actions which are implemented in the first 12 to 18 months, or with import substitution or export-led growth, these later concepts are better explained in the context of medium-term strategies.

Medium-term strategies. Since the end of World War II, governments have attempted two general types of medium-term economic strategies: inwardly oriented strategies based on import-substitution processes with protectionist devices; and outwardly oriented strategies based on an export orientation. Switching from an inward to an outward orientation is sometimes described as achieving a more "neutral" trade orientation, since the attempt is to equalize incentives to produce in both domestic and foreign markets. This process is well described by Gustav Ranis:

> Such a move should of course be aided by a change in public policies. Any orientation to-

> ward international markets on a competitive basis requires reducing protection, adopting and keeping more realistic exchange rates and interest rates which are closer to their shadow price, and constantly resisting the temptation of artificially lowering agricultural trade terms in the domestic market.[16]

Import substitution. During the period after World War II, policy makers in many developing countries were enticed by the idea of building a domestic industrial base to substitute the import of industrial goods. The logic behind the process, as described by John Fei and Gustav Ranis, was that the excessive labor supply in the rural sector could be transferred to the modern manufacturing sector, while keeping their wages basically constant.[17] Since productivity would be increased because the capital/labor ratio in industry declined, business could amass profits needed to finance local investments, which in turn would foster economic growth. Based on this logic, policy makers were willing to throw up tariff barriers to protect infant industries. Many countries including India, Pakistan, Brazil, Mexico, and indeed most of Latin America, achieved solid rates of GDP growth by adopting this model.

Export promotion. As experience with the import-substitution model accrued, many critics argued that in countries with an abundance of labor, import substitution caused economic returns to shift away from labor and toward capital, thus hindering the development of the dynamic domestic market promised by its advocates. In its place the critics advocated outwardly oriented economic strategies because producing for a large world market, they thought, would better absorb excess labor and improve income distribution—as it had in fact done in countries like Singapore, Hong Kong, Japan, Korea and Taiwan. In the case of small, open economies, there were three reasons why the advantages would be even greater: (1) the foreign market would induce an increase in exportable production based on the country's comparative advantage; (2) this would absorb surplus labor which in turn would create a better functional income distribution; and (3) better income distribution would develop the domestic market as a complement to the world market.

Medium-term economic policies. *Import-substitution policies.* The policies associated with import substitution, unlike short-term policies, tend to modify the economic structure and incentives in a more permanent direction. Typical policies have been: (1) tax incentives for import-substituting industries; (2) subsidized credit; (3) duty-free imports of capital goods; (4) quotas or high rates of effective protection on imports of goods that are already being produced locally; (5) minimum wage policies for industrial labor; (6) overvalued exchange rates; and (7) subsidized food and transportation for urban workers.

While import-substitution policies did help to produce high rates of GDP growth in many countries, there were substantial criticisms. It was argued that, first, the overvalued exchange rates and duty-free import of capital goods created a capital-intensive bias. This cheapened imports and reduced export-sector profitability. All of this led to deteriorating trade balances and increased relative price distortions. Second, subsidized interest rates often became negative in real terms. The result was increased demand for credit and a disincentive for savings. Under these circumstances, the public often switched its preferences to shorter-term financial instruments. This made it harder for the financial system to provide resources for productive investment projects. (The process is known as "financial disintermediation.") Third, the quality of domestic industrial goods produced under high levels of protection was not equal to the quality of equivalent foreign goods. Fourth, tariff barriers and quotas helped create active black markets for imported goods. Fifth, capital-intensive production made it difficult to absorb excess labor in modern industry, because production/employment elasticity decreased while the investment/employment ratio increased. As a consequence, market forces depressed wages, forcing governments to set minimum wages at levels above marginal labor productivity. This created even greater distortions in the relative prices of capital and labor. Indeed, if one accepts the Stopler and Samuelson theorem, which states that a rise in the relative price of one product increases the return to the input used most intensively in the productive process in real terms, then import substitution contributed to a deterioration in the functional distribution of labor income because it increased the relative price of capital-intensive goods.[18] Sixth, an inefficient, protected industrial sector had to be supported by export agriculture at a time when world overproduction and poor prices made this a questionable long-term proposition. Finally, for small developing countries there was no new source of growth and employment once industrial goods were substituted in the domestic market.

Export policies. Export-oriented strategies are

based on concepts of economic efficiency and competitiveness in the world market.[19] The policies most closely associated with an export orientation are part of the structural adjustment process described earlier (see figures 2.2 and 2.3). Fiscal policy emphasizes improved productivity and efficiency in the public sector as well as the reduction of the size of the state through privatization of state-owned companies and services. Monetary policy includes letting the money supply grow at a rate roughly equal to GDP growth, increasing credit for the private as opposed to the public sector, and increasing real interest rates. Trade policy emphasizes the liberalization of foreign and domestic trade. Reducing quotas, substituting quotas for uniform tariffs, and reducing effective rates of protection are also cornerstones of such a trade policy. Removal of producer and consumer subsidies are considered essential to help in the efficient reallocation of society's resources. Flexible as opposed to minimum wages and benefits are normal components of labor policy. Finally, real (as opposed to overvalued) exchange rates are considered essential to the process.

As noted in chapter 1, the evidence favoring outwardly oriented strategies is impressive. The World Bank and other sources have shown that countries that adopted strongly outwardly oriented strategies had higher rates of GDP growth, lower unemployment, and more equitable income distribution than their more inwardly oriented neighbors.[20] Nonetheless, many policy makers in developing countries express the following doubts. First, the rising wave of protectionism in the industrial countries raises serious questions about the viability of outwardly oriented models. Second, there is fear that industrial overproduction of textiles, shoes, and other goods by developing countries will take place as it did in the export of agricultural primary products. Third, the most successful developing countries with export strategies are in Asia. Policy makers from other regions question whether such transformations can occur on other continents with different cultural characteristics and modes of social organization.

Strengths and weaknesses of short- and medium-term economic strategies. A few general conclusions can be reached about the strengths and weaknesses of the short- and medium-term policies discussed above. For example, stabilization programs often become necessary to correct imbalances and provide the basis for further growth. Normally, the costs of not implementing an orderly adjustment process are much higher than those derived from a stabilization program. However, stabilization has its risks. For example, a program intended to control imported inflation may actually create an unwarranted recession. During stabilization short-term unemployment actually increases. At the same time a very long stabilization program may become socially and politically explosive.

Governments that cannot generate new growth and that are unwilling to mount stabilization efforts often search for foreign resources or try to protect short-term employment at the cost of generating an inflationary process. Such policies make it possible to postpone adjustment in the short run, but they never become substitutes for real economic growth.

Governments committed to generating new growth attempt to do so through either inwardly or outwardly oriented economic policies. Import substitution is relatively easy to implement at first, since it focuses on producing nondurable consumer goods, whose technological requirements are less complicated than for many other products. This initial stage tends to elapse relatively quickly, due to the smallness of the domestic market, particularly in countries with populations under ten million. While there may be major growth in the industrial sector at this stage, this growth does not keep pace with the need for new employment. Finally, the process reinforces a bias against exports.

Export promotion has potential for long-term sustained growth because it builds upon the capacity of world rather than domestic markets. Outwardly oriented strategies generally reduce distortions in relative prices. They favor the generation of productive employment and improve functional income distribution. However, export promotion is not without its risks. For example, the protectionism currently existing in industrialized countries can significantly reduce the opportunities offered by the international market. Finally, the transition from import substitution to export promotion must be made in such a way that costs, which are always present, do not destroy the political feasibility of the necessary adjustment process.

The problem of policy sequences in structural adjustment. The appropriate sequence of policies in stabilization and structural adjustment is a hotly debated topic. Many students of the subject argue that stabilization must precede structural adjustment.[21] Others, citing the Bolivian liberalization effort (1985–1988), indicate that stabilization and adjustment can be combined successfully.[22]

There is increasing but not totally conclusive evidence to indicate that implementing some stabilization policies before others can increase the social costs of the process and sometimes actually reverse it. For example, in Argentina and Uruguay liberalizing capital transactions before current account transactions helped contribute to capital outflows and a setback in stabilization.[23] A plausible sequence for liberalization has been proposed by Anne Krueger. It starts with

> current account transactions, agricultural pricing, and domestic labor and capital markets, leaving capital account transactions initially subject to controls. These controls would be removed (gradually? suddenly?) in a second stage of liberalization, once domestic resources had responded to altered policy signals.[24]

Since a clear consensus about sequencing has not emerged, it is essential to think carefully about the characteristics of each country rather than to apply simple recipes.

Conclusions

This chapter has provided frameworks to help managers analyze short- and medium-term economic problems and the strategies and policies governments have most frequently employed to help correct them. We saw how a country's size and openness are important determinants of the ways in which strategies and policies can be employed. It should be clear from the review of policies and strategies that all options have their potential risks and benefits. Neither managers nor their governments will encounter risk-free options.

A few conclusions can be reached about short- and medium-term economic policy and strategy.

1. When a country is suffering from economic crisis, instant recovery can hardly be expected. Instead, a slow and painful readjustment is often the norm. These transformations have taken a minimum of 10 to 15 years in some of the successful Asian countries and, more often than not, even longer.

2. When a country's economy is stagnant and policy makers cannot secure foreign resources, they sometimes prolong the illusion of prosperity through inflationary policies. Eventually, however, real aggregate demand will be reduced and living standards will fall with or without the presence of the IMF-sponsored stabilization programs. Adjustment is inevitable. The true dilemma is not between making a domestic adjustment or not making it, but rather between making it in an orderly fashion or simply letting it arise in an uncontrolled manner. Disorderly adjustment often turns out to be more costly in view of the uncertainty created in the economic system.

3. While the social costs of stabilization are high, some governments have used special programs to minimize the negative impacts on high-risk poverty groups. While such program efforts are relatively new and controversial, their potential to soften the social costs of adjustment should be explored further.

4. When world or national economies are growing rapidly, everyone pays less attention to frameworks for understanding the government's options for national economic policy. However, the frameworks presented in this chapter have special relevance when economies are in crisis.

5. Governments in crisis often try first to secure foreign resources and then choose between inflationary policies and stabilization programs. At this point, cultural, social, and political differences become so complex that it is difficult to predict how countries will respond. According to some sources, emergent democracies and populist governments, like Alan Garcia's Peru, have been unwilling or unable to implement stabilization programs; while authoritarian governments, like Chile under General Pinochet, have opted to preserve the nation's financial stability in spite of excessive social costs. Yet many of the experiences of the 1980s throw classic generalizations about regime and probable economic strategy into doubt. For example, Bolivia (1985–1988) and Gambia (1986–1988) implemented shock-type stabilization and adjustment programs

under conditions of democratic rule with relatively little social upheaval and with relative success. The implication is that managers must be pragmatic. They must be aware not only of what economic strategies governments might employ but of their feasibility in the political, social, and cultural contexts in which they must be employed. They can help themselves more through using frameworks that permit them to adapt their knowledge to specific situations than by following rigid rules about how key actors will behave and what will work.

This chapter has expanded upon the general framework for analysis presented in chapter 1 by developing an economic perspective in more detail. The next chapter discusses the detailed political consequences of economic action. It provides frameworks to help managers identify which groups perceive themselves to be winners or losers as the result of economic policy. It looks at the strategies and tactics governments use to make policies more economically and politically feasible. After reviewing frameworks to assess both the economic and political consequences of national policies, managers should be in a better position to participate intelligently in policy dialogue and to anticipate some of the consequences of changes in government policy.

Notes

Works cited only by author and date are fully listed in the bibliography at the end of this book.

1. See also Noel Ramírez (1987b).

2. A country's openness is strongly influenced by the relative importance of its external sector. Good indicators of the degree of openness of an economy are its exports as a proportion of its gross domestic product (GDP), or its total trade (imports and exports) as a proportion of GDP. A second important factor is the country's ability to affect terms of trade in the world market, more specifically, the prices of its imports and exports. The ones that can affect world markets for their products have different options from the ones that cannot. For interesting literature on the problem of size, see B. Jalan (1982) and the special 1980 issue of *World Development*, vol. 8, no. 12 (Dec.) called "Islands," as well as S. Kuznets (1960).

3. John Maynard Keynes ([1936] 1964).

4. According to the monetary approach to the balance of payments, in the case of small and open economies with a fixed exchange rate, increases in the rate of expansion of domestic credit above the level of demand for money will lead to a proportional loss in the level of international reserves without affecting domestic price levels, which are exogenously determined by world inflation rates. This approach to the balance of payments stemmed from a model developed by the International Monetary Fund (IMF), based on earlier work by Dutch theorists. However, the approach was given its strongest push in the late 1960s by Harry G. Johnson, Robert Mundell, and their students at the University of Chicago. Its basic assumptions are as follows.

1. First, it is assumed that the demand for money is a stable function of a few factors, which in turn must remain relatively constant throughout time.

2. It is also assumed that there is a "perfect capital mobility," in the sense that foreign and domestic bonds are perfect substitutes, which means that interest rates should be the same since there is no uncertainty about the exchange rate.

For more recent applications see, among others, R. Dornbusch (1980), Jacob Frenkel and Harry Johnson (1976), and International Monetary Fund (1977).

5. From the government's point of view, foreign borrowing can be viewed as a domestic resource. Such a thing happens when the central bank borrows abroad to subsequently provide this financing to the central government. In this case, although appearing as "domestic resources" in government financial operations, these are actually "foreign resources." In the second place, when the World Bank finances the government and the latter uses its international reserves to back the loan, these resources, while actually being "domestic," would not be inflationary, although they would have a negative impact on the country's level of international reserves. In the third place, the president of the central bank might face the need for financing a fiscal deficit without access to foreign credit and with international reserves unavailable. In this situation, the central bank might decrease credit to the private sector and use these resources to finance the deficit. In this case, the economy's liquidity would not be affected, and hence a short-term price effect should not be

expected. In the medium term, however, a pressure on domestic prices could be anticipated, particularly if the financial deficit had been caused by higher public spending which would generate more demand, and if credit denied to the private sector was originally destined to finance productive activities that contributed to domestic supply. On the other hand, it could also be possible for the central bank to resort to monetary emission instead of restraining credit to the private sector, in which case the liquidity of the economy would have an upsurge and inflation would then appear more rapidly.

6. See, among others, E. Fernández (1970), Frenkel and Johnson (1976, 1978). See also Iliana Cardoso and R. Dornbusch (1980).

7. See Weintraub, Cline, and Associates (1981).

8. See Arnold C. Harberger (1984). Also see Hollis Chenery et al. (1986).

9. William Cline and Stanley Weintraub (1981). See also Economic Commission for Latin America (ECLA 1986).

10. For a good description of the roles of each organization, see V. Corbo et al. (1987).

11. See, for example, Nissan Liviatan (1988) or S. Fisher (1987).

12. For interesting discussions of the issue of third world debt and options for managing the problem, see Jeffrey Sachs (1987) and Weintraub, Cline, and Associates (1981).

13. For a good discussion of causes of inflation and anti-inflationary policies, see Phillip Cagan (1979).

14. Cline and Weintraub (1981).

15. For discussion of alternative means of controlling inflation see, for example, Fisher (1987).

16. Gustav Ranis (1987: 8).

17. John Fei and Gustav Ranis (1964).

18. The Stolper and Samuelson theorem is particularly interesting. See W. Stolper and P. Samuelson (1949).

19. Corbo et al. (1987).

20. See World Bank (1988a) for a good review of the performance of outwardly versus inwardly oriented development strategies.

21. Armeane Choksi and Demetris Papageorgiou (1986: 15–36, 41–68, 185–219).

22. World Bank (1988c).

23. Nicolás Ardito-Barletta et al. (1983).

24. Anne Krueger (1986: 30).

Managing Winners and Losers: Assessing the Political Impacts of Economic Strategies

[The] need for [structural] adjustment . . . can develop because the sum total of demands for resources . . . in an economy exceeds the global amount of resources that can be made available internally and . . . from abroad. . . . But it can also emerge on account of inefficiencies in the use of available resources. . . . An accurate assessment of the various features of the imbalance . . . can contribute greatly to the quality of the design of the required adjustment effort . . . and the strength and pace of the . . . effort required for its elimination.

—Manuel Guitian *

Often these people who come here from international organizations to preach the gospel of stabilization and structural adjustment know as much about the political and economic consequences of what they are proposing as the medicine men who used to prescribe leeches to correct imbalances in the four humors of their patients. I've heard that today, just as in the past, the patient often dies from the cure. Then they'll blame my government. They'll say that we didn't use enough leeches and they weren't sucking blood from the right places.

—Central American president, 1985

Successful governments walk on two legs. They need coherent economic strategies to improve the well-being of their subjects. At the same time, these strategies must be politically feasible. Problems with either leg can cause a government to stumble. For example, poorly conceived economic strategy can result in undue national hardship. Popular reaction to ill-conceived policies is sometimes strong enough to bring governments down. Similarly, politically expedient policies can keep rulers in power in the short term at the expense of national bankruptcy, increased human misery, and public outrage.

Striking a balance between economically viable and politically feasible policies is part of the art of successful government. As in any art, the necessary insights, lessons, and techniques are hard to pass on. In fact, it is even difficult at times to figure out what the lessons are. For example, similar policy responses to similar economic problems may appear to contribute to the collapse of one government and to the strengthening of another. Consider the following paradoxes.

Cutting fiscal deficits. *Guatemala, 1988.* In early 1988 Guatemala's President Venicio Cerezo narrowly survived a coup d'etat by military officers who

*At the IMF Symposium on Growth-Oriented Adjustment Programs, Washington, D.C., February 25, 1987.

claimed to be acting to restore national balance.[1] Cerezo's government had been a lightning rod for popular discontent due to its policies of stabilization and structural adjustment. A tax reform—part of the policy package to increase revenues and cut the fiscal deficit—was met with a national strike by CACIF, the powerful consolidated chamber organization of the private sector, in October of 1987.[2] Demonstrations intensified in the months leading up to the coup attempt. The Cerezo government was lucky to survive at all, since tax reform in Guatemala has always led to intense social conflict.[3]

Panama, 1984–1985. Panama's President Nicolás Ardito-Barletta was not as fortunate. In November 1984 he convinced the legislature to pass Public Law 46.[4] The law, a response to Panama's sluggish economic growth, fiscal deficits, and increasing debt-service payments, created new taxes and froze salaries. Private-sector groups, labor unions, and public employees responded with a national strike.[5] Within a month the president was forced to rescind the law. Ardito-Barletta's public expenditure cuts also met strong resistance. Functionaries at the Ministry of Housing spearheaded an indefinite work stoppage to protest layoffs of public employees. During the next 11 months, opponents of Ardito-Barletta within his own political party, the Democratic Revolutionary party (PRD), and the military mounted a campaign to remove him from office. They used economic issues as a rallying point to mobilize demonstrations and leaked information about policies to fuel discontent.[6] In September 1985 the president resigned, specifically after trying to form a commission to investigate the death of Hugo Spadafora, an opponent of military strongman General Manuel Noriega. Ardito-Barletta's resignation was the last act in a difficult internal political struggle between civil and military authorities in which his opponents used his economic policies as one of the key instruments to mobilize opposition.

Costa Rica, 1982–1984. The Costa Rican government carried out a successful economic stabilization program with broad social consensus between 1982 and 1984.[7] Public employment was reduced, taxes increased, wages restrained, and fiscal deficits cut. The program reduced hyperinflation, corrected imbalances in the commercial account, and laid the base for a shift to an export-led economic strategy. The public gave Costa Rica's President Luis Alberto Monge high marks, even though his government used many of the same unpopular measures that helped bring down President Ardito-Barletta in Panama and weaken President Cerezo in Guatemala.

Reducing consumer subsidies. *The Dominican Republic, 1984.* In April 1984 in the Dominican Republic Jorge Blanco's government, under pressure to comply with IMF agreements, moved most imports from the official to the free-market exchange rate.[8] Food and gasoline prices soared. In the riots that followed at least 50 people were killed. The government was forced to rescind some of its measures.

Zambia, 1986. In December 1986 urban groups rioted in Zambia in reaction to the lifting of price controls on basic food stuffs.[9] They expressed an overall lack of confidence in the government's stabilization program. Riots have also followed government food price deregulation in such countries as Egypt (1977) and Morocco (1980).[10]

Ghana, 1983–1985. Between 1983 and 1985 Ghana reduced controls on 6,000 prices in 700 basic consumer product groups, including food items, with a minimum of social discontent.[11] The price deregulation was part of a general effort to overcome economic collapse and reduce distortions in key markets. Ghana successfully deployed some of the same measures that caused riots in the Dominican Republic, Egypt, Morocco, and Zambia and seriously damaged the credibility of those governments.

The country examples demonstrate that there are no recipes for successful management of economic change. They show instead how diverse the experiences of developing countries really are, and how difficult it is to anticipate the reactions of key groups to new government policies. However, it is possible to think more analytically about the political management of economic change, to anticipate negative reactions, and to try to channel them in constructive directions.

Leaders concerned with the political feasibility of economic measures such as the ones discussed can do three things to reduce their risk of failure. First, they can think analytically about which groups might perceive themselves to be winners and losers as the result of new policies and try to find equitable solutions. Second, by digging into the paradoxes of comparative country performance they can try to extract some general lessons about why some governments have managed change more effectively than others. Finally, based on this analysis they can design strategies that try to minimize anticipated problems.

The purpose of this chapter, then, is to provide

frameworks to help policy makers identify winners and losers in the process of managed economic change, and to sketch some of the very general lessons from recent country experiences.

Managing Winners and Losers

In recent years many studies have analyzed the welfare consequences of economic policy options like stabilization or structural adjustment programs.[12] Economists often use frameworks from welfare economics to analyze who will gain or lose from policy shifts. While these studies provide a useful starting point, for several important reasons they are insufficient for decision makers who must manage economic change. First, groups are often motivated more by perception of their potential gains and losses than by what more careful analysis shows their real gains might be.[13] These perceptions force political leaders to spend as much time managing fantasies as they do realities.

For example, in Malaysia in 1976, lower-income Malays perceived that government rural development programs had improved their income levels and well-being. Their support for the government increased even though more careful economic analysis by the World Bank showed no gains in real family income.[14] In contrast, even though it can be demonstrated that one group has made important gains, they may still be highly discontented because they believe that they did not gain as much as they should have. A second problem is that economic analysis might show that certain groups are supposed to gain in the long run once shifts in resource allocations take place. Unfortunately, they may actually lose in the short run. Their negative reactions, based on initial losses, may be enough to bring the government down. For example, the same industrialists who are to benefit from increased export incentives in the long run may oppose more neutral tariff regimes for their country out of fear because of short-run losses they incur while trying to adjust their firms to the rigors of the international market. Finally, while analysis may show that certain groups will gain from policy change in the long run, the failure of governments to accommodate short-run policies may mean that the long run never comes. Thus, groups may harbor well-founded suspicions of technicians' perceptions of the real impacts of new policies and so reject them out of hand.

A framework for analyzing winners and losers. To avoid the trap of simple theoretical analysis of winners and losers, policy makers might instead address themselves to the following questions: (1) What is the purpose of a new policy, and what specific measures will be taken? (2) Who, in theory, is supposed to benefit or lose from this policy change, and who in actual practice usually supports or opposes this kind of policy? (3) What strategies and tactics have supporters and opponents used in the past? (4) How have other governments successfully managed similar economic changes, and when have they had the most problems? With answers to these four questions, those involved in designing economic strategy might ask a final question: What strategy might be most useful for managing the implementation of the economic change with a minimum of violence in our country?

Such an analysis can be made for any of the short-term economic strategies discussed in chapter 2 of this book such as, for example, stabilization, or increasing production, or such medium-term strategies as inward versus outward orientation. Let us perform this analysis using one short-term strategy, stabilization, and one medium-term strategy, structural adjustment, to achieve outward orientation. We will treat the polices and their implications separately but refer to them together as "adjustment policies."

Applying the Framework: The Political Management of Adjustment Policies

What is the purpose of the policies and what measures are usually included? Between 1980 and 1985, about 47 countries a year have had adjustment programs with the International Monetary Fund. During the same period, more than 21 countries have had structural adjustment programs with the World Bank. (See table 3.1 for data on the increasing importance of structural adjustment lending in developing countries as a proportion of the current World Bank portfolio.) Since stabilization and structural adjustment have become so important, it will be useful to understand the policies of and potential winners and losers from this process.

Stabilization policies. The purpose of economic stabilization is the correction of a country's "macroeconomic imbalances which usually manifest themselves in high and unpredictable inflation and periodic balance of payments crises" and in sluggish economic growth.[15] Such imbalances take place when "the aggregate demand for resources exceeds the amounts of resources available internally or ob-

TABLE 3.1 Structural Adjustment Lending by the World Bank, 1975–1986 (millions of U.S. dollars)

Destination	FY '75	FY '79–'80 (avg.)	FY '81–'82 (avg.)	FY '83	FY '84	FY '85	FY '86
Total lending to all countries	5,895.9	10,746.1	12,653.5	14,477.0	15,522.3	14,384.4	16,318.1
Sector adj. program and structural adj. loans[a]	520.0	405.5	1,082.4	2,035.6	2,619.8	1,637.9	3,099.5
As percentage of total	8.8	3.8	8.6	14.1	16.9	11.4	19.0
To low-income countries[b]	2,051.2	3,270.2	3,965.4	4,906.4	6,164.7	5,771.5	6,046.1
Sector adj. program & structural adj. loans	350.0	122.5	290.0	445.9	447.5	354.5	574.5
As percentage of total	17.1	3.8	7.3	9.1	7.3	6.1	9.5
To middle-income countries[b]	3,844.7	7,476.0	8,688.1	9,570.6	9,357.6	8,612.9	10,272.6
Sector adj. program & structural adj. loans	170.0	280.8	792.4	1,589.7	2,172.3	1,283.4	2,525.0
As percentage of total	4.4	3.8	9.1	16.6	23.2	14.9	24.6
To highly indebted middle-income countries[c]	1,803.4	3,403.7	4,428.4	4,668.3	4,398.6	4,558.4	6,070.5
Sector adj. programs & structural adj. loans	0.0	98.3	231.6	1,042.8	1,396.1	745.0	2,105.0
As percentage of total	0.0	2.9	5.2	22.3	31.7	16.3	34.7
To sub-Saharan Africa[d]	1,075.7	1,374.4	1,807.0	1,794.0	2,368.3	1,597.3	2,046.5
Sector adj. programs & structural adj. loans	60.0	230.0	429.8	406.5	818.2	192.9	574.5
As percentage of total	5.6	16.7	23.8	22.7	34.6	12.1	28.1

a. Includes both program and structural adjustment loans and credits.
b. Countries with per capita income less than US$400 in FY'87 dollars are considered low-income countries; those above that level are classified as middle-income countries.
c. The 17 countries in this category are Argentina, Bolivia, Brazil, Chile, Columbia, Costa Rica, Ecuador, Ivory Coast, Jamaica, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela, and Yugoslavia. Lending to this group is also included in that of middle-income countries.
d. This group covers all countries south of the Sahara, except South Africa.
SOURCE: The World Bank, Planning and Budgeting Department.

tainable from abroad on appropriate terms."[16] According to the World Bank, "monetary, fiscal, and exchange rate policies are the three main instruments of a stabilization program. Fiscal and monetary policy have mainly absorption-reducing effects while exchange rate policy has primarily expenditure-switching effects (toward tradeable goods)."[17]

Fiscal deficits are attacked by measures for generating revenue, on the one hand, and for reducing expenditures, on the other. Measures for generating revenue include new value-added, sales, or income taxes; increased license fees; increased charges for electricity, water, or public transportation; and sale of public enterprises. Typical measures for reducing expenditure are reductions in public capital expenditures; wage freezes; layoffs of public employees; discontinuation of some public services or cuts in the hours when they are delivered; privatization of money-losing public enterprises; and campaigns for greater efficiency.

Stabilization has included such monetary measures as reduction of the volume of monetary emission to a level at or below rates of GDP growth; raising domestic interest rates; and eliminating subsidies to both producers and consumers. The key to the stabilization process has been the maintenance

of a real exchange rate through the process of devaluation— either single, large devaluations, or a more gradual, crawling peg system. Such devaluations have had the impact of helping to bring trade into balance through making exports cheaper and imports more expensive.

While stabilization is concerned more with short-term demand reduction to restore economic balance, structural adjustment is more concerned with the medium run, so that an economy "can maintain both its growth rate and the viability of its balance of payments in the medium term."[18]

Structural adjustment policies. While some of the measures required for structural adjustment overlap with stabilization, they are used with different intentions. As in stabilization programs, attempts are made to maintain real exchange rates and to control fiscal deficits. However, policy makers become more concerned with how to increase the efficiency of public-sector investments and operations. Monetary expansion is geared more closely to rates of overall growth of GDP.

The greatest contrast in the policy measures of stabilization and growth-oriented structural adjustment is the latter's more conscious attempt to achieve at a macro level "an incentive structure which is neutral between production for the domestic and foreign market."[19] The practical implication of more neutral treatment of domestic versus export production is a move in favor of exports (outward orientation), since most developing countries have had policies that favor import substitution.

The policy measures usually recommended are (1) a switch from quantitative restrictions to uniform tariffs; (2) lowering effective protection and removing export taxes; (3) reducing consumer and producer subsidies; (4) making wage rates more flexible; (5) letting domestic interest rates approach those in the international market; and (6) liberalizing international capital transactions.[20]

There is an expanding literature on the problems of how to sequence liberalization efforts.[21] Some students of the subject argue that countries have been more successful in recovering from shocks and reorienting their economies when they have engaged in stabilization first, and then continued with structural adjustment; used simultaneously, they point out, the two processes are said to produce contradictory pressures.[22] Others believe that this conclusion may be more appropriate for the Latin American countries but that in many African countries simultaneous efforts at stabilization and structural adjustment are necessary. Although there is less consensus about the appropriate sequencing of structural adjustment policies, Anne Krueger, for example, has argued that fewer distortions are created when a country liberalizes its current account first (liberalization of imports and exports), then reduces producer and consumer subsidies, then liberalizes the labor market, then the domestic capital market, and finally international capital transactions.[23]

Who is supposed to win or lose as a result of the policies? The entire population was supposed to win from successful stabilization and structural adjustment. The nation was to be positioned to either resume its successful economic strategy or to make subsequent adjustments that would ensure future growth, employment, and improved levels of well-being.[24] During the stabilization phase, reduced inflation was thought to benefit consumers, the poor especially but also those on fixed incomes, such as retirees. Since structural adjustment helps to produce a "neutral trade orientation," it helps exporters.

The losers in stabilization were thought to be black marketeers and speculators, as well as those whose jobs disappeared in the short term as a result of the reduction in demand and output that the process calls for. However, new jobs were supposed to be created once the economy had recovered. During structural adjustment, the short-term losers were thought to be the consumers and producers whose subsidies were reduced, and the businessmen and workers who had to make transitions from one set of activities to another. In the long term, however, labor was thought to benefit as increased overall employment was generated; so, too, were businessmen thought to benefit, as new opportunities for investment were created. (See table 3.2 for a listing of winners and losers and the ways specific measures were supposed to affect them.)

More traditional analysis of winners and losers from the stabilization process has been subject to revision based on emerging empirical analysis of the experiences of the 1980s. For example, a 1987 study sponsored by UNICEF whose English title is *Adjustment with a Human Face* concludes that the effect of the world recession on the unemployed, the poor, and particularly on high-risk groups like children under the age of five and pregnant mothers, is more negative than initially imagined.[25] The UNICEF study comes to three important conclusions. First, the impact of the world recession on poverty groups would probably have been worse without stabilization policies. Second, growth-oriented structural ad-

TABLE 3.2 Winners and Losers in Stabilization and Structural Adjustment According to Economic Theory

Stabilization policies and their consequences	
Winners	**Losers**
• The nation (correction of imbalances, efficient resource allocation)	• Black marketeers (gaps close)
• Consumers (inflation reduced)	• Speculators
• Producers hurt by previous policy bias (devaluations, for example, begin to remove the bias against exports)	• New private-sector unemployed (laid off due to economic contraction)
• International banks (with payments overdue on their loans to the country)	• Poverty groups and high-risk disadvantaged groups (for example, low-income nursing mothers)
	• Public employees (layoffs and job freezes)
Growth-oriented outwardly focused structural adjustment	
Winners	**Losers**
• Nation (positioning, employment competitiveness, and growth)	• Industrialists who could not adjust to an outward strategy
• Consumers (inflation control and cheaper, higher-quality goods)	• Labor in the protected sector (short-term losers)
• Unemployed (new opportunities generated from new strategy)	• Agricultural producers (who lose subsidies and cannot adjust to the new strategy)
• Producers (against whom the previous policy bias discriminated)	• Consumers (short-term losers as price controls are lifted)
• International lenders	• Poverty groups (short-term losers during first phases)
	• Public employees

SOURCE: Marc Lindenberg.

justment programs had less negative impact on poverty groups than stabilization programs. Third, stabilization and/or structural adjustment programs designed without special attention to high-risk poverty groups contributed to this deterioration in health and nutritional standards in four very direct ways: (1) indiscriminate reduction of public health expenditures; (2) radical reduction of food assistance programs; (3) lifting of price controls on food and the subsequent high prices of food; and (4) reduction of fiscal deficits through increasing regressive taxation.[26] The UNICEF study concludes that health and nutritional status deteriorated less in countries such as Zimbabwe, Korea, and Botswana, which implemented adjustment strategies with targeted programs to protect vulnerable groups, than in countries such as Brazil, Ghana, and the Philippines, with adjustment programs and no special efforts to protect poverty groups.[27] (See table 3.3 for a more detailed review of these results.)

Additional studies argue that the effects of adjustment programs on the public sector in developing countries are even more far-reaching.[28] The drive to reduce fiscal deficits helps destroy the incentive structure of the public sector by increasing the gap between public- and private-sector wages,

and by reducing the differential between lower- and higher-paid public employees. The results are increased corruption, low levels of motivation, flight of professionals to other sectors, reduced public-sector efficiency, and drastically reduced public services. Weakening of the public sector in developing countries makes it doubtful that it can play even the weak collateral role proposed by many international organizations in providing the efficient support for the new export thrust.

As a result of some of the recent work on analyzing the real winners and losers in the process of stabilization and structural adjustment, the director of the International Monetary Fund has concluded:

> Adjustment programs which take into account the health, nutritional and educational needs of the most vulnerable populations will more adequately protect quality of life than those programs which ignore basic needs. This implies that governments have to concern themselves not only with cutting their fiscal deficit but how they achieve these cuts.[29]

Who might the real supporters and opponents of the policy be? Leaders responsible for adjustment policies must be more concerned with who really supports or opposes them in actual practice than with who might benefit from such policies in theory. It is real as opposed to theoretical support or opposition that leaders must ultimately manage.

The stabilization process has met with so much resistance in the developing world that it is logical to ask why governments tried it at all. But in the 1980s financial disequilibrium became so great that many nations had no recourse but to search for ways to reverse hyperinflation and economic collapse. If they wanted to do this with the assistance of external resources, they had to do so within the policy framework and preferences of the IMF and the World Bank or specific bilateral donors.

Initial coalitions to begin the stabilization process were usually formed between a small government economic team and foreign donors. The challenge was usually to win over the president and key members of the new government, as well as important interest groups. Often governments were elected with a mandate from the population to try to reverse economic collapse and get things moving again. This often meant at least tacit support for the first phase of stabilization efforts. Where the governments emerged through coup d' etat, they also came with the publicly stated purpose of restoring economic order. Where civilians replaced military leaders, as they did in Guatemala, they came as well with the expressed purpose of economic reactivation.

Thus, governments usually started with the tacit consent of the population. In the initial phases, key domestic interest groups were supportive of the process. For example, many of the private-sector protests in Guatemala between 1983 and 1986 focused on the lack of coherent government policy to reverse the economic collapse. These protests helped permit a return to civilian rule. Many of the initial protest demonstrations in Costa Rica in 1982 were against rising consumer prices and inflation. The Monge government, subsequently elected, certainly had a mandate from both labor and the private sector to reverse the economic crisis. However, domestic pressure groups began to turn from mild

TABLE 3.3 Typology of Adjustment Policies in Ten Selected Countries

Social policies	Macro policies		
	Without adjustment	Stabilization only	Growth-oriented structural adjustment
With important elements of protection for low-income high-risk groups	Jamaica (1972–80)	Botswana (1981–82) Chile (1981–85)	S. Korea (1981–83) Peru (1985–86) Botswana (1983–85) Zimbabwe (1980–85)
Without important elements of protection for low-income high-risk groups	Ghana (1974–82)	Peru (1977–85) Philippines (1981–85) Jamaica (1981–85)	Brazil (1981–85) Sri Lanka (1978–84) Ghana (1983–85)

SOURCE: UNICEF 1987: 158. Reprinted with permission of UNICEF.

support to neutrality and finally to opposition when specific measures began to impact them harshly.

A comparison of actual opponents of stabilization and adjustment in three Central American countries, Costa Rica, Panama, and Guatemala, reveals a great deal about the style of protest and the successes and failures in managing such groups.

Who protested? Table 3.4 shows which groups protested what kinds of stabilization measures in three Central American countries between 1982 and 1987.[30]

These data should give policymakers a feel for analyzing the actual sources of discontent during the stabilization efforts in these three countries. Protests came most frequently from labor unions, second from public employees, and third from citizens' and businessmen's groups; these were all followed in frequency by teachers and students and political party organizations. About 68.6 percent of the actions were taken by single groups, 17.5 percent by two or more groups or by national organizations that represented groups in the same sector, and 13.9 percent by multisectoral coalitions.

What policies were resisted? The policy measures that caused most reaction during stabilization were (1) perceived erosion of real wages as well as gov-

TABLE 3.4 Reported Protests against Economic Adjustment Measures, by Group Protesting, in Three Central American Countries, 1982–1987

	Costa Rica		Guatemala		Panama		All three countries	
Group protesting	Total	%	Total	%	Total	%	Total	%
Urban labor	4	5.6	8	12.9	16	19.5	28	13.0
Rural labor	13	18.1	1	1.6	8	9.8	22	10.2
Popular groups	17	23.6	8	12.9	2	2.4	27	12.5
Teachers and students	8	11.1	3	4.8	6	7.3	17	7.9
Public employees	16	22.2	7	11.3	15	18.3	38	17.6
Business chambers	5	6.9	7	11.3	0	0.0	12	5.6
Political parties	2	2.8	1	1.6	1	1.2	4	1.9
National labor	2	2.8	5	8.1	9	11.0	16	7.4
National business	1	1.4	11	17.7	3	3.7	15	6.9
National popular	1	1.4	0	0.0	0	0.0	1	0.5
National public sector	0	0.0	2	3.2	4	4.9	6	2.8
Multisector (no private)	2	2.8	3	4.0	7	8.5	12	5.6
Multisector (with private)	1	1.4	6	9.7	11	13.4	18	8.3
Total	72	100.0	62	100.0	82	100.0	216	100.0
Summary of groups protesting								
Labor	19	26.4	14	22.6	33	40.2	66	30.6
Popular groups	18	25.0	8	12.9	2	2.4	28	13.0
Education	8	11.1	3	4.8	6	7.3	17	7.9
Public employees	16	22.2	9	14.5	19	23.2	44	20.4
Business chambers	6	8.3	18	29.0	3	3.7	27	12.5
Political parties	2	2.8	1	1.6	1	1.2	4	1.9
Multisectoral	3	4.2	9	14.5	18	22.0	30	13.9
Total	72	100.0	62	100.0	82	100.0	216	100.0

SOURCE: Prepared by Marc Lindenberg and María Larraz de Quant, based on content analysis and rating of all reported protest news items in *Inforpress* (Guatemala) between 1982 and 1987. Number of news items may not reflect actual number of protests.

ernment attempts to make labor legislation codes more flexible; (2) reductions in public subsidies for consumer goods such as food or raised prices for public services; (3) cutbacks in public services or erosion of the quality of those services; (4) general discontent with government policy; (5) layoffs of public employees; (6) suspicion of the IMF and World Bank efforts (see table 3.6).

The timing of people's reactions to the measures is equally interesting. Table 3.5 shows that reactions to key elements of the stabilization programs such as wage deterioration, consumer subsidy reduction, public service reduction, and public employee layoffs, came quickly and almost immediately.

They continued, moreover, throughout the period, while issues related more to structural adjustment—tariff reduction, changes in the tax structure, reduction of producer subsidies—came later. There are a number of possible reasons for these differences. First, some of the high levels of protest at wages and prices could have been due to the initial economic collapse continuing even into the first phases of stabilization efforts. Second, the initial reactions may have been due to the fact that large segments of the population actually did experience real initial losses, or feared that they would while the effects of other policies were taking place. Finally, it is logical to expect reactions to stabilization before reactions to structural adjustment because except in Panama, where they came mixed, that is the order in which the policy measures occurred.

Which groups resisted which measures? It is interesting to note some of the differences in who protested which specific measures in different countries (see table 1.4 in chapter 1). For example, in Panama the predominant groups that mobilized against economic policy were public and private unions. This is not surprising since unions in Panama are the strongest and best organized in the region. However, it probably also had to do with the nature of the policy choices the government had at its disposal. Since Panama does not have its own currency, devaluation and control of the money supply were out of its hands. Thus, it had to rely on direct measures to cut fiscal deficits. This meant direct confrontation with public employees. In contrast Costa Rica was able to avoid some of the direct confrontations with labor by granting wage gains and later devaluing in order to keep exports competitive.

In contrast to Panama, Guatemala's strongest and most important actor was the organized private sector. That sector strongly resisted efforts to minimize fiscal deficits with new taxes and also efforts to temper the effects of stabilization on the poor. Finally, in Costa Rica public employees, citizens' groups, and labor organizations, particularly in the banana plantation areas, played equal roles in protesting major aspects of the stabilization process.

Different features of the stabilization process were resisted by different groups. For example, erosion of real wages and changes in overall labor legislation were most actively resisted by the public and private labor unions. The strongest resistance by labor in the three countries studied here was to changes in the labor code in Panama. The changes would have made salaries, conditions of dismissal, and benefits packages more flexible. The logic of the measures was to try to make Panamanian labor more competitive. According to President Ardito-Barletta, although privately, labor leaders agreed to a series of revisions in labor policy, opponents in his own party and administration were able to destroy these agreements by leaking information to the press and the general public that both groups had agreed to keep private.

As governments attempted to reduce consumer subsidies, they met strong resistance from the unions, citizens' groups, public employees, and teachers. Since this issue of consumer prices crosscut enough interests, it was relatively easy to form multisectoral coalitions for national strikes. Sometimes, business groups would join the protests over price hikes for gasoline, an item whose increasing prices affected their own firms' profitability.

Public employee associations were the strongest resisters of wage freezes, hiring freezes, and layoffs. Public service cutbacks were opposed by consumer groups, unions, teachers, and students, and sometimes by public employees themselves. However, there was little awareness of and little active resistance to cuts in capital expenditures. The strongest advocates of expenditure reductions in the public sector have been external donors, business interest groups, and center to center-right political parties.

One of the biggest surprises to policy makers in the region was the active resistance to devaluations. Since setting real exchange rates has been one of the most important tools recommended by the IMF and the World Bank during stabilization, this resistance has been a source of high-level friction between donors and developing country governments and citizen groups. In perceptual terms, devaluations became equated with surrendering national sovereignty to the IMF. In Honduras parity with the dollar was considered such a sacred cow that discussion of devaluation was barred from public forums, and advocates were warned not to discuss it and threat-

TABLE 3.5 Reported Protests against Economic Adjustment Measures, by Issue Protested, in Three Central American Countries, 1982–1987

Economic policy issue	'82	'83	'84	'85	'86	'87	Total	Percentage
Costa Rica								
Reduced public services	0	3	6	2	0	3	14	19.4
Wages, benefits, and labor code changes	9	5	6	1	2	4	27	37.5
Public-sector layoffs	0	0	0	0	2	1	3	4.2
General government policies	2	0	1	0	0	0	3	4.2
Consumer price hikes	4	6	0	1	4	0	15	20.8
Producer subsidies reduced	0	0	0	1	1	0	2	2.8
Against IMF/WB	0	0	2	0	2	1	5	6.9
Tax increases	0	0	0	0	1	0	1	1.4
Trade and tariff policy changes	1	0	0	0	0	1	2	2.8
Total	16	14	15	5	12	10	72	100.0
Percentage	22.2	19.4	20.8	6.9	16.7	13.9	100.0	
Guatemala								
Reduced public services	2	1	1	0	0	2	6	9.7
Wages, benefits, and labor code changes	0	0	2	6	3	6	17	27.4
Public-sector layoffs	0	0	0	0	0	4	4	6.5
General government policies	2	2	1	2	1	0	8	12.9
Consumer price hikes	0	0	1	5	3	4	13	21.0
Producer subsidies reduced	1	1	0	0	0	0	2	3.2
Against IMF/WB	0	0	0	0	0	0	0	0.0
Tax increases	0	3	4	1	0	1	9	14.5
Trade and tariff policy changes	2	1	0	0	0	0	3	4.8
Total	7	8	9	14	7	17	62	100.0
Percentage	11.3	12.9	14.5	22.6	11.3	27.4	100.0	
Panama								
Reduced public services	1	0	5	2	1	1	10	12.2
Wages, benefits, and labor code changes	1	2	6	14	5	7	35	42.7
Public-sector layoffs	0	1	0	7	1	3	12	14.6
General government policies	0	0	5	3	0	2	10	12.2
Consumer price hikes	0	0	0	0	0	1	1	1.2
Producer subsidies reduced	0	0	0	0	0	0	0	0.0
Against IMF/WB	0	0	3	8	0	1	12	14.6
Tax increases	0	0	2	0	0	0	2	2.4
Trade and tariff policy changes	0	0	0	0	0	0	0	0.0
Total	2	3	21	34	7	15	82	100.0
Percentage	2.4	3.7	25.6	41.5	8.5	18.3	100.0	

SOURCE: Prepared by Marc Lindenberg and María Larraz de Quant, based on content analysis and rating of all reported protest news items in *Inforpress* (Guatemala) between 1982 and 1987. Number of news items may not reflect actual number of protests.

ened with expulsion or jail sentences if they did.[31] In Panama, which has maintained a dollar-based parity and has not issued its own currency, the idea of devaluation would have required an entire new set of policies and institutions including creation of a central bank, as well as a psychological adjustment on the part of the population. Lack of understanding of how devaluations worked, when combined with suspicion by many groups toward the often secret negotiations and agreements between their countries and international donors, led to more than 15 large and sometimes violent demonstrations between 1982 and 1987 in the three countries studied.

What conclusions can be drawn about supporters and opponents? In the analysis of supporters and opponents, some interesting paradoxes emerged. First, many of the very groups that, in theory, are supposed to be the long-term beneficiaries of the stabilization process spent a great deal of time opposing it in actual practice. For example, while control of inflation through reduced monetary emission, fiscal deficit control, and realistic exchange rates is supposed to ultimately benefit consumers, middle- and lower-income groups experience what they believe are losses in real wages that accompany the initial stabilization measures. While part of this occurs because inflation continues while new stabilization measures are being put into place, the policies themselves are often perceived to add to the problem. For example, reduced public subsidies for food and public transportation and the inability to negotiate wage gains together create the perception as well as the reality of a squeeze. Even if other policies help reduce inflation later, this initial squeeze probably helps create a negative disposition toward the whole process. The problem is doubled for public employees, who not only find their income initially reduced but also fear dismissal from their jobs due to attempts to reduce the fiscal deficit. They correctly perceive that there are few immediate sources of alternative employment during the demand-reduction phase of stabilization. Thus, not surprisingly, the strongest attacks on the initial phase of the process came from organized labor in the public and private sector.

Second, while the effects on the poor may have been even harsher than was originally imagined, they protested less frequently as a group. It is undoubtedly much harder for citizens' groups and poor people to organize themselves than it is for labor or business groups. Thus, only in Costa Rica where community organizations are more of a tradition did citizens' groups protest the deterioration in their levels of living. Finally, although the general population is supposed to be the ultimate beneficiary of the process, the general public does not normally organize itself. There is little impetus for pressure groups representing the general public to actively support the belt tightening associated with stabilization. Recent experiences in Costa Rica, Ghana, and Sri Lanka suggest that after serious economic collapse the general population stays neutral or gives the government tacit consent to undertake the first part of the process.[32] Later, when the move takes place from stabilization to structural adjustment, this more general support begins to erode into increased pressure group reaction.[33]

What strategies have groups used to support or oppose economic stabilization programs? Policy makers concerned with implementing stabilization policy would do well to be aware of the styles of discontent that groups are accustomed to using. Groups in each country may be inclined to express their discontent differently and styles may be different in each country.

For example, table 3.6 shows that in Guatemala the preferred protest strategy on economic issues was strong public statement in the newspapers or a press conference followed by tough private negotiations. Strikes and the seizure of installations were the second most common ways of drawing attention to problems with economic policies. In Panama, in contrast, strikes by just about every sector were the preferred method. These usually finished in private negotiations. The second most frequent tactic in Panama was the protest march and demonstration. Strong public statements unaccompanied by other tactics were very uncommon. In Costa Rica strikes predominated as the major protest vehicle. Other important tactics were strong public statements, press conferences, and demonstrations.

Table 3.7 provides an overview of the preferred protest strategy of different groups. In Guatemala, for instance, the private sector preferred strong public statements, while public employees relied on a combination of strikes and seizures of installations to make their feelings known. In Costa Rica citizens' groups used a combination of demonstrations, street blockades, and seizures of installations to express their discontent, while teachers' organizations used strikes and demonstrations.

When did the risk to the government increase? One of the key issues for policy makers is to know when protest activity is serious and when it is not. A serious protest is one that so damages the

TABLE 3.6 Styles of Group Protest against Economic Adjustment Measures, by Issue Protested, in Three Central American Countries, 1982–1987

Economic policy issue	Strikes	Demon-strations	Seizure of land or facilities	Road blocks	Public state-ments	Terror-ism	Total	Per-centage
Costa Rica								
Reduced public services	2	3	4	5	0	0	14	19.4
Wages, benefits, and labor code changes	21	0	0	0	6	0	27	37.5
Public sector layoffs	1	0	1	0	1	0	3	4.2
General government policies	0	0	0	1	2	0	3	4.2
Consumer price hikes	2	6	0	1	6	0	15	20.8
Producer subsidies reduced	1	0	0	1	0	0	2	2.8
Against IMF/WB and donor imposition	0	3	0	0	2	0	5	6.9
Tax increases	0	0	0	0	1	0	1	1.4
Trade and tariff policy changes	0	0	0	1	1	0	2	2.8
Total	27	12	5	9	19	0	72	100.0
Percentage	37.5	16.7	6.9	12.5	26.4	0.0	100.0	
Guatemala								
Reduced public services	0	0	4	0	2	0	6	9.7
Wages, benefits, and labor code changes	6	0	4	0	7	0	17	27.4
Public sector layoffs	2	0	1	0	1	0	4	6.5
General government policies	0	0	1	0	7	0	8	12.9
Consumer price hikes	2	4	1	0	5	1	13	21.0
Producer subsidies reduced	0	0	0	0	2	0	2	3.2
Against IMF/WB and donor imposition	0	0	0	0	0	0	0	0.0
Tax increases	1	0	0	0	8	0	9	14.5
Trade and tariff policy changes	0	0	0	0	3	0	3	4.8
Total	11	4	11	0	35	1	62	100.0
Percentage	17.7	6.5	17.7	0.0	56.5	1.6	100.0	
Panama								
Reduced public services	5	2	3	0	0	0	10	12.2
Wages, benefits, and labor code changes	31	2	1	0	2	0	35	43.9
Public sector layoffs	7	4	0	1	0	0	12	14.6
General government policies	4	5	1	0	0	0	10	12.2
Consumer price hikes	1	0	0	0	0	0	1	1.2
Producer subsidies reduced	0	0	0	0	0	0	0	0.0
Against IMF/WB and donor imposition	3	6	0	0	3	0	12	14.6
Tax increases	2	0	0	0	0	0	2	2.4
Trade and tariff policy changes	0	0	0	0	0	0	0	0.0
Total	53	19	5	1	5	0	82	100.0
Percentage	64.6	23.2	6.1	1.2	6.1	0.0	100.0	

SOURCE: Prepared by Marc Lindenberg and María Larraz de Quant, based on content analysis and rating of all reported protest news items in *Inforpress* (Guatemala) between 1982 and 1987. Number of news items may not reflect actual number of protests.

TABLE 3.7 Styles of Group Protest against Economic Adjustment Measures, by Group Protesting, in Three Central American Countries, 1982–1987

Group protesting	Strikes	Demonstrations	Seizure of land or facilities	Road blocks	Public statements	Terrorism	Total
Costa Rica							
Urban labor	1	2	1	0	0	0	4
Rural labor	5	1	3	3	1	0	13
Popular groups	3	7	0	4	3	0	17
Teachers and students	3	1	1	0	3	0	8
Public employees	14	0	0	0	2	0	16
Business chambers	1	0	0	2	2	0	5
Political parties	0	0	0	0	2	0	2
National labor	0	0	0	0	2	0	2
National business	0	0	0	0	1	0	1
National popular	0	0	0	0	1	0	1
National public sector	0	0	0	0	0	0	0
Multisector (no private)	0	1	0	0	1	0	2
Multisector (with private)	0	0	0	0	1	0	1
Total	27	12	5	9	19	0	72
Percentage	37.5	16.7	6.9	12.5	26.4	0.0	100.0
Guatemala							
Urban labor	3	0	3	0	2	0	8
Rural labor	0	0	1	0	0	0	1
Popular groups	0	2	3	0	3	0	8
Teachers and students	2	0	0	0	0	1	3
Public employees	3	0	2	0	2	0	7
Business chambers	0	0	1	0	6	0	7
Political parties	0	0	0	0	1	0	1
National labor	0	1	0	0	4	0	5
National business	1	0	0	0	10	0	11
National popular	0	0	0	0	0	0	0
National public sector	1	0	0	0	1	0	2
Multisector (no private)	1	1	1	0	0	0	3
Multisector (with private)	0	0	0	0	6	0	6
Total	11	4	11	0	35	1	62
Percentage	17.7	6.5	17.7	0.0	56.5	1.6	100.0
Panama							
Urban labor	13	1	1	0	1	0	16
Rural labor	4	1	2	1	0	0	8
Popular groups	0	1	1	0	0	0	2
Teachers and students	3	3	0	0	0	0	6
Public employees	13	2	0	0	0	0	15
Business chambers	0	0	0	0	0	0	0
Political parties	1	0	0	0	0	0	1
National labor	5	2	0	0	2	0	9
National business	1	1	0	0	1	0	3
National popular	0	0	0	0	0	0	0
National public sector	3	1	0	0	0	0	4
Multisector (no private)	5	2	0	0	0	0	7
Multisector (with private)	5	5	0	0	1	0	11
Total	53	19	4	1	5	0	82
Percentage	64.6	23.2	4.9	1.2	6.1	0.0	100.0

SOURCE: Prepared by Marc Lindenberg and María Larraz de Quant, based on content analysis and rating of all reported protest news items in *Inforpress* (Guatemala) between 1982 and 1987. Number of news items may not reflect actual number of protests.

government's support base that it cannot govern at all. A less serious effort might require changes in the policy or it might slow down the implementation process. A weak effort may have no impact whatsoever. One practical way to monitor the potential seriousness of opposition to the new policy is to watch three factors: the types of coalitions the group has mobilized; the kinds of actions they want to employ; and the resources they have at their disposal. All of these factors normally combine to produce a manageable or unmanageable effect on the government's political base. Risk to the government increases the larger, more broadly based, and more multisectoral the protest effort is, the more violent it is, and the more resources it has.

Table 3.8 and 3.9 compare the kinds of coalitions opposition groups employed to combat stabilization polices in Costa Rica, Guatemala, and Panama between 1982 and 1987. The tables show the number of protest efforts that were made simply by a single group, ministry, or organization, versus two or more groups from the same sector, or a national umbrella organization made up of many groups from the same sector versus multisectoral coalitions. The two tables viewed together are instructive because they show the way pressure has built from simple, single groups to national organizations and finally to country-wide strikes and opposition. The material serves as a history of actual government problems as well as a weather vane to anticipate future ones. For example, there is an immediately noticeable difference between the number of general strikes and multisectoral protests Costa Rica has had to manage in the last five years as compared to Panama or Guatemala (see table 3.8). In Costa Rica only 9.8 percent of the total reported incidents of protest at economic policies were by national umbrella organizations or multisectoral coalitions as opposed to 43.5 percent in Guatemala and 41.5 percent in Panama. Panama had to manage the highest percentage of multisectoral protests (22.0 percent), as opposed to Guatemala (14.5 percent), and Costa Rica (only 4.2 percent).

By tracing the pattern of protest actions in Panama (see table 3.9), we can see a lower volume of protest before Ardito-Barletta takes office (1982–1983). The volume increases dramatically during the Ardito-Barletta government (1984–1985), drops off after his resignation (1986), and picks up again as opposition to General Noriega increases (1987). Also, the percentages of multisectoral and national actions before the Ardito-Barletta government (1983) are low. However, protest becomes more national and multisectoral during the Ardito-Barletta period (1984–1985) and stays high for the rest of the period.

In Costa Rica, in contrast, the highest percentages of national and multisectoral protest are for 1982, during the last phases of the economic collapse. With the advent of the Monge administration, multisectoral coalitions and national-level protests are on the wane during the stabilization efforts (with the exception of a brief moment in 1984), and have only begun to re-emerge as the problems of implementing long-term structural adjustments during the Arias administration have come out.

Guatemala presents a preoccupying picture for the government of President Venicio Cerezo. National and multisectoral protest was high in the last years of the military government of Gen. Oscar Mejía Víctores (1985). It dropped at the beginning of the Cerezo period, but grew again tremendously in 1987 as the government made efforts at adjustment, with some attention to social expenditures to mitigate some of its more difficult aspects. Protest continued to grow in 1988 as the Guatemalan government proved able to satisfy neither those who wanted more populist measures nor those who wanted less.

When have governments managed political coalitions for adjustment policies well, and when have they had problems? Governments that try to implement adjustment programs are caught in a vortex of political forces. On the one hand, they must meet donor requirements if they wish to use external resources. On the other, they must balance donor requirements against the competing demands of their own population, which is struggling to recover its levels of living. Finally, they must juggle the conflicting requirements, pressures, and threats of their own military, business, organized labor, and the popular groups.

Such a task is far from easy. In fact it is difficult to determine when a government has been successful in its efforts. For the purposes of this chapter, success in political management of stabilization and adjustment is judged on four levels: (1) Did the government stay in power while continuing the policies? (2) Did they stay in power but with high levels of social conflict about the policies and with limited success in achieving policy objectives? (3) Did they stay in power with social conflict and have relative success in stabilization and/or structural adjustment efforts? (4) Did they stay in power with limited social conflict and have relative success in stabilization and/or structural adjustment efforts that protected poverty groups?

Although in many countries it is too soon to tell

TABLE 3.8 Type of Group Protesting Economic Adjustment Measures, by Year, in Three Central American Countries, 1982–1987

Group protesting	'82	'83	'84	'85	'86	'87	Total	Percentage
Costa Rica (grand totals)								
Urban labor	0	0	1	0	2	1	4	5.0
Rural labor	2	1	5	1	2	2	13	18.1
Popular groups	1	7	3	3	1	2	17	23.0
Teachers and students	3	2	1	0	1	1	8	11.1
Public employees	3	4	3	0	3	3	16	22.2
Business chambers	1	0	0	1	2	1	5	6.9
Political parties	2	0	0	0	0	0	2	2.8
National labor	1	0	0	0	1	0	2	2.8
National business	1	0	0	0	0	0	1	1.4
National popular	1	0	0	0	0	0	1	1.4
National public sector	0	0	0	0	0	0	0	0.0
Multisector (no private)	0	0	2	0	0	0	2	2.8
Multisector (with private)	1	0	0	0	0	0	1	1.4
Total	16	14	15	5	12	10	72	100.0
Percentage	22.2	19.4	20.8	6.9	16.7	13.9	100.0	
Guatemala (grand totals)								
Urban labor	1	0	1	0	3	3	8	12.9
Rural Labor	0	0	0	0	0	1	1	1.6
Popular groups	1	0	3	2	1	1	8	12.9
Teachers and students	0	0	1	2	0	0	3	4.8
Public employees	0	0	0	0	1	6	7	11.3
Business chambers	2	3	0	0	2	0	7	11.3
Political parties	0	1	0	0	0	0	1	1.6
National labor	0	0	0	5	0	0	5	8.1
National business	3	3	2	2	0	1	11	17.7
National popular	0	0	0	0	0	0	0	0.0
National public sector	0	0	0	1	0	1	2	3.2
Multisector (no private)	0	0	0	0	0	3	3	4.8
Multisector (with private)	0	1	2	2	0	1	6	9.7
Total	7	8	9	14	7	17	62	100.0
Percentage	11.3	12.9	14.5	22.6	11.3	27.4	100.0	
Panama (grand totals)								
Urban labor	0	1	4	7	0	4	16	19.5
Rural labor	0	2	4	0	1	1	8	9.8
Popular groups	0	0	0	2	0	0	2	2.4
Teachers and students	1	0	2	2	1	0	6	7.3
Public employees	0	0	2	7	1	5	15	18.3
Business chambers	0	0	0	0	1	0	0	0.0
Political parties	0	0	1	0	0	0	1	1.2
National labor	0	0	1	5	1	2	9	11.0
National business	0	0	0	2	0	1	3	3.7
National popular	0	0	0	0	0	0	0	0.0
National public sector	0	0	0	2	1	1	4	4.9
Multisector (no private)	0	0	0	3	4	0	7	8.5
Multisector (with private)	1	0	5	4	1	1	11	13.4
Total	2	3	19	34	11	15	82	100.0
Percentage	2.4	3.7	23.2	41.5	13.4	18.3	100.0	

SOURCE: Prepared by Marc Lindenberg and María Larraz de Quant, based on content analysis and rating of all reported protest news items in *Inforpress* (Guatemala) between 1982 and 1987. Number of news items may not reflect actual number of protests.

TABLE 3.9 Summary of Type of Group Protesting Economic Adjustment Measures, by Year, in Three Central American Countries, 1982–1987 (percentage)

Summary of type of group protesting	'82	'83	'84	'85	'86	'87	Total
Costa Rica[a]							
Single sectoral organization	75.0	100.0	86.7	100.0	91.7	100.0	90.3
Two or more organizations from the same sector	18.8	0.0	0.0	0.0	8.3	0.0	5.6
Multisectoral coalition	6.3	0.0	13.3	0.0	0.0	0.0	4.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Percentage of protests per year	22.2	19.4	20.8	6.9	16.7	13.9	100.0
Guatemala[b]							
Single sectoral organization	57.1	50.0	55.6	28.6	100.0	64.7	56.7
Two or more organizations from the same sector	42.9	37.2	22.2	57.1	0.0	11.8	29.0
Multisectoral coalition	0.0	12.5	22.2	14.3	0.0	23.5	14.5
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Percentage of protests per year	11.3	12.9	14.5	22.2	11.3	27.4	100.0
Panama[c]							
Single sectoral organization	50.0	100.0	68.4	52.9	36.4	66.7	58.5
Two or more organizations from the same sector	0.0	0.0	5.3	26.5	18.2	26.7	19.5
Multisectoral coalition	50.0	0.0	26.3	20.6	45.5	6.7	22.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Percentage of protests per year	2.4	3.7	23.2	41.5	13.4	18.3	100.0

NOTE: Totals may not add due to rounding.
a. Total news items with reported incidents equals 72.
b. Total news items with reported incidents equals 62.
c. Total news items with reported incidents equals 82.
SOURCE: Prepared by Marc Lindenberg and María Larraz de Quant, based on content analysis and rating of all reported protest news items in *Inforpress* (Guatemala) between 1982 and 1987. Number of news items may not reflect actual number of protests.

how successful governments have been, table 3.10 provides a typology of country performance during specific time periods.

There is no evidence, particularly for recent programs, that efforts noted as successful in the typology will continue to be successful in the late 1980s. With this framework, for example, the Panamanian government (1984–1985) fits into category I. It tried to promote a combination of stabilization and structural adjustment from 1984 to 1985 but encountered severe resistance and was unable to maintain its policies. Opponents used economic issues as one of many instruments in their struggle to restrict the actions of a civilian president and remove him from office. Guatemala (1986–1988) and the Dominican Republic (1982–1984) are examples of category II countries. Their governments tried to maintain such policies in a climate of heightened tension and social conflict. Ghana (1982–1985), Costa Rica (1983–1984), and Brazil (1981–1985) are examples of category III. They had successful stabilization efforts with levels of violence and discontent. Finally, in category IV, Costa Rica (1985–1987), Botswana (1983–1985), South Korea (1981–1983) and Zimbabwe (1980–1985) managed adjustment programs that favored the poor and did so with low levels of violence and at least marginal economic success. How did the successful countries manage the political coalitions? What strategies and tactics appeared to work? What didn't work — and why? What special factors contributed to success? Rather than discuss specific countries in detail we will draw on examples from a variety of

countries with two subjects in mind: first, the problem of managing coalitions within developing countries; and second, the problem of managing the donors themselves.

Managing internal coalitions: successes and failures. While there are no foolproof rules about successful management of internal coalitions in stabilization efforts, there are some emerging patterns that seem to have worked in some of the more successful country situations. Let us look at some of these.

Taking advantage of the grace period. "Every crisis provides an opportunity," says a Chinese proverb. Governments fortunate enough to take office after economic chaos presided over by their predecessors have had better chances of mobilizing the population to support stabilization efforts than those who have presided over a collapse and tried to reverse it.[34] These new governments often seize power (Ghana, 1982) or are elected with a mandate to forge an economic recovery (Costa Rica, 1982). They frequently receive a grace period in which the population gives them "the benefit of the doubt" while they try new measures. In contrast, governments like Jamaica under Prime Minister Edward Seaga in 1983, or Costa Rica under President Rodrigo Carazo Odio in 1982, which were forced to reverse policies and move toward stabilization, were viewed by the public with a great deal of suspicion and contempt.[35] Their credibility was low and, particularly in the case of Costa Rica, the level of public protest rose substantially.

The importance of rapid, decisive action. Forceful action during the grace period appears to be one of the key elements in success. For example, the governments of Costa Rica (1983), Ghana (1982), and Bolivia (1985) moved almost immediately, creating a spirit of national emergency and the necessity to share losses during the crisis. Their efforts were relatively successful.

In contrast, the governments of Guatemala (1986), the Dominican Republic (1982), and El Salvador (1985) lost the initiative, because they lacked either a clear economic strategy or appreciation of how serious the economic crisis was. In all three situations the government began with a grace period. The public had protested the economic collapse and the policies of the previous government. However, there was not sufficient consensus or interest in economic policy in any of these three new governments to produce immediate, forceful action or communicate the spirit of sharing during crisis. In El Salvador, President José Napoleón Duarte viewed the war as his most important issue. He had relatively little interest in economic policy.[36] It took his government more than a year and a half to articulate an economic strategy.[37] In the Dominican Republic in 1982, President Jorge Blanco underestimated the seriousness of the crisis and hoped that recovery in coffee prices would make strong action unnecessary. His government lost valuable time. By the time it was ready to act, the public blamed the government for making the economic crisis worse. In 1986 in Guatemala the new democratically elected government, the first since 1950, had concentrated so much of its energy on the election campaign that its members were not ready with a complete economic strategy. They took the better part of a year resolving differences between factions within the Christian Democratic party and government ministers about what policies were appropriate.[38]

The dangers of getting ahead of the public. Reacting too soon can be as dangerous as waiting too long. In Panama in 1984 President Ardito-Barletta, an excellent economist and former vice president of the World Bank, tried to anticipate a clearly impending economic collapse with sound programs before the population had experienced enough of the negative effects of the collapse to believe the crisis was real.[39] Many groups questioned the relevance of the measures and opposed them actively.

Involving the public and building consensus. Many of the more successful governments involved citizens' groups in dialogue about the economic crisis and asked them to help formulate measures. In Costa Rica, President Monge mounted dialogue programs with business, labor, cooperatives, popular organizations, and government officials. These groups discussed the economic crisis, the measures, and possible solutions.[40] The groups had a high sense of involvement. They were aware of and actively discussed the proposals of the IMF and the World Bank. The president also met frequently with groups from each sector, listened to their complaints, and made attempts to get his economic team to take these objections into account where possible. In Jamaica, for example, while the Seaga government did not have a general reputation for consulting with key sectors, it did in one case create a multisectoral consultative commission to review a government proposal for income tax reform.[41] The outcome was viewed as largely successful.[42] In other countries like Honduras and, later, El Salvador and

Guatemala, these programs included the military—clearly a group whose support was vital to the stability of any new economic strategy.

In contrast there are dangers to both secrecy and to what groups perceive to be nonresponsive or "rigged" consultations. For example, from 1982 to 1988, particularly before and after the Ardito-Barletta government, successive Panamanian governments handled their negotiations with the IMF and the World Bank as highly secret processes. As a result both the private sector chambers and the labor movement viewed the agreements as "mysterious outside impositions." They developed inaccurate perceptions of the terms of the agreements and a high level of hostility toward the IMF and the World Bank—hostility that often exploded in demonstrations and protests. Government officials helped contribute to these misperceptions by refusing to explain the details of the agreements in dialogue seminars with the private sector in 1983.[43] Later in the period before President Ardito-Barletta took office, a more open consultative style was adopted, and in 1984 national dialogue programs were begun. However, participating groups reacted negatively when the substance of their private negotiations with the president were made public without prior consultation.[44]

Showing initial success. Picking some measures that have tangible, visible short-term impact helps to build a sense of confidence. While elements of luck are involved, picking the right measures has enhanced the credibility of some governments. For example, getting hyperinflation under control and helping to reduce the spread between the official and black market exchange rate in Bolivia in 1985 helped to build confidence for the newly elected government of Víctor Paz Estenssoro.[45]

Providing a sense of equity. Creating within the population the sense that policies were fair was an important part of successful coalition management. For example, during the Monge administration in Costa Rica, the government used the policy of a crawling peg exchange-rate system with minidevaluations. The purpose of this was to maintain a real exchange rate and to accustom the population to this incremental adjustment. The government also allowed the partial indexing of wages to help workers keep up with inflation. Observers noted the interaction of these two policies—an effect called "rotating the crisis."[46] First, workers received increments while exporters complained about the effect on their firms' profitability and competitiveness. Then the government would have one of its periodic minidevaluations, which would in turn help compensate exporters. Then workers would complain about further inflation and wages would increase through the partial indexing process. Other strategies involved asking multisectoral groups to figure out where to make cuts in budgets for their own sectors or to help the government design difficult tax proposals.[47]

Winning the bureaucracy and the party. Disagreements among members of the government economic team waste time and effort. Getting control of the bureaucratic and party machinery is a key element in making stabilization and structural adjustment work. Joan Nelson's work on adjustment in Costa Rica, Jamaica, and the Dominican Republic suggests that it is easier for the government to get immediate control of policies handled by the central bank or finance ministry—exchange rates, taxes, interest rates, and the money supply—than it is to implement policies that require the collaboration of other ministries, for example, to get a new ministry of exports moving.[48] One implication might be to start with policy areas that are easier to control and work toward the coalitions in areas that are more difficult.

Another key problem is getting and maintaining consensus among the economic team. In Costa Rica, crucial time was lost during the adjustment process in the agricultural sector due to disagreements between the president of the central bank and the minister of agriculture. First, one resigned, and when the president convinced him to return, the other left the government. In Panama, according to President Ardito-Barletta, his economic strategy was weakened due to a constant battle with elements in his own party and the military.

Maintaining the effort. One of the greatest areas of suspicion within key pressure groups in countries undergoing stabilization and structural adjustment is whether the government is serious in its efforts. Governments can try to build confidence through sending consistent signals to the public. For example, from 1982 to 1984 the government of Costa Rica maintained its policies in a consistent fashion and, surveys showed, convinced the public of its seriousness. Flight capital returned to the country during this period. In contrast, although the government of Zambia began an adjustment program in 1985, enough inconsistencies in policy implementation existed to cause serious questions of confidence on the part of key interest groups.[49] Even when consis-

TABLE 3.10 Government Adjustment Policies and Levels of Social Conflict

Levels of social conflict and political instability	Country
I. Government could not maintain itself in office.	Panama (1984–1985)
II. Government stayed in office but with high levels of social conflict and limited economic policy success.	Guatemala (1987–1988) Dominican Republic (1982–1984)
III. Government stayed in office with limited social conflict and some success in adjustment objectives.	Ghana (1982–1985) Costa Rica (1983–1984) Brazil (1981–1985)
IV. Government stayed in office with limited social conflict and some success in adjustment objectives which also protected poverty groups.	Costa Rica (1985–1987) South Korea (1981–1983) Zimbabwe (1980–1985) Botswana (1983–1985)

SOURCE: Lindenberg 1989.

tent policies are maintained it is not always possible to generate confidence.

Dilemmas of political management. Joan Nelson rightly notes that it is easier to get public support for stabilization than for structural adjustment. Stabilization efforts normally follow economic collapse. The population is aware of the seriousness of the situation and so is willing to temporarily suspend some of its demands for improvement in levels of living. However, outward-oriented structural adjustment, with all that it implies in the way of changes in trade policy and reduction in subsidies, is not as easy. Groups begin to tire. They begin to protest when more thoroughgoing transformations are required in their sector.

Some of the most common areas of tension are the following: resistance by the industrial sector to the speed of changes required by the move toward exports; resistance by agricultural producers to loss of subsidies; and conflicts between donors who want tariff reductions and countries that cannot meet the requirements without violating the rules of their regional common markets. In addition, strong reactions come from groups when policies get out of sequence and damage their industries. For example, in Chile in 1981–1982, wage policy and tariff policy got out of balance.[50] Industrialists producing for the local market found their wage bill going up because of government indexing of salaries while at the same time foreign goods were entering the country more cheaply as a result of tariff reductions. Reactions against the government were strong. In Argentina in 1978, the government liberalized capital transfers in and out of the country before it permitted domestic interest rates to rise. Capital flight escalated and local investors sought higher interest rates abroad, so that many local banks collapsed.

Since the process is still under way at the end of the 1980s, it is too soon to draw lessons for the successful management of political groups in long-term structural adjustment. However, there are successful examples from the 1960s and 1970s. For example, in the 1970s the president of Korea used a process of weekly lunches and consultation with key industrialists to listen to their problems and to encourage them to export.[51] At the same time in Korea, there was increasing evidence of detailed guidance and intervention right to the firm level. In Taiwan in the 1970s, the government persuaded industrialists to set up a fund based on a small percentage of their sales to award monetary prizes to successful exporters.[52] There is increasing recognition that a more gradual withdrawal from inward orientation, with help given to firms making the adjustments, is a more politically feasible strategy than quick cutting of subsidies.[53]

Protecting the poor. Experience has revealed that, while this is not necessary to the success of stabilization or adjustment programs, it is possible to combine adjustment programs with attention to protection of at-risk groups (as long as foreign resources are available to help make this dual process possible).[54]

In Botswana (1980–1984) the government implemented stabilization programs to correct imbalances caused by a drought as well as by the world economic crisis. However, in conjunction with stabilization programs the government introduced five

programs to minimize the damage to high-risk poverty groups. The programs were: (1) a public works employment program that covered 74,000 workers; (2) a special program to repair damaged water storage systems in villages; (3) assistance to low-income farmers; (4) livestock improvement programs for small farmers with guaranteed markets; and (5) food assistance programs for school children, children under five years of age in urban and rural settings, and pregnant and nursing mothers.[55] In spite of a five-year drought, levels of malnutrition among children increased only marginally according to UNICEF studies. UNICEF argues that the cost of such programs is not prohibitive in small countries.

In 1982–1983 the government of Zimbabwe also introduced a stabilization program in an effort to correct imbalances created by a severe drought and the world economic crisis. However, in conjunction with the program they not only introduced a supplementary food program for rural children suffering from malnutrition but actually increased their expenditures for public health programs. In spite of the serious economic situation from 1982 to 1984, UNICEF studies show that the rate of infant mortality actually dropped, and that the rate of primary school completion went up.[56]

In contrast, from 1982 to 1985 after a prolonged economic collapse, the government of Ghana carried out a successful stabilization program. During this period, major cuts were made in health expenditures. Infant mortality rose substantially.[57] In the Philippines in the 1983–1985 period, similar measures were taken. The stabilization program was successful in correcting economic imbalances, but health and nutrition among at-risk groups greatly deteriorated.[58]

Managing the donors: sucesses and failures. Few countries have attempted stabilization or structural adjustment without substantial inflows of foreign resources. Where there are results, they have been disappointing. For example, in 1988 the government of Nicaragua attempted to stem its economic collapse, stimulate its deteriorating export sector, and control its hyperinflation through a series of economic reforms that created a new currency, imposed a massive devaluation, freed consumer goods and food from price controls, reduced the fiscal deficit, and limited monetary emission.[59] This was attempted without major foreign resource inflows and during a war. Public discontent with rising prices grew and demands for wage increases escalated. Within three months, the gap between the official and black market exchange rate began to climb again, and the government resorted to more public spending and increased its monetary emission.

Foreign resources would have made this process more manageable. But to get and maintain foreign resource flows requires careful management of the relationship with donors. There is evidence of success with some strategies.

Establishing credibility. Some of the governments inheriting economic collapse have moved to successfully establish their credentials with key donors, for instance by stating their intention to pay their foreign debt and honor the obligations of their predecessors.[60] They have gone ahead and made their debt-service payments before visiting key donors.[61] Where serious problems of credibility existed, as in the Dominican Republic in 1984, or where nationalistic feelings prohibited direct negotiations with donors, as in Colombia,[62] governments have tried to establish their credibility by designing shadow agreements that mirror the adjustment plans normally proposed by the donors and then beginning to implement the plans themselves. In contrast some governments have developed a reputation for trickery. They hide figures from international teams. One respected international economist said: "I had worked on the national accounts of that country for years. I knew when I visited that they were holding things back." Other negotiating teams have played "shell games" with deficit reduction by reducing central government spending in some ministries and picking it up in others. They have reduced central government debt but increased central bank debt. As a last resort they have relied on capital inflows from drug money or arms sales to replace normal donor assistance or normal foreign investment.[63] Finally, some governments have signed agreements and taken first disbursements knowing that they could not meet the conditions. After discovery of their inability to comply with basic conditions, further disbursements have been stopped. But government credibility is damaged in the process.

Controlling the agenda. Some governments have created good first impressions by getting their own plan ready in advance of any negotiations. In 1982, for example, Ghana approached donors with its own plan, which fitted well within international donor guidelines.[64] In 1982 Costa Rica assigned a small, respected economic team the task of designing a strategy. By the time the team went to negotiate, they had a strategy that impressed international organizations. In 1986 the Arias govern-

ment in Costa Rica assigned a highly respected businessman the task of renegotiating his country's commercial debt.

Educating donors about local conditions. One of the most difficult problems that local officials comment on is that of the insensitivity of functionaries from donor agencies to local problems, conditions, and limitations. One of the most effective strategies for helping overcome this problem has been to arrange meetings between IMF or World Bank functionaries and local pressure groups.[65] This has permitted, for example, a dialogue between industrialists who were worried about specific aspects of tariff reduction, or agriculturalists worried about reduced subsidies, and the officials who were proposing it from the outside. In Costa Rica such meetings resulted in fine-tuning the recommendations of the first World Bank mission's 1983 report, establishing a new realism. It also permitted better understanding of donor viewpoints by key local leaders. In contrast some countries held their negotiations in secret. This increased suspicion in the local community and left donor officials without a real understanding of the problems involved in some of the things they were proposing.

Patience and careful institutional analysis. Focusing on final objectives and not personalizing aspects of negotiations has helped move some agreements along. One Costa Rican official involved in the negotiation of his country's first structural adjustment loan (SAL) said:

> My first reaction to the 1983 World Bank team report was fury. It seemed that from one day to the next, they wanted to change not only an economic structure but our whole way of life. The report seemed more like the program proposed by a political party than an economic recovery plan prepared by a responsible donor agency.[66]

He went on to say, however, that after he calmed down he recognized that it was in both his country's and the bank's interest to reach an agreement, and he convinced himself that with patience and persistence he and his colleagues would eventually make their viewpoint understood. Some of the successful strategies were (1) reaching agreement on the easy issues first and delinking the difficult issues from the ones on which there was substantial agreement; (2) getting the donor to agree to evaluate the program in phases in which the policies that enjoyed a broader national consensus were put into effect first; (3) having officials from the bank meet with the groups that most opposed certain measures so that bank officials understood the difficulties; (4) understanding what the bank guidelines were and where there was potential for flexibility and where not; and (5) understanding the bank's decision-making process and where to put pressure on it if necessary.

Playing geopolitical chess. Some countries have been able to use their status in East-West struggles or use their knowledge of donor fads and priorities to get resources to move their economic strategies along. At crucial times, Taiwan and South Korea positioned themselves in the minds of members of the U.S. Congress as key elements along the United States defense perimeter.[67] Taiwan received substantial aid flows from 1959 to 1965 that permitted it to make the initial transition from industrial import substitution of labor-intensive nondurable consumer goods to the export of those goods. By the time U.S. assistance flows ceased in 1965, that country had replaced the dollar amount of those flows with private foreign investment.[68] Zimbawbe was successful in presenting itself as a newly independent nation in the early 1980s; sizable donor inflows resulted.[69] Botswana used a combination of an innovative approach to stabilization and donor interest due to a drought to try a policy of "pro-poor" adjustment, that is, with help for the poor. Sri Lanka's new government in 1978 successfully capitalized on donor interest in increasing ties and resource flows in order to get resources for a large capital investment project that did not fit the normal guidelines of donor adjustment programs.[70] A final winning combination results when donor governments perceive small democratic countries, like Costa Rica in 1982 and Jamaica in 1980, to be threatened by external and internal efforts at destabilization. In both cases substantial resource inflows occurred.

Conclusion

There are no golden rules for managing winners and losers during the process of economic change. Each country is unique and its political dynamics have special features. However, policy makers can gain a great deal through patient analysis of the experiences of other countries in the political management of economic policies similar to the ones that have been reviewed in this chapter. Before deciding whether to support a new economic policy, they should try to answer four basic questions: (1) What

is the policy we are proposing, and what specific measures are involved? (2) Who, in theory, is supposed to benefit or lose from this policy, and who in actual practice has usually supported or opposed it in other countries? (3) What strategies and tactics might supporters or opponents of the policy use, and how risky will their actions be for our government? (4) How have other governments successfully managed similar situations? Based on answers to these questions, a judgment can be made about the political feasibility of a new policy.

Notes

Works cited only by author and date are fully listed in the bibliography at the end of this book.

1. *El Grafico* (Guatemala) and *La Prensa Libre* (Guatemala), April 1–30, 1988.

2. *El Grafico* and *La Prensa Libre*, Oct. 7, 1987. See also *Inforpress* (Guatemala), Oct. 1–15, 1987. (For *Inforpress*, see note 30, below.)

3. For example, President Rios Montt's attempts to pass the value-added tax in 1983 were met with protest and demonstrations. See *El Grafico* and *La Prensa Libre*, March 3, April 7, April 29, and June 7, 1983. See also *Inforpress*, Oct. 1–15, 1987.

4. *La Prensa* (Panama) and *La Estrella de Panama* (Panama), Nov. 11, 1983. See also *Inforpress*, Nov. 8–14, 1983.

5. Reactions were particularly strong on Nov. 19 and continued through March 22. Pressure mounted and on Dec. 12 the law was reversed. See *La Prensa* and *La Estrella de Panama*, Nov. 19, 21, 22, and Dec. 12, 1983. See also *Inforpress*, all of Nov. and Dec., 1983. A series of three-hour work stoppages began Jan. 17 after an announcement by the planning minister of the possible dismissal of 2,000 public employees. Problems continued intermittently. On March 3 employees held four demonstrations in front of the Ministry of Housing. See *La Prensa* and *La Estrella de Panama*, Jan. 17, 18, and March 3, 4, 1984. See also *Inforpress*, all of Jan. and March, 1984.

6. Dr. Ardito-Barletta was kind enough to provide his notes on this period. He views his resignation as the end result of a long struggle over the role of civil versus military rule. In particular he feels that one key opponent within his own party formed a coalition with a prominent military personality to undercut civilian rule and seize the presidency directly. He believes that both used economic issues and economic discontent to rally opposition and demonstrations in the context of this larger political struggle. See Dr. Ardito-Barletta's private notes currently in my files.

7. Joan Nelson (1988) has a particularly good account of the politics of stabilization and structural adjustment; her work compares Costa Rica, the Dominican Republic, and Jamaica. For other sources, see Xavier Argüello (1987b) and Victor Hugo Céspedes (1984).

8. See Nelson (1988, particularly pp. 16–21). Also see Andres Dauharje, Jr. (1985).

9. See Foreign Broadcast Information Service (Washington), *Daily Report on Africa*, all of December 1986.

10. World Bank (1988c, ch. 7) describes the process and problems of removing consumer price controls in detail.

11. Ibid. See also UNICEF (1987).

12. Useful sources are Simon Rottenberg (1986) and Arnold Harberger (1986). See also Sebastian Edwards and Sweder van Vijnbergen (1983).

13. For an extensive review of the literature on theories of political violence, discontent, and the role of perceptions in that process, see Ekhart Zimmermann (1983).

14. Ibid.

15. Constantine Michalopoulos (1987: 7–8). This paper contains an excellent overview of the objectives of stabilization and structural adjustment, and a discussion of the sequencing and impact of problems based on the experiences of the 1980s. See also William Cline and Sidney Weintraub (1981) for a good review of stabilization policies and their impact in the 1970s.

16. Michalopoulos (1987: 7–8).

17. Ibid.

18. World Bank (1982).

19. Michalopolous (1987: 13).

20. For a good summary of the economic problems that result in the need to liberalize and of some of the key policies, see Anne O. Krueger (1984).

21. For some of the most recent discussions, see Michael Michaely (1986), Michael Mussa (1986), and Sebastian Edwards (1986b). See also Jacob Frenkel (1982).

22. Michalopoulos (1987: 15).

23. Krueger (1984).

24. Chapters 1 and 2 of Cline and Weintraub (1981) review the normal discussion of winners and losers.

25. Giovanni Andrea Cornia, Richard Jolly, and Frances Stewart (1987; see particularly the introduction and chs. 1–2). Joan Nelson (1987), in another

insightful paper, looks at the factors that make it difficult for low- income groups to lobby to protect their interest during adjustment.

26. Cornia et al. (1987: 91–112).

27. The country studies appear in vol. 2 of Cornia et al. (1987).

28. Robert Klitgaard (n.d.) treats this subject in a highly convincing manner; see also Klitgaard (1986, 1988). Also highly relevant are Arturo Israel (1987) and Peter S. Heller and Alan A. Tait (1983).

29. Cornia et al. (1987: 4).

30. The data presented in tables 3.4–3.9 come from content analysis of the economic news section (weekly issues) of *Inforpress* (Guatemala) by Marc Lindenberg and María Joaquina Larraz de Quant, 1982–1987. *Inforpress* provides a reporting service that summarizes economic policies in every Central American country, with local reaction to those policies. Items related to stabilization and adjustment were coded by type of issue, type of protest action, and date. The percentage data provide a measure of changes in tactics, issue focus, and groups protesting. The data on total number of actions reported per year in *Inforpress* are only a surrogate for changes in the actual number of protest activities per year and should be treated as such.

31. In May 1984, as INCAE's rector, I met with the president of the Central Bank of Honduras. He informed me that exchange-rate policy was a highly sensitive topic since President Suazo had decided that there would be no devaluations during his term. I was advised that the government had come close to expelling some professors who had recently discussed the topic in a seminar in San Pedro Sula earlier that year, and that the president and some of his economic advisors were "fed up" with pressure from donor organizations on this issue. Although he acknowledged that the purpose of INCAE seminars was not to present proposals but to exchange viewpoints on economic policy, he reiterated that the president of the country considered the topic inappropriate within the context of the upcoming seminars on economic policy.

32. The case studies on Sri Lanka and Ghana in Cornia et al. (1987: 119–58, 301–44) are particularly useful. See also Thomas M. Callaghy (1987).

33. Nelson (1988, particularly pp. 47–68).

34. The discussions in both Nelson (1988) and Nelson (1987) about criteria for successful political management are extremely insightful on these matters.

35. Compare, for example, the high volume of protests as well as the higher percentage of multisectoral protests reported in *Inforpress* for Costa Rica in 1982, the last year of the Carazo administration, with the drop showed for 1983–1984, the first two years of the Monge government (see table 3.10).

36. Author's interview with President Duarte, May 1986.

37. *Inforpress* review, 1986–87.

38. Author's interviews with government officials and review of *Inforpress* coverage of Guatemala, 1986–87.

39. In a May 1986 interview President Duarte gave the author, he commented that he felt it had been much easier for President Monge and for himself to inherit a crisis than for President Ardito-Barletta to try to anticipate one before the population really felt it. He believed that this explained part of the difference between Monge's relative success and Ardito-Barletta's difficulties. He made no comment about his own relative success.

40. There were more than five INCAE dialogue sessions in 1983–1984 and frequent separate meetings with the business chambers.

41. As noted in Nelson (1988: 65–66).

42. Between 1986 and 1987 INCAE held 5 economic dialogue seminars in Guatemala, 6 in Honduras, 17 in El Salvador, and 6 in Costa Rica. In the first three countries representatives from the military attended along with members of the public sector, labor, cooperatives, and business.

43. The tight-lipped approach to structural adjustment loan negotiations in Panama, particularly before the Ardito-Barletta adminstration, provided an interesting contrast with the highly open discussion in Costa Rica. For example, in 1983 the Panamanian chapter of, the Interamerican Council for Commerce and Industry (CYCIP), comprised of local businessmen, prepared a seminar on structural adjustment lending in Panama to try to learn more about how the process worked. Government officials were unwilling to provide material on the general agreements under discussion or to attend the sessions. Government officials said the structural adjustment loan process was not a subject for public discussion.

44. See *Inforpress*, Nov. and Dec. 1984, for a discussion of the deterioration of the relationships between the government and key sectors.

45. For one analysis, see Jeffrey Sachs (1986).

46. Professor Noel Ramírez, director of the Center for Policy Research at INCAE, made this observation frequently in his presentations on Costa Rican economic policies between 1983 and 1986.

47. Nelson (1988: 65–66).

48. Ibid.

49. As noted in Thomas Callaghy (1987). See also

the similar comments on Chile and Colombia in Michaely (1986, particularly pp. 55–56) and, on Chile, World Bank (1988a: 121).

50. See Sebastian Edwards (1986a, particularly pp. 265–66); also James Hanson (1986) and Arnold Harberger (1986a).

51. See Lawrence Lau (1986).

52. See Shirley Kuo, Gustav Ranis, and John Fei (1981).

53. See Michaely (1986), Edwards (1986a), and Michalopoulos (1987) on issues of sequencing.

54. One of the interesting issues for countries that have successfully tried pro-poor policies along with stabilization or structural adjustment is whether they could have done so if foreign donors had not been willing to pay for these programs. A second issue is whether the particular circumstances of special crises, like the drought in Botswana, put the country in a unique position to try pro-poor policies because foreign donors had a high level of interest in the problem. A third issue has to do with the cost limitations of such programs in larger countries.

55. Programa Cornell and B. N. Kgosidintsi (1987).

56. Rob Davies and David Sanders (1987).

57. UNICEF (1987).

58. Wilfredo Nuqui, Linda Tidalgo, and Alejandro Herin (1987).

59. See *Inforpress*, March-June 1988, for listings of the policies and problems.

60. The details of the negotiations are presented in Arguello (1987b).

61. Ibid.

62. See for example, Hernando Ruiz (1988).

63. World Bank (1988a: 114).

64. Arguello (1987b: 10–17).

65. Ibid., pp. 33–34, exhibit 9.

66. Ibid., interview notes with Minister Juan Manuel Villasuso and case pp. 12–13.

67. See case in chapter 7 of this book (Taiwan 1961).

68. Ibid.

69. UNICEF (1987: vol. 2, 272–300).

70. See Brian Levy, "Structural Adjustment in Sri Lanka," forthcoming in *Policy Sciences* in 1989.

PART II

Analyzing Short- and Medium-Term Economic Strategy

This part, "Analyzing Short- and Medium-Term Economic Strategy," presents a range of cases that will permit the reader to utilize the concepts and frameworks presented in part I, "Understanding National Strategy." We begin with "Bolivia: Controlling Hyperinflation, 1985–1986" (chapter 4), a case that provides a chance to look at the implications of hyperinflationary policies, design short-term strategies to counter them, and identify the potential sources of support and opposition to new policies. Part II continues with "Costa Rica: Stabilization and Structural Readjustment" (chapter 5), a case that begins after a relatively successful stabilization program has taken place. The reader is asked to decide what to do next. "Chile: An Economy in Transition" (chapter 6) offers a look at phases in stabilization and adjustment, and presents the task of identifying problems in policy sequencing and their consequences. We conclude with two non–Latin American cases: "Taiwan 1961: The Search for a Viable Economic Strategy" (chapter 7) and "The Indonesian Oil Crisis, 1986" (chapter 8). These final cases permit analysis of medium-term economic strategic options.

The cases help emphasize that there is no single path to economic growth and improved well-being. For example, Chile and Bolivia achieve success using free-market models, while in Indonesia and Taiwan the state plays a highly active role in the process. Costa Rica achieves its objectives using a more intermediate role for the state. Bolivia and Costa Rica achieve success within the framework of democratic government, while Chile does so during authoritarian rule. Policy makers in each country build upon the cultural conditions prevalent to find strategies that are relatively successful.

Bolivia: Controlling Hyperinflation, 1985–1986

In August 1985 Víctor Paz Estenssoro became president of Bolivia. His new government faced the challenge of reversing a serious economic collapse accompanied by increasing political instability. Paz Estenssoro's predecessor, Hernán Siles Suazo, had recently resigned as head of a constitutionally elected government. Siles Suazo's term had been tarnished by the second longest hyperinflationary period in Bolivia's history. (A hyperinflationary period is defined here as more than two consecutive months in which the inflation rate is higher than 50 percent; see the tables in chapter appendix for economic data.)

Recent Political and Economic Events

In 1980 Hernán Siles Suazo had almost become president in what was generally considered to be an honest election. His electoral coalition, called the Democratic and Popular Unity Coalition (UDP), received 36 percent of the vote. It consisted of his own National Revolutionary Movement of the Left (MNRI) and two smaller left-of-center political parties, the Movement of the Revolutionary Left (MIR) and the Communist party of Bolivia (PCB). The Christian Democratic party (PDC) also supported the coalition. The opposition to the ideological right of the UDP was composed of the National Revolutionary Movement (MRN), with 19 percent of the vote, and the National Democratic Action party (ADN) of former military ruler Hugo Banzer, which got 15 percent of the vote. A group of small parties to the left of the UDP got about 30 percent of the vote.

Siles, however, was never permitted to take office. In July 1980 General Luis García Meza Tejada declared the election results invalid. He closed the Congress, banned political parties, jailed union leaders, and curtailed labor activities. His regime quickly developed a reputation in the international press for repression, corruption, and economic mismanagement. García Meza was forced from office by another military coup. Economic deterioration continued. After three more unsuccessful military governments, the armed forces permitted a transition to civilian rule.

In 1982 the Bolivian Congress permitted Siles Suazo to take office as president, more than two years after his normal term should have begun. His UDP coalition had strong support from important unions, like the Bolivian Mine Workers Union (COB) and the Teachers Union. It was viewed as too conservative by the students at the National University and too radical by the National Business Chamber Organizations. (See figure A4.1 in the chapter appendix for a political map of the key actors in 1982.)

Siles's period as president was a difficult one. During his government, international tin prices plummeted from US$6 to US$2.50 per five-pound unit. At this level most Bolivian tin mines became losing ventures. Tax revenues in Bolivia had never been indexed. Thus, when inflation reached an annualized rate of 25,000 percent, annual tax revenues dropped to less than 2 percent of gross domestic product (GDP). The system for tax collection collapsed under the weight of low revenues, poor salaries and incentives for public employees, and

outdated procedures. Bolivia's access to financial markets dried up completely. Net international resource transfers to Bolivia became negative US$190 million in 1983 and US$140 million in 1984. In an effort to maintain employment and stimulate the economy, the government increased its fiscal deficit and financed it with unbacked monetary emission.

Government price controls created large distortions. For example, in July 1985 the controlled domestic price of gasoline was 3 U.S. cents per liter while the world price was 23 cents (see table A4.7). Some goods disappeared entirely from the market. Active black markets appeared and contraband trade with Peru flourished.

Similar distortions appear in foreign exchange markets. For example, in August 1985 the official exchange rate of the Bolivian peso was 67,000 per U.S. dollar while the parallel market rate soared to 1,145,000 pesos per dollar. With this level of distortion, only a minimum number of transactions actually took place at the official exchange rate. Nevertheless, since exporters were required by law to convert their foreign exchange income at the official rate, legal exports almost vanished (see table A4.8). As a consequence of the contraband trade thus stimulated, Peru became a tin-exporting country even though it had no tin mines. As a result of the reduction in total trade, tariff revenues almost disappeared.

By 1985 the crisis reached unprecedented proportions. Paper money from Brazil became the second most important import commodity. Central bank employees went on strike. In the absence of central bank financial statements, the position of Bolivia's net international reserves became a mystery. The average annual inflation rate reached 11,858 percent. Strikes became a daily problem.

The coalition that had brought Siles to office disintegrated (see figure A4.2 in the chapter appendix for a political map of the situation in 1985). He was forced to resign a year before his term ended and to call national elections. The ADN and its presidential candidate General Hugo Banzer won a plurality of 32 percent of the vote. The MRN and its candidate Víctor Paz Estenssoro followed with 30 percent, MIR's Jaime Paz Zamora got about 10 percent, MNRI got 9 percent, and other small parties got the rest.

In the absence of a clear presidential winner, the vote was thrown into the Congress. MIR sided with MRN and Víctor Paz Estenssoro became president. He began with support from the unions and many left-of-center groups.

The government, however, inherited an economy in shambles. Controlling hyperinflation became its first priority. But the unions, particularly the COB, threatened general strikes should the government adopt harsh austerity measures where workers bore the brunt of the adjustment.

Study Questions

1. Had you been asked to help the new government with its short-term economic strategy, what would you have recommended? Specifically, what fiscal, monetary, trade, wage, and exchange-rate policies would you have suggested?

2. Draw a political map of Bolivia immediately after the 1985 elections. Where would you suspect to find political allies for your new economic program? Which groups might oppose your policies?

3. How would you manage the process of economic change? How and when would you announce your plan? What coalitions would you form? How would you handle your opposition?

4

Appendix

FIGURE A4.1 Bolivia: Political Map, October 1982

	ANTISYSTEM	LEGAL OPPOSITION	GOVERNMENT	LEGAL OPPOSITION	ANTISYSTEM
EXTERNAL SECTORS	Sendero		Socialist International USSR Cuba F. Ebert Foundation Adenauer Foundation USA W. Germany USAID	IMF World Bank	
SOCIAL SECTORS					
REGIME			Siles Suazo		
POLITICAL PARTIES		Others (30%)	UDP (36%) MIR MNRI PCB PDC	ADN (15%) MRN (19%)	
PRESSURE GROUPS		State university Media	ILDES Teachers union FLACSO Public sector Church UCB Media	Chambers National chambers Business Military Regional federations Media Private university	

SOURCE: Marc Lindenberg.

FIGURE A4.2 Bolivia: Political Map, October 1985

	ANTISYSTEM	LEGAL OPPOSITION	GOVERNMENT	LEGAL OPPOSITION	ANTISYSTEM
EXTERNAL SECTORS.	Sendero	Socialist International USSR Cuba	F. Ebert Foundation	USA IMF World Bank W. Germany USAID	
SOCIAL SECTORS					
REGIME			Siles Suazo		
POLITICAL PARTIES		Others MIR PCB PDC	MNRI	ADN MRN	
PRESSURE GROUPS		State university ILDES Teachers union FLACSO Media	Public sector Church UCB Media	Chambers National chambers Regional federations Business Media Private university Military	

SOURCE: Marc Lindenberg.

TABLE A4.1 Bolivia: Inflation Rate, 1952–1985 (annual average)

Year	Inflation rate (percent)	Year	Inflation rate (percent)
1952	24.5	1969	2.2
1953	100.9	1970	3.9
1954	124.4	1971	3.6
1955	80.0	1972	6.5
1956	178.8	1973	31.6
1957	115.1	1974	62.7
1958	3.1	1975	8.0
1959	20.3	1976	4.5
1960	11.5	1977	8.1
1961	7.6	1978	10.4
1962	5.9	1979	19.6
1963	–0.7	1980	47.2
1964	10.2	1981	32.2
1965	2.9	1982	123.5
1966	6.9	1983	275.6
1967	11.2	1984	1,282.4
1968	5.5	1985	11,857.1

SOURCE: Central Bank of Bolivia.

TABLE A4.3 Bolivia: Base for the Inflationary Tax, 1981–1985 (millions of U.S. dollars)

Year	Monetary base	Fiscal income as percent of public expenditures
1981	660	62
1982	225	17
1983	156	13
1984	167	8
1985[a]	91.5	7

a. First period.
SOURCE: Central Bank of Bolivia.

TABLE A4.4 Bolivia: Interest Rate of the Central Bank, 1985 (30-day %)

Month	Peso
April	34
May	35
June	44
July	50
August	45

SOURCE: Sachs 1986: 34.

TABLE A4.2 Bolivia: Monthly Inflationary Tax, 1981–1985 (millions of U.S. dollars)

Month	1981	1982	1983	1984	1985
January	–43.6	–11.3	2.9	6.0	14.3
February	–6.6	40.3	7.0	6.4	11.6
March	– 1.5	18.1	13.8	12.2	21.4
April	10.4	19.6	14.3	11.2	20.3
May	–14.9	22.2	19.5	16.4	31.3
June	–13.8	33.9	21.2	31.9	8.2
July	44.7	19.6	19.7	57.6	28.7
August	34.3	25.4	12.1	20.9	24.3
September	29.0	14.2	9.3	9.0	23.9
October	–16.2	25.8	11.2	16.7	16.8
November	20.1	32.9	7.8	16.9	0.8
December	69.6	43.9	40.6	82.2	36.8
Total	111.4	284.6	179.4	287.3	238.4
Monthly Average	9.3	34.3	14.9	23.9	18.5

NOTE: The monthly inflationary tax is measured as (Mt – Mt – 1)/Er, where Mt is the amount of money at month end and Er is the free market exchange rate.
SOURCE: Sachs 1986: 33.

TABLE A4.5 Bolivia: Fiscal Accounts of the Government, 1979–1984 (percentage of GDP)

	1979	1980	1981	1982	1983	1984
Revenue	9.4	9.6	9.4	4.6	2.6	2.6
Domestic	3.6	3.1	3.0	1.8	1.4	0.7
Tariffs	2.3	2.1	2.1	0.9	0.4	0.6
Oil	0.1	1.4	1.7	1.1	0.5	0.2
Other	3.4	3.0	2.6	0.8	0.3	1.1
Expenses	14.3	16.0	15.1	26.9	20.1	33.2
Wages and salaries	6.7	7.5	7.2	5.6	5.2	8.0
Other services	0.7	0.7	0.7	0.4	0.3	0.5
Materials	0.8	1.2	1.5	11.0	0.7	0.8
Investment	0.4	1.0	1.0	0.4	0.4	0.5
Domestic debt (with the CBB)	1.7	1.4	1.8	10.4	0.3	0.4
Foreign debt	0.4	2.1	1.3	7.7	10.8	2.2
Other	3.6	2.1	1.6	1.4	2.4	20.8
Deficit	4.9	6.4	5.7	22.3	17.5	30.6

SOURCE: Central Bank of Bolivia.

TABLE A4.6 Bolivia: Exchange Rates, 1982–1985 (Bolivian pesos per U.S. dollar)

Period	Controlled (average)	Free-market (average)	Differential (percentage)
1982			
I	43.18	56.74	31.40
II	43.18	92.20	113.52
III	43.18	208.06	381.84
IV	145.06	248.21	NA
1983			
I	196.00	424.84	116.76
II	196.00	402.78	105.50
III	196.00	671.28	242.49
IV	398.67	1,158.74	190.65
1984			
I	500.00	2,137.19	327.44
II	2,000.00	3,396.77	69.84
III	2,000.00	8,194.52	302.73
IV	6,666.67	18,545.81	178.19
1985			
Jan.	8,571.00	70,064.50	717.46
Feb.	45,000.00	133,535.70	196.75
March	45,000.00	123,548.30	174.55
April	45,000.00	161,600.00	259.11
May	67,000.00	250,935.50	274.50
June	67,000.00	460,600.00	587.50
July	67,000.00	802,741.00	1,098.10
Aug.	67,000.00	1,143,548.00	1,606.80

NOTE: NA = not available.
SOURCE: Central Bank of Bolivia.

TABLE A4.7 Bolivia: Domestic Price of Gasoline, March–July 1985 (U.S. dollars)

1985	Price per liter
March	0.09
April	0.07
May	0.06
June	0.05
July	0.03

NOTE: The international price per liter at the same period was US$0.23.
SOURCE: Central Bank of Bolivia.

TABLE A4.8 Bolivia: Tin Exports by COMIBOL, 1972–1983 (millions of U.S. dollars)

Year	Exports	Year	Exports	Year	Exports
1972	$93.1	1976	$185.6	1980	$234.8
1973	114.8	1977	217.9	1981	142.8
1974	196.4	1978	192.2	1982	93.7
1975	171.8	1979	196.6	1983	75.1

NOTE: COMIBOL (Mining Corporation of Bolivia) is the government corporation that controls the nationalized Bolivian tin mining industry.
SOURCE: Central Bank of Bolivia.

TABLE A4.9 Bolivia: Growth of GDP, by Sector of Origin, 1979–1985 (at constant 1980 prices, in percentage)

	1979	1980	1981	1982[a]	1983[a]	1984[a]	1985[b]
GDP at market prices	0.0	–0.9	0.1	–4.3	–6.9	–0.8	–1.9
Indirect taxes on imports	–8.6	0.9	4.2	–54.8	–57.9	40.0	47.7
GDP at producer prices	0.2	–1.0	0.0	–2.9	–6.3	–1.0	–2.3
Agriculture	3.2	1.5	–0.9	4.4	–24.9	18.7	2.5
Mining	–9.2	1.2	–0.6	–4.9	–1.3	–13.8	–11.0
Hydrocarbons	–10.5	6.8	6.3	7.6	–6.3	–2.5	–2.5
Minerals	–8.5	–1.5	–4.3	–12.3	2.4	–21.3	–18.0
Manufacturing	–1.9	0.6	–7.3	–13.9	–6.7	–11.8	9.7
Electricity, gas, and water	3.3	16.6	14.0	0.4	–0.4	1.3	0.0
Construction	–11.6	–6.7	–11.0	–2.4	–4.5	–6.7	2.0
Commerce	2.6	–1.8	8.3	–5.3	–4.0	–1.0	1.5
Transport, storage, and communication	16.6	–3.9	12.0	–5.2	2.1	0.7	0.4
Financial services	–1.2	–0.8	–4.7	0.7	0.6	0.5	0.3
Banking	–3.3	–2.3	–12.0	1.4	1.2	1.0	1.4
Ownership of dwellings	0.5	0.4	0.6	0.3	0.2	0.1	–0.4
Communal, social, and personal services	3.7	2.4	15.2	–4.9	–5.7	–2.9	–3.8
General government	8.9	–7.5	2.7	1.6	3.0	0.4	–2.5
Domestic services	2.2	2.5	2.8	–3.1	–3.0	–2.0	–2.3

a. Preliminary figures.
b. Estimated figures.
SOURCE: Central Bank of Bolivia, National Accounts Department, unpublished worksheets dated July 1987. Indirect import taxes are staff estimates.

TABLE A4.10 Bolivia: Distribution of GDP, by Sector of Origin, 1978–1985 (at constant 1980 prices, in percentage)

	1978	1979	1980	1981	1982[a]	1983[a]	1984[a]	1985[b]
GDP at market prices	103.0	102.7	102.7	102.9	101.3	100.6	100.8	101.3
Indirect taxes on imports	3.0	2.7	2.7	2.9	1.3	0.6	0.8	1.3
GDP at producer prices	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture	17.9	18.4	18.9	18.7	20.1	16.1	19.3	20.2
Mining	17.5	15.9	16.2	16.1	15.8	16.6	14.5	13.2
Hydrocarbons	5.8	5.2	5.6	6.0	6.6	6.6	6.5	6.5
Minerals	11.7	10.7	10.6	10.1	9.2	10.0	7.9	6.7
Manufacturing	15.1	14.8	15.0	13.9	12.3	12.3	11.0	10.1
Electricity, gas, and water	0.6	0.6	0.7	0.8	0.8	0.8	0.9	0.9
Construction	4.5	4.0	3.8	3.4	3.4	3.4	3.2	3.4
Commerce	10.9	11.2	11.1	12.0	11.7	12.0	12.0	12.5
Transport, storage, and communication	5.4	6.3	6.1	6.9	6.7	7.3	7.4	7.6
Financial services	14.6	14.4	14.4	13.7	14.3	15.3	15.5	15.9
Banking	6.3	6.1	6.0	5.3	5.5	6.0	6.1	6.3
Ownership of dwellings	8.3	8.3	8.4	8.5	8.7	9.3	9.4	9.6
Communal, social, and personal services	2.3	2.4	2.5	2.8	2.8	2.8	2.7	2.7
General government	10.7	11.6	10.8	11.1	11.6	12.8	13.0	12.9
Domestic services	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.6

a. Preliminary figures.
b. Estimated figures.
SOURCE: Central Bank of Bolivia, National Accounts Department, unpublished worksheets dated July 1987. Indirect import taxes are staff estimates.

TABLE A4.11 Bolivia: Growth of GDP, by Expenditure Category, 1981–1985 (percentage)

	1981	1982[a]	1983[a]	1984[a]	1985[b]
GDP at market prices	0.1	–4.3	–6.9	–0.8	–1.9
TOT effect	—	57.3	–15.5	109.1	441.4
GDY	0.4	–4.1	–7.0	–0.2	3.0
Imports of goods and NFS	37.8	–34.5	2.2	–10.4	44.5
Exports of goods and NFS	–1.4	–6.8	–5.9	–6.4	–11.9
Exports TOT adjusted	0.3	–5.8	–6.2	–3.6	12.7
Resource gap	–115.5	–793.5	–27.9	21.4	–73.4
Available resources	6.7	–10.3	–5.7	–1.2	7.4
Consumption	8.0	–8.3	1.2	–4.5	10.8
Public	–13.7	25.0	6.7	3.6	–14.5
Private	15.0	–13.5	0.0	–6.5	17.6
Investment	–12.1	–25.2	–66.4	87.1	–39.0
Fixed investment	–17.3	–5.9	–43.8	–23.4	–11.0
Public-sector		–20.8	–28.9	–26.8	–3.0
Private-sector		25.3	–63.7	–14.6	–28.7
Changes in stock	–461.6	–403.0	71.4	–134.0	–165.4
Gross domestic savings	–36.5	26.9	–53.4	46.1	–104.4
Net factor income		11.4	–12.0	–9.4	18.9
Current transfers		16.5	139.4	–15.1	–10.5
Gross national savings	–57.3	43.6	–67.7	128.6	–194.3

NOTE GDY stands for gross domestic income, TOT for terms of trade, and NFS for nonfactor services.
a. Preliminary figures.
b. Estimated figures.
SOURCE: Central Bank of Bolivia and World Bank mission estimates.

-71-

5 NOEL RAMÍREZ

Costa Rica: Stabilization and Structural Adjustment

In March 1986, Costa Rican business, labor, and political leaders met to analyze their country's short- and medium-term economic options. In one month a new National Liberation party (NLP) government would begin its term under the leadership of President Oscar Arias Sánchez. The group was optimistic about the immediate future. Coffee prices had risen, and the price of petroleum—one of Costa Rica's largest imports—had fallen to US$10 per barrel. In spite of several positive changes in the international economy, the group was concerned about the feasibility of implementing the structural adjustment loan (SAL) negotiated in 1985 with the World Bank.

The group's agenda included three topics. First, was the import substitution process begun by Costa Rica in the 1960s already obsolete? Should the country abandon this course of action and embark upon what had come to be known as export-led growth? Were these two processes compatible with each other, or were they, instead, mutually exclusive? This item was closely related to the World Bank's structural adjustment program and to the tariff revision scheme under the coordination of the Central American Economic Integration Secretariat (SIECA).

Second, those assembled would analyze Costa Rica's short-term economic options under the new Arias administration. According to Don "Pepe" Figueres, one of the country's most important past presidents, the country had "clear skies ahead and a good pilot on board." However, the group worried that the regional recession and the political and economic problems of Costa Rica's neighbors, Panama and Nicaragua, would spill over, particularly if Costa Rica could not bring about a strong economic recovery. Might there be ways to accelerate recovery like increasing foreign borrowing while continuing the stabilization process, or simply resorting, as in the past, to policies to generate employment even at the cost of higher inflation? The latter topic had been a hotly debated campaign issue.

Third, participants wished to take advantage of the opportunity to analyze the future of the export sector. Were there actually new product possibilities in the international market? Did local businessmen have the capacity and interest to adapt their activities to take advantage of new opportunities? Would groups in the industrial sector who supplied the local market resist policy changes necessary to promote exports?

The common denominator of all three agenda items was the desire to know which groups would perceive themselves to be winners and losers in any of the new strategies selected, and how the government might manage policy changes with a minimum of social discontent.

Recent Behavior of National Economy

The 1980–1982 recession. During this period, Costa Rica, like all other Central American countries, had faced its worst economic crisis since the 1930s. The economy stagnated in 1980, and growth in gross

This chapter was translated from the Spanish by Orlando García-Valverde. Quoted material in this chapter comes from the author's interviews and from the newspapers *La Nación* and *La República*.

TABLE 5.1 Costa Rica: National Accounts, 1980–1982 (real growth rates, in percentage)

	1980	1981	1982
Gross domestic product	0.8	-2.4	-9.0
Supply			
Agricultural sector	-0.5	3.8	-6.0
Industrial sector	0.8	-0.5	-14.2
Construction	-1.1	-21.7	-32.6
Commerce	-3.0	-10.6	-16.0
Demand			
Public consumption	1.5	-10.9	1.8
Private consumption	-1.8	-13.2	-4.7
Public investment	0.8	-26.3	-28.5
Private investment	-14.2	-28.3	-39.3
Exports	-7.8	-8.2	-20.0

SOURCE: Central Bank of Costa Rica.

domestic product (GDP) was negative in 1981. There was a 9.0 percent decline in real GDP during 1982. As in the rest of the countries in the region, it was impossible to find a single sector that had performed well (see table 5.1).

However, surprisingly in face of the decline in economic activity, domestic credit had grown (see table 5.2). Domestic resources obtained by the financial system itself expanded considerably (by 78.73 percent in 1981 and 58.33 percent in 1982). Although the tax burden had increased slightly, the overall fiscal deficit had increased substantially as had the tax burden on exports (see table 5.3).

The current account deficit had been reduced despite the fall in exports in 1982. The net capital inflow (which had been considerable, particularly during 1980 and 1981) also was significantly reduced in 1982, especially the official portion of it. According to some estimates, the balance of the medium- and long-term foreign public debt had increased from US$1.35 billion in 1979 to US$2.8 billion by the end of 1982.

TABLE 5.2 Costa Rica: Nominal Growth in Domestic Credit, 1981–1982 (percentage)

Credit	1981	1982
Total credit	14.29	34.73
To the public sector	20.13	30.85
To the private sector	9.96	37.88

SOURCE: Central Bank of Costa Rica.

TABLE 5.3 Costa Rica: Taxation Indicators of the Central Government, 1980–1982 (percentage)

	1980	1981	1982
Tax burden	11.30	11.61	12.54
Total expenditures/GDP	21.81	16.58	16.64
Resource gap/GDP	10.51	4.97	4.10
Effective tax rate on exports	8.29	11.09	12.40
Effective tax rate on imports	6.71	4.13	3.02

SOURCE: Central Bank of Costa Rica.

Finally, as a consequence of the financial imbalance and the reduction in foreign aid, Costa Rican inflation climbed to almost 100 percent in 1982 (see table 5.4).

Stabilization: 1983–1985. When President Luis Alberto Monge's administration took office in May 1982, it adopted a stabilization program whose objectives were

1. To control the erratic fluctuations of the exchange rate, which went from 8 to more than 20 colones per U.S. dollar; and to "unify" the "free market" exchange rate of 60 colones with the official rate of 20 colones.

2. To stabilize the economy and reduce "inflationary pressures." In 1982, production in real terms fell by almost 10 percent, and inflation had reached almost 100 percent.

3. To reestablish the overall equilibrium of the balance of payments.

TABLE 5.4 Inflation in Central America: Changes in the Consumer Price Index (percentage)

	1980	1981	1982
Guatemala	10.7	11.4	0.2
El Salvador	17.3	14.8	11.8
Honduras	18.1	9.4	9.4
Nicaragua	35.3	23.9	24.2
Costa Rica	18.1	37.1	90.1

SOURCE: Central Bank of Costa Rica.

4. To "reestablish" the country's foreign credit with the international financial institutions, credit that had considerably deteriorated over the past few years on account of problems related to the country's foreign debt.

These objectives formed the core of the 12-month Standby Agreement signed by the new government with the International Monetary Fund on January 2, 1983.

A revised agreement with the IMF was completed in late March 1984. It was accompanied by a new Economic Emergency Law passed by the Costa Rican Congress. According to the new agreements, inflation was to be reduced to 10 to 12 percent per year. The expansion of credit was not to exceed the previous year's total by more than 15 percent.

Both IMF representatives and local authorities agreed that the fiscal deficit had to be drastically reduced. This required substantial reductions in consumer and producer subsidies managed by the National Production Council (NPC). Two alternatives for subsidy reduction were proposed. One was to raise the price of beans, flour, bread, noodles, and spaghetti, products that, as one politician noted, "feed the poor"; the other was to create a tax on securities.

Another institution suffering from a severe deficit, estimated at 1.5 billion colones, was the Costa Rican State Development Corporation (CODESA). Carlos Manuel Castillo, the president of the Central Bank, suggested that this problem was a political one since forming CODESA had been a major element of earlier NLP party strategy and ideology. Privatization would require new political decisions.

President Monge voiced his dissatisfaction with IMF requirements but felt that if Costa Rica wished to remain in the international financial community, it had to abide by many of the stipulations.

The government had to balance between attempts to reduce the fiscal deficit and desire to help exporters maintain their competitiveness. As a consequence, the government decided not to continue the tax on the exchange-rate differential, which traditional exports had been paying until December 1983. According to Minister of Agriculture Francisco Morales-Hernández, as a result of this decision, cattle ranchers would stop paying 68.5 million colones, while coffee growers would save 700 million colones. Furthermore, also effective December 1983, the government had been forced to reduce by 25 cents the tax of one U.S. dollar levied on each box of bananas exported. This reduction was implemented to try to keep the banana companies from closing their operations in Costa Rica.

Changes in the economic team. In 1984, shortly after the new IMF agreement, President Monge was forced to change some key members of his economic team. Castillo, one of the leading architects of the stabilization program, resigned as president of the Central Bank to start campaigning as a candidate for the presidency of the republic. Rodolfo Silva left his position as minister of exports to join the Inter-American Development Bank. In view of this situation, President Monge had to reorganize his team almost totally. After a few interim appointments, the president replaced Castillo with Eduardo Lizano. According to many, Lizano was likely to "institutionalize" the minidevaluation policy in Costa Rica, which had allowed the government to make its fiscal policy more flexible without seriously hurting the export sector. Observers wondered whether the new team would ensure continuity.

The Stabilization Program and Its Early Results

According to the Ministry of National Economic Planning (MIDEPLAN), the stabilization program had been successful. In 1984 GDP had grown 6 percent. Inflation dropped to 15 percent, and unemployment was reduced to less than 8 percent. The consolidated deficit of the nonfinancial public sector dropped from 13.7 to 3.0 percent.

On May 1, 1984, President Monge said:

> I am not contending that we have surmounted the crisis. But I do wish to stress that now, after two years during which we had to adopt bitter and hard decisions to heal a seriously ill and almost bankrupt economy, we have come a long way from the Costa Rica we were entrusted with in May 1982. We have drawn away from the precipice, and an objective reference to the main economic indicators is the best proof I can offer of what I am saying.

Policy Controversies, 1983–1985

As the group began its meeting, it reviewed some of the policy controversies that had been discussed during the last three years. These involved, among other things, the role of the industrial sector and the potential of nontraditional exports.

The role of the industrial sector. As a result of the crisis of 1982 Costa Rica's industrial sector had virtually collapsed. Industrial exports had fallen by more than US$60 million since the crisis began. According to some, the problem was the result of both the crisis and the loss of liquidity in the regional common market due to capital flight.

On the other hand, according to some foreign experts, the origin of the problem was in the import-substitution model itself. They argued that tariff protection had made industry notoriously inefficient. For example, the World Bank document entitled "Costa Rica, Current Economic Position and Prospect," of November 1980, warned that the levels of protection to industry were very high: between 60 and 70 percent on average. According to the Economic Research Institute (IICE), this had led to development of excess plant capacity, so that in 1985 only 67 percent of industrial plant capacity was being utilized. The IICE also judged that the imported component of industrial exports was 56 percent.

According to Alberto Di-Mare, a respected Costa Rican economist, "import-substitution possibilities were exhausted five years ago. This confronts us with the need for larger markets. We now require a development model based on exports."

However, Carlos Araya, chairman of the Chamber of Industry of Costa Rica, had a different opinion:

> Industrial activities in Costa Rica deserve to be preserved and strengthened. They are not only the direct source of income for more than 115,000 workers, but a source of employee contributions to the Costa Rican Social Security Institute (CCSS), the National Insurance Institute (INS), the Mixed Institute for Social Assistance (IMAS), and the National Learning Institute (INA). Also, industry has substantially contributed to the treasury through income and property taxes, as well as other numerous indirect taxes.

Thanks to import substitution, Araya claimed, industrial exports had grown from 2 percent of the total in 1962 to more than 30 percent in 1985. Real protection rates in Central America, he insisted, were generally moderate, and were not conducive to inefficiency of the sector. On other occasions he had said:

> Tariff protection is an industrial policy instrument employed not only in Central America. In fact most developed countries benefit from protectionist measures. The existence of the Central American tariff system has not protected Costa Rican industry from competition. In fact countries like Colombia, Mexico, and Venezuela give their industries a number of advantages while maintaining high tariff barriers themselves. The advantages allow them to send their products to our region at marginal cost prices.

Araya recommended a two-way strategy: "On the one hand, strong export promotion, and on the other hand, strong restrictions on finished imported products."

Castillo disagreed with Araya. He called for the rationalization of tariffs and the reduction of levels of effective protection:

> We do not intend to annihilate our industrial firms. The idea behind the tariff reform is—and we must insist on this—to eliminate the anti-export bias that currently affects the operations of the Costa Rican economy. It is not fair to try to promote exports and, at the same time, continue doing everything possible to make our entrepreneurs believe that it is worth more for them to produce for the local market. If we maintain this attitude we shall never reach satisfactory export levels.

At this point in time, President Monge spoke again:

> We are at that critical point where it becomes indispensable to recover the productive apparatus of the country and substantially increase exports. Without this effort, the entire structural adjustment effort will prove insufficient to surmount the acute crisis our economy faces. The industrial sector must play a leading role in this decisive battle for production and increased exports.

The role of traditional exports. According to Alberto Di-Mare, most of the new export thrust had gone into the stimulation of nontraditional exports with tax rebates and other special measures, while in fact traditional exports had been taxed. In the coffee industry, for instance, production that in 1970 would have paid for 100 minimum daily wages in 1980 only paid for 76, in spite of the fact that the price index of coffee had gone from 100 to 240. Likewise in the banana industry, 100 daily wages had become

98; in the meat industry, 62; in the sugar industry, 87; and in the cocoa industry, 74.

Controversies about Specific Policies: 1983–1985

The group moved its discussion to specific policy issues.

Fiscal policy. To overcome some of the problems mentioned by Di-Mare, the minister of exports had promised to eliminate more than one billion colones in export taxes. On the other hand, according to Minister of Finance Fernando Naranjo, more than 30 percent of government revenue came from export taxes, so that such a measure would have great repercussions not only on central government finance, but possibly also on credit policy, which was controlled by the central bank.

The proposal of the minister of exports became even more interesting as a subject for analysis. Luis Liberman, a prominent Costa Rican businessman, pointed out:

> One of the objectives of the current administration is to reduce the consolidated public-sector deficit. Indeed, it has been reduced from 14.0 percent of GDP to 9.5 percent last year, and hopefully to 4.5 percent in 1985. However, reduction of the deficit is almost exclusively aimed at increasing tax revenues, and more than two-thirds of the increase in 1982 tax revenues was paid by the export sector.

Liberman added: "It was acceptable to do this during the first year of devaluation because of the windfall profits generated. But the system was maintained and export competitivity was reduced."

Federico Vargas, minister of finance, also expressed his concern:

> The situation will worsen gradually if the real price of exports is not increased. This could be achieved through increases in the nominal exchange rate, tax reductions, or reducing, in the long run, the protection to nonexporting industries. However, at the same time we have to be consistent. We cannot have tax reductions that will cause the fiscal deficit to rise.

He concluded that it was necessary to reduce public expenditures, which meant "incurring political costs, since the reduction thereof would affect the interests of the groups that benefit from public expenditures."

Monetary policy. Costa Rica in the 1970s and 1980s had been known as an economy with an inflationary bias by Central American standards. Claudio González-Vega, a well-known Costa Rican economist, has stated that the policy of subsidized interest rates in the 1980s and the inflationary process the country had experienced until 1982, resulted in highly negative real interest rates. This in turn caused a massive transfer of wealth to the sectors that had had access to institutional credit.

Negotiation with the IMF resulted in a balance between the government's interest rate policy, the need to encourage the growth of financial savings, and the need to avoid obstructing the country's productive effort.

The government's intention was to make the necessary adjustments in order to establish real positive rates. However, serious implementation questions remained. For example, should the nominal rate be established in relationship to past inflation rates (as high as 100 percent per year)? Or should this be done in relationship to current inflation rates which, according to all expectations, would be considerably lower?

With respect to the interest rate policy, Liberman indicated:

> We do not have much access to international resources. Therefore, the role of interest rates is basic. However, there are contradictory interests. National savings have to be increased. What has happened in other countries with positive real interest rates is that financial savings have increased substantially as a means of avoiding capital flight. Hence the contradiction between maintaining attractive interest rates for savers and the need to maintain competitive interest rates to finance exports.

Exchange-rate policy. Both the National Planning Bureau (OFIPLAN) and the Ministry of Finance recommended that the government discontinue taxes on traditional exports (coffee, bananas, sugar, and beef) through exchange-rate differentials. Traditional producers carried burdens ranging from 5 to 20 percent. The tax was collected upon the cancellation of one part of the value of the exports at the official exchange rate of 20 times 1 and the remainder at the interbank rate, which fluctuated around 40 times 1.

According to the Export and Investment Promo-

tion Center (CENPRO):

> Almost all of the foreign exchange necessary to cover imports of raw materials and certain capital goods is obtained at the interbank market rate, while only 95 percent of the foreign exchange from exports is exchanged in the same market, with 5 percent being exchanged at the official rate, which is barely one-half of the former. At the same time, many imports of raw materials, machinery, and equipment necessary to produce exports must be paid for at free exchange rates. The comparison between the two activities is frankly unfavorable to exporters.

According to CENPRO, this multiple exchange-rate system was partially destroying the nominal benefits offered by the tax savings certificates (CAT).

In an effort to eliminate this antiexport bias, the minister of finance and the president of the Central Bank included provisions in the IMF agreement to gradually eliminate multiple exchange rates. But such decisions had political implications. In late 1982, Congressman Alvaro Montero-Mejía accused the president of the Central Bank of "giving away" 2 million colones to exporters just by changing the interbank rate from 38.18 colones to 40.18 colones.

A second issue was whether devaluations really served as a stimulus to exports. To a large extent, the exchange-rate policy controversy had started when the dollar went from 8.60 colones to 20, 40, and even 63 colones; both the authorities and the experts spread the rumor that "from the somber night of devaluation would emanate the beam of hope," since all producers would suddenly want to export.

These predictions, however, did not come true, and the explanations were numerous and varied. For instance, according to Odalier Villalobos, then vice-minister of finance, no advantages were obtained, since the devaluation took place at a time of world recession. But according to the minister of finance, this occurred because the devaluation process had been so disorderly that producers had not been willing to risk investment and production. Others said that windfall profits were made by exporters, but that the government had not received appropriate tax revenues because of underbilling by producers. Finally, Liberman and Vargas believed that "exports did not respond to the devaluation in 1981 and 1982 because a sizable portion of the earnings the exporters could have received had been taken away by taxes. The exchange rate became a fiscal instrument."

Finally, the group asked themselves other questions about future policies. Should the exchange rate be fixed, floating, or flexible? If it were flexible, should the adjustments be programmed or not? Should a single exchange-rate system or multiple rates be used?

Exports and the infrastructure. In order to promote the country's exports, the availability of a foreign market and adequate policies at the domestic level were not enough. The infrastructure had to be also considered. The minister of exports had pointed out:

> In the realm of infrastructure, transportation—mainly maritime transportation—displayed some of the most serious problems. This includes problems at the ports, where present-day conditions are considerably better at the technical level, but rates are not competitive. The explanation lies in the fact that the evolution of the Costa Rican state is characterized by a policy of disguised tax burdens levied by decree on public services. For example, 400 million colones are imposed on exporters as surtaxes. One of the purposes of the current administration is to reduce disguised taxes, which, at any rate, are of dubious constitutionality.

The Future of Costa Rica: Stabilization versus Reactivation

Between 1982 and 1985 the government's priority had been stabilization, in order to lay the groundwork for economic reactivation. But Costa Rican leaders from business, labor, and government wondered when a real reactivation process might begin.

Both the minister of exports, Mario Carvajal, and the minister of national planning, Juan Manuel Villasuso, felt that "reactivation implies the growth of production and a greater democratization of the economy. Such reactivation, however, must not be indiscriminate. Production must be oriented to the satisfaction of basic needs and export requirements." While both expressed their satisfaction with the success of the stabilization program, Viliasuso felt that "a less severe stabilization pattern would have been preferable, in order to allow the economy to grow sooner and to generate employment." According to him, reactivation needed to be based upon three fundamental principles:

> First, keep the Central American Common Market from deteriorating still further. Second, stimulate the growth of traditional exports (coffee, bananas, sugar, and meat); and third, promote nontraditional exports to third countries outside the region.

Villasuso divided the nontraditional export problem into three phases:

> The first one is the reactivation of businesses that generate employment in the short run, that is, offshore assembly. The second is the reactivation of quickly installed businesses—for instance, toy manufacturing, lumber, flowers and plants. Lastly, the long-term projects, that is, agro industry.

Reactivation, he argued, would be achieved in the short run by using idle installed capacity, first to encourage domestic demand, then to export to the common market, and finally to export outside the region. Dynamic growth would be evident in 1986 and over the following years.

The two experts maintained also that, in order for this to occur, certain assumptions had to be made, such as that the barriers to exports would be eliminated and public expenditures reduced. They stated:

> We are willing neither to subsidize the infrastructure, nor to sell our labor at slave-trade prices. However, we are ready to compete with other countries on the basis of income tax exemptions, since this is one of the most important methods of attracting investment.

"Unfortunately," remarked Minister of Exports Carvajal, "one of Costa Rica's worst problems is the tariff schedule, which provided excessive protectionism; it went on too long, and when the good life lasts a long time it becomes very difficult to make a sacrifice and adapt to less favorable conditions." Other leaders were more skeptical about Costa Rica's future. They argued that the economy had grown between 1983 and 1985 because of massive foreign aid, particularly from the United States. It was not clear that a sound basis had been set for future growth. They questioned whether Costa Rica would really find market niches in the world economy and expressed fear of protectionism by the industrial countries.

After reviewing the origins of the Costa Rican crisis (1980–1982) and the stabilization program (1983–1985), the group began to debate the options for 1986–1989.

Study Questions

1. What were the main problems Costa Rica faced in 1982?
2. What economic strategy and policies would you have expected the Monge administration to adopt?
3. Which sectors would be favored or harmed by that strategy?
4. What lessons have you learned from this experience?
5. What would you recommend now?

5

Appendix

EXHIBIT 5.1 Agreement of March 20, 1984, between Costa Rica and the IMF

The following are excerpts from the "letter of intent" submitted to the IMF by the Costa Rican government on March 20, 1984 (summarized passages have been placed in square brackets).

[The Government of Costa Rica hereby applies for a one-year contingency arrangement for US$50 million. The government's adjustment program places special emphasis on fiscal and external policies, as explained below.]

As a basic objective of fiscal policy, the Government has the intention of promoting the nonfinancial public sector over the next few years, toward the attainment of a situation of global balance. Consistent with this medium-term objective, the Government intends *to limit the global deficit of the nonfinancial public sector during 1984 to an amount not to exceed 2% of the GDP.* Most of this deficit would be reflected on the operations of the central government, since the rest of the nonfinancial public sector is expected to be in approximate global equilibrium. As a result of the measures taken recently by the Legislative Assembly and the Executive Branch to change the 1984 budget, *the amount in taxes collected by the central government this year will be higher by 15%,* which will make it possible to maintain approximately the same GDP level achieved the previous year. This measure is particularly significant, as the Government has had to replace certain temporary tax impositions which expired at the end of last year, such as the exchange rate differential on exports, with increases in internal taxes. The latter includes an increase in the selective taxes on consumption, a modification to the income tax, and a new 15% sales tax on gasoline. At the same time, the allocation of fiscal revenue to the rest of the public sector, which amounts to 450 million colones, has been stopped, and this amount has been concentrated on the budget.

With respect to expenditures, the Government has committed itself to the implementation of a policy of restrictions during 1984 and subsequent years. To this effect, *government employment has become frozen,* and certain salary adjustments have been postponed, while a new salary scale for the public sector is being introduced. In the same manner, transfers to the rest of the public sector will be reduced to categories lower than those budgeted, and *only those investment projects which may be financed through long-term foreign loans, and mainly of a concessional nature, shall be carried out.* As a result of this, central government expenditures shall decline slightly in 1984 as a percentage of the GDP, after having shown a considerable increase during the previous year.

The additional strengthening of public finance in 1984 shall also depend upon an improvement in the financial situation of the rest of the public sector. As [was] being done in the last program, a number of *adjustments in the rates of the public services* are being made in order to strengthen the current account situation of the main state-owned corporations. The Board of the National Power Service (SNE) has already approved an adjustment of the rates for electric and telephone service, to be provided by the ICE, equivalent, [on] average, to 9% and 70%, respectively; an increase of 30% has also been approved [in] the rates charged by the national authority in charge of water (ICAA). *The prices for staple grain operations of the National Production Council (NPC) have been also adjusted with the purpose of*

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reducing its internal financial requirements to a minimum. Increased savings in the rest of the public sector this year will be reflected [in] an increase in the transfers to the central government. The Government has also initiated, based on an authorization by the Legislative Assembly, the process *of selling some of the main companies which belong to the State Development Corporation (CODESA).* These sales will make possible the reorientation of future CODESA operations and the reduction of its net debt with the Central Bank.

In accordance with the governmental policy of improving the profile of the external debt in the medium term, *the entering into new foreign loan agreements with a maturity of more than one year on the part of the public sector (including the public financial institutions) shall be limited to US$50 million* for up to and including twelve years during the term of the program. Within these global limits, new commitments with maturities of more than one year shall be limited to US$25 million for up to and including five years. Such limitations shall be also applied to officially guaranteed loans of the private sector and supplier credits, but new loans which are directly associated with the refinancing or restructuring of the existing external public debt, and credits pertaining to the Mexico-Venezuela oil facility shall be excluded.

At present, most of *the banking system interest rates are positive in real terms, and shall be maintained as such during the term of the program.* At the same time, subsidized credit operations are being reduced.

The Government is set on ensuring that the economic adjustment burden be distributed equitably. This shall be done in a manner consistent with the belief of the authorities that, under the current circumstances and for the foreseeable future, *the market forces shall be the main price-determining factors, and that administrative controls and subsidies shall be limited to a minimum number of staples,* which will benefit mainly the basic income groups. Salary policy shall be adjusted to reduce inflationary pressure and minimize the effects of price increases on low-income groups.

In the external sector, *the Government looks forward to a flexible exchange-rate policy,* through which the value of the colon in the unified exchange market may be adjusted from time to time, so as to reflect the events affecting the current account balance of payments, and *to maintain the competitiveness of exports.*

[In like manner, and as per the letter of intent, an economic emergency bill was to be presented to the Legislative Assembly "no later than the 30th of June, 1984," with the purpose of sanitizing the public treasury. According to this law, which was to enter into effect at the beginning of March, state expenditures should be rationalized; in order to achieve this, it regulated the hiring of new civil servants, froze vacancies, made it compulsory for functionaries to retire at 65, and authorized the payment of severance benefits to those who wanted to retire from government offices and corporations.

Other chapters of the new law referred to modifications to the income tax, and to the selective taxes on consumption. Thus the law increased by 5 percentage points the ad valorem rates applicable to certain merchandises included in the legislation for the consolidation of the selective taxes on consumption. Furthermore, it increased by 300 percent each item on the consular tariff schedules, and determined that two-thirds of the consular revenue would be allotted to the single state account, while one-third would be credited to the Mixed Institute for Social Assistance (IMAS).

Similarly, the law directed the Costa Rica Oil Refinery (RECOPE) to credit the treasury with all amounts collected in the form of taxes on fuels no later than ten working days after the collections were made. Also, by virtue of article 23, the Central Bank was authorized to credit, for the four years beginning 1983, the receipts from temporary surtaxes on imports to more than 20 institutions and programs. Finally, it was stated that 18 public agencies had to pay the government, during 1984, the combined amount of 1.175 billion colones as a special contribution, which they were not allowed to obtain by means of increases in charges for public services.

The Government of the Republic was confident that this law would contribute both to the reduction of the fiscal deficit—a key element in the country's financial stability—and to negotiations with the IMF.]

EXHIBIT 5.2 IMF Contingency Agreement: Costa Rica, 1985

I. Requirements prior to approval
   A. Cancellation of US$20 million in overdue debt-service payments (Club of Paris).
   B. Subscribe to 90 percent of the revolving credits of US$75 million for imports with private banks.

II. General objective
   A. To reduce the balance of payments deficit.
   B. To strengthen the position of the monetary reserves at the Central Bank.

III. Means
   A. Stabilization Program.
   B. Financial support for US$60 million.

IV. Specific measures
   A. Fiscal policy
      1. Equilibrium between income and expenditures of the nonfinancial public sector
         Budget deficit: 1.5% of GDP in 1985
      2. Government revenues/GDP 7% in 1983, 20.5% in 1985:
         Selective tax on consumption
         Income tax law
         Exemptions
      3. Expenditure restriction policy:
         Freeze hiring
         Accelerate retirement
         Maintain the expenditures/GDP ratio at the 1984 level
      4. Periodical revision of public service rates: price = operation cost
      5. Price of staple grains must permit CNP deficit
      6. Price of fuel must reflect cost of imported oil
      7. Restructuring of CODESA
      8. No imposition of taxes in [an] indiscriminate manner
      9. Financing [for] the public sector:
         Total 1-to-5-year maturity: US$25 million
         Total 1-to-12-year maturity: US$50 million
      10. Entering into force of new tariff schedules
   B. Monetary policy
      1. Expansion of credit in consistency with.
         Price policies
         Balance-of-payments objectives
      2. Interest rates in accordance with:
         Encouragement of internal savings and production
         Flexibility (inflation, international interest rates, growth of savings, private-sector credit demand)
   C. Exchange- rate policy
      1. Rate of exchange will not be fixed (local and imported inflation, changes in the balance of payments)
      2. No delays in the payment of external debt
      3. Disappearance of the arrears of foreign currency
      4. No restrictions [on] international payments and transfers or [on] imports
   D. Price and salary policy
      1. Prices set by the market
      2. Reduction of subsidies and administrative controls
      3. Salary adjustments as per the variations of the staples basket.

EXHIBIT 5.3 World Bank Structural Adjustment Program: Costa Rica, 1985

I. Goals of the program for 1990
   A. 5% growth of the GDP in real terms
   B. Inflation under 10%
   C. Reduction of debt service ratio by 27%
   D. Reduction of current account deficit to 5% of GDP

II. Objectives: Achieve a more neutral trade orientation by
   A. Reducing levels of nominal and effective protection
   B. Increasing competitiveness in new markets

III. Means
   A. Reform of tariff schedules (reduction of protection):

Nominal protection	Current	Proposed
Final goods	40–220%	35–70%
Intermediate goods	30–60%	10%
Raw materials	0–2.5%	10%
Capital goods	0–2.5%	20%
Effective protection	50–1,600%	

   B. Promotion of nontraditional exports to markets outside of Central America by reducing taxes (36% of tax revenue originates in the export sector)
   C. Control and reduction of public-sector expenditures by
      1. Freezing employment
      2. Controlling salary increases
      3. Controlling investment
      4. Restructuring CODESA
   D. Better management of external debt by
      1. Reducing growth rate of external public debt
      2. Improving the profile of debt-service payments
   E. Acquisition of external resources of US$300 million over the next four years

IV. Amount of initial financing
   A. US$20 million for macro structural adjustment
   B. US$28 million for structural adjustment–related projects
   C. US$3.5 million for technical assistance

SOURCE: *La Nación*, Jan. 18, 1985.

TABLE A5.1 Costa Rica: Gross Domestic Product by Sector, 1977–1985 (millions of 1966 colones)

	1977	1978	1979	1980	1981	1982	1983	1984	1985
Gross domestic product	8,587	9,125	9,576	9,648	9,430	8,743	8,993	9,714	9,808
Agriculture	1,629	1,736	1,745	1,736	1,825	1,739	1,808	1,990	1,933
Manufacturing	1,893	2,048	2,103	2,120	2,109	1,869	1,902	2,100	2,167
Commerce	1,653	1,723	1,794	1,741	1,556	1,374	1,418	1,580	1,623
Construction	483	511	609	603	472	321	337	416	421
General government	839	881	933	967	984	956	941	955	959
Utilities	182	191	201	225	242	253	304	313	290
Transp. and commun.	512	572	643	676	672	666	676	701	714
Financial services	410	444	486	500	490	494	522	552	577
Real estate	603	624	649	665	676	682	689	700	711
Personal services	383	395	412	416	403	389	396	408	412
Nominal GDP (million colones)	26,331	30,194	34,584	41,406	57,103	97,505	129,314	163,011	192,425

SOURCE: Central Bank of Costa Rica.

TABLE A5.2 Costa Rica: Aggregate Demand Components, 1977–1985 (millions of 1966 colones)

	1977	1978	1979	1980	1981	1982	1983	1984	1985
Gross domestic product	8,587	9,125	9,576	9,648	9,430	8,743	8,993	9,714	9,808
Private consumption	5,726	6,205	6,353	6,238	5,706	5,158	5,447	5,842	6,097
Public consumption	1,127	1,168	1,258	1,276	1,205	1,174	1,140	1,184	1,196
Fixed private investment	1,408	1,633	1,824	1,556	1,165	842	889	1,222	1,234
Fixed public investment	739	689	852	868	656	473	534	573	648
Variation in stock	218	34	−103	329	−106	−36	278	91	195
Exports of goods and svcs.	3,101	3,409	3,520	3,367	3,742	3,537	3,491	3,885	3,664
Imports of goods and svcs.	3,732	4,012	4,129	3,987	2,937	2,405	2,785	3,082	3,227

SOURCE: Central Bank of Costa Rica.

TABLE A5.3 Costa Rica: Central Government Financial Operations, 1977–1985 (millions of colones)

Item	1977	1978	1979	1980	1981	1982	1983	1984	1985
Total expenditure	4,355	5,385	6,600	8,651	9,491	15,488	25,722	31,494	35,550
Current expenses	3,325	4,288	5,051	6,747	7,938	13,108	20,631	26,102	29,748
Capital expenses	1,030	1,098	1,549	1,903	1,553	2,380	5,091	5,392	5,802
Current revenue	3,488	4,096	4,331	4,986	7,158	12,555	21,485	27,012	32,005
Tax revenue	3,282	3,789	3,996	4,685	6,933	12,281	20,940	24,659	29,666
Direct	781	956	989	1,069	1,555	3,015	5,166	4,895	5,153
Indirect	2,501	2,833	3,007	3,617	5,378	9,267	15,774	19,764	24,513
Domestic transactions	1,491	1,476	1,518	2,063	2,256	3,573	7,932	11,452	14,978
Foreign trade	1,010	1,357	1,489	1,554	3,123	5,694	7,841	8,313	9,535
Nontax revenue and transfers	206	307	335	301	225	273	545	2,353	2,339
Current account balance	163	–192	–720	–1,761	–780	–553	854	910	2,258
Overall surplus or deficit	–867	–1,290	–2,268	–3,665	–2,333	–2,933	–4,237	–4,482	–3,544
Net domestic financing	695	1,086	1,848	3,363	1,758	2,010	4,046	2,825	-874
Net foreign financing	172	204	421	302	575	923	191	1,657	4,418

SOURCE: Central American Monetary Council and Central Bank of Costa Rica.

TABLE A5.4 Costa Rica: National Banking System, Monetary Picture 1977–1985 (millions of colones)

Item	1977	1978	1979	1980	1981	1982	1983	1984	1985
Net international monetary reserves	1,986	1,639	1,003	–1,142	–6,784	–1,909	4,578	8,332	16,694
Total credit	9,521	12,233	16,968	21,011	24,069	32,402	57,243	66,897	72,039
Domestic credit	9,521	12,227	16,931	20,971	23,968	32,293	57,203	66,857	71,999
Public sector	2,379	3,361	6,291	8,922	10,718	14,024	29,555	34,402	34,347
Private sector	7,142	8,866	10,640	12,049	13,250	18,269	27,648	32,455	37,652
Credit to foreign debtors	0	6	37	40	101	109	40	40	40
Other net assets	925	1,594	1,840	2,525	39,567	50,029	79,168	88,606	110,877
Assets = liabilities	12,432	15,466	19,811	22,394	56,852	80,522	140,989	163,835	199,610
Total liquidity	9,678	12,560	15,103	17,559	31,384	49,690	64,733	74,693	87,831
Monetary supply	4,625	5,643	6,175	7,104	10,809	18,104	24,609	28,420	32,122
Quasi-money	5,053	6,918	8,927	10,455	20,575	31,586	40,124	46,273	55,709
Foreign borrowing	2,754	2,906	4,708	4,835	25,468	30,832	76,256	89,142	111,779

NOTE: Data reflect balance as of Dec. 31 of each year.
SOURCE: Central Bank of Costa Rica.

TABLE A5.5 Costa Rica: Balance of Payments, 1977–1985 (US$ million)

	1977	1978	1979	1980	1981	1982	1983	1984	1985
Current account balance	–226	–363	–558	–664	–409	–297	–283	–217	–162
Trade balance	–193	–301	–462	–522	–199	–23	–115	–87	–135
Exports of goods (FOB)[a]	828	865	934	1,002	1,008	870	873	1,006	963
Imports of goods (CIF)[b]	1,021	1,166	1,397	1,524	1,208	893	988	1,094	1,098
Balance of services	29	31	38	60	67	94	97	60	80
Balance of factors	–77	–110	–146	–217	–303	–404	–334	–323	–314
Unilateral transfers	16	17	12	15	27	36	69	133	207
Capital account balance	333	336	458	466	363	435	423	287	345
Official capital (net)	179	233	400	403	411	394	342	226	226
Private capital (net), errors and omissions	154	103	58	63	–48	41	81	61	119
Change in net international monetary reserves	107	–27	–100	–198	–46	138	140	70	183
Balance of net international monetary reserves	187	160	59	–139	–185	–47	92	162	345

a. Free on board, i.e., less delivery to shipper.
b. Cost, insurance, and freight.
SOURCE: Central Bank of Costa Rica.

TABLE A5.6 Costa Rica: Growth Rate of Prices and Exchange Rate, 1977–1985 (percentage)

Growth rate	1977	1978	1979	1980	1981	1982	1983	1984	1985
Prices									
Consumer prices	5.3	8.1	13.2	17.8	65.1	81.8	10.7	17.3	10.9
Wholesale prices	7.4	8.9	24.0	19.3	117.2	79.1	5.9	12.2	7.6
Nominal interbank exchange rate	0.0	0.0	0.0	66.0	153.1	12.5	7.8	10.0	12.4

SOURCE: Bureau of Statistics and Census.

TABLE A5.7 Costa Rica: Rates of Growth in Unemployment and Wages, 1977–1985 (percentage)

Growth rate	1977	1978	1979	1980	1981	1982	1983	1984	1985
Total unemployment rate	11.1	10.8	12.5	13.5	17.4	23.8	19.9	15.0	15.3
Open unemployment rate[a]	4.6	4.5	4.9	5.9	8.7	9.4	9.0	6.4	6.8
Minimum wages (percentage change)									
Nominal	12.9	18.1	12.0	23.2	33.9	104.2	30.6	15.5	24.3
Real[b]	7.3	9.2	–1.0	4.6	–18.9	12.4	18.0	–1.6	12.1

a. Excluding subemployment.
b. Base year = 1970.
SOURCE: Survey of Households, Sample.

TABLE A5.8 Costa Rica: Foreign Debt Indicators, 1977–1985 (US$ million)

	1977	1978	1979	1980	1981	1982	1983	1984	1985
Foreign debt balance	1,424	1,764	2,119	2,840	3,271	3,658	3,893	4,118	4,310
Private	639	758	770	1043	956	852	710	698	658
Public	785	1,006	1,349	1,797	2,315	2,807	3,184	3,419	3,652
Effective debt service	212	318	483	392	449	838	538	571	504
Private	114	139	275	133	121	89	80	75	62
Public	98	179	208	258	328	748	458	496	442
Effective debt service as % of exports of goods	25.6	36.8	51.7	39.1	44.5	96.2	61.6	56.7	52.3

SOURCE: Central Bank of Costa Rica.

Chile: An Economy in Transition

Few economies have provided more grounds for debate than that of Chile. Once ranked among the most advanced developing countries, Chile's relative economic position eroded steadily from the 1930s onward. By the mid-1970s, its per capita income was below that of Brazil, Panama, and Mexico.

The wide ideological swings that occurred from one election to another may have been partly due to voter dissatisfaction with the pace of economic progress. Successive governments brought abrupt changes in economic philosophies, from the mild socialism of the Popular Front regimes of the late 1930s through the 1940s, the charismatic populism of President Carlos Ibáñez (1952–1958), Jorge Alessandri's partial restoration of orthodox capitalism (1958–1964), Christian Democracy under Eduardo Frei (1964–1970), and the Marxist socialism of Salvador Allende (1970–1973). The latter administration was ended by a coup d'etat, resulting in a sharp swing toward laissez-faire capitalism under the present Pinochet administration. Despite the major shifts in economic doctrine and the varying problems encountered by each administration in the management of aggregate demand, several consistent policy threads characterized the fabric of economic policy from the Great Depression until 1973. In pursuit of greater insulation from externally generated economic shocks, and also of domestic growth, stabilization, and various allocative and distributional objectives, governments actively intervened in the economy. They did so both directly, through state ownership of production, distribution, and financial enterprises; and indirectly, through controls on prices, wages, interest rates, selective credit allocation, subsidies, tax exemptions, multiple exchange rates, import quotas, and so on. Among the economic policies that dominated the period were the following:

1. overvalued exchange rates supported by high levels of tariff and nontariff protection
2. negative real interest rates
3. low administered prices for food and other wage goods
4. legally mandated wage adjustments intended, in varying degrees, to control inflation, protect real incomes in the face of inflation, and alter income distribution
5. high and growing levels of social benefits
6. large public-sector deficits financed in varying proportions by monetary expansion and foreign loans
7. many specific exemptions from taxes, tariffs, controls, rules, and subsidies in

This case is based on a World Bank document on the Chilean experience, *Chile: An Economy in Transition* (Washington, D.C.: World Bank, 1980).

pursuit of special distributional or allocative objectives

The Allende Period

The immediate economic objectives of the Allende government, which took office in November 1970, were the reactivation of the economy; early progress toward the establishment of direct state control over those sectors whose resources and functions were deemed essential to fulfillment of the government's development plan; an increase in the wage share of national income; acceleration of the agrarian reform set in motion by Frei; and reduction of the rate of inflation. Although rapid initial progress was made on all these fronts, resource limits were soon reached and the unavoidable conflicts among objectives proved unmanageable.

Aggregate demand expanded rapidly in 1971. It was stimulated by a 58 percent nominal increase in central government expenditures, a 55 percent average wage adjustment, which was tailored to provide a larger proportional increase to the lower-income workers, and a more than doubling of the money supply. Idle industrial capacity, an excellent agricultural harvest, and the drawing down of international reserves contributed to a strong supply response. Real gross domestic product (GDP) rose almost 8 percent and real consumer goods imports increased 17 percent over the previous year. At the same time, increased price controls, the fixing of the exchange rate, and the freezing of public enterprise tariffs helped to restrain inflation. Thus employment expanded, and average real wages rose almost 20 percent. Also during 1971, the state took control over more than 80 enterprises, including the copper, iron, nitrate, and coal mines; 16 commercial banks accounting (along with the State Bank) for more than 90 percent of domestic credit; and the major enterprises in the metallurgical, metal-mechanical, cement, textile, fisheries, beer, and wholesale marketing sectors. Furthermore, under the land reform, almost as many farms were expropriated in 1971 as in the previous six years under Frei.

Although 1971, viewed in isolation, was thus a year of spectacular progress toward the government's objectives, serious problems became apparent as the year ended. The productive capacity limit had been reached in a number of sectors, breakdowns occurred in the distribution system, and labor-management conflicts were increasingly severe. Supply shortages of both intermediate and consumer goods were increasingly evident, and more and more transactions were being shifted to the black market. Private investment declined. State-run enterprises' profits were squeezed by the redundant expansion of their work forces, increased wages, controlled prices, and inexperienced management. Net medium- and long-term lending dropped drastically, and international reserves were exhausted. There had been a net withdrawal of financial resources by international creditors in 1971. In spite of a shift to the financial resources of socialist and neighboring countries, the total volume of short-term credit dropped. By the end of the year, Chile suspended its foreign debt-service payments.

While some external events such as a fall in copper prices hurt the Chilean economy, the administration's most serious economic problems were associated with domestic policies that resulted in substantial fiscal deficits, exploding growth in the money supply, an extensive system of subsidies, and gross price distortions.

During this same period 500 enterprises were confiscated and more than one-fourth of total agricultural land was expropriated. A deep economic and political crisis developed. Before the period ended, real GDP per capita and real wages had fallen well below 1970 levels; agricultural output had dropped to the level of the early 1960s; monthly inflation reached an annualized rate above 1,000 percent; the central government's fiscal deficit alone exceeded 20 percent of GDP; the black market exchange rate rose to over 10 times the official rate; and net international reserves were negative. Internal tensions and external political pressure mounted, and a coup d'etat brought General Pinochet to power.

The New Chilean Model

Stabilization, 1973–1975. After taking over in 1973, Chile's new authorities carried out a liberalization program that transformed the country's economic structure.[1] This program was intended to reduce the role of the state, control the inflationary process, liberalize trade, and eliminate distortions in domestic factor and product markets. Its ultimate objective was to improve the efficiency of the economy and hence its long-term growth prospects.

Fiscal policy was adjusted. The government reduced the growth of public spending and, between 1973 and 1981, strongly increased its revenues through a tax reform, adjustment in prices of public goods and services, and the sales of many of its enterprises to the private sector. The combination

TABLE 6.1 Chile: Public-Sector Summary Account (percentage of GDP)

	1975	1979	1981
Current revenues	25.0	34.0	32.0
Current expenditures	19.0	25.0	26.0
Current account surplus or deficit (–)	6.0	9.0	6.0
Capital revenue	—	1.0	0.4
Capital expenditures	5.0	5.0	5.0
Overall surplus or deficit (–)	1.0	5.0	1.4

SOURCE: *Chile: An Economy in Transition* (Washington, D.C.: World Bank, 1980).

transformed a huge public deficit (about 22 percent of GDP in 1973) into a surplus after 1975 (see table 6.1).

With the public-sector deficit eliminated, the government used monetary policy to control inflation. Trade and commercial policies were also modified. Subsidies and price distortions disappeared; a unified exchange rate regime was established; and foreign trade was liberalized through a compensated devaluation program. This program consisted of reducing tariffs and eliminating quotas. At the same time, crawling peg devaluations resulted in a fixed real exchange rate that provided fair protection to import-competing industries and incentives to export-oriented industries. Trade liberalization was followed by financial liberalization. From 1975 onward, credit was allocated in accordance with the supply of and demand for funds, as the government followed a policy of financial liberalization in which capital flows were freely determined by interest rate differentials.

Export-oriented growth, 1976–1979. After an early period of capital inflow, copper prices dropped in real terms from an annual average of 93 U.S. cents a pound in 1974 to 42 cents in 1975 (at 1972 prices). Chile's lack of creditworthiness at the time caused an acute shortage of foreign resources in 1975. The government had no alternative but to introduce a stabilization program whose main features included a major reduction of the fiscal deficit, a sharp devaluation of the exchange rate, and a sharp reduction in overall liquidity. According to some sources, from 1975 until 1978 the policies put into practice by the government were consistent with the country's requirements for resuming growth.[2] They consisted of a combination of internal price liberalization, opening the foreign sector, skillful management of the exchange rate, and liberalization of the domestic financial sector. As a result, between 1976 and 1979 inflation abated from over 500 percent in 1976 to 33 percent in 1979. The public-sector account shifted from deficit to surplus. The Chilean economy began to experience export-oriented economic growth with important adjustments in its productive sectors (see table 6.2).

Unification of the exchange rate was achieved during 1975. Until June 1979, first a passive crawling peg regime, then a preannounced minidevaluation system was followed. Simultaneously, tariffs were reduced and quotas eliminated, until an almost unified 10 percent tariff was completed in 1979 (see table 6.3).

TABLE 6.2 Chile: Average Rates of Growth, 1960–1979 (percentage)

	1960–70	1970–75	1975–79
GDP	4.2	–2.2	7.4
Exports	3.6	5.6	15.3
Imports	6.0	–7.7	19.5

SOURCE: Central Bank of Chile, *Economic and Social Indicators 1960–1982.*

The 1975 world recession notwithstanding, Chile diversified and increased its exports substantially from that year onward, while at the same time experiencing positive import substitution until 1979. Initially, low copper prices and trade restrictions slowed the growth of trade. After 1977, however, access to inputs imported at competitive prices and to credit at lower interest rates stimulated a strong expansion of noncopper exports. These new nontraditional exports combined with declining copper prices to reduce the share of copper in total export earnings to 47 percent in 1979 (the average share in the 1960s was 70 percent). The share of

TABLE 6.3 Chile: Tariff Structure Evolution, 1974–1979

Year	Modal tariff	Average tariff [a]
1974	90	105
1975	55	57
1976	35	38
1977	20	24
1978	10	15
1979	10	12

a. Weighted by number of tariff items.
SOURCE: Central Bank of Chile.

TABLE 6.4 Chile: Evolution of Exports, 1970–1979 (percentage)

Export	Share of total exports				Average rate of growth
	1970	1975	1977	1979	1975–1979
Copper	89	57	54	47	—
Agricultural products	3	5	7	6	32
Fish and forestry products	5	10	14	16	21
Manufacturing products	7	15	17	22	22

SOURCE: *Chile: An Economy in Transition* (Washington, D.C.: World Bank, 1980).

industrial goods increased to 22 percent and that of agricultural goods to 6 percent (see table 6.4).

By 1977 exports surpassed those of 1974, their previous record, in real terms. By contrast, it took Chile until 1978 to equal 1974's real import levels. Even so, for the same 1975–1979 period, imports in real terms increased at an annual average rate of 12 percent for both consumer goods and capital goods, and of 18 percent for intermediate goods—well above the growth rates achieved in the 1960s. Hence, whereas in the 1960s imports and exports as a proportion of GDP represented an average of 14 percent each, during the 1974–1979 period the liberalization stimulated exports of resource-based goods such as forest products, fishmeal, and fruits. Imports of capital and semimanufactured goods increased their ratios to GDP to 24 and 23 percent, respectively. Yet no major imbalance was created in the foreign sector; instead, an efficient, privately run productive sector emerged in response to the foreign competition.[3]

The liberalization program produced a redistribution of value added among productive sectors. Between 1970 and 1977, as can be seen from table 6.5, share in GDP of value added by manufacturing shrank substantially, while the agricultural and financial sectors' share increased. Once this basic adjustment was finished, the impact of the liberalization program was reflected in changes in the composition of production within sectors. By the end of 1979, with inflation under increasing control and the private sector's confidence restored, the government's liberalization policies had encouraged four years of economic growth based upon productivity gains, increases in capacity utilization, and a restructuring of production in most sectors (see table 6.6).

TABLE 6.5 Chile: Value Added, by Sector, 1970–1979 (percentage of GDP)

Sector	1970	1977	1979
Agriculture, forestry, fishery	6.8	9.8	8.6
Mining	8.8	8.1	7.4
Manufacturing	25.4	21.7	21.9
Commerce	18.6	15.6	17.7

SOURCE: *Chile: An Economy in Transition* (Washington, D.C.: World Bank, 1980).

Agriculture shifted production from the traditional crops (cereal, oilseeds, sugar beets) toward export-oriented crops (fruit, timber, and vegetables). Meanwhile, in manufacturing the new circumstances favored the emergence of many

TABLE 6.6 Chile: Changes in Value Added per Worker, 1970–1979

Sector	Index of productivity			Percentage change in productivity		Average rate of growth	
	1970	1975	1979	1970–75	1975–79	1961–70	1975–79
Manufacturing	100	79	96	-21.0	22.0	4.6	7.9
Agriculture	100	132	140	32.0	6.0	2.1	2.7
Commerce	100	77	94	-23.0	23.0	2.9	14.3
Financial services	100	104	169	4.0	21.0	NA	17.8
Mining	100	94	130	-6.0	38.0	1.8	5.4
Total economy	100	93	108	-7.0	16.0	3.7	7.4

NOTE: NA = not available.
SOURCE: Central Bank of Chile, *Economic and Social Indicators 1960–1982.*

natural-resource based industries (wood products, fishmeal, nonferrous metals), while reducing the number of firms in industrial activities subjected to import competition (textiles, chemical products, nonmetal goods).

More efficient use of capital helped spur the country's rate of growth during the 1976–1979 period. Domestic firms faced with increasing competition from foreign firms greatly improved their capital productivity by adapting their old equipment with small investments or by adopting modern management techniques. Thus, between 1976 and 1979, substantial capital productivity gains led sustained increase in production in spite of a low level of investment.

However, excess capacity and productivity gains concealed the country's weak investment record. After the 1975 recession, producers' utilization of excess capacity allowed the country strong rates but not high levels of fixed investment. Simultaneously, the government sharply reduced capital expenditures in its effort to balance the public budget. Hence, fixed public investment for the period was low. While the ratio of total investment to GDP increased between 1976 and 1979 (see table 6.7), net investment in equipment was low. As a result, by 1979 many firms had outdated capital stock. When combined with the 1979–1981 shift in policy, this had serious consequences for the manufacturing and agricultural sectors' competitiveness.

TABLE 6.7 Chile: Investment Ratios, 1976–1979

Investment and depreciation	Ratio to GDP			
	1976	1977	1978	1979
Total investment	13.6	14.4	16.4	19.6
Fixed investment	12.7	13.3	14.4	15.6
Change in stocks	0.9	1.1	2.0	4.0
Depreciation allowance	14.0	11.7	10.5	11.0

SOURCE: *Chile: An Economy in Transition* (Washington, D.C.: World Bank, 1980).

Levels of domestic savings dropped dramatically in 1975 but began to recover in 1976. Still, the average ratio of gross domestic savings to GDP was only 14 percent. Gross domestic savings in 1976 were only 12 percent of GDP, almost one-third lower than 1965–1970 levels. Furthermore, private savings were negative.

The role of foreign capital in domestic savings increased. The high domestic real rates of interest attracted US$600 million in 1976, US$800 million in 1977, US$1.4 billion in 1978, and US$2.2 billion in 1979.[4] International reserves increased by a yearly average of US$570 million. Since the average ratio of investment to GDP was nearly 16 percent—about the same as the domestic savings ratio—external resources not used to build up reserves financed higher levels of consumption rather than investment. This phenomenon reached its peak between 1979 and 1981.

One of the most noteworthy features of the period was increased unemployment. This can be explained, according to some, by two major factors. First, reductions in unemployment occurred between 1970 and 1973 due to public-sector job creation. After 1974, worker layoffs due to rationalization of labor costs caused unemployment to jump to double-digit levels. Second, a new capital/labor ratio was established by the economy's adjustment to an open economy. Almost half the new jobs created from 1976 to 1979 were in commerce, which expanded employment by close to 11 percent a year. Employment growth rates were slower in such other sectors as fishing, wood products, and financial services.

Growth and disequilibrium, 1980–1982. According to World Bank reports, much of the success of the 1975–1979 economic policies was a result of the realistic exchange rate policy followed until mid-1979, plus a strong international demand for Chilean products. The external sector played a key role in Chile's economic growth. In June 1979, however, the authorities attempted to reduce inflation further from its 30 percent rate to world levels by fixing the Chilean peso at 39 per U.S. dollar. This was also intended to bring down interest rates.

It is now believed that, in taking this action, the authorities underestimated the lags that can occur in the adjustment process, even in an open economy. Real interest rates remained high during the 1970–1980 period, averaging 30 percent per year before finally reaching 9 percent by the end of 1981. High interest rates increased the cost of domestic capital and induced Chilean firms to resort to outside financing. The result was a huge jump in interest payments abroad and a widening current account deficit. At the same time, as part of the government's labor policy, automatic ex-post indexing of wages had been in force from 1977 onward to protect workers' real income against inflation. From 1975 to 1979, real wages in the formal sector increased at an average rate of 13 percent a year, the real index increasing from 87 in 1970 to 100 in 1979. With

TABLE 6.8 Chile: Evolution of Real Effective Exchange Rate Indexes, 1978–1982 (December 1977 = 100)

Index	1978	1979	1980	1982
WPI 16 patterns, trade weighted[a]	102.6	84.5	74.6	75.2
CPI 16 patterns, trade weighted[a]	105.2	101.2	83.6	73.7

NOTE: WPI = wage and price index and CPI = consumer price index. A decline in the index reflects increasing overvaluation.
a. End-of-year values.
SOURCE: International Financial Statistics; Central Bank of Chile.

production increasing, the growing scarcity of skilled workers further pushed up the real cost of labor from 1979 to 1980. The combination of automatic wage adjustment and a fixed exchange rate proved calamitous for the country. For example, between June 1979 and December 1981, as the downward adjustment in inflation lagged, the index of real wages increased 31 percent in the manufacturing sector, and 28 percent for the economy as a whole. In the process the real exchange rate appreciated (see table 6.8). The overvalued peso made imports cheaper, eroding the competitiveness of the Chilean productive sectors and reflecting distorted relative prices between tradeable and nontraditional products. To make things worse, the U.S. dollar (against which the peso had been pegged) appreciated substantially vis-a-vis other currencies of countries in the Organization for Economic Cooperation and Development (OECD), thus reducing even further the competitiveness of Chilean products in European markets.

When the 1981–1982 world recession occurred, Chile's trade deficit soared. The appreciated peso encouraged the private sector to secure foreign goods in order to satisfy increased consumption and investment demands. From 1975 to 1978, rates of growth of imports and exports had produced a manageable resource deficit of just over 3 percent of GDP. After 1979, however, real private consumption rose at the unprecedented level of 10.5 percent a year, while gross investment (including stocks) peaked. By 1981 consumption and investment had increased so substantially that the resource gap reached 10 percent of GDP, with imports of goods and nonfactor services representing 27 percent of GDP.

Normally, by 1981 the external imbalance should have initiated an economy-wide adjustment, through either an increase in savings or a reduction in the rate of growth. However, high interest rates and a too willing international financial community attracted foreign capital into the domestic financial markets. The opening of the capital account and the pegging of the nominal exchange rate promised huge profits to both domestic borrowers and external lenders So, in the end, it was the surplus of the capital account that determined the state of the current account, as US$410 billion in foreign funds entered the country between 1979 and 1981—the equivalent of about one-half of GDP.

Credit was both expensive and inefficiently allocated. By 1977 a few industrial groups had obtained control of the nation's largest private banks. A complicated system of interlocking allocation of credit followed. By 1981 total indebtedness had risen substantially (see table 6.9).

If judged merely by the expansion of domestic financial markets and inflation abatement in the period, the government's program would have been deemed a success. However, the objective of the policies started in June 1979 was the development of efficient financial markets, where diversified instruments for short-, medium-, and long-term capital would foster investment. A different conclusion emerges. To begin with, some of the expansion was due to increases in wealth due to speculation in the Santiago stock market and land overvaluation. Secondly, although the government surplus provided the financial system with a new credit source, this was largely a result of reduced public investment. By late 1981 the stress this caused had become visible. Nonmineral exports, which had seen spectacu-

TABLE 6.9 Chile: Total Indebtedness as Proportion of Sector's GDP, 1975–1981 (percentage)

Sector	1975	1979	1981
Agriculture	10.7	49.1	71.4
Manufacturing	8.9	42.1	41.6
Construction	1.0	32.3	96.3
Commerce	4.6	38.9	52.8
Transport	1.5	18.0	24.9

Source: Chilean Ministry of Economy.

lar growth earlier, dropped in dollar terms in 1981. Agricultural exports grew moderately and then dropped precipitously. Manufactured exports also fell. By the fourth quarter of 1981, growth had halted and unemployment increased to 11 percent from the expected January level of 8.5 percent. Finally, the dimension of the external debt was reflected in the country's debt service, including short-term amortizations and interest payments, which in 1981 totaled 7 percent of total GDP.

The Chilean attempt to reduce inflation by fixing the exchange rate and opening the capital account produced serious problems. The leads and lags of the adjustment process, which the government had assumed would be minimal, were quite lengthy. Large capital inflows led to import growth, declining interest rates, and a short-lived boom in construction and consumption during 1980 and early 1981. Unfortunately, the government's belief that the supply of external funds to Chile was perfectly elastic was too optimistic. Once confidence in the Chilean economy began to wane, foreign loans were no longer available in sufficient amounts. With an economy running such a large trade deficit and, in addition, an expensive external debt, the stage was set in January 1982 for adjustment measures. However, despite the initial signs of a recession, the government kept its basic policies unaltered during much of 1982. By December 1982, the recession had become a depression.

In 1982 GDP fell 14.3 percent. Real added value in construction, which had boomed in 1980–1981, dropped almost 27 percent; real added value in commerce and transport decreased by 15 percent and 10 percent, respectively. Furthermore, added value in manufacturing dropped almost 22 percent, while real fixed investment dropped almost 37 percent. As conditions worsened, the unemployment rate rose rapidly. Official unemployment, which stood at 8 percent in 1981, rose to 19 percent by the end of 1982. The financial situation of many firms and banks deteriorated severely. As early as November 1981, the government had to intervene in the affairs of some insolvent banks. But the situation worsened considerably in 1982, when a series of bankruptcies—combined with interlocking ownership of banks and borrowing companies—complicated government efforts to support banks that were confronting liquidity problems. Moreover, the 1982 budget proved to be too optimistic. As revenues fell with depressed copper prices[5] and worsening economic conditions, public-sector finances moved from experiencing a surplus in 1981 to a deficit equivalent to 3 percent of GDP in 1982.

New period of adjustment, liberalization, and growth, 1983–1987. The deepening crisis finally forced the government to act. In June 1982 policy makers reversed a three-year policy of fixed exchange rates with an 18 percent devaluation. They also adopted a crawling peg exchange-rate system tied to a basket of currencies and reversed the 100 percent automatic wage-indexing clause. In early August the crisis worsened and the peso was floated. As its value dropped, a preferential rate of foreign exchange was established for debtors in foreign currency. Moreover, a further devaluation was implemented in September 1982, and the float became controlled within a preannounced range. This time, however, the Central Bank accompanied its exchange policy with restrictions on foreign exchange transactions. It announced a policy that would unite the preferential rate for debtors with the official rate during 1983. An indicator of the severity of the 1982 economic depression was the drop in merchandise imports by an estimated one-third in real terms. This reduction in imports halved the current account deficit from 1981 to US$2.4 million (around 10 percent of GDP).

In January 1983 the government began a short-term stabilization program with the IMF, assisted with a US$500 million stand-by and US$295 million access to the Compensatory Finance Facility. The financial insolvency of the banking system, however, impeded compliance with the first quarter's targets. An IMF "shadow program"—by which Chile would meet its original targets by September—was drawn up in March, and the government completed negotiations with the international banks, rescheduling the country's 1983–1984 amortization payments on its external debt. The government's economic policies in 1983 led to a trade surplus of US$1 billion, a 23 percent rate of inflation, a current account deficit of only US$1 billion, and a small increase in gross international reserves. However, a decline in domestic expenditures occurred for a second year. GDP fell by another 1 percent. The unemployment rate remained at 15 percent only because the emergency work programs employed 10 percent of the work force. Real gross fixed investment dropped another 15 percent and real private consumption declined 7 percent from 1982 levels. Finally, a tariff revision policy was initiated that increased the average tariff from 20 to 35 percent.

Since 1984 the Chilean economy has begun to experience new economic growth averaging 5 percent per year. Much of this growth is due to agriculture. As a result of agricultural performance, total

exports almost doubled between 1982 and 1987.

In 1985 the government adopted a new set of economic policies. It began, for example, a new tariff-reduction process (the average tariff was reduced from 35 percent to 20 percent) accompanied by minidevaluations (22 percent in 1985). The purpose of the new policies was to keep the cost of imported goods constant and encourage exports. The fiscal deficit was reduced to 3 percent of GDP. The Central Bank purchased the overdue portfolio from commercial banks and established new requirements for capitalization.

According to monetary authorities, one of the causes underlying high real interest rates in the Chilean financial market was the government deposit guarantee insurance, which focused investor attention only on yield, regardless of risk. The government altered its policy to provide insurance only to institutions that were adequately capitalized and had a sound portfolio. As a consequence of this policy and the fiscal deficit reductions, the real interest rate fell to 3.5 percent, a rate comparable with world market conditions.

Finally, the privatization process continued through the "popular capitalism" that allowed thousands of Chilean workers to become owners of companies previously in the hands of the state.

Chile has been one of the few Latin American countries that has launched a strong liberalization program. Its experience has been extremely controversial because periods of economic growth have alternated with periods of economic crisis. In the future it will face the task of managing both economic expansion and a democratic opening.

Study Questions

1. Compare Chile's economic policies from 1970 to 1973 with those that followed. Consider the following elements:
   a. objectives
   b. strategy
   c. economic policy package
   d. outcomes
2. After having identified the overall strategy followed by the Pinochet government, divide this strategy into subperiods identified by:
   a. objectives versus results
   b. events that forced the government to shift its short-term strategy
   c. factors that contributed to success (try to distinguish between factors that were intrinsic to the liberalization process and factors unrelated to it)
3. What might you have done to minimize the problems in 1982–1983? What problems do you anticipate now?
4. Compare Chile's process of stabilization and adjustment with those of Bolivia and Costa Rica.

Notes

Works cited only by author and date are fully listed in the bibliography at the end of this book.

1. For detailed descriptions of this transition, see World Bank (1980); V. Corbo, "Chile: An Overview of Macroeconomic Developments," unpublished memo (Washington, D.C.: World Bank, April 1983); and T. Condon, V. Corbo, and J. de Melo, "A Simulation Analysis of the Macroeconomic Effects of Capital Inflows and Wage Indexation in Chile," unpublished manuscript (Washington, D.C.: World Bank, 1977–81).

2. A detailed description of the 1975 program can be found in J. C. Méndez (1979).

3. For a thorough analysis of the shifts in manufacturing, see V Corbo, "Chile: An Overview."

4. Capital inflows in 1979 represented 16.2 percent of GDP.

5. Copper prices fell from US$1 a pound in 1980 to less than 68 cents in 1982.

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Appendix

TABLE A6.1 Chile: Share of GDP by Industrial Origin, 1970–1987 (percentage)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Agriculture	6.8	8.1	8.3	6.7	5.7	6.6	8.4	9.8	7.6	7.3	7.2	6.4	6.2	9.2	9.3	9.6	9.9	9.6
Mining	8.7	5.8	6.8	9.1	12.0	10.4	10.2	8.0	7.4	9.8	8.6	5.6	6.1	8.9	8.7	8.8	8.4	7.9
Construction	5.1	6.1	6.1	4.3	6.1	5.4	4.3	4.1	4.2	4.3	5.2	6.3	5.0	5.2	5.1	5.6	5.5	5.8
Manufacturing	25.5	24.4	23.4	27.1	29.6	20.3	23.3	21.7	22.4	21.2	21.4	22.0	19.6	20.0	20.7	20.6	20.9	20.8
Elec., gas, and water	2.0	2.2	1.4	0.5	1.1	2.1	2.3	2.3	2.0	2.0	2.1	2.2	3.0	2.5	2.5	2.6	2.6	2.5
Transportation and communication	5.2	5.1	5.8	6.1	5.7	5.7	4.9	5.3	5.5	5.2	4.9	4.6	4.7	5.5	5.4	5.5	5.7	6.0
Trade	18.6	18.0	19.2	20.9	14.1	17.3	15.1	15.6	16.5	16.7	16.3	16.9	16.5	17.1	16.9	16.9	16.7	17.0
Banking, insurance, and real estate	5.2	5.4	4.5	5.0	5.3	6.2	6.1	6.3	7.0	8.1	9.8	10.9	11.3					
Ownership of dwellings	5.5	5.0	3.8	4.0	3.7	8.3	7.4	7.1	7.9	7.4	7.4	7.8	9.0					
Services	10.4	12.4	12.6	9.7	9.1	10.8	10.7	11.7	11.6	11.0	11.6	12.5	13.6	31.6	31.4	30.4	30.3	30.4
Public administration and defense	5.6	6.7	7.4	6.1	6.5	6.2	6.0	6.4	5.8	5.5	5.1	5.2	6.5					
Imputed banking svc. charges	–1.9	–1.7	–1.8	–2.1	–2.4	–3.0	–2.6	–3.2	–2.9	–3.9	–5.2	–6.3	–6.2					
Import duties	3.4	2.5	2.4	2.7	3.6	3.7	3.8	4.9	5.2	5.5	5.6	6.0	40					
GDP at market prices	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0				100.0

SOURCE: Central Bank of Chile and World Bank mission estimates.

TABLE A6.2 Chile: GDP by Industrial Origin, Real Growth Rates, 1970–1987 (percentage)

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Agriculture	–1.1	–8.3	10.0	26.8	4.4	–1.6	–10.6	–3.7	6.2	3.8	5.3	–2.3	–2.5	7.5	5.0	8.8	5.5
Mining	6.0	–3.8	–2.3	22.2	–11.3	12.2	2.7	1.6	5.4	5.2	8.0	5.7	–1.9	4.4	2.2	1.5	3.5
Construction	0.1	–19.5	–11.0	26.3	–26.0	–16.5	–0.9	8.1	23.9	23.9	21.1	–29.0	–5.0	4.2	12.0	1.3	6.0
Manufacturing	13.6	2.2	–7.7	–2.6	–25.5	6.0	8.5	9.3	7.9	6.2	2.6	–21.6	3.1	9.8	1.6	8.0	5.5
Elec., gas & water	14.9	6.7	–2.8	5.2	–3.8	5.8	5.8	6.7	6.8	5.0	2.1	–0.2	4.3	7.0	2.9	6.5	4.0
Transportation, & communication	6.2	–0.9	–2.0	1.0	–7.7	4.6	10.8	8.4	9.0	11.1	1.1	–9.9	–1.4	6.0	3.4	8.1	4.0
Trade	15.8	3.8	–6.4	–19.7	–17.1	2.5	24.8	20.0	11.0	12.4	6.7	–17.8	–1.5	5.0	2.3	5.5	5.0
Banking, insurance, & real estate	16.9	–15.6	–3.1	21.4	–4.2	9.3	14.5	20.1	28.0	22.6	16.1	–9.0	NA	NA	NA	NA	NA
Ownership of dwellings	2.2	1.4	2.5	2.8	1.8	0.7	0.6	0.9	0.5	1.0	1.5	1.0	NA	NA	NA	NA	NA
Services	7.3	4.8	–2.8	2.7	–1.2	1.3	3.6	3.6	4.4	2.4	0.9	–10.0	–2.6	5.4	0.0	4.7	3.0
Public administration & defense	3.6	3.3	2.4	8.0	1.9	5.9	1.8	–3.1	–1.2	–3.2	–1.8	–2.9	NA	NA	NA	NA	NA
GDP at market prices	9.0	–1.2	–5.6	1.0	–12.9	3.5	9.9	8.2	8.3	7.8	5.7	–14.3	NA	NA	NA	NA	NA

NOTE: NA = not available.
SOURCE: Central Bank of Chile and World Bank mission estimates.

TABLE A6.3 Chile: Shares of GDP by Expenditure Component, 1970–1987 (percentage)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Total consumption	89.2	86.5	91.3	93.9	78.2	88.9	82.9	87.4	85.5	85.0	83.2	87.6	90.6	87.5	87.4	83.5	81.6	79.8
Private consumption	70.1	71.3	75.2	80.8	62.4	73.2	68.9	72.8	71.1	70.7	70.7	74.5	75.3	73.3	72.9	69.3	68.9	67.4
General govt. consumption	12.8	15.3	16.1	13.1	15.7	15.7	14.0	14.6	14.4	14.3	12.5	13.1	15.3	14.2	14.5	14.2	12.7	12.4
Gross domestic investment	16.5	14.5	12.2	7.9	21.2	13.1	12.8	14.4	17.8	17.8	21.0	22.7	11.3	9.8	13.6	13.7	14.6	13.4
Fixed investment	15.0	14.6	13.1	12.8	17.0	17.7	13.3	13.3	14.7	14.9	16.6	NA	NA	NA	NA	NA	NA	NA
Increase in stocks	1.4	–0.1	–0.9	–4.9	4.2	–4.6	–0.5	1.1	3.1	2.9	4.3	NA	NA	NA	NA	NA	NA	NA
Net export of goods & NFS	0.6	–1.0	–3.5	–1.9	0.7	–2.0	4.3	–1.8	–3.3	–2.8	–4.2	NA	NA	NA	NA	NA	NA	NA
Exports of goods & NFS	15.0	11.3	10.1	14.0	20.4	25.5	25.1	20.6	20.6	23.3	22.8	16.4	19.4	24.0	24.3	29.1	30.6	35.9
Imports of goods & NFS	14.4	12.4	13.6	15.8	19.7	27.4	20.8	22.4	23.9	26.1	27.0	26.8	21.2	21.3	25.3	26.3	26.8	29.2
GDP at market prices	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Net factor service income	–2.4	–1.2	–0.6	–1.1	–1.6	–3.9	–3.3	–2.6	–2.7	–3.2	–3.4	NA	NA	NA	NA	NA	NA	NA
GNP at market prices	97.6	98.8	99.4	98.9	98.4	96.1	96.7	97.4	97.3	96.8	96.6	NA	NA	NA	NA	NA	NA	NA
Net indirect taxes	10.6	9.8	8.5	10.5	15.6	14.0	13.7	14.4	13.8	12.4	12.1	NA	NA	NA	NA	NA	NA	NA
Gross domestic saving	17.1	13.5	8.7	6.1	21.8	11.1	17.1	12.6	14.5	15.0	16.8	NA	NA	NA	NA	NA	NA	NA
Gross national saving (excl. trans.)	14.6	12.3	8.1	5.0	20.3	7.2	13.8	10.0	11.7	11.8	13.5	NA	NA	NA	NA	NA	NA	NA
Current transfers	0.5	0.2	0.2	0.3	0.4	0.7	0.7	0.7	0.9	0.7	0.4	NA	NA	NA	NA	NA	NA	NA
Gross national savings (incl. trans.)	15.1	12.4	8.3	5.2	20.7	7.9	14.5	10.7	12.6	12.4	13.9	NA	NA	NA	NA	NA	NA	NA

NOTE: NFS = nonfactor services, NA = not available.
SOURCE: Central Bank of Chile and World Bank mission estimates.

TABLE A6.4 Chile: GDP by Expenditure Component, Growth Rates, 1971–1983 (percentage)

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Total consumption	13.1	7.4	–5.5	–14.3	–11.2	0.2	13.8	7.4	6.9	4.2	12.2	–13.5	–5.8
Private consumption	13.2	7.7	–6.6	–18.3	–11.4	0.3	16.0	7.5	6.5	6.8	14.2	–14.4	–5.8
General govt. consumption	12.4	5.7	1.7	9.6	–10.3	–0.1	3.8	6.8	9.2	–8.1	0.3	–7.8	–5.8
Gross domestic investment	–3.2	–27.3	–10.9	81.5	–52.6	0.2	16.8	23.4	29.1	31.2	5.7	–65.4	15.3
Fixed investment	–2.3	–20.1	–6.0	19.1	–22.8	–14.8	15.4	17.4	16.8	21.9	14.7	–37.1	–14.4
Exports of goods & NFS	0.8	–15.1	2.8	45.9	2.3	24.4	11.9	11.2	14.1	14.3	–5.3	10.9	1.4
Imports of goods & NFS	8.5	3.2	–5.4	3.4	–38.7	4.3	35.5	17.6	22.7	18.7	14.7	–32.9	–9.4
GDP at market prices	9.0	–1.2	–5.6	1.0	–12.9	3.5	9.9	8.2	8.3	7.8	5.7	–14.3	–0.8
GNP at market prices	10.3	–0.6	–6.1	0.5	–15.0	4.2	10.6	8.1	7.8	7.4	4.2	–14.1	0.5

NOTE: NFS = nonfactor services.
SOURCE: Central Bank of Chile.

TABLE A6.5 Chile: Balance of Payments, 1975–1983 (US$ million)

	1975	1976	1977	1978	1979	1980	1981	1982	1983
Exports (G and NFS)	1,838.2	2,412.9	2,601.2	2,940.9	4,620.2	5,967.5	5,505.5	5,026.6	4,699.0
Merchandise (FOB)	1,590.5	2,116.2	2,185.6	2,460.2	3,834.7	4,705.0	3,959.6	3,797.8	3,855.0
Nonfactor services	274.7	296.7	415.6	480.8	785.5	1,262.5	1,545.9	1,228.8	844.0
Imports (G and NFS)	2,049.5	1,980.0	2,870.9	3,622.0	5,217.1	7,023.1	8,872.0	5,345.6	4,235.0
Merchandise (FOB)	1,520.1	1,473.2	2,150.6	2,885.9	4,190.0	5,469.0	6,558.5	3,580.3	2,882.0
Nonfactor services	529.4	506.8	720.4	736.2	1,027.1	1,554.0	2,313.5	1,765.3	1,353.0
Resource balance	–211.3	432.9	–269.7	–681.1	–596.9	–1,055.5	–3,366.5	–319.1	464.0
Net factor income	–291.4	–333.7	–379.4	–505.8	–696.4	–1,028.2	–1,547.1	–2,162.8	–1,870.9
Factor receipts	3.7	11.5	17.5	42.6	126.6	308.5	603.7	483.6	ND
Factor payments	295.0	345.2	397.0	548.4	823.0	1,336.7	2,150.8	2,646.3	ND
Medium- and long-term interest paid	195.4	252.0	263.5	383.5	582.5	918.5	1,423.1	1,945.7	1,395.0
Net current transfers	3.6	32.3	80.6	75.1	87.9	61.2	44.8	45.3	–96.6
Transfer receipts	3.6	32.3	80.6	100.2	117.6	92.4	95.4	94.9	ND
Transfer payments	—	—	—	25.0	29.7	31.2	50.7	49.7	ND
Current account balance	–497.8	131.6	–568.6	–1,112.9	–1,204.2	–2,023.9	–4,868.8	–2,436.6	–1,503.5
Medium- and long-term capital inflow									
Direct investment	49.8	–1.2	16.3	176.5	232.6	170.5	376.2	365.4	152.0
Official grant aid	8.5	16.2	16.3	22.5	16.8	53.4	55.4	55.2	57.0
Net medium- and long-term loans	44.9	17.2	196.5	1,145.2	1,468.8	2,105.0	3,389.9	1,415.5	1,000.0
Disbursements	464.6	653.2	989.1	2,232.6	2,785.7	3,566.6	5,188.6	2,673.6	1,900.0
Repayments	419.7	636.0	792.6	1,087.4	1,316.8	1,461.1	1,798.8	1,258.2	900.0
Other medium- and long-term (net)	77.8	34.8	–143.9	186.9	102.2	–3.1	–15.1	–10.0	ND
Net credit from IMF	207.6	82.0	–119.1	–42.6	–169.3	–52.1	–64.9	39.7	614.0
Net short-term capital	140.8	68.1	557.9	449.5	471.6	999.6	1,107.2	–619.3	ND
Capital flows not elsewhere included	4.9	–5.8	–43.3	–62.6	23.3	143.2	214.6	92.7	–98.2 [a]
Errors and omissions	–109.3	68.1	116.9	–125.3	-14.2	50.8	114.4	–57.4	ND
Change in net reserves	72.8	–411.0	–28.0	–637.3	–927.7	–1,443.4	–308.9	1234.3	–221.3

NOTE: G = goods, NFS = nonfactor services, FOB = free on board, ND = not determined.
a. Includes errors and omissions and short-term capital.
SOURCE: IMF and World Bank mission estimates.

TABLE A6.6 Chile: Exports of Merchandise by Product Type, 1971–1987 (US$ million)

Product	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Mining products	813.2	734.5	1,132.6	1,806.9	1.075.4	1,448.6	1,403.2	1,422.3	2,253.9	2,919.4	2,261.3	2,155.8	2,296.6	1,961.7	2,120.7	2,096.1	2,603.3
Copper	701.8	657.6	1,025.6	1,653.5	890.4	1,246.5	1,187.4	1,201.5	1,799.6	2,200.4	1,714.9	1,731.4	1,835.7	1,603.8	1,788.7	1,757.1	2,243.7
Other	111.4	76.9	107.0	153.4	185.0	202.1	215.8	220.8	454.3	719.0	546.4	424.4	460.9	357.9	332.0	339.0	359.6
Agro. and fishing products	29.4	19.3	25.5	55.0	86.1	118.9	159.5	203.5	264.5	339.9	365.4	374.9	327.5	428.1	515.1	683.1	796.3
Fresh fruits	13.4	22.8	13.6	18.4	37.8	53.9	63.6	101.0	123.3	168.7	198.5	232.8	220.5	276.6	357.3	478.9	530.9
Other	16.0	7.5	11.9	36.6	48.3	65.0	95.9	102.5	141.2	171.2	166.9	142.1	107.0	151.5	157.8	204.2	265.4
Manufacturing products	119.6	82.4	89.4	290.6	390.6	528.1	627.6	782.0	1,245.0	1,558.8	1,279.6	1,178.8	1,211.4	1,260.3	1,168.3	1,419.7	1,824.1
Fish meal	29.8	12.4	12.0	31.1	29.2	61.6	86.5	105.8	152.6	233.7	202.0	256.0	307.1	ND	ND	ND	ND
Wood products	7.0	4.9	4.1	12.7	25.2	29.4	70.4	94.4	164.7	286.2	163.4	122.3	116.4	ND	ND	ND	ND
Pulp and paper	24.9	21.0	29.0	106.0	83.7	121.4	119.1	144.2	213.6	265.2	228.4	199.5	190.6	ND	ND	ND	ND
Other	57.9	44.1	44.3	140.8	252.5	315.7	351.6	437.6	714.1	773.7	685.8	601.0	597.3	ND	ND	ND	ND
Total	962.2	836.2	1,247.5	2,152.5	1,552.1	2,095.6	2,190.3	2,407.8	3,763.4	4,818.1	3,906.3	3,709.5	3,835.5	3,650.1	3,804.1	4,198.9	5,223.7

NOTE: ND = not determined. Total exports are from the "Register of Exports" in the Central Bank, while the balance of payments reflects exports for which the actual transactions took place.
SOURCE: Central Bank of Chile (customs data).

TABLE A6.7 Chile: Imports of Merchandise by Type of Goods, 1971–1987 (US$ million)

Type of goods	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Consumer goods	245.3	276.6	237.9	153.1	87.3	229.0	526.5	595.9	852.0	1,493.1	2,727.0	1,484.2	1,024.3	1,044.4	728.9	754.0	900.5
Food	144.8	202.5	178.1	46.0	25.5	48.1	102.5	132.2	169.7	422.8	823.0	589.8	530.9	492.1	246.5	168.9	209.5
Other	100.5	74.1	59.8	107.1	61.8	180.9	424.0	463.7	682.3	1,070.3	1,904.0	894.4	493.4	552.3	482.4	585.1	691.0
Capital goods	199.9	312.2	333.4	502.1	378.8	375.0	503.8	653.3	879.1	1,218.9	1,477.0	696.9	391.8	597.4	650.2	735.0	1,100.6
Intermediate goods	720.4	822.7	1,110.0	1,757.1	872.1	1,171.8	1,384.0	1,753.2	2,486.5	3,108.5	3,144.0	1,912.8	1,754.7	2,097.0	1,866.7	1,947.3	2,395.2
Fuel and lubricants	109.7	101.5	147.9	480.8	257.0	392.2	447.0	480.0	888.7	959.6	ND	ND	ND	ND	ND	ND	ND
Agricultural raw materials	152.2	237.4	303.9	328.6	240.5	246.6	154.9	282.7	276.9	357.7	ND	ND	ND	ND	ND	ND	ND
Industrial raw materials	325.8	357.5	372.2	575.9	188.7	283.3	385.2	407.0	544.7	801.0	ND	ND	ND	ND	ND	ND	ND
Industrial intermediate goods	ND	ND	107.4	141.7	76.9	125.6	193.1	277.5	402.5	530.9	ND	ND	ND	ND	ND	ND	ND
Other	132.7	126.3	178.6	230.1	109.0	124.1	203.8	306.0	373.7	459.3	ND	ND	ND	ND	ND	ND	ND
Total	1,165.6	1,411.5	1,681.3	2,412.3	1,338.2	1,775.8	2,414.3	3,002.4	4,217.6	5,820.5	7,348.0	4,093.9	3,170.8	3,738.8	3,245.8	3,436.3	4,396.3

NOTE. ND = not determined. Total imports are from the "Register of Imports" in the Central Bank, while the balance of payments reflects imports for which the actual transaction took place.
SOURCE. Central Bank of Chile (customs data).

TABLE A6.8 Chile: External Debt Evolution, 1975–1987 (US$ million)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
External debt, medium- and long-term[a]	4,267	4,274	4,510	5,923	7,507	9,413	12,553	13,815	14,832	16,963	17,650	17,814	17,191
Reserves[b]	–129	108	273	1,058	2,314	4,074	3,775	2,578	2,023	ND	ND	ND	ND
Net external debt	4,396	4,166	4,237	4,865	5,193	5,339	8,778	11,237	12,809	ND	ND	ND	ND

Note: ND = not determined.
a. Medium- and long-term loans include public and private debt as of Dec. 31 of each year.
b. Assets in the Central Bank minus liability to the IMF. Gold is valued at market prices, and the reciprocal credit agreements are considered in terms of the "net value."
SOURCE: Central Bank of Chile.

-107-

7 MARC LINDENBERG

Taiwan, 1961: The Search for a Viable Economic Strategy

Members of the Ministry of Economic Affairs looked back on the last 12 years in Taiwan with a sense of satisfaction. In the bleak days of December 1949, things had seemed hopeless. Nationalist Chinese government troops had lost all but a few of their last strongholds on the Chinese mainland. In November 1949, the Executive Yuan (the highest administrative organ of state) had voted to move the capital of the Nationalist government to Taipei, Taiwan (see figure 7.1). In December Chiang Kai-shek hurriedly left Chengtu in the face of advancing Communist troops to join the more than two million Chinese refugees who moved to Taiwan between 1948 and 1950.

A U.S. State Department white paper had written off the Nationalist government and advised American diplomats to prepare for the fall of Taiwan (Formosa) to the Communists.[1] On January 5, 1950, President Harry S. Truman announced that the United States did not

> have any intention of utilizing its armed forces to intervene in the present situation. . . . Similarly the United States Government will not provide military aid or advice to the Chinese forces on Formosa.[2]

U.S. assistance was terminated. The economic situation became serious and chaos reigned.

> Food, clothing and basic necessities of living were in short supply as a consequence of wartime losses of production facilities and a rapid increase in population by natural causes and the inflow from mainland China. Heavy military spending. . . had created huge deficits in the Chinese budget.
>
> Price inflation was threatening to repeat the tragic sequence of events that contributed to the Communist takeover of the mainland. During 1950, the Chinese government lost about US$90 million in convertible currencies, reducing its foreign exchange resources below a minimum level. There was widespread popular unrest. . . .[3]

Yet in 12 years the Nationalist government successfully organized an emergency stabilization program, carried out a successful land reform plan, developed a viable industrial base to meet domestic needs, and had achieved annual rates of economic growth of more than 6 percent. It had successfully resisted mainland Chinese incursions against Quemoy and Matsu, and had benefited from renewed U.S. assistance.

Two four-year economic plans (1953–1956 and 1957–1960) had helped to create a viable economy. However, 1961 presented new dilemmas. Agricultural commodity prices continued to deteriorate, affecting Taiwan's principal export, sugar. Industrial growth slowed due to reduced opportunities for future import substitution, and U.S. economic assistance policy shifted in two important ways. First, Agency for International Development (AID) officials announced that in the future they would mainly provide concessional loans rather than grants; and second, U.S. assistance, which had been

Dr. Gustav Ranis, Frank Altschul Professor of International Economics at Yale University, is gratefully acknowledged for advice on this chapter.

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vital in financing government deficits, would be phased out by 1965. Finally, officials feared that

> a softening in the American attitude toward the Communist Chinese government [would take place]. The government reacted sharply to a suggestion by Mrs. Eleanor Roosevelt—now an American delegate at the United Nations . . . that the representation of Nationalist China at the U.N. should be limited to Taiwan (making it possible for the Peking regime to represent "China").[4]

In response to the new problems, the Ministry of Economic Affairs began to prepare a new 1961–64 economic plan with annual growth rates set at 8 percent. To achieve this target, planners set the following objectives:

1. Make a thorough review of past control measures in order to liberalize those measures
2. Give preferential treatment to private businesses in regard to taxes, foreign exchange, and financing
3. Reform the tax system and its administration to enhance capital formation
4. Reform the foreign exchange and trade systems, aiming at the establishment of a unified exchange rate and liberalization of trade control, consistent with the payments situation
5. Promote export expansion, improve procedures governing the settlement of foreign exchange earned by exporters, and increase contacts with foreign business organizations[5]

To set objectives was easy, but to carry them out effectively was much more difficult. The planners needed to answer the following basic questions:

1. What economic strategies were viable for 1961–64?
2. What sources of growth might be found in the economy and what specific policies would be necessary in the agricultural and industrial sectors?
3. What general monetary, fiscal, commercial, and labor policies would be useful?
4. What political, economic, and social problems might be expected as a result of the strategy, and how might these problems be managed?

The Context

The land and the people. Taiwan, an island off the southeast coast of mainland China, is recognized by both the Nationalist Chinese government and the government of the People's Republic of China (PRC) to be part of China. The island is 36,000 square kilometers in extent, roughly equal to the Netherlands (figure 7.1). Its population in 1961 was over 11 million, with more than 513 people per square kilometer (one of the densest population concentrations in the world) and population growth of 3.3 percent annually. Only one-quarter of the land, mostly along the west coast, is arable. Some 64 percent of the island is made up of mountains; the rest is sandhills and dunes. There are small strips of arable land along the northeastern and eastern regions of the island. While double cropping is possible in these areas, yields are low, due to heavy winds and rain in the northeast and lack of sun on the east coast. In the western region, which is the principal agricultural zone, double cropping produces high yields in rice, but irrigation is necessary. Sugar is also one of the principal products of the western zone. Taiwan is not rich in minerals but does have coal, as well as highly limited deposits of natural gas and petroleum. Two-thirds of the area is covered with forests.

Taiwan's population of 11 million is divided into distinct language and ethnic groups.[6] Another important source of division among groups is based on their time of migration to the island. For example, the 2 million Chinese (18 percent of the total) who immigrated from the mainland between 1948 and 1950 form a distinct group that controls key government posts, the political party apparatus, and the key military operations in the private sector. Around 2 percent of the population are aborigines; the remaining 80 percent are considered Taiwanese. Of the Taiwanese group, roughly four-fifths speak Hokkien (or Min-nan) and the rest speak Hakka. Evidence of social stratification by date of migration and also language group is documentable. For example, although Taiwanese make up 95 percent of the military, they hold only 4 percent of the officer positions.[7]

Brief history. Taiwan became known to the mainland Chinese in the third century A.D., through visits of fishermen and pirates. When the Dutch first landed in 1622, there were less than 25,000 Chinese on the island. In the middle 1600s Koxinga, the pirate, controlled the island but was finally displaced by forces from the Manchu dynasty in 1683. Manchu control lasted until the late 1800s, when the Japanese gained control of Taiwan as part of their victory spoils from the Sino-Japanese war.[8]

During Japanese rule, from 1895 to 1945, the island was transformed into a productive, agricultural colony. The Japanese established order and organization throughout the island, built farmers' organizations, infrastructure, and finally some manufacturing industries. During this period Japan received more than 84 percent of Taiwan's exports and supplied 74 percent of its imports. Economic growth rates between 1911 and 1940 averaged 4 percent per year.

Between 1945 and 1947, Taiwan was reincorporated into the mainland Republic of China. Although the Taiwanese were initially pleased with the return to China, frictions developed quickly. General Yin Chi, appointed administrator general, exacerbated the tensions. According to one source,

> all of the most desirable residences, as well as 90 percent of the commercial enterprises formally owned by the Japanese were quickly taken over by the new arrivals from the mainland.... Many of the enterprises were stripped of their assets and shipped to the mainland.... Food shortages developed when large grain shipments were made to Nationalist armies on the mainland.... Discontent and unrest intensified. In 1947 an estimated 10,000 Taiwanese were killed in an attempted rebellion.[9]

Finally, between 1948 and 1950 additional tensions and disorder were created by the inflow of more than two million refugees from the mainland and the establishment of the capital of the Republic of China in Taipei.

Political Structure and Dynamics

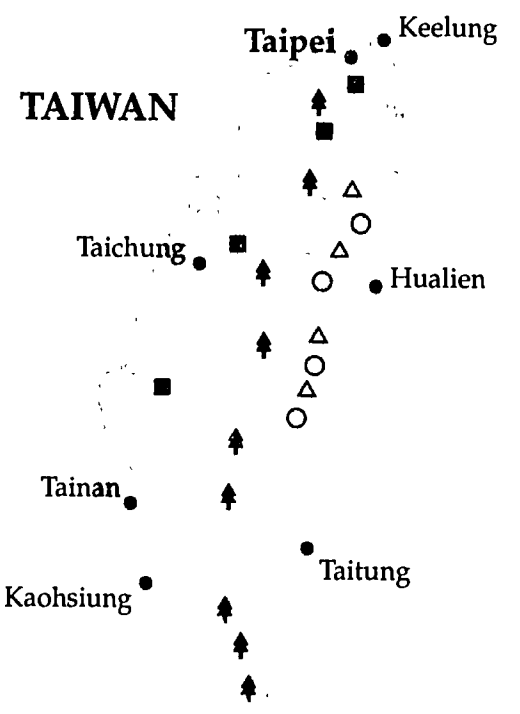
Government structure. The political ideology reflected in the constitution is derived from Sun Yat-sen, leader of the independence movement and first president of the republic. The political concepts of Sun Yat-sen are said to be embodied in the Three Principles of the People: nationalism, democracy,

FIGURE 7.1 Taiwan: Area and Resources, 1961

Total area: 36,000 square kilometers
Arable land: 25% of total area
Forest land: 64% of total area

Resource	Reserves
■ Coal	205 million metric tons
△ Marble	300 billion metric tons
○ Dolomite	116 million metric tons
♠ Forest	241 million cubic meters

Total population: 11,149,000
Population density: 512.7 persons per square kilometer



SOURCE: Council for Economic Planning and Economic Development, Republic of China, (Taiwan) 1983.

and people's livelihood.[10] Nationalism included the idea of China's self-determination and therefore liberation from the unequal treaties imposed by the Western powers and Japan in the 1800s and early 1900s.

Sun's concepts of democracy included four political "powers to the people": election, recall, initiative, and referendum. Corresponding to these were five "powers to the government": administration, legislation, adjudication, examination, and control. The last two government powers represented a special Chinese cultural tradition. For example, examination meant a special government organization to run a neutral civil service examination system in which all members of Chinese society could compete. The concept of control included auditing, the right to consent in the appointment of key officials, and censorship.

The five-power government system reflected in the Constitution of 1947 is embodied in the actual structure in which the president of the republic, the supreme authority, governs through five administrative *yuan* (organizations): the executive, legislative, judicial, examination, and control. The president receives his authority by being elected by the National Assembly, a body composed of elected delegates. Each county or municipality has at least one delegate elected by occupational groups, racial minorities, and overseas Chinese.

Political dynamics. While the formal structure provided for a series of checks and balances and freely elected representatives, the political dynamics of Taiwan were tied to a single party mobilization system with a high degree of control.[11] The Nationalist party, organized in 1904 by Sun Yat-sen and managed for more than 40 years by Chiang Kai-shek, was the hub of political activity (see figure 7.2 for a political map). The party held an overwhelming majority of all elected positions and although two other political parties, the Chinese Youth party and the Democratic Socialist party, also existed, their influence was minimal. The Nationalist party was dominated by exiles from the mainland who arrived during the 1948–1950 period. In 1961 the party had more than 500,000 members (more than 1 member for every 8 voters).

Another key feature of the system was highly centralized control. Although the original constitution called for periodic elections, only one national election was ever held, for the National Assembly in November 1947. National elections through 1961 were prohibited due to a state of emergency that placed centralized powers in the hands of the president, Chiang Kai-shek. The end result was that the National Assembly, which according to the official doctrine of the republic represented all of China, was composed in the 1950s through 1970s of men who had highly limited formal power.

An additional result of the process was two-tiered government. On the one hand, the party structure and national government structure applied to all of China. On the other hand, real decisions for allocating resources could only be made for Taiwan. Thus, provincial and majority elections took on special significance and were held with frequency. Nationalist party officials and Chinese mainlanders who arrived in the 1948–1950 period dominated at political levels in the provinces and in local government.

In 1961 military emergency, war preparedness, and official anti-Communism continued to dominate political life in the Republic of China. The consequences were high levels of military spending, the retention of a 600,000-man army, a highly organized state security apparatus, military emergency laws, press censorship, and limited participation of opposition groups in formal political life. For example, labor unions were permitted, but only in enterprises with more than 30 employees (which excluded more than 60 percent of the labor force), and the right to strike was prohibited due to emergency laws. Disputes were usually handled directly by the party and the government rather than employers. Collective bargaining was not a common practice.

Finally, a key feature of regime behavior was its role in serving as the guardian of traditional Chinese cultural traditions. Regime spokesmen portrayed Taiwan as the logical extension of Chinese culture with appropriate adaptations due to the absorption of Western technology and ideas. They viewed the adherence of the People's Republic of China to the principles of Marxism-Leninism as a deviation from the Chinese cultural heritage.

Social and Cultural Values

The key to Taiwan's transformation has been a mixing of Western technology with traditional values. Taiwan has drawn on traditional culture to reformulate the concepts of nationalism, secularism, and egalitarianism (in a limited sense) after it was found to be necessary to bring about a process of economic and social reformulation.[12] There is, for example, ample basis in the traditional Chinese concept of nationalism for the view of China as a "universal empire" or "middle kingdom" that must blend out-

FIGURE 7.2 Taiwan: Political Map, 1961

	ANTISYSTEM	LEGAL OPPOSITION	CENTRAL COMBINATION	LEGAL OPPOSITION	ANTISYSTEM
EXTERNAL SECTORS	PRC	W. Europe G. Britain	Japan U.S.A. USAID		
SOCIAL SECTORS		Lower-class Taiwanese (Haaka and Kukicen); Taiwainese (all classes) (9,000,000)	Upper- and middle-class mainland Chinese exiles (2,000,000)		
REGIME					
POLITICAL PARTIES	Taiwanese Independence Movement →	Democratic Socialist party Chinese Youth party	Nationalist party		
PRESSURE GROUPS		Labor	Business groups Press	Business groups	

SOURCE: Marc Lindenberg.

side ideas with its own long and valuable historical tradition. The secularity of religion in China, which stresses the common theme of "how to organize an ideal society right here on earth as opposed to paying attention to ghosts and spirits," is critical in providing a foundation for acceptance of economic development and change. Sun Yat-sen's concepts also placed importance on reducing inequalities and the responsibility of government.

> The extent of social concern is embodied by the Three People's Principles, broad equalization of land ownership, and curbing private capital ownership. Over time these slogans have been attached to many different policy interpretations . . . in respect to the need for economic growth. Recently, land reform policy of the early years has been changed to a policy that encourages a collective managerial approach to farmland. Public enterprises were dismantled when wisdom dictated that this kind of change was not the result of revisionist conspiracy. Far more important than is ordinarily recognized is the ideology of nondogmatic pragmatism. . . .[13]

Finally, the emphasis on meritocracy in examinations and positions but also in acceptance of authority provides a compliance structure that has permitted implementation of economic change. The family with its extended relationships along patrilineal lines is still given key value. Proper authority relationships and respect for elders and authority figures is considered to be of the utmost importance.

While mainland exiles have continued to dominate Taiwan's social structure, the values of secularism and nationalism have been generally accepted by the population. The concept of equality in absolute terms is not in evidence, but sufficient attention to land reform and economic leveling has helped provide regime stability.

General Economic Strategy and Results, 1947–1960

It is useful to divide the years from 1947 to 1960 into two subperiods: 1947–1952, characterized by early economic deterioration and subsequent stabilization; and 1953–1960, characterized by growth and diversification of the agricultural sector and by industrial import substitution. In the second period two different four-year plans were launched (1953–1957 and 1957–1960).

Chaos and stabilization, 1947–1952. The 1947–1952 period was an extremely difficult one for the government of the Republic of China. It included the loss of the mainland and the evacuation of almost two million refugees, a period of tensions with the Taiwanese, high inflation, scarcity, and shortages. On the international scene relations with the United States deteriorated rapidly and U.S. assistance was cut off. With the onset of the Korean War, however, aid was resumed because Taiwan was considered essential to U.S. strategic interests. Friction with the government of the People's Republic of China remained high, and the government of the Republic of China struggled to gain international legitimacy and recognition.

The objectives of the early part of the period were, first, to gain control of a runaway economic situation and, later, to implement a stabilization program. In the early period, 1947–1949, the government pursued inflationary policies in an effort to finance the war. In the absence of tax revenues, and with serious military and other responsibilities, it expanded the money supply rapidly and engaged in high levels of deficit spending. Hyperinflation was one result.[14] Between 1946 and 1948, "prices had risen at an annual rate of 500 percent and then accelerated to about 3,000 percent in the first half of 1949."[15]

The objective of stabilization was achieved through a mix of monetary reform and foreign assistance, with preferential interest rates on time deposits and a balanced government budget. Monetary reform was attempted through devaluing the old Taiwan dollar to a rate of 40,000 per U.S. dollar, establishing a new currency (the new Taiwan dollar) with an official exchange rate of 15 per U.S. dollar, and then setting a limit of issuance of the new currency at 200 million Taiwan dollars with a 100 percent reserve in gold, silver, and foreign exchange. Attempts to unify the exchange rate were also made (see table 7.1).

In an effort to increase the savings rate and to remove currency from circulation, the Central Bank established a series of preferential interest rates in the banking system. Finally, government expenditures were reduced marginally and existing deficits began to be covered by increases in U.S. economic assistance (see figure 7.3).

In addition, to set the basis for further growth of the agricultural sector and provide social stability, a comprehensive agrarian reform was carried out (see the section on agricultural policy, below). By 1951 prices began to stabilize, and overall economic growth was 11 percent (see table 7.2 for data on economic recovery).

Agricultural diversification and industrial import substitution, 1953–1960. Between 1953 and 1960

TABLE 7.1 Taiwan: Exchange Rates and Interest Rates, Official and Unofficial, 1949–1961

	Exchange rate (new Taiwan dollars per U.S. dollar)		Interest rate (percentage per month)		
Year	Official	Black market	Bank of Taiwan[a]	Other banks	Unorganized money market
1949	—	40,000.00	—	—	—
1952	15.65	23.11	1.80	3.30	6.6
1953	15.65	26.49	1.20	2.40	4.3
1954	18.78	30.31	0.99	1.98	4.1
1955	24.78	39.84	0.99	1.86	5.5
1956	24.78	38.53	0.90–0.99	1.86	3.9
1957	24.78	38.40	0.90–0.99	1.86	3.6
1958	36.38	46.58	0.90–0.99	1.86	3.3
1959	36.38	45.26	0.90–0.99	1.74	3.9
1960	36.38	42.26	0.90–0.99	1.74	3.9
1961	40.03	43.89	0.90–1.35	1.56	2.7

a. Applicable only to government enterprises. Interest rate on loans to private enterprises is the same as charged by other banks since 1956.
SOURCE: CBC (Central Bank of China).

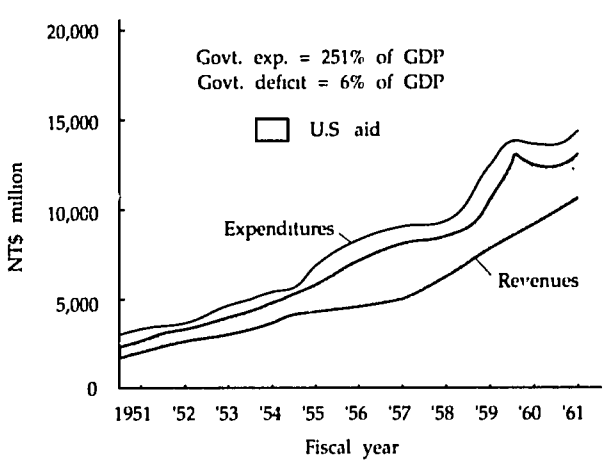
tensions with the People's Republic of China remained high. The worst incidents were in 1958. After that year Taiwan began to attract foreign investment in greater amounts. The relationship to the United States remained a close one. Almost US$1 billion in economic assistance was disbursed. Land reform was consolidated, while gains in productivity and output took place in agriculture (see tables 7.3 through 7.6). Industry showed even more impressive growth.

The objectives of the 1953–1956 four-year plan were to (1) promote agricultural and industrial production; (2) foster economic stability; and (3) improve the balance of payments. For the second plan, in 1957–60, the objectives were to (1) stimulate industrial (import substitution) and mining development; (2) promote exports (on a limited basis); (3) increase employment; and (4) improve the balance of payments. Economic growth targets were set at between 7 and 8 percent for the entire period.

In an effort to encourage industrial import substitution, tariff protection was provided, and the exchange rate became overvalued. However, export promotion was encouraged through tax rebates on import duties for raw materials. In the agricultural sector, to force diversification, the government offered guaranteed prices for sugarcane, corn, mushrooms, and other products and also tried to control the supply of rice.

Between 1953 and 1960, GDP growth averaged between 6 and 7 percent, agricultural growth 4 percent, and industrial growth 14 percent. The importance of the composition of each sector and its contribution to GDP began to change.

FIGURE 7.3 Taiwan: Consolidated Government Revenues and Expenditures, 1951–1961 (millions of new Taiwan dollars)



NOTE: U.S. economic assistance was 10% of the deficit in 1951 and 5% in 1961. In 1951 foreign investment was 1% of an $83-million U.S. foreign assistance budget and in 1961 14% of $97-million U.S. foreign assistance budget.
SOURCE: Adapted from Jacoby, 1966: 94.

TABLE 7.2 Taiwan: Gross Domestic Product of Major Sectors at 1964 Prices

	Total economy			Agriculture			Industry			Others		
Year	Value (N.T. $ million)	Growth rate (%)	% in total economy	Value (N.T. $ million)	Growth rate (%)	% in total economy	Value (N.T. $ million)	Growth rate (%)	% in total economy	Value (N.T. $ million)	Growth rate (%)	% in total economy
1952	36,675	11.6	100	15,323	–3.10	41.78	4,264	7.11	11.63	17,088	31.01	46.59
1953	39,477	7.64	100	16,122	5.21	40.84	5,369	25.91	13.60	17,986	5.26	45.56
1954	41,209	4.39	100	15,447	–4.10	37.48	7,122	32.65	17.28	18,640	3.64	45.24
1955	44,738	8.56	100	17,174	11.18	38.39	7,006	–1.63	15.66	20,558	10.29	45.95
1956	46,815	4.64	100	17,383	1.22	37.13	7,098	1.31	15.16	22,334	8.64	47.71
1957	50,014	6.83	100	18,203	4.72	36.40	7,933	11.76	15.86	23,878	6.91	47.74
1958	53,249	6.47	100	19,861	9.11	37.30	8,823	11.22	16.57	24,565	2.88	46.13
1959	57,841	8.62	100	20,329	2.36	35.15	10,958	24.20	18.95	26,554	8.10	45.90
1960	62,251	7.62	100	19,139	–5.85	30.74	11,855	8.19	19.04	31,257	17.71	50.22
1961	67,368	8.22	100	20,045	4.73	20.75	13,752	16.00	20.41	33,571	7.40	49.84

NOTE: The estimates of total gross domestic product are valued at factor (as distinct from market) prices. The figures for Agriculture and Industry are based on estimates in current prices deflated by index numbers of prices received by farmers and of prices for industrial products. Others were obtained by deducting the figures for Agriculture and Industry from the total gross domestic product.

SOURCE: Mo-Huan Tsing, *Taiwan: Industrialization and Trade Policies* (New York: Oxford University Press, 1970), 224.

TABLE 7.3 Taiwan: Recovery of Key Products, 1938–1953

	Recovery 1938–53 (%)	Most important products before war
Agriculture	—	—
Rice	114	3
Sweet potatoes	129	5
Sugar cane	75	1
Bananas	44	2
Pineapples	46	4
Processed goods (agricultural and manufactured)		
Sugar	62	1
Canned pineapple	21	2
Cement	23	3
Paper	150	—
Sulfuric acid	375	—
Calcium superphosphate	287	—

SOURCE: Compiled from statistics of the Ministry of Economy and the Department of Agriculture, *Industry in Free China*, January 1959.

TABLE 7.4 Taiwan: Agricultural Employment, Production, and Development, 1952–1960 (selected indexes)

	1952	1956	1960
Agricultural population	100.0	110.4	126.2
Agricultural employment	100.0	100.1	104.7
Total agricultural production	100.0	121.0	142.8
Agricultural crop production[a]	100.0	116.8	132.1
Output of crops and livestock	100.0	121.4	139.1
Agricultural crop production per worker	100.0	115.4	126.1
Man-days of labor	100.0	104.1	111.5
Agricultural crop production to man-days of labor	100.0	112.2	118.5
Man-days of labor to employment	100.0	104.0	106.5
Fixed capital	100.0	107.5	116.6
Working capital	100.0	151.5	169.7
Multiple cropping	171.9	175.5	183.6
Diversification[b]	3.54	4.07	4.01

a. Excludes forestry, fishing, and livestock.
b. The diversification index is calculated for 181 different crops by the formula 1/(value of each product/value of total products).
SOURCES: Parameters of land and population and indexes of production from Economic Planning Council, *Taiwan Statistical Data Book, 1975* (Taipei, 1975), 47–51; indexes of labor man-days, output of crops and livestock, working capital, and fixed capital from Samuel P. S. Ho, *Economic Development in Taiwan: 1960–1970* (New Haven: Yale University Press, 1978), 245; index of diversification from Shirley W. Y. Kuo, "Effects of Land Reform, Agricultural Pricing Policy, and Economic Growth on Multiple Crop Diversification in Taiwan," in *Economic Essays*, vol. 4 (Taipei: National Taiwan University, Graduate Institute of Economics, Nov. 1973); other indexes from calculations by the authors.

TABLE 7.5 Taiwan: Distribution of Farm Families and Agricultural Land, by Type of Cultivator, before and after Land Reform

	Before land reform (1949)		After land reform (1957)	
Status	Number of families	%	Number of families	%
Owner	224,378	36	455,357	60
Tenant	239,939	39	125,653	17
Part-owner	156,558	25	178,224	23
Total	620,875	100	759,234	100

SOURCE: Department of Agriculture & Forestry, Provincial Government of Taiwan, *Taiwan Agricultural Yearbook 1950*, 28; *1967*, 27.

Agricultural Policy

Agricultural policy 1949–1952. Agricultural policy and performance can be viewed as having two subphases: a recovery phase, in which production was restored to its prewar levels (see table 7.4); and a second phase, in which land reform helped to restructure the agricultural sector.

According to one source:

> Three interrelated policy elements played a crucial role in this phase: (1) the establishment of the Chinese-American Joint Commission on Rural Reconstruction (JCRR) in 1948, which became a major institution— comparable to the Ministry of Agriculture—in planning and helping to implement Taiwan's agricultural development; (2) U.S. foreign aid which was largely directed toward agriculture at the outset . . . ; and (3) a set of land reform measures.[16]

The land measures had three components. First, a rent reduction program was developed to reduce farm rents from what had traditionally been 50 percent of annual yields to 37 percent. Second, the government sold public land inherited from the Japanese to cultivators at subsidized prices. Finally, it instituted a "land to the tiller" program that forced landlords to sell estates in excess of three hectares. They were compensated with bonds that could be used as equity in industrial development and sometimes with actual enterprises.

> The program affected approximately 28 percent of the farm families and over 16 percent of the land area. . . . Thus, under these last two steps about 210,000 hectares of land were redistributed or approximately one-fourth of the total cultivated area in 1951–55. . . .[17]

The output of the agricultural sector grew substantially and the product mix began to change.

Agricultural policy 1953–1960. During the remainder of the period, farmers' organizations were strengthened, infrastructure and irrigation systems expanded, crops diversified, and technological change introduced.

The government followed a policy of stabilization of the price of rice through various methods of compulsory rice collection. It established collection of land taxes in kind, a rice fertilizer barter system, and the purchase and collection of rice at a price lower than the market price. The government made huge profits from the rice collection operation.[18]

These profits in turn permitted it to offer guaranteed prices for sugarcane, corn, mushrooms, asparagus, and other crops. The shift toward labor-intensive crops led to a reduction of underemployment; additional labor surplus was absorbed in the growing industrial sector.

Industrial Policy

Industrial policy 1949–1952. In the postwar period, the Chinese inherited an industrial sector operating at well below 50 percent of its prewar peak (see table 7.3). Since the Japanese had owned enterprises that produced over 50 percent of the industrial sales, the Chinese had to decide what to do with these state-owned industries. In the initial period, they opted to keep and operate the Japanese-owned industries as public enterprises and to concentrate on recovering the basic prewar production level. At the same time, they selected several key industries—primarily textiles and fibers— to begin the process of industrial import substitution. By 1952 many of the industrial operations had recovered to their prewar peaks.

TABLE 7.6 Taiwan: Terms of Trade for Industry and Agriculture (1952 = 100)

	Total economy			Industry			Agriculture		
Period	Unemployment (percentage)	Wholesale prices	Retail prices	Prices of industrial products	Prices of industrial materials	Industrial real wages	Prices received by farmers	Prices paid by farmers	Agricultural real wages
1951	—	81.22	85.60	91.41	84.31	—	69.29	73.90	—
1952	8	100.00	100.00	100.00	100.00	100	100.00	100.00	100
1953	7	108.75	104.47	109.14	105.64	102	134.77	136.88	104
1954	7	111.33	104.75	113.18	105.22	104	124.11	126.75	106
1955	6	127.00	119.52	130.20	122.43	106	137.21	138.88	106
1956	6	143.16	131.96	155.42	145.58	108	148.16	151.45	104
1957	5	153.48	140.06	176.26	171.77	110	164.15	161.79	110
1958	5	155.63	144.47	173.42	172.19	112	164.92	163.58	112
1959	6	172.47	159.75	184.12	201.98	114	182.98	180.19	116
1960	6	196.87	189.24	198.09	208.22	116	254.96	243.72	120
1961	7	203.24	204.07	194.27	207.58	118	262.88	254.71	123

SOURCE: *Taiwan Monthly Commodity-Price Statistics.*

TABLE 7.7 Taiwan: Evolution of Controls over Imports of Manufactures, by Category, 1953–1960

Category of imports	1953 No. of items	1953 Percentage of no.	1956 No. of items	1956 Percentage of no.	1960 No. of items	1960 Percentage of no.
Permissible	280	55.23	252	48.10	506	53.72
Controlled	20	3.94	49	9.35	378	40.13
Suspended	165	32.55	192	36.64	3	0.32
Prohibited	28	5.52	25	4.77	33	3.50
Others[a]	14	2.76	6	1.14	22	2.33
Total	507	100.00	524	100.00	942	100.00

a. Imports partly permissible, controlled, suspended, or prohibited.
SOURCE: Fei and Ranis 1964.

Industrial policy 1953–1960. Although industrial planning was by no means a rigid process, the Taiwanese stimulated import substitution and balanced agricultural with industrial development. In the early period, for example, priority was given to processing agricultural products. The government turned over key Japanese industries (notably four former public corporations) to the private sector as partial compensation for lands taken in the land reform. They helped large private-sector landowners overcome the problems of transition involved in managing new industrial operations. The concentration on absorption of rural labor in industrial operations was part of a consciously considered process.

In his work on Taiwan's early industrial policy, Mo-Huan Tsing notes six key elements: (1) direct control over industry; (2) foreign trade and exchange controls; (3) tariff protection; (4) export promotion; (5) encouragement of investment; and (6) subsidized credit.[19] Let us look at each of these elements in more detail.

Between 1953 and 1960, the Chinese government exercised a great degree of direct control over the industrial sector. It did not deliberately set out to create public enterprises. Nonetheless, it inherited industries that produced 50 percent of the sector's sales. The government's policy was to contain future expansion of the public-enterprise sector and reduce it gradually, as well as to encourage private investment in the industrial sector. It actually built factories—a plate glass factory, for instance—and turned them over to private investors. At the same time, it actively developed policy as to the kind of industry to be developed, using licensing to permit, as well as restrict, private-sector operations. Criteria for such decisions were based on factors such as availability of foreign exchange, market potential, capital shortages, and technical feasibility. For example, in 1954 the government actually limited the development of additional textile factories because the domestic market was saturated.

In addition to direct control of licenses, the government used import and exchange controls as an active policy mechanism. In the 1950s it rated imports on a scale of "permissible," "controlled," "suspended," and "prohibited." During the years 1949–1960, the policies changed (see table 7.7). A third mechanism for influencing industrial policy was tariff structure. Earlier, during the 1952–1960 period, protection was maintained in an effort to protect, first, light labor-intensive industry that used

TABLE 7.8 Taiwan: Percentages of Items Falling in Different Ranges of Tariff Rates in Four Tariff Schedules, 1948–1959

Tariff rates	1948	1955	1959
Below 30 percent	39.6	38.7	48.0
30–50 percent	28.7	29.8	22.7
50–100 percent	21.5	20.0	21.1
Above 100 percent	10.2	11.4	8.2

SOURCE: Hsu 1977: 106.

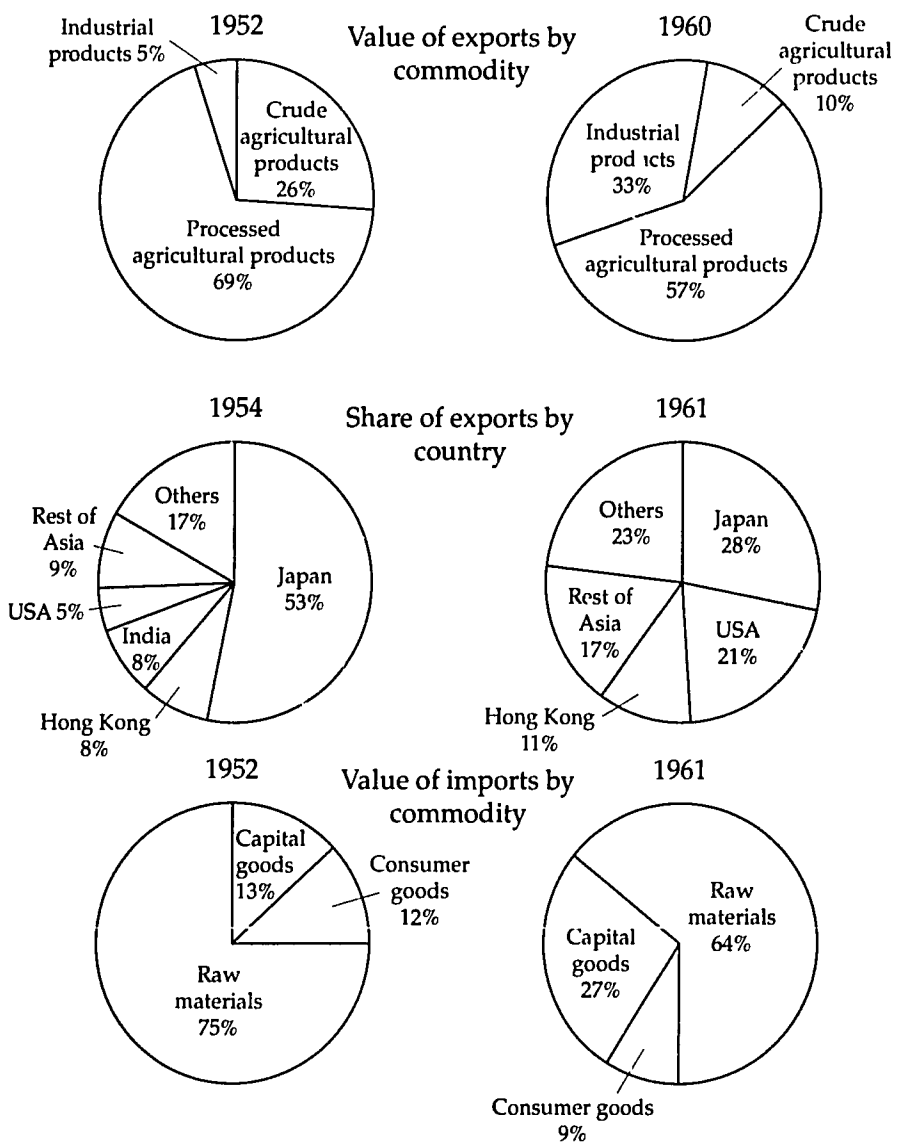
local raw materials; and later, light industry intensive in labor, that used foreign raw materials (see table 7.8 for details). Although the thrust of the policy moved toward import substitution, some effort was made to encourage export promotion simultaneously. In 1951 and 1952, tax rebates were given on imported materials used in exports. Attempts were also made to encourage foreign investment. Finally, the Bank of China began to give concessionary credit to import-substituting industries.

During the 1953–1960 period, the industrial sector experienced considerable growth (see figure 7.4 and table 7.9 for pertinent data). Labor productivity increased, and labor absorption increased substantially.

The Future: Problems and Prospects

As Taiwan searched for a new strategy in 1961, problems old and new continued to crop up. K. T. Li commented on some of the problems encountered during the transition in a speech to the News Editors' Association:

FIGURE 7.4 Taiwan: Changes in the Composition of Imports and Exports, 1952–1961



SOURCE: Council for Economic Planning and Development, Republic of China (Taiwan), 1962.

TABLE 7.9 Taiwan: Value Added and Employment in the Industrial Sector, 1952–1961

	Value added			Employment		
	Share in industrial sector		Annual average growth	Share in industrial sector		Annual average growth
Sector	1952	1961	1952-1961	1952	1961	1952–1961
Food	32	40	14	24	20	13
Textiles	14	10	13.9	22	24	21
Wood and wood products	6	5	12.8	6	4	15
Paper	5	5	8.2	3	5	28
Chemical products	9	7	7	10	9	17
Petroleum and derivatives	5	5	16	0.004	1	33
Nonmetallic products	3	6	24	10	10	19
Metallic products	4	10	32	12	15	22
Electrical products	1	2	23	0.004	2	800
Others	21	10	15	13	10	15
Total percentage	100	100	13.4	100	100	18
Total value	4.2[a]	3.7[a]		208,533[b]	344,677[b]	
Local sales as a % of total sales of manufactured goods	90	80				

a. Millions of new Taiwan dollars.
b. Number of persons employed.
SOURCE: Mo-Huan Tsing, *Taiwan: Industrialization and Trade Policies* (New York: Oxford University Press, 1970), summary of exhibits A-1-35.

The planning process. In 1953, the nation saw the need for setting up machinery within the Central Government responsible for economic planning. Consequently . . . the Financial and Economic Working Group of the Executive Yuan was reorganized into the Economic Stabilization Board . . . . In 1957 the former Administrative Reform Committee took the view that the functions of the working group overlapped those of several ministries . . . . Its functions were subsequently divided among the Ministry of Economic Affairs (MOEA), Ministry of Communications and the council for USAID. . . . It soon became evident that the task of the two ministries could not be accomplished due to insufficient personnel and financial resources. . . . This eventually necessitated the activation of the Industrial Coordinating and Planning Group and the Agricultural Planning and Coordinating Group under the Ministry of Economic Affairs, financed respectively by USAID and the Joint Commission on Rural Reconstruction (JCRR). . . . In 1960 a separate unit was set up in the Ministry of Communications (MOC) for the communications sector. . . . Despite efforts to maintain dialogue between the planning groups, the lack of central authority is a hindrance to aggregate planning. . . .[20]

Data base and trust levels. Some overly conservative manufacturers were reluctant to furnish information about their business operations and prospects. Those who were cooperative would provide information only in regard to projects already in process . . . . The setting of production targets also ran into difficulties for some time. Targets were often understated deliberately by some of the public enterprises for the purpose of obtaining special performance bonuses. . . .[21]

Private-sector participation. . . . Highly promising investment projects were included in the industrial program by the planners but their implementation had to be postponed because private capital would not come forward. Plans for a four ton per day PVC plant calling for an investment of US$1.5 million and a seven ton per day rayon plant had to be scrapped. The government had to entrust implementation of other projects to the Central Trust of China because no prospective investors could be found.[22]

> *Resistance by existing industrialists.* . . . The government was pestered with many requests from established industrialists to restrict construction of new plants on the grounds that their production had already saturated the domestic market. (At the same time, the move to stimulate exports met with resistance) . . . my suggestion to promote textile exports provoked a heated debate. The prevailing opinion [was] that our textile industry can never compete with Japanese manufactures. . . .[23]
>
> *Government red tape.* Businessmen complained about entry and exit permits, all kind[s] of registrations for doing business, transfers of land title, applications for electric power supply, licensing of commodity imports and exports, customs clearance bonding and rebate of customs duties payable to export processors and inward and outward remittances. . . .[24]
>
> *Competition between agriculture and industry.* As a result of government policies at the beginning of the sixties, the need for land to accommodate factory expansions and site new plants was increased. . . . This development, came into conflict with the much rooted Chinese tradition that farmland must not be put to any other use. It led to opposition from government authorities responsible for agricultural production.[25]

In addition to the problems mentioned in the speech, planners were concerned about the cutoff of U.S. assistance in five years, the problems that future conflicts in Asia might cause for attraction of foreign investment, and Taiwan's competitive position. They needed to take all these problems into account as they designed the new strategy for 1961–1964.

Study Questions

1. Describe Taiwan's economic strategies between 1949 and 1960. What problems did policy makers have and how did they try to solve them?

2. What economic strategies were viable for 1961–1964?

3. What sources of growth might be found in the economy, and what specific policies would be necessary in the agricultural and industrial sectors?

4. What general monetary, fiscal, commercial, and labor policies would be useful?

5. What political, economic, and social problems might be expected as a result of the strategy, and how might these problems be managed?

Notes

Works cited by only author and date are fully listed in the bibliography at the end of this book.

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16. Walter Galenson (1979: 171–72).
17. Kuo et al. (1981: 50).
18. Ibid.
19. See Gustav Ranis (1979).
20. K. T. Li (1976: 91–92).
21. Li, p. 98.
22. Ibid., p. 99.
23. Ibid., p. 100.
24. Ibid., p. 101.
25. Ibid., p. 112.

The Indonesian Oil Crisis, 1986

In January 1986 President Suharto released the Indonesian budget for the 1986–87 fiscal year. For the first time since Suharto came to power in 1966, the budget called for a spending reduction: a 7 percent drop in nominal terms compared with the previous year's estimated spending (see table 8.1).

The cause of the budget cut was an anticipated 14 percent decline in revenues from oil and natural gas because of falling world prices. Such revenues provided over half of central government income in 1985–86. Additional steps to meet the anticipated revenue decline included reforms in the land and building tax and in the stamp duty, and a call for greater remittances (through increased efficiency) from state-owned enterprises. In spite of the unprecedented budget cut and the increased nonenergy revenue projections, the current account deficit was projected to rise 5.2 percent in 1986–87, to 2,214 billion Indonesian rupiahs (rps.), compared with 2,104 million rupiahs estimated for 1985–86. However, Suharto pledged in his parliamentary budget announcement not to devalue the rupiah.

Like any country facing such an economic squeeze, Indonesia had three basic tools at its disposal: government spending cuts and taxation; internal and external borrowing; and trade policy, including primarily the exchange rate but also tariffs, quotas, and other trade restrictions. The specific history and politics of Indonesia determined the appeal and feasibility of government actions in these three areas.

Since coming to power in 1966, President Suharto has faced few serious challenges to his rule. The government party dominates the parliament; opposition parties are weak, and the army supports the president. Nevertheless, political considerations cannot be entirely ignored in choosing economic policies. Competing interests include proponents of agricultural versus industrial development; rural versus urban residents; government officials; army officers and private businessmen implementing government-funded investment projects; the beneficiaries and victims of trade protection; economic planners; and external forces such as private and government creditors, the World Bank, and the International Monetary Fund.

The Indonesian economy is characterized by a strong government role and heavy dependence on the extractive industries: agriculture and mining, including oil and gas production. Government economic control includes not only macroeconomic policy instruments but also sole rights over many natural resources, public enterprises in many sectors, and numerous bureaucratic controls.

The industrial origin of 1985 gross domestic product (GDP) is shown in table 8.2. Agriculture made the largest contribution, at a quarter of GDP, while mining, including energy production, contributed 16 percent. Together these sectors contributed 40 percent of GDP. They also accounted for virtually all of Indonesia's exports: oil and gas alone were 68.4

This case was written by researcher Naomi Goldstein under the supervision of Professor Shantayanan Devarajan, both of the John F. Kennedy School of Government at Harvard University. It relies heavily on "Indonesian Economic Policies and Their Relation to External Debt Management," an unpublished paper by Wing Thye Woo of the University of California at Davis and Anwar Nasution of the University of Indonesia (Cambridge, Mass., October 1987).

TABLE 8.1 Indonesia: Breakdown of Government Revenue and Expenditure, 1981–1987 (billions of rupiahs)

	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87
Revenue[a]						
Domestic revenue	12,213	12,418	14,433	15,905	19,253	17,833
Direct taxes[b]	10,098	9,982	11,584	12,708	13,625	12,903
Oil/gas company tax	8,628	8,170	9,520	10,430	11,145	9,738
Personal income tax	207	289	399	2,121[c]	2,313[c]	2,881
Nonoil/gas corporation tax	559	675	757			
Withholding tax	513	642	628			
Tax on interest, dividends, and royalties	88	101	148			
Land tax	94	105	132	157	167	284
Indirect taxes[c]	1,743	1,932	2,265	2,372	3,928	3,857
Sales taxes & VAT	534	708	831	878	2,327	2,143
Excise tax	438	544	620	773	944	1,055
Import duties	536	522	557	530	607	580
Export tax	129	82	104	91	50	79
Other taxes[d]	44	69	65	138	208	119
Non-tax receipts	337	435	519	687	1,492	954
Foreign aid receipts	1,709	1,940	3,882	3,478	3,573	3,589
Total[f]	13,922	14,358	18,315	19,383	22,826	21,422
Expenditure						
Routine expenditure	6,978	6,996	8,412	9,429	11,952	13,126
Personnel	2,277	2,418	2,757	3,047	4,018	4,213
Materials	923	1,041	1,057	1,183	1,367	1,367
Regional subsidies	1,209	1,315	1,547	1,883	2,489	2,640
Debt service[e]	931	1,225	2,103	2,776	3,323	4,223
Other	1,638	997	948	540	754	684
Development expenditure	6,940	7,360	9,899	9,952	10,873	8,296
Total[f]	13,918	14,356	18,311	19,381	22,825	21,422

NOTE: Inclusive dates are for fiscal years ending March 31.
a. Budget.
b. Excludes unspecified "other" taxes.
c. After the tax reform of January 1, 1989, a single income tax replaced these separate taxes.
d. Direct and indirect.
e. Internal and external.
f. Totals may not add due to rounding.
SOURCE: *Country Profile: Indonesia, 1986–87* (London: Economist Intelligence Unit, 1988)

percent of export value in 1985. Imports were primarily intermediate products rather than consumer goods, including machinery, petroleum products, chemicals, minerals, and metals. Indonesia's largest export customers were Japan and the United States. These countries were also Indonesia's largest suppliers of imports.

Indonesia is the fifth most populous country in the world, with a 1985 estimated population of 163 million. The country is comprised of 13,000 islands scattered over an area of some five million square kilometers between Australia and Southeast Asia. Indonesia's population is heavily concentrated in a few islands: Java, Madura, and Bali contain almost 65 percent of the people, though only 7 percent of the land. The population is not highly urbanized, however. In 1980 only 22 percent lived in urban areas.

Suharto comes from a peasant background and has consistently emphasized the importance of improving the rural standard of living. Two historical factors may have contributed to this commitment. First, the Communist party of Indonesia (PKI) sponsored a coup attempt in 1965. The defeat of this attempt resulted in deaths estimated between 500,000 and one million, and led to Suharto's acces-

sion to the presidency. The PKI was a peasant-based movement that claimed over 20 million followers in 1965. Improvements in the rural standard of living may reduce opportunities for the PKI to organize opposition to Suharto's regime.

Second, the diversity of the ethnic groups populating Indonesia's 13,000 islands has led to numerous secessionist movements. The potential for such movements increases the importance of economic policies favoring the rural Outer Islands.

Prorural policies include not only spending on rural development projects, but also trade policies favorable to agricultural producers. Currency devaluations tend to favor the agricultural export sector over the typically urban manufacturers of import substitutes, since quantitative import restrictions make these goods practically nontradeables. Since imports of restricted goods cannot increase regardless of the price difference between imports and import substitutes, the prices of import substitutes are determined by domestic conditions rather than by world prices.

While rural development is one important national goal, industrial development also has a claim on government resources, a claim based on popular and intellectual support and on the influence of special interests. The economic policies of the Dutch colonists were seen as designed to limit Indonesia to the production of raw materials for Dutch manufacturing. Consequently industrialization is an important symbol of independence and is considered essential to economic growth. The result is not only government investment in industrialization, but also high levels of protection for the manufacturing sector, primarily through quotas and monopoly licenses, many of which are held by relatives and friends of government officials.

TABLE 8.2 Indonesia: Origins and Components of Gross Domestic Product (GDP), 1985

Origins of GDP, 1985 (percentage of total)[a]		Components of GDP, 1985 (percentage of total)[a]	
Agriculture	23.6	Personal consumption	59.2
Mining & quarrying	16.2	Government consumption	11.9
Manufacturing	13.5	Gross domestic capital formation	27.3
Construction	5.3	Exports	22.7
Wholesale & retail trade	15.4	Imports	–21.1
Transport & communications	6.5	GDP at market prices	100.0
GDP at factor cost (incl. other)	100.0		

Principal exports, 1985 (US$ millions)[a]		Principal imports, 1985 (US$ millions)[a]	
Crude oil & products	9,083	Machinery & equipment	2,699
Natural gas	3,635	Chemicals	1,514
Wood & products	1,194	Mineral products	1,451
Rubber & products	718	Base metals	1,331
Textiles & garments	559	Transport equipment	889
Coffee	556	Resins & plastics	489
Tin & products	247	Prepared foods	407
Total (incl. other)	18,587	Total (incl. other)	10,262

Main destinations of exports, 1986 (percentage of total)[a]		Main origins of imports, 1986 (percentage of total)[a]	
Japan	44.9	Japan	29.2
USA	19.6	USA	13.8
Singapore	8.4	Singapore	9.1
Netherlands	3.1	West Germany	6.7
South Korea	2.4	Saudi Arabia	6.0
Hong Kong	2.3	Australia	3.9
West Germany	2.3	UK	3.8

a. Provisional.
SOURCE: *The Economist*, "Country Report: Indonesia," third quarter (London: Economist Intelligence Unit, 1987), p. 2.

The long-standing involvement of army officers in business ventures means there is a powerful constituency favoring trade protection for industry. During the war for independence in the 1940s, the army was self-supporting by necessity. Under Suharto's predecessor, Sukarno, army generals were expected to raise revenue to supplement their budgets; under Suharto senior army officers have continued to be heavily involved in business. This involvement is consistent with the doctrine of *dwifungsi*, which means "dual function" and refers to the army's dual role in defense and in development.

These ambidextrous army officers are important members of one of the two major camps competing to influence economic policy in Indonesia. These two groups are known as the "technician-engineers," on the one hand, and the "technocrat-economists," on the other. The engineers include officials in the Ministries of Trade, Industry, Communications, and Manpower, and structuralist economists, as well as army officers. Many come from nonacademic backgrounds. They favor large government investments in capital-intensive projects as well as trade protection. Their business interests and institutional affiliations lead them to prefer import-substitution industrialization as the means to economic growth.

The economists include officials in the Ministry of Finance and the National Planning Body. Many are U.S.-educated neoclassical economists, and the group is sometimes known as the "Berkeley Mafia." This group opposes trade protection, and in the 1980s has advocated austerity measures in response to falling oil revenue. In these positions it is allied with outside advisors like the World Bank. The group's institutional affiliations give it control over macroeconomic policies but not over tariffs, which are controlled by the Ministry of Trade. Consequently its members tend to focus on exchange-rate management as the means to growth through increased exports.

The 1960s: Austerity and Stabilization

When Suharto came to power in 1966 after the bloody suppression of the communist rebellion, he inherited an economy in chaos. An overvalued exchange rate over a prolonged period had damaged the export industries. Import-competing industries, protected by high tariffs, were notoriously inefficient. The complex tax system featured high marginal rates and serious corruption. The government had fueled inflation by monetizing large deficits and by extending central bank credit to state enterprises and private-sector favorites. Central government spending was 103 percent larger than revenue in 1963, 140 percent in 1964, and 163 percent in 1965. The inflation rate had grown from 127 percent in 1963 to 152 percent in 1964; in 1965 it reached 662 percent. External debt-payment obligations in 1966 were US$530 million: 70 percent of GDP and 132 percent of exports.

Several months after assuming power, Suharto's government announced a new economic program of which the central plank was a commitment to balanced budgets. This meant no internal borrowing to finance government deficits, so that government expenditure would be limited to the sum of domestic revenue and external loans. At the time this constraint was quite stringent, since foreign loans were not forthcoming. In addition, central bank credit was significantly reduced for both state and private enterprises. Inflation fell to 100 percent in 1967 and 18 percent in 1969. By 1971 inflation was only 4 percent.

In addition to these expenditure reduction measures, the government devalued the rupiah from 10 to 100 per U.S. dollar,[1] and allowed moderate devaluations at frequent intervals over the next several years whenever balance-of-payments problems emerged. To encourage exports, the government also removed price controls from many commodities. Real nonoil exports (primarily agricultural commodities) rose 12 percent between 1965 and 1968, and real GDP increased at an 8 percent annual rate from 1968 to 1973. Indonesia also secured a reorganization of its external debts: its creditors agreed to a long-term rescheduling of existing debts and to a plan for further loans on generous concessionary terms.

The 1970s: Energy Revenues Support Rapid Growth

The 1970s were characterized by high growth in GDP and government spending, financed by growing energy revenues and foreign borrowing. The government continued to adhere to the rule of no internal borrowing, but this constraint no longer limited government spending. The growth of oil and gas export volume, combined with the price increases of OPEC I (1973) and II (1979) is the most striking trend of this period. Oil and gas tax revenues grew almost twelvefold in real terms between 1969 and 1970, and between 1979 and 1980.

One of the critical events of this period was the crisis of 1975 when Pertamina, the state oil company, overextended itself in the foreign credit market. This crisis strengthened the role of the technocrat-economists vis-a-vis the technician-engineers.

Trade policy. The rupiah remained stable at rps. 415 per U.S. dollar for over seven years, from August 1971 to October 1978. This stability was possible because there was a strong balance-of-payments position throughout this period. The current account deficit was never greater than 4 percent of GDP, and in some years there was a current account surplus (see table 8.3). Growth averaged 7.9 percent annually during this period, and inflation 22 percent.

The government reduced a number of duties on tradeable goods in 1976. However, they were often replaced by quotas or monopoly import licenses. Consequently government revenues were transformed into rents for private enterprises, with little resulting stimulus to the nonenergy tradeables sector.

While energy exports were rising both in volume and revenue, nonenergy exports were also rising in volume, in dollars, and in the volume of imports for which they could be exchanged. However, the inflation driven by the growth of the energy sector was lowering the price ratio of tradeables to nontradeables (the real exchange rate). Producers of tradeable goods were selling at prices determined by the world market. Meanwhile, inflation was steadily reducing the domestic purchasing power of their revenue, and raising the prices of their domestic inputs. One indicator that the Indonesian nonenergy tradeables sector was being hurt, even though it was growing by some measures, is that it grew much more slowly than Malaysia's and Thailand's exports of similar products (see table 8.4).

Perhaps in response to the deteriorating real exchange rate, the government devalued the rupiah by 50 percent in November 1978 even though there was no deterioration in the current account balance. In response, nonenergy exports increased in one year by 36 percent in volume, 52 percent in dollars, and 78 percent in domestic purchasing power. The devaluation was also followed by a sharp increase in inflation, in spite of tight credit and government efforts to control the prices of staples. In the year ending September 1979, consumer-price inflation was 30 percent, compared with 10 percent in the first ten months of 1978. This inflation eroded the effect of the devaluation. The Morgan Guaranty competitiveness measure rose from 79.6 before the devaluation to 111.3 in 1979, but fell to 101.1 by 1980.

Following the devaluation, the government announced a policy of "managed float," under which the rupiah would be linked to a basket of the currencies of its main trading partners rather than to the dollar exclusively. In practice, however, the link with the dollar continued to predominate.

Taxation and expenditure. Real total government revenue increased almost fivefold during the 1970s. Since energy revenues grew almost twelvefold during the decade, they accounted for an increasing proportion of total revenue, rising from 26.2 percent in 1969–70 to 63.6 percent in 1979–80. During the same period total revenue grew from 9.3 to 19.5 percent of GDP (see table 8.5).

Spending was characterized by an increasing emphasis on development. The official development category grew from 36.8 percent of total gov-

TABLE 8.3 Indonesia: Selected Indicators of Economic Conditions during Period of Fixed Exchange Rate, August 1971–November 1978

Year	Current account balance (as % of GDP)	Current account receipts (as % of GDP)	Nongold reserves/imports (in weeks)	GDP growth rate (%)	Inflation rate (%)
1970	–3.4	13.6	8.1	6.5	12.3
1971	–4.0	14.8	8.7	7.0	4.4
1972	–3.0	17.2	19.1	9.4	6.4
1973	–2.9	20.7	15.3	11.3	31.0
1974	2.3	29.1	20.2	7.6	40.6
1975	–3.6	23.1	6.4	5.0	19.1
1976	–2.4	23.6	13.7	6.9	19.8
1977	–0.1	23.9	20.9	8.9	11.0
1978	2.7	22.0	20.4	7.7	8.1

SOURCE: Woo and Nasution 1987: 13.

TABLE 8.4 Indonesia: Performance Indexes of Nonoil Exports, 1969–1980 (1974 = 100)

Year	Physical volume[a]	US$	Foreign purchasing power[b]	Domestic purchasing power[c]
1969	NA	28.6	52.2	51.6
1970	NA	33.6	58.5	60.1
1971	73.9	36.0	59.4	66.9
1972	83.4	40.0	60.2	73.7
1973	96.3	73.2	91.1	103.2
1974	100.0	100.0	100.0	100.0
1975	99.6	82.6	74.2	69.5
1976	111.9	115.2	103.8	80.8
1977	121.0	159.7	133.0	100.9
1978	118.0	166.4	123.0	103.6
1979	160.0	253.7	162.4	184.6
1980	144.5	276.4	155.9	170.8

Indonesia and Its Neighbors: Average Annual Growth Rate of Nonoil Exports in U.S. Dollars, 1973–1978 (percentage)

Indonesia	Malaysia	Thailand	S. Korea	Hong Kong	Singapore
15.5	32.3	19.9	30.6	19.0	20.0

a. From deflating rupiah value series by nonoil export price index.
b. From deflating US$ value series by export unit value of industrial countries.
c. From deflating rupiah value series by Indonesian CPI.
SOURCE: Woo and Nasution 1987: 14.

ernment spending in 1969–70 to 49.7 percent in 1979–80. These figures must be interpreted with some caution, since the government includes in development some items not ordinarily categorized as such, notably military spending.

Foreign debt. During the 1970s public external debt rose substantially. Indonesia's growing energy sector made foreign loans increasingly available. While debt was rising, exports and GNP were rising even faster, so that both the debt-to-export and debt-to-GNP ratios fell during the decade. However, as an increasing proportion of Indonesia's debt became private rather than official, higher repayment rates meant that annual debt service grew faster than exports or GNP. Annual foreign borrowing fell over the decade as a proportion of government spending, from 26.6 percent in 1969–70 to 17.1 percent in 1979–80. At the same time, since government spending was rising as a proportion of GDP, annual foreign borrowing rose as a proportion of GDP, from 3.4 percent in 1969–70 to 4.0 percent in 1979–80 (see table 8.6).

The Pertamina crisis. Pertamina, the state oil company, grew rapidly from the beginning of the Suharto administration. Pertamina exemplified the power of the technician-engineers, who were playing an increasingly large and independent role in development. An army officer, General Ibnu Suktowo, became chairman of the National Oil committee in 1966 and president-director of Pertamina in 1968. In these jobs he developed a reputation for effectiveness that led to his taking over lagging development projects of diverse kinds. In addition to increasing oil production from less than half a million barrels per day in 1966 to one and a half million barrels per day in 1973, Pertamina "improved harbours, developed residential and commercial estates, and built roads and hospitals."[2] Pertamina borrowed heavily in the international credit market to finance its diverse activities.

The sequence of events culminating in Pertamina's 1975 default began with a direct conflict between the company and the technocrat-economists at the Ministry of Finance. In 1972 it came to light that Pertamina had borrowed US$350 million in short- and medium-term loans without informing the Ministry of Finance, as it was required to do under a recent regulation. When the United States discovered this, it suspended economic aid. After

TABLE 8.5 Indonesia: Revenue Structure, 1969–1980

Revenue and Sources	69/70	70/71	71/72	72/73	73/74	74/75	75/76	76/77	77/78	78/79[a]	79/80
Total revenue (bill. rps.)	251.6	354.7	440.0	590.6	967.7	1,753.7	2,241.9	2,906.0	3,534.4	4,266.1	6,696.8
Tax on nonoil income	42.9	52.8	67.4	84.6	135.4	217.8	287.2	359.8	475.8	581.2	736.5
Tax on oil and gas	65.8	99.2	140.7	230.5	382.2	957.2	1,248.0	1,635.3	1,948.7	2,308.7	4,259.6
Tax on nonoil domestic consumption	50.8	61.8	72.5	92.1	133.3	184.3	253.6	328.9	432.1	534.7	599.0
Tax on int'l trade	81.0	117.8	119.9	133.7	247.5	299.8	308.1	421.3	481.7	587.8	843.0
Tax on property	8.0	10.0	12.0	15.1	19.5	28.0	34.6	42.2	52.5	63.1	71.4
Nontax receipts	3.1	13.1	27.5	34.6	49.8	66.6	110.4	118.5	143.6	191.4	187.3
Share of total revenue (%)											
Tax on nonoil income	17.1	14.9	15.3	14.3	14.0	12.4	12.8	12.4	13.5	13.6	11.0
Tax on oil and gas	26.2	28.0	32.0	39.0	39.5	54.6	55.7	56.3	55.1	54.1	63.6
Tax on nonoil domestic consumption	20.2	17.4	16.5	15.6	13.8	10.5	11.3	11.3	12.2	12.5	8.9
Tax on int'l trade	32.2	33.2	27.3	22.6	25.6	17.1	13.7	14.5	13.6	13.8	17.6
Tax on property	3.2	2.8	2.7	2.6	2.0	1.6	1.5	1.5	1.5	1.5	1.1
Nontax receipts	1.2	3.7	6.3	5.9	5.1	3.8	4.9	4.1	4.1	4.5	2.8
Share of nonoil revenue (%)											
Income tax	23.1	20.7	22.5	23.5	23.1	27.3	28.9	28.3	30.0	29.7	30.2
Domestic consumption tax	27.3	24.2	24.2	25.6	22.8	23.1	25.5	25.9	27.2	27.3	24.6
International trade	43.6	46.1	40.1	37.1	42.3	37.6	31.0	33.2	30.4	30.0	34.6
Property tax	4.3	3.9	4.0	4.2	3.3	3.5	3.5	3.3	3.3	3.2	2.9
Nontax receipts	1.7	5.1	9.2	9.6	8.5	8.4	11.1	9.3	9.1	9.8	7.7
Indicative ratios[a]											
Total revenue/GDP	9.3	11.0	12.0	12.9	14.3	16.4	17.7	18.8	18.6	17.8	19.5
Oil and gas tax/GDP	2.4	3.1	3.8	5.1	5.7	8.9	9.9	10.6	10.2	9.6	12.4
Nonoil income tax/GDP	1.6	1.6	1.8	1.9	2.0	2.0	2.3	2.3	2.5	2.4	2.1
Property tax/GDP	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2
Nonoil income tax/domestic consumption tax	84.4	85.4	93.0	91.9	101.6	118.2	113.2	109.4	110.1	108.7	123.0
Nonoil export tax/total revenue	2.8	7.0	6.4	5.5	7.1	4.0	2.7	2.1	2.3	3.9	5.8
Memorandum items											
Tax on nonoil exports (%)	7.0	25.0	28.1	32.7	68.6	70.3	61.6	61.7	80.2	166.2	389.1
Nominal GDP (bill. rps.)	2,718.0	3,238.0	3,672.0	4,564.0	6,753.4	10,708.0	12,642.5	15,466.7	19,033.0	24,002.5	34,344.7
GDP deflator (1980=100)	13.9	15.4	16.3	18.5	24.6	36.2	40.7	46.6	52.7	58.4	77.4

a. New GDP series used from 1978 onward.

SOURCE: Adapted from Woo and Nasution 1987: 16.

TABLE 8.6 Indonesia: Selected Trends in Aggregate Expenditure and Revenue, 1969/70–1979/80 (billions of rupiahs)

Trend	1969/70	1970/71	1971/72	1972/73	1973/74	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80
Total expenditure	342.7	467.8	557.0	736.3	1,164.2	1,977.9	2,730.3	3,684.3	4,305.7	5,299.3	8,076.0
Total revenue	251.6	354.7	440.0	590.6	967.7	1,753.7	2,241.9	2,906.0	3,534.4	4,266.1	6,696.8
Foreign borrowing	91.1	113.1	117.0	145.7	196.5	224.2	488.4	778.3	771.3	1,033.2	1,379.2
Foreign borrowing as % of expenditure	26.6	24.2	21.0	19.8	16.9	11.3	17.9	21.1	17.9	19.5	17.1
Foreign borrowing as % of GDP	3.4	3.5	3.2	3.2	2.9	2.1	3.9	5.0	4.1	4.3	4.0
Memo item											
GDP deflator (1980/81=100)	13.9	15.4	16.3	18.5	24.6	36.2	40.7	46.6	52.7	58.4	77.4

SOURCE: Woo and Nasution 1987: 18.

U.S. aid resumed, Pertamina started borrowing only short-term loans, which did not require approval by the Ministry of Finance. Unfortunately, short-term rates rose following the OPEC I price increase, as the industrialized countries tried to forestall inflation through tight money. In addition, a couple of bank failures from international speculation made the international banking community nervous. Pertamina's creditors took a close look at Pertamina's debts. They discovered that they had extended US$10.5 billion in credit without ever having seen a full statement of Pertamina's finances, and that Pertamina's debt was not guaranteed by the Indonesian government. The banks refused to roll over existing debts automatically without additional information about Pertamina's finances. Pertamina defaulted in February 1975, when it was unable to meet a payment to the Republic National Bank of Dallas.

The Indonesian government assumed responsibility for Pertamina's debt, undertaking a combination of repayment, rescheduling short-term debts as longer-term debts, and canceling contracts. Even with access to international credit, the rescue operation put a strain on the country's finances: the foreign reserve position of Bank Indonesia fell from US$1.5 billion at the end of 1974 to a deficit of US$0.7 billion at the end of 1975.

The technocrat-economists were given responsibility for reorganizing Pertamina following its 1975 default, and were also given increased control over external borrowing by all state enterprises. They used this control to reduce the long-term publicly guaranteed external debt of state enterprises from US$2.2 billion, or 33 percent of total public debt at the time of the crisis, to US$1.7 billion in early 1979, which was only 13 percent of total public debt.

The 1980s: Falling Oil Revenues and Retrenchment

In 1982 a global recession was followed by the collapse of world oil prices. Indonesia's oil revenue declined (in 1980 dollars) from US$7.8 billion in 1981–82 to US$6.9 billion in 1982–83. The government responded by devaluing the rupiah in 1983; by increasing taxes in 1984, 1985, and 1986; and by increased borrowing. The 1980s also saw increased use of quantitative restrictions on imports.

Trade policy. Following the 50 percent devaluation of 1978, the government allowed the rupiah to decline gradually to compensate for domestic

inflation, which was accelerated by the OPEC II price increase of November 1979. However, low worldwide growth reduced demand for Indonesia's exports, leading to a deterioration in the balance of payments. Both the volume and the real domestic value of nonenergy exports fell by half between 1979 and 1982 (see table 8.7).

By 1982 the current account deficit was a record 6 percent of GDP, and foreign currency reserves were worth only ten weeks of imports. Capital flight was accelerating. The "errors and omissions" category of accounts, which includes private capital transactions, grew from $0.6 billion outflow in 1979 to over $2.0 billion outflow annually during 1980–1982. Low real growth in 1982 (GDP actually decreased 0.3 percent) added to the appeal of a devaluation. In March 1983 the government devaluated the rupiah by 28 percent. In response, nonenergy exports increased by 25.7 percent in volume, and by 58.4 percent in domestic purchasing power between 1982 and 1983. The current account deficit fell to 2.5 percent of GDP in 1984. Through tight monetary and fiscal policies, the government was able to keep inflation to roughly 10 percent in 1983 and 1984.

In late 1982 the government not only increased the number of import quotas and monopoly licenses, limiting imports but also weakened the tradeables sector by allowing holders of monopoly licenses to raise the price of imported inputs. By 1985, 1,780 out of 5,229 imported items were subject to licensing or quotas. License restrictions covered 30 percent of total import value.

Taxation and expenditure. The government accompanied the 1983 devaluation with increased taxes and reduced spending. Some 47 capital-intensive projects were postponed indefinitely at the time of the devaluation. In December 1983 the government announced a revision of the corporate and personal income taxes, and a tax amnesty program to encourage future compliance by past scofflaws. These measures led to an increase in registered income taxpayers, from 550,000 in March 1984 to 995,000 at the end of 1985. Real

TABLE 8.7 Indonesia: Economic Conditions after the 1978 Devaluation (selected indexes)

Indexes	1979	1980	1981	1982	1983	1984	1985	1986
General economic conditions								
Income growth in industrial nations (%)	3.4	1.3	1.4	–0.4	2.7	4.7	3.0	2.4
Real prices of oil in foreign Purchasing power (1980=100)	67.7	100.0	119.2	124.1	111.6	109.1	104.1	59.1
Indonesian inflation rate (%)	20.6	18.5	12.2	9.5	11.8	10.5	4.7	5.9
Indonesian growth rate (%)	6.3	9.9	7.9	2.2	4.2	6.6	1.1	2.4
Balance-of-payments situation								
Merchandise exports to GDP (%)	27.5	27.9	25.2	20.8	23.1	24.3	21.4	21.4
Current account balance to GDP (%)	1.9	4.0	–0.7	–5.9	–7.8	–2.5	–2.1	–4.3
Reserves-to-imports ratio (weeks)	29.3	25.9	19.6	9.7	11.8	17.9	20.5	23.0
External long-term public debt service to export (%)	13.5	7.9	8.2	10.6	12.8	14.7	20.1	29.3
Nonoil exports sector (1974=100)								
Nonoil import price deflated by housing cost	65.2	62.8	63.0	56.9	63.2	59.8	58.2	57.7
Nonoil export price deflated by housing cost	99.0.	101.0	91.1	80.5	105.9	102.9	98.4	98.9
Competitiveness (Morgan Guaranty index)	111.3	101.1	89.0	79.5	98.4	91.8	92.7	109.7
Nonoil exports in physical volume	160.0	144.5	90.2	80.3	100.9	115.5	129.2	142.7
Nonoil exports in local purchasing power	184.6	170.8	111.8	93.5	148.1	175.0	188.5	222.4
Nonoil exports in foreign purchasing power	162.4	155.9	118.1	107.3	142.6	169.3	177.0	168.2

SOURCE: Adapted from Woo and Nasution 1987: 20.

nonenergy income taxes rose from rps. 1.0 trillion in fiscal 1983 to rps. 1.7 trillion by fiscal 1986.

In April 1985 the government replaced a complex sales tax with a value-added tax of 10 percent. Like the income tax reform, this measure also led to a dramatic increase in the number of registered taxpayers, from 25,000 in March 1985 to 60,000 in December of the same year. Revenue from domestic consumption taxes increased 94 percent in the first year after this reform. Finally, in January 1986, the government consolidated seven property taxes into one and revised the stamp duties.

External debt. Both debt and debt service have risen in the 1980s, whether measured in real terms, or relative to exports or GNP (see table 8.8).

The debt-to-export ratio grew from 63.7 percent in 1981 to 108.8 percent in 1983 and 212.2 percent in 1986. The debt-to-GNP ratio grew from 19.2 percent to 48.2 percent over the same period. As the proportion of debt that had been granted on concessionary terms continued to fall during these years, interest payments rose, so that debt service rose even more sharply. The depreciation of the rupiah also raised the domestic cost of debt service. The debt service-to-export ratio grew

TABLE 8.8 Indonesia: External Debt, 1980–1986 (millions of U.S. dollars)

Debt (end of period)	1980	1981	1982	1983	1984	1985	1986
External public and publicly guaranteed long-term debt							
Debt outstanding and undisbursed	24,451.9	27,211.0	32,216.0	35,492.0	36,922.8	41,872.6	48,712.0
Debt outstanding and disbursed (DOD)	14,971.3	15,870.3	18,515.0	21,689.5	22,861.9	26,624.6	32,119.0
Private creditors	5,464.9	5,812.5	7,403.4	9,649.6	10,048.6	11,667.9	14,556.0
Total debt service (TDS)	1,758.5	2,047.2	2,246.6	2,550.8	3,251.0	4,015.1	4,401.0
Private creditors	1,127.6	1,336.4	1,374.3	1,526.8	2,069.9	2,631.7	2,549.0
Principal ratios							
DOD/XGS[a] (%)	67.4	63.7	87.1	108.8	103.2	133.0	212.8
DOD/GNP (%)	21.6	19.2	21.2	28.0	26.5	33.4	48.2
TDS/XGS (%)	7.9	8.2	10.6	12.8	14.7	20.1	29.3
TDS/GNP (%)	2.5	2.5	2.6	3.4	3.8	5.0	6.6
Proportion of DOD which:							
Is concessionary	50.2	48.5	42.7	37.3	34.9	35.1	NA
Bears variable interest rates	16.8	17.8	20.0	22.7	23.7	21.7	NA
Is from private creditors	36.5	36.6	40.0	44.5	43.9	43.6	45.3
Proportion of public debt service paid to private creditors	64.1	65.3	61.2	59.9	63.6	65.5	57.9
External private nonguaranteed long-term debt							
Debt outstanding and disbursed	3,142.0	3,579.0	3,200.0	3,400.0	3,800.0	3,810.0	3,800.0
Total debt service	1,051.0	1,173.0	1,260.0	1,116.0	960.0	1,036.0	800.0
External short-term debt	2,775.0	3,274.0	4,787.0	4,639.0	5,384.0	5,280.0	5,000.0
Total external debt	20,888.3	22,723.3	26,502.0	29,728.5	32,045.9	35,714.6	40,919.0
Memo item							
Exports of goods and services (XGS)	22,208.0	24,926.3	21,262.1	19,932.6	22,163.8	20,014.5	15,094.0

NOTE: NA = not available. Figures do not include liquified natural gas expansion credits.
a. See memo item.
SOURCE: Adapted from Woo and Nasution 1987: 21.

from 8.2 percent in 1980 to 29.3 percent in 1986, and the debt service-to-GNP ratio grew from 2.5 percent to 6.6 percent over the same period.

1986: Pressures Build

During the first quarter of 1986, after Suharto announced the austerity budget, oil prices fell even more sharply than anticipated. While the budget was based on an average price of US$25 per barrel, the actual price fell 50 percent in the first quarter, to less than US$13 per barrel (see table 8.9).

Each 1-dollar drop in the price of oil was estimated to mean a 300-million-dollar drop in government revenues. Nevertheless, the House of Representatives passed the budget without revision in late February. This appeared to be primarily a political move, designed to maintain public confidence. By March, analysts projected a budget shortfall of rps. 3 trillion, or 14 percent of the budget. However, President Suharto declared on March 10 that the unfavorable export situation had not caused the government to abandon its development strategy.

In spite of the worsening oil market, foreign banks showed no reluctance to lend, and in the first quarter of 1986 Indonesia was able to undertake two major international borrowings that had been under discussion since early December. Indonesia also had available more than US$2 billion in standby loans arranged during the past few years. The London *Economist* attributed the continued availability of loans to the austere budget, which it said had "stunned the international banking community into another bout of admiration for the Indonesian government's disciplined approach to financial housekeeping."[3]

TABLE 8.9 Average 1986 Monthly Crude Spot Price for Indonesian Oil (U.S. dollars per barrel)

Jan.	24.25
Feb.	18.00
March	12.90
April	10.45
May	11.35
June	11.15
July	9.50
Aug.	11.25
Sept.	12.70
Oct.	12.65
Nov.	13.00
Dec.	14.25

SOURCE: *Petroleum Intelligence Weekly* (London), various issues.

The government demonstrated a determination to maintain order and suppress possible tensions in anticipation of the April 1987 legislative elections. The press received clear warnings to adhere to official ideology and the ongoing trials of several prominent dissidents provided a warning to any potential opposition.

Analysts expected the budget to be implemented with flexibility, and it was. For example, on April 3 the government reduced the fertilizer subsidy, one of very few budget items that had been scheduled for increased spending. Nevertheless, debate focused on ways to raise government revenues, including even the possibility of relaxing the balanced-budget restriction to permit internal borrowing. Several economists recommended a countercyclical budget deficit, accompanied by anti-inflationary measures. Another such policy, proposed on the grounds that it could accomplish the same effect without violating the letter of the balanced-budget constraint, was increased creation of credit by the Central Bank. Others suggested expanded external borrowing, or a devaluation of the rupiah to increase dollar-denominated oil revenues.

Government foreign exchange reserves remained high: in March they were US$10.7 billion, equivalent to 11 months of imports. However, concern about a possible devaluation of the rupiah was causing massive outflow of capital as speculators hurried to buy dollars. Indonesians bought more than US$800 million in the first two weeks of March; turnover on March 14 alone was a record US$120 million. This speculation was slowed but not stopped when the government revalued the rupiah slightly in mid-March (from 1,130 to 1,126 per U.S. dollar).

Some analysts argued for postponing or altogether avoiding a devaluation. They argued that, in contrast with 1983, foreign exchange reserves and available foreign credit were high. These analysts pointed out that a devaluation would increase the rupiah value of Indonesia's debt-service obligations, denominated primarily in yen and dollars. Most important, they argued that the rupiah was not overvalued for three reasons: domestic inflation had been low (less than 0.4 percent in the second half of 1985, in fact); the rupiah had been allowed to adjust gradually downward against the U.S. dollar since 1983, falling from rps. 970 per dollar at the beginning of 1983 to rps. 1,131 per dollar in the second quarter of 1986; and the dollar itself had been in decline relative to the yen and European currencies since 1984 (see table 8.10).

TABLE 8.10 Value of U.S. Dollar in Indonesian Rupiahs and Japanese Yen, 1981–1987

Year	Nation (currency) Indonesia (rupiahs)	Japan (yen)
1981	644.0	219.900
1982	692.5	235.000
1983	994.0	232.200
1984	1,074.0	251.100
1985	1,125.0	200.500
1986		
Quarter 1	1,125.0	179.600
June	1,131.0	165.000
July	1,131.0	154.300
Aug.	1,132.0	156.100
Sept.	1,633.0	153.600
Oct.	1,640.0	161.500
Nov.	1,650.0	162.400
Dec.	1,641.0	159.000
1987		
Jan.	1,633.0	152.500
Feb.	1,644.0	153.050
March	1,644.0	145.800
April	1,641.0	139.500
May	1,649.0	144.000

SOURCE: United Nations, *Monthly Bulletin of Statistics* (New York: U.N. Statistical Office, 1987), vol. 41, no. 2 (Feb.) and no. 8 (Aug.).

In the year ending July 1986, the rupiah fell by almost 55 percent against the Japanese yen, by 27 percent against the German mark, by 23 percent against the French franc, and by 7 percent against the British pound. Nondollar currencies accounted for some 55 percent of import costs and 60 percent of debt service in 1986. The IMF estimated that in the year ending March 1986, the real effective exchange rate of the rupiah fell by 17 percent against a basket of currencies, to a level 10 percent below that immediately following the 1983 devaluation. The Morgan Guaranty competitiveness index was at 110 in 1986, almost identical to its level in 1979 following the devaluation of 1978, and well above its level of 98.4 following the 1983 devaluation (see table 8.7).

The finance minister, Ali Wardhana, argued that budget cuts were the only adequate response to the oil revenue crisis. Anwar Nasution, a University of Indonesia economist, argued that devaluation without structural reforms—such as removing quantitative restrictions on imports—would only fuel inflation and depress demand, providing a quick fix but no lasting benefit. In May the government introduced a package of reforms that liberalized trade restrictions slightly. The same month the World Bank released a report emphasizing the importance of lifting trade restrictions and increasing nonoil exports. This advice, however, was easier to give than to follow, since many of the trade restrictions took the form of import licenses that provided monopoly rents to relatives and friends of government officials.

On the other hand, some economists argued that a devaluation was necessary precisely in order to offset the effects of the increase in quantitative restrictions on imports since 1983. For a given real exchange rate, restrictions on imported inputs to tradeables would allow monopoly license-holders to raise prices, and so reduce the profitability of the tradeables sector without affecting the real exchange rate (typically measured with world prices for traded goods). Thus, the prevalence of quantitative restrictions made the real exchange rate an inaccurate measure of the relative attractiveness of tradeables and nontradeables.

By September the World Bank was projecting a US$5 billion shortfall in oil revenues, about one-quarter of the budget. Low world prices for Indonesia's other exports diminished the benefits of increased nonoil export volume (see table 8.7). The current account deficit for 1986–1987 was expected to approach US$4 billion, almost double the previous year's deficit, and almost double the amount projected in the January budget proposal.

Whether or not the prices of nonoil tradeables were undervalued, the radical decline in oil prices was creating a current account deficit that would require either significant capital inflows in the form of international borrowing, or internal borrowing, or an inevitable devaluation as foreign exchange reserves ran out.

Study Questions

1. Describe the economic conditions in Indonesia during the last five years of the case. What changed?

2. What are the strengths and weaknesses of that country's economic situation at the end of the case?

3. What strategy and policies do you recommend now? Why?

Notes

Works cited only by author and date are fully listed in the bibliography at the end of this book.

1. These figures are not precise because there were different official exchange rates for different types of transactions until 1970.
2. Wing Thye Woo and Anwar Nasution (1987).
3. *Economist, Quarterly Economic Review of Indonesia,* first quarter (London: Economist Intelligence Unit, 1986), p. 32.

PART III

Formulating Industrial Strategy

Part III, "Formulating Industrial Strategy," offers formats for analyzing industrial strategies such as input substitution and export promotion, along with cases to illustrate the use of these concepts. "An Approach to Formulating Industrial Strategy" (chapter 9) describes how the framework presented in part I can be adopted to look at industrial strategy and offers some broad lessons that can be drawn from industrial transitions that have occurred in the past.

The cases that follow provide a window on the problems of developing and implementing industrial strategy. "Singapore: Switching to an Export Orientation" (chapter 10) helps us to explore the general problems of change in strategic orientation. "Industrial Policy in León: The President's Industrial Policy Commission" (chapter 11) permits us to examine the problems of the pace and sequence of policy change and the relationships between the agricultural and industrial sectors in a "disguised" case from a real country. "Industrial Policy in Costa Rica: Import Substitution or Export Promotion" (chapter 12) allows discussion of the problems that arise when mixed strategies are employed simultaneously. "Taiwan 1986: Choices for the Future" (chapter 13) provides an opportunity to look at the problems of countries that are attempting to move beyond Stage I Export Promotion. Finally, the "Malaysia Planning Exercise: The Dilemma of Employment Policy" (chapter 14) provides an opportunity to look at problems of training and employment policy in the industrial sector. Each case will permit the reader to put the concepts presented in chapter 9 into practice.

139

9 MARC LINDENBERG

An Approach to Formulating Industrial Strategy

The past three decades of industrialization in developing countries have created a second industrial revolution that is transforming the world economy even more radically than did the changes that took place in Great Britain in the late eighteenth and early nineteenth centuries.

—Helen Hughes *

The last decade has witnessed sweeping reforms in industrial policies in developing countries. . . . Obviously, the reforms are undertaken with the belief that the long-term effects will be beneficial. In the short term, some firms may benefit. There are many, however, who face bankruptcy . . . for what appears to be no fault of their own—just the unexpected . . . impacts of government policies.

—Steven Guislinger and Robert Miller †

The two quotes at the head of this chapter highlight both the benefits and the risks of industrial strategy since World War II. ("Industrial strategy" is defined here as a set of measures, usually undertaken in conjunction with macro policies, to increase the efficiency, competitiveness, growth, and employment of the manufacturing sector.)[1]

On the one hand, recent World Bank studies confirm Helen Hughes's observations. Between 1965 and 1985, developing countries increased their contribution to world manufacturing production from 14.5 to 18.1 percent and their share of world manufactured exports from 7.3 to 17.4 percent.[2] Industry became a leading sector in the developing world economies (see table 9.1). The average annual growth rate of industry in developing world economies was more rapid than its rate for developed economies.[3]

But did appropriate policies really make much difference in this transformation? In one of the most extensive studies of post-World War II industrialization, Hollis Chenery and his colleagues concluded that

> the shift from tariff-induced import substitution to a neutral trade policy can account for an increase of as much as 1 percentage point in [GDP] growth. . . . Economies which pursued export-

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*"Achievements and Objectives of Industrialization" in John Cody, Helen Hughes, and David Wall (eds.), *Policies for Industrial Progress in Developing Countries* (New York: Oxford University Press, 1980), p. 63.

† "Industial Policy in Developing Countries," *Journal of Contemporary Business*, vol. 5, no. 1 (1980), p. 35.

TABLE 9.1 Shares of Production and Exports of Manufactures by Country Group, 1965–1985 (percent)

Country group	Share in production		Share in exports		Growth in production	Growth in exports
	1965	1985	1965	1985	1965–1985	1965–1985
Industrial market economies	85.4	81.6	92.5	82.3	3.8	6.8
Developing countries	14.5	18.1	7.3	17.4	7.2	12.2
Low-income	7.5	6.9	2.3	2.1	7.5	6.0
Middle-income	7.0	11.2	5.0	15.3	6.6	13.8
High-income oil exporters	0.1	0.3	0.2	0.3	8.4	16.0
Total	100.0	100.0	100.0	100.0	4.5	7.4

SOURCE: World Bank 1988a: 47.

> led growth—as opposed to a strategy of import substitution—grew faster, industrialized sooner, [and] had higher rates of total factor productivity growth. . . . the experiences of the countries which have successfully pursued export-led growth shows that their governments followed active interventionist policies, albeit with heavy reliance on market incentives.[4]

For a poor country with substantial unemployment, an additional 1 percent annual increase in GDP growth for three to five years with the accompanying increases in employment can make a substantial difference in levels of living.

Unfortunately, the policies that might result in such gains are not all that easy to design and implement. In fact since the 1960s, most developing countries have made little attempt to increase their industrial exports. As a result, by 1985 only 10 countries were producing 80 percent of the manufactured exports of all 85 developing countries (the ten were Hong Kong, the Republic of Korea, Singapore, Brazil, Yugoslavia, India, Malaysia, Mexico, Turkey, and the Philippines).[5]

Furthermore, as Steven Guislinger and Robert Miller warn in the chapter headnote, poorly conceived and inconsistent policies have frequently weakened the same industrial sector that national leaders hoped to stimulate. For example, in 1982–1983 many Chilean industrialists were caught in a squeeze between government policies of fixed exchange rates which reduced their export sales, on the one hand, and wage increases indexed to inflation which increased their costs, on the other.[6] To stay afloat they increased their borrowing. When they could not meet their obligations, the crisis overflowed into Chile's domestic financial sector. It cascaded into the foreign financial sector after domestic banks could not repay their international debts. Finally, by the beginning of 1983, the government was forced to liquidate four banks and intervene in four more in order to reverse the financial collapse.[7]

Industrial exporters in Argentina also bore the brunt of inconsistent government policies in the early 1980s. Government attempts to combine trade liberalization and export promotion with inflation control placed these exporters in a different kind of squeeze, one between rising interest rates for badly needed loans and declining export sales. According to the World Bank,

> The ordering of the reforms encouraged an appreciation of the real exchange rate. Initially traditional exporters responded to the removal of large export taxes, but since exports were liberalized before imports [this] helped fuel expectations of currency appreciation. At the same time, internal financial liberalization resulted in higher interest rates, and external financial liberalization thus attracted foreign capital. The stubbornly high public sector deficit helped push up the local interest rates even further and sucked in more foreign loans.[8]

The impact of liberalization of capital markets combined with the appreciation of the peso had a disastrous effect on manufacturers in Argentina.

> Negative real interest rates for over thirty years made it rational for firms to operate with high debt-equity ratios, since high leverage paid off handsomely. The violent real appreciation of the peso made price increases difficult, whereas the main cost components of firms—interest, wages, and public and private services—soared. . . . Industrial output declined steadily after the first quarter of 1980. . . . [There was a] marked in-

crease in business failures—by 69 percent in 1979 and 62 percent in 1980—and the bankruptcy of over 10 percent of the financial system by March of 1981.[9]

While both the gains and risks of launching new industrial policies are great, the world economic collapse of the 1980s has forced many governments to search for new ways of generating growth and employment. This has been accompanied by increasing willingness to rethink policies and restructure the industrial sector accordingly.

To achieve the objectives of industrialization while minimizing its undesired consequences, leaders from different sectors need working knowledge of the key issues involved in the formulation and implementation of industrial strategy. To get an overview, they might ask the following questions:

1. *Definitions.* What is industrial strategy and what policies does it usually include?

2. *Reconstructing the past and understanding the present.* What industrial strategies have been most successful in recent years?

3. *Shaping the future.* What industrial strategy might maximize our country's growth and employment?

4. *Managing change.* What dilemmas will we encounter during implementation and how might we manage them?

The purpose of this chapter is to help decision makers organize information about these questions so that they can get an overview of industrial strategy in their countries and its implications for their organizations.

What Is Industrial Strategy and What Policies Does It Usually Include?

Industrial strategy can be thought of as the set of measures undertaken, usually in conjunction with macro policies, to increase the efficiency, competitiveness, growth, and employment of the manufacturing sector. The term "strategy" is used here to mean the overall game plan for the sector; "policies" are the specific measures that combine to form the game plan. Discussion of industrial strategies can be divided along three dimensions: (1) *inward versus outward strategic orientation;* (2) *the specific policy mix;* and (3) *the role of the government.* These three dimensions combine to determine a country's overall *industrial policy style.* This chapter examines each dimension in more detail.

Inward versus outward strategic orientation. Since the end of World War II, much of the discussion of medium-range strategy in developing countries has been posed in terms of inward versus outward strategic orientation.[10] Inwardly oriented policies give an advantage to those who produce goods and services for the domestic market. A neutral stance provides an incentive structure that treats production for the domestic and foreign markets on an equal basis, and an outward orientation favors those who produce for foreign markets.

The most common inward versus outward industrial strategies can be understood with the assistance of the matrix that appears in figure 9.1. The matrix permits the classification of industrial strategies by the types of products manufactured and the markets served. Along the product axis of the matrix a country can make labor intensive, nondurable consumer goods like shoes and shirts, intermediate goods or, finally, capital goods like machines. These goods can be sold in either domestic or foreign markets, the other axis of the matrix.

A different industrial strategy is associated with each of the four quadrants of the matrix.[11] In the quadrant marked *A* appear countries following "Stage I Import Substitution" (IS1)—the substitution of local production of nondurable consumer goods for sale in the domestic market. For example, Guatemala's industrial strategy in 1981 fell into this category, since 79 percent of its industrial sales were for the domestic market and the vast majority of its products were nondurable consumer goods. Some countries, like Mexico, and Argentina in the 1960s and early 1970s, opted for import substitution of capital goods—"Stage II Import Substitution" (IS2), for which see quadrant *B* of the matrix. After passing through the stage of easy import substitution of nondurable consumer goods (quadrant *A*), they elected to produce intermediate and, later, capital goods for their domestic market. Still other countries, like Singapore, Taiwan, and Hong Kong in the late 1960s and early 1970s, moved from easy import substitution of nondurable consumer goods, or IS1, to the export of these same consumer goods—"Stage I Export Promotion" (EX1). These countries appear in quadrant *C* of the matrix. Finally, many of

FIGURE 9.1 Import Substitution and Export Promotion: Four Dimensions of Industrial Strategy

Products	Markets: Domestic	Markets: Foreign
Nondurable consumer goods	A. *Stage I Import Substitution (IS1)* Guatemala (1981)	C. *Stage I Export Promotion (EX1)* Taiwan (late 1960s and early 1970s) Hong Kong (late 1960s and early 1970s) Singapore (1973)
Intermediate goods Capital goods	B. *Stage II Import Substitution (IS2)* Mexico (1975) Argentina (1960s and early 1970s)	D. *Stage II Export Promotion (EX2)* U.S.A. Japan (1988) West Germany (1988)
	Examples of import substitution policies	Examples of export promotion policies
	• High levels of effective protection • Quotas • Duty-free import of raw materials and equipment • Subsidized credit • Tax credits and holidays • Minimum wage laws • Overvalued exchange rates	• Reduced tariff levels • Elimination of quotas • Some duty-free imports • Credit and other factors of production at world levels • Export incentives (CAT) • Wage gains tied to productivity gains • Realistic exchange rates

SOURCE: Marc Lindenberg.

the Western European nations, the United States, and more recently Japan produce intermediate and capital goods for export (quadrant *D*)—"Stage II Export Promotion" (EX2).

The specific policy mix. Whether or not they are trying to promote an inward versus outward strategic orientation, governments usually combine five kinds of policies to shape an overall industrial policy. These policies govern (1) *foreign exchange management*; (2) *trade orientation*; (3) *monetary dynamics*; (4) *fiscal management*; and (5) *labor relations*. Let us review the purpose of these policies and how they might be used to stimulate an inward versus out-

ward strategic orientation. (See figure 9.1 for a summary list of those policies associated with these orientations.)

Foreign exchange management. One of the most important places where a country defines its industrial policy is through its foreign exchange window. Payments for goods sold or purchased in foreign markets, credit in foreign currencies, and instruments for hedging to protect against future currency fluctuations all pass through this window.

A country's monetary authorities must make a number of decisions about the foreign exchange window and what passes through it.[12] First, they must decide how open they want that window to be. Most industrial countries leave it entirely open. They operate under article VIII of the International Monetary Fund (IMF) agreements, which permit full current account convertibility. Many developing countries, however, operate under article XIV and maintain restrictions on current account payments until the balance-of-payments position is strong enough to permit payment. Still others implement foreign exchange controls, while others maintain current account convertibility but restrict capital account transactions.

A second decision is whether the relationship between local and foreign currencies that pass through the window should float freely or be managed directly by the monetary authority. Most industrial countries have exchange rates determined by the market, although their monetary authorities intervene periodically to shore up the currency. However, most developing countries operate with managed exchange rates usually because their foreign exchange markets have a high level of imperfection.[13]

Once a decision is made to manage the exchange rate, two important subsequent steps follow. First, monetary authorities must decide which currency to relate their own currency to. This is called *pegging*. Some countries, like Honduras with its lempira, relate their unit of currency to a single foreign currency, the U.S. dollar. Others like Malaysia and Singapore relate their currency to a basket of foreign currencies. Still other countries like Cameroon and Equatorial Guinea tie their currencies to fixed exchange rates with other country members of their currency union, and peg the union's exchange rates to a single foreign currency, in this case the French franc.

Once the pegging process is complete, monetary authorities make another decision: whether to maintain a fixed or flexible rate of exchange with the currency selected for pegging. Honduran authorities, for example, prefer a fixed exchange rate because they believe that it instills public confidence. Other countries maintain flexible, real exchange rates to help stimulate exports. They allow their local currency unit to fluctuate based on comparisons between rates of domestic versus international inflation. For example, if domestic inflation is increasing more rapidly than international inflation, monetary authorities often devalue the local currency unit to maintain the original relationship with the pegged foreign currency. If international inflation is occurring more rapidly, the local currency is allowed to appreciate.

Flexible exchange rate adjustments are usually made through either a "crawling" or an "adjustable" peg system. A *crawling peg system* is managed through frequent, monthly or bimonthly adjustments of the exchange rate. Crawling peg systems make a more incremental impact on the firm, and thus are easier to incorporate into the strategic planning process. An *adjustable peg system* requires fewer, but larger adjustments in the exchange rate. Such adjustments are frequently more difficult for firms to predict and assimilate.

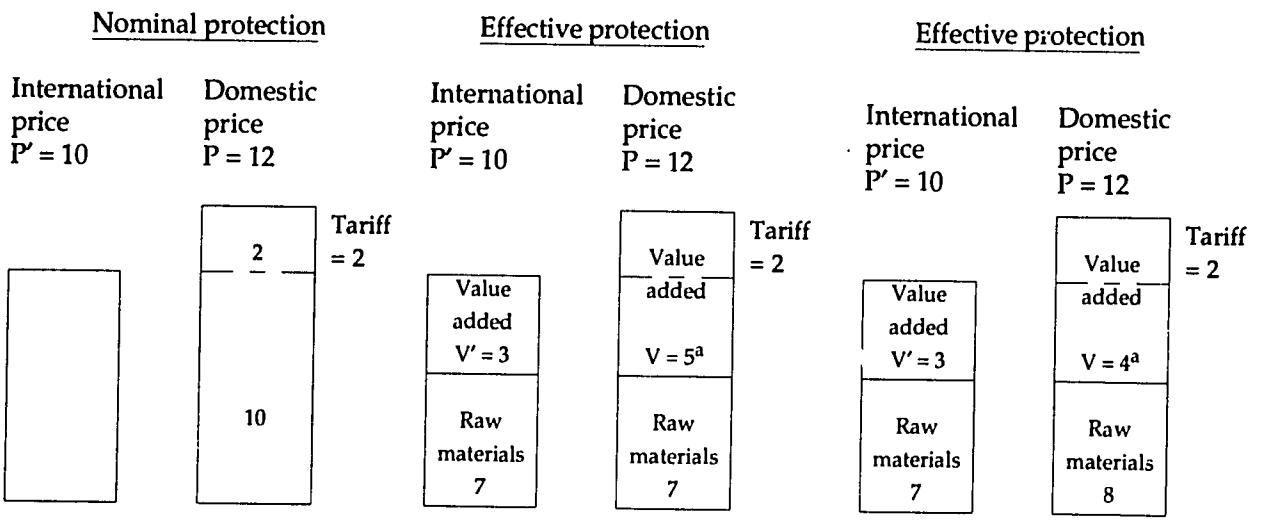
The macro policy associated with import substitution is that of fixed and overvalued exchange rates. The impact of such a policy is to make imports of raw materials, intermediate goods, and capital goods cheaper for domestic producers, while exporters have increasing difficulty selling their goods in international markets.

Once policy makers decide to move toward an outward orientation, maintaining a real exchange rate becomes critical. This macro policy, in contrast, is often combined with special policies to favor the industrial sector: multiple exchange rates, with favorable rates for imports of key inputs used for industrial export products; special exchange rates to liquidate export sales; or priority access to rationed foreign exchange for exporters. These exchange-rate preferences can even be targeted to specific subproduct lines that a country wants to stimulate.

Trade policy. Trade policy is another key element in industrial strategy since it helps to send signals to producers about the benefits of production for domestic versus foreign markets. The major vehicles for shaping these incentives have been import quotas, import licenses, stamp taxes, and tariffs.[14]

In order to decide what kind of trade policy a country may want to follow, it is essential to understand the current orientation of macro policy. There are two ways to measure the degree of outward

FIGURE 9.2 Calculating Rates of Nominal and Effective Protection



The nominal rate of protection is the difference between the domestic and international price as a percentage of the international price.

$P - P'/P'$
$2/10=0.2=20\%$

The effective rate of protection measures protection on value added. It is the difference between domestic and international value added as a percentage of international value added.

$V-V'/V'$
$5-3/3=0.66=66\%$

Effective protection has the benefit of measuring not only tariffs on final goods but also on raw materials as in the example above.

$V-V'/V'$
$4-3/3=0.33=33\%$

a. This value includes the tariff of 2.
SOURCE: Marc Lindenberg.

versus inward orientation of trade regimes: analysis of either nominal or effective rates of protection. The *nominal rate of protection* for a good is calculated by looking at its domestic price as a percentage of its international price, that is, its actual price in the international market. For example, if the international price of shoes is $10 a pair but there is a $2 tariff on each pair imported, then the domestic price is (12/10) X 100 or 120 percent of the international one and the nominal rate of protection is 20 percent. The same concept can be used to measure the neutrality of a country's overall trade regime by comparing the nominal rate of protection for all imported goods with that of all exported goods. If the ratio of domestic to international prices were the same—that is, if domestic prices were 100 percent of international prices—then the nominal rate of protection would be zero, and the trade regime would be completely neutral.

While nominal rates of protection are relatively easy to calculate, they do not accurately reflect the degree of support domestic shoe producers may get through, for example, subsidies on inputs like leather or thread. Thus, it is often more useful to measure *effective protection*, which is the degree of protection on value added during production rather than on the final product. As with nominal protection, a ratio of effective protection of 1/1 for a country's tradeables would indicate a neutral trade regime. (See figure 9.2 for examples of how to calculate rates of nominal and effective protection.)

Inwardly oriented trade policies in many developing countries have the following characteristics.[15] They often rely on quotas and quantitative restrictions of imports instead of on tariffs. These quota systems are administered through the preparation of a list of acceptable, controlled, and restricted products. Importers must apply for licenses that are granted for a fee. In other countries general tariff systems are used to provide intermediate to high

levels of effective protection for domestic goods.

Countries interested in reducing their antiexport bias often take a series of steps to move their trade regime toward a more neutral orientation. For example, some countries begin by simply making their import licensing systems more efficient and by moving whole categories of goods off the prohibited list. Others try to replace quota and licensing systems with uniform tariff systems even without reducing rates of protection. Still others begin to reduce the variance in their tariff systems or the rates of overall protection.

Once policy makers attempt to reduce levels of tariff protection they must decide whether to make general or specific tariff reductions.[16] General reductions (which affect all goods) can be accomplished by cutting all tariffs proportionally, by absolute cuts at all levels, or by the "concertina method."[17] This last method sets ceilings to which all tariff levels are reduced by a specific time period. Once this is done a new ceiling is set and the next stage of reduction is accomplished. Specific reductions can be made on certain types of finished goods, intermediate goods, or raw materials.

Monetary policy. Monetary policy has a number of important functions that affect industrial strategy.[18] At the macro level authorities control the growth of the money supply, the rates of interest, the operating procedures of the domestic financial system, the volume and allocation of credit to different sectors, and the rules for international financial operations within domestic boundaries. They also fix support prices for certain products and subsidies for others.

Monetary policies related to inward strategies include subsidized interest rates for import-substitution activity; producer subsidies to specialized products; consumer subsidies, for example, for urban transportation or food; and restrictions on foreign investment and repatriation of profits.

Macro policies to reduce the antiexport bias often include permitting interest rates in the domestic financial system to rise or fall to international levels; reducing consumer and producer subsidies; and allowing free movement of international capital transactions. Specific sectoral measures for industry include special concessional loans to industrial exporters, subsidized interest rates, and export subsidies.

Fiscal policy. Fiscal policy, the use of tax incentives, rebates, and exemptions, has been critical in stimulating both inward and outwardly oriented industrial strategies.[19] Inwardly oriented policies have included five-year tax holidays for those involved in industrial import substitution and tax exemptions on import of raw materials or capital equipment.

Moving toward a more neutral trade orientation has often meant reducing these incentives toward import substitution without adding new incentives for exports. At the same time it has sometimes meant specific new tax exemptions equal to or greater than those awarded for industrial import substitution as well as removal of taxes on export. An interesting typology of additional specific fiscal incentives divides them into profit, sales, value-added, and investment-based incentives, and other incentives such as infrastructural support or technical or marketing assistance.[20] An example of a sales-based incentive is a tax rebate certificate for exporters. Under this rebate system, they receive a certificate for a tax credit of 10 to 20 percent of the sales value of their exports. These certificates are redeemable over a year to two years, and a substantial market has developed in many third world countries that permits them to be sold at a discount.

Labor relations and wage policy. Policies that affect wage rates, benefits, and conditions for work have been vital in stimulating industrial transformation.[21] Inward-looking policies have included the establishment of minimum wages, special pension funds, and a variety of provisions related to firing and strikes, as well as inflation-indexed wage gains. During the use of inward-looking policies, high levels of protection for domestic industry have provided special margins that permit indexed wage gains.

Wage and benefits packages that are competitive internationally are a key element of outwardly oriented industrial policies. Yet making wage policy more flexible is one of the most conflictive areas in industrial transitions. Some countries, like Panama, have attempted to alter labor legislation to get new flexibility in wages and benefits, but at the cost of serious resistance on the part of the labor movement.[22] Yet in other countries more flexible labor policies have helped smooth the transition to a new industrial policy. For example, in the late 1960s Singapore, instead of direct wage gains, at first offered workers other benefits like increased health services or access to home loans through the social security system.[23] Later they offered wage gains equal to productivity gains. In other countries, like Costa Rica in the early 1980s, the pace of wage gains was slowed through changing the rates of indexing for

TABLE 9.2 Comparative Industrial Policy Styles and Industrial Structures in Selected Countries, 1983 and 1985

Country groups	Industrial policy style	Importance of manufacturing (1985)			Composition of manufacturing exports (1983)			
		Mfg. as % of GDP	Exports as % of GDP	Mfg. exports as % of all exports	Textiles	Machinery	Other	Total
Industrial market economies								
U.S.A.	Passive (Without national strategy, but with occasional firm- or product-level defensive actions)	20	7	75	3	63	34	100
W. Germany	Moderately active (General strategy, with national and regional focus)							
France	Highly active (National strategy that includes specific industrial targets)	25	25	75	6	47	47	100
Developing countries								
Guatemala	Passive (General strategy)	16	19	25	17	16	67	100
Costa Rica	Moderately active (General strategy, with incentives for nontraditional exports)	22	32	30	11	14	75	100
Taiwan[a]	Highly active (General strategy, with programs at regional, industry, and firm levels)	52	50	91	35	32	33	100

a. Figures for Taiwan from George C. Lodge, *Taiwan 1986* (Harvard Case Clearinghouse) and chap. 13 of this book.
SOURCE: World Bank 1988a: chapter 9 appendix tables 3, 5, 10, 11.

inflation.[24] Still others have attempted to handle the problem of wage competitiveness through devaluations. Where serious resistance to more flexible wage policies exists, governments and the private sector have looked to other elements in the cost structure to help firms become competitive. A final controversial experiment has been a dual wage policy with negotiated wages in industrial free zones and a minimum wage for the rest of the country.[25] The results of dual policies have been mixed: on the one hand, they have created friction and distortions in the labor market, and on the other have helped keep a developing export sector competitive.

The role of government: industrial policy style. In addition to an industrial strategy's overall orientation and policy emphasis, it also has a tactical focus—the role that government chooses to take to implement the strategy. Different countries have highly different styles of industrial policy formulation and management (see table 9.2). Some governments, like the United States or Guatemala, played a *passive role* in industrial policy in the early 1980s.[26] They engaged in general regulation; while they passed specific legislation for certain industries, there appeared to be no consciously articulated overall strategy. Other governments, like West Germany and Costa Rica, played a *moderately active role* in the same period.[27] They used both general and specific measures to encourage industrial adjustment and investment in new industries. France, Taiwan and Japan took *highly active roles*, targeting specific industries for development and marshaling a host of specific micro level incentives to move the process along.[28] Finally, some governments, like the Soviet Union, engaged in *central planning* of all sectors of the economy.

Within an overall policy style governments can also opt for national versus regional programs, or they may focus on the industry segment or the firm. *Regional programs* are designed to help decentralize industrial development to poverty areas or areas with other special characteristics. Examples of regional industrial policy can be found in Malaysia's 1971–1975 National Plan, which establishes regional growth poles,[29] and in the British strategy for industrial development along its northeast coast, which began with the Special Areas Act of 1934.[30] *National programs* provide general incentives regardless of geographic location. For example, Costa Rica's current industrial strategy is national in its focus although there are some regional incentives.[31]

Finally, governments can use policies to play a specific tactical role, for example, a *defensive role*, as when they insulate obsolete firms from international competition; an *adjustment role*, by helping industries adapt to changing market situations; or an *offensive role*, by stimulating entry into entirely new product areas. Pressure from the U.S. footwear industry for protection might be seen as an example of a plea that the government play a defensive role.[32] The arrangement of the motorcycle company Harley Davidson with the U.S. government for temporary tariff protection and assistance during its successful retooling is an example of an adjustment role.[33] Finally, the Boston Consulting Group study, with its recommendations to the Swedish government about entry into new product lines, is an example of how a government might adopt an offensive role.[34] A government may try many of these tactics simultaneously in different segments of the industrial sector.

How have different industrial strategies really performed in recent years? This topic will be explored in the next section.

Reconstructing the Past and Understanding the Present

What industrial strategies have been most successful in recent years? In the last five years two kinds of study have been completed on the relationship between industrial strategies and country economic performance: (1) simulations that project hypothetical economic results of different policy packages; and (2) empirical analysis that groups countries by policy style and examines actual country results. Both types of studies conclude that outward-oriented industrial strategy had (or could have) a more positive impact on overall country performance than other kinds of strategies. For example, Hollis Chenery and his colleagues performed a simulation in which they compared the effects of import-substitution, balanced, and export-promotion industrial policies on economic performance (see table 9.3 for a review of the results).[35] They found that export-promotion strategies added almost 1 percentage point in GDP growth and 7 percent in export growth compared with import-substitution strategies. Balanced strategies, too, added more than half a percentage point to growth compared with import substitution.

The World Bank, in its 1987 *World Development Report*, sorted 41 developing countries into four groups based on their actual industrial strategies: strongly outward oriented, moderately outward oriented, moderately inward oriented, and strongly

TABLE 9.3 Selected Countries' Alternative Trade Strategies and Projected Economic Performance over a 20-Year Period (percentage)

	Countries (1960s)		
	Import substitution[a]	Balanced[b]	Export promotion[c]
Indicators	Turkey Mexico Philippines Colombia	Israel Thailand Tunisia Greece	S. Korea Taiwan Singapore Malaysia
GDP growth rate	5.7	6.2	6.5
Export growth rate	7.9	10.3	14.1
Import growth rate	4.5	6.4	9.3
Average ratio of capital inflow to GDP	4.5	4.4	4.1

a. Assumes policies of medium to high levels of effective protection or import rationing, an inward trade bias, low or falling trade shares, borrowing limited by low exports, low to intermediate productivity growth, and a high cost of capital goods.
b. Assumes policies of real exchange rates, a neutral trade bias, constant trade shares, borrowing that maintains neutrality, intermediate productivity growth, and world prices of capital goods.
c. Assumes policies of real exchange rates, an outward trade bias, rising trade shares, borrowing policies that sustain liberalization, high productivity growth, and world prices of capital goods.
SOURCE: Adapted from Chenery, Robinson, and Syrquin, 1986: 321–22.

TABLE 9.4 Trade Strategies and Actual Country Performances, 1963–1973 and 1973–1985 (percentage)

Indicators	Strongly outward oriented	Moderately outward oriented	Moderately inward oriented	Strongly inward oriented
1963–1973[a]				
GDP growth	9.8	8.8	4.0	7.0
Real GNP per capita	6.5	5.0	2.0	4.0
Inflation	5.0	6.0	6.0	4.0
Gross domestic savings	13.0	20.0	15.0	22.0
Avg. growth in mfg. exports	14.0	16.0	5.0	10.0
1973–1985[b]				
GDP growth	7.0	4.5	3.0	5.0
Real GNP per capita	6.0	2.0	-0.4	2.2
Inflation	10.0	45.0	16.0	14.0
Gross domestic savings	32.0	20.0	18.0	23.0
Avg. growth in mfg. exports	14.0	14.5	4.0	8.0

a. In 1963–1973 the countries were: *Strongly outward oriented* (Hong Kong, Korea, Singapore); *Moderately outward oriented* (Brazil, Cameroon, Colombia, Costa Rica, Guatemala, Indonesia, Israel, Ivory Coast, Malaysia, Thailand); *Moderately inward oriented* (Bolivia, El Salvador, Honduras, Kenya, Madagascar, Mexico, Nicaragua, Nigeria, Philippines, Senegal, Tunisia, Yugoslavia); *Strongly inward oriented* (Argentina, Bangladesh, Burundi, Chile, Dominican Republic, Ethiopia, Ghana, India, Pakistan, Peru, Sri Lanka, Sudan, Tanzania, Turkey, Uruguay, Zambia).
b. In 1973–1985 the countries were: *Strongly outward oriented*(Hong Kong, Korea, Singapore); *Moderately outward oriented*(Brazil, Chile, Israel, Malaysia, Thailand, Tunisia, Turkey, Uruguay); *Moderately inward oriented* (Cameroon, Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Indonesia, Ivory Coast, Kenya, Mexico, Nicaragua, Pakistan, Philippines, Senegal, Sri Lanka, Yugoslavia); *Strongly inward oriented* (Argentina, Bangladesh, Bolivia, Burundi, Dominican Republic, Ethiopia, Ghana, India, Madagascar, Nigeria, Peru, Sudan, Tanzania and Zambia).
SOURCE: World Bank 1988a: 83–85.

TABLE 9.5 Selected Country Groups and Costa Rica: Average Annual Growth of GDP and the Industrial Sector, 1965–1985 (percentage)

	Average growth of GDP		Average growth of industry		Industry as percentage of GDP	
Country group	1965–80	1980–85	1965–80	1980–85	1965	1985
Industrial market economies	3.7	2.3	3.6	2.5	40.0	36.0
Developing countries	6.0	3.3	7.6	3.5	29.0	34.0
Low-income[a]	3.2	2.8	4.4	3.7	17.0	19.0
Middle-income	6.5	1.7	8.5	0.6	16.0	17.0
Upper-middle-income	6.6	1.7	7.2	1.4	34.0	35.0
High-income oil exporters	7.5	–2.2	NA	–8.3	65.0	58.0
Costa Rica[b]	6.3	0.5	8.7	0.3	23.0	29.0

NOTE: NA = not available.
a. Excluding China and India.
b. The World Bank classified Costa Rica as a middle–income developing country.
SOURCE. World Bank 1988a: 204–7.

inward oriented. It then looked at their actual economic performance between 1963 and 1985 (see table 9.4).[36] It found that outwardly oriented countries had higher GDP growth, employment growth, and domestic savings.

Finally, the Chenery study attempted to identify the actual sources of industrial growth in different countries.[37] In particular, it tried to identify differences in growth generated by what the authors called adding more "factor inputs," like labor, capital, or technology, and by using factor inputs more efficiently, which they called "total factor productivity." They compared data for a group of countries between 1960 and 1975, and concluded that at initial stages of industrialization, growth came largely from additions of factor inputs. In countries with an outward orientation like Korea and Japan, later growth came from increases in total factor productivity.

What policies have been followed in the country to be studied, and with what level of success? Once policy makers have reviewed the essential elements of industrial strategy as well as the actual performance of different strategies in recent years, it is important for them to relate their own country's strategy and performance to world trends. Such a process provides the basis for discussion about future options. Let us take Costa Rica as an example. A quick look at table 9.5 tells us that Costa Rica's industrial sector was a remarkable motor for growth and employment during a 20-year period; that it performed favorably compared to both developing and developed countries; and that it increased its importance relative to agriculture and services.

More detailed analysis of Costa Rica's industrial sector (see table 9.6) shows that since 1960 the country has followed a strategy of import substitution of labor-intensive nondurable consumer goods (IS1). By the end of 1985, Costa Rican manufacturing still got most of its value added and employment from labor-intensive consumer goods and 82 percent of total sales were for the domestic market.

More detailed analysis by product area can provide a sense of the relative competitiveness of a country like Costa Rica. Table 9.7, for example, provides a comparison of Costa Rican factor costs and profitability in the apparel industry with those of five other nearby countries. If we use solely financial criteria, Costa Rica's production cost structure and projected profitability make it appear a slightly more advantageous location for clothing assembly operations than the Dominican Republic, Panama, Jamaica, and Mexicali, Mexico, but less advantageous than Juarez, Mexico, and, Haiti. Its transportation costs are higher and its productivity levels are lower than some of the other countries' but its wage and benefits as well as raw materials costs are more competitive. When Costa Rica's political and social stability are considered, in 1988 it looked like a better location site than Haiti, the country with the best profitability on purely financial criteria.

Shaping the Future

What kind of industrial strategy might maximize Costa Rica's growth and development? Governments that decide to change their strategic orientation have a new set of dilemmas to manage as well.

TABLE 9.6 Composition of Value-Added Primary Market for Costa Rican Industrial Products, 1973–1985

Industrial category	Composition of value added (percentage)			Sales in domestic market (percentage)			
	1973	1981	1983	1973	1981	1984	1985
Food/beverages and tobacco	46.3	44.7	41.2	97	94	94	94
Textiles, confections, and leather	11.6	10.5	10.0	60	52	64	60
Lumber and wood products	6.8	6.0	4.4	65	61	64	66
Paper and printing	5.5	4.3	7.8	84	84	86	90
Chemicals, rubber, and plastics	14.3	18.1	23.2	73	72	75	77
Nonmetallic minerals	4.1	3.3	3.2	92	92	96	97
Light metals	9.9	12.2	10.0	72	72	71	72
Other	1.7	1.0	0.3	76	77	80	82
Total	100	100	100	85[a]	79[a]	82[a]	82[a]

a. These figures are averages for the industrial products listed.
SOURCE: For 1983, *Yearbook of Industrial Statistics, 1981–1984* (Geneva: United Nations,1985); for 1984, IICE (Economic Research Institute), *Evolucion de la Industria en Costa Rica durante 1985*, no. 93 (Jan. 1986); for 1985, ibid. (Feb. 1987).

For example, after analyzing its general performance and its industrial policy in 1983, the government of Costa Rica decided that it would move toward an outward orientation. As part of the process it decided to move toward a policy of promoting labor-intensive nondurable manufacturing exports (EX1). Some of the pros and cons of the choices they had to consider to arrive at this new industrial strategy are considered next (see table 9.8 for a summary).

Stage I Import Substitution: nondurable, labor-intensive consumer goods. The original rationale for import substitution in the 1960s was a convincing one.[38] Developing countries could save foreign exchange currently spent on imports by creating their own domestic industrial base to produce the same products for the domestic market. In the process they could generate employment and improve the quality of life for their populations. Citizens of developing countries could develop expertise in manufacturing management and production, and eventually such industries could serve as a base for export-oriented manufacturing. It appeared to make sense to begin with the substitution of labor-intensive nondurable consumer goods since these goods were less technologically complex to manufacture.

On balance most of the 85 developing countries attempted some form of Stage I Import Substitution.[39] This process did result in turning the industrial sector into a motor that helped pull the entire economy along. Structural changes did take place, and newly established domestic industry captured a larger share of GDP and employment, thus helping resolve the part of the unemployment problem.

By the 1980s, however, criticisms of this process were widespread.[40] The domestic import-substitution sector was said to be inefficient and incapable of surviving without substantial protection.[41] Critics also argued that due to the limited size of most developing country markets, large, overly diversified industries with excess capacity were created, which used capital intensive technologies and failed to create either the employment or foreign exchange savings promised.[42] Finally, it was argued that IS1 policies discriminated against the agricultural sector and opened the country to foreign ownership.[43] Based on its own analysis of the problems of continuing with IS1, the Costa Rican government felt that it would not generate the necessary growth, employment, and value added by continuing the old strategy. It therefore considered the other three options.

Stage II Import Substitution: intermediate and capital goods. When faced with the challenge of defining an appropriate industrial strategy after the easy phase of import substitution, countries like Brazil, Mexico, and India opted for expanding import substitution to include intermediate and capital goods (IS2).[44] This choice was particularly attractive to developing countries with large domestic markets and potential economies of scale for the capital investments to be made.

The risks for those considering Stage II Import Substitution are considerable as well.[45] IS2 capital and technical requirements are substantial. More

TABLE 9.7 Costa Rica and Five Neighboring Countries: Assumed Factor Costs and Profitability in the Clothing Industry

Item	Costa Rica	Haiti	Dominican Republic	Jamaica	Mexico		Panama
					Mexicali	Juárez	
Direct labor							
Base wage per hour (US$)	0.558	0.310	0.880	0.740	0.555	0.555	1.0422
Hours per week	48	48	48	48	48	48	48
Payroll taxes							
Direct (%)	41.02	33.00	28.60	30.50	42.00	42.00	43.00
Indirect (%)	25.71	29.00	17.30	27.80	35.71	35.71	27.40
Number of operators	200	200	200	200	200	200	200
Productivity factors (%) [a]	5	15	5	10	5	5	10
Production level (dozen/year)	108,700	101,900	99,650	90,584	108,700	108,700	108,700
Compound rate per KWH/month (US$)	0.144	0.679	0.170	0.120	0.290	0.290	0.095
Rent (US$ per m^2)	3.50	1.50	1.30	3.42	3.75	3.75	2.00

Statements of earnings (thousands of U.S. dollars)

Item	Costa Rica	Haiti	Dominican Republic	Jamaica	Mexico		Panama
					Mexicali	Juárez	
Exchange rate [b]	43	1	1	2.35	118	118	1
Sales	6,930	6,496	6,353	5,775	6,930	6,930	6,930
Direct labor	257	134	338	284	350	350	480
Indirect costs of manufacturing	379	336	409	431	466	466	549
Raw material	3,968	3,719	3,637	3,306	3,968	3,968	3,968
Cost of sales	4,604	4,189	4,384	4,021	4,784	4,784	4,997
Gross profit	2,316	2,307	1,969	1,754	2,146	2,146	1,933
Overhead	133	136	140	138	149	148	155
Interest	85	57	92	107	85	85	137
Transportation, insurance, and introduction duties	506	379	418	418	423	392	583
Transportation and shipping insurance	155	103	89	91	103	56	133
Total expenditures	879	675	739	754	760	681	1,008
Net profit before tax (before U.S. costs)	1,447	1,632	1,230	1,000	1,368	1,465	925

a. Based on Production Sharing International's experience of production to meet U.S. standards. b. Dollars in local currency.
SOURCE: Production Sharing International.

TABLE 9.8 Examples of Strengths and Weaknesses Normally Attributed to Import Substitution and Export Promotion (+ = strength; – = weakness)

Products	Markets: Domestic	Markets: Foreign
	Stage I Industrial Import Substitution	*Stage I Export Promotion*
Nondurable consumer goods	+ Foreign exchange savings + Employment + Expertise developed in manufacturing + Goods not complicated to produce + Springboard for other strategies – Quality – Inefficient producers – Overly diversified – Excess capacity – Capital-intensive technologies often used – Not enough employment of foreign exchange	+ Foreign exchange generated ++ Worldwide market access ++ High employment creation + Low capital and technology requirements + Builds on existing labor skills base goods – Limited room in world markets – Protectionism – Quality and competition – Risks destroying domestic industry during adjustment
	Stage II Industrial Import Substitution	*Stage II Export Promotion*
Intermediate goods	+/– Same as Stage I Industrial Import Substitution + More foreign exchange savings + Economies of scale in large markets	+/– Same as Stage I Export Promotion + Relatively fewer problems in the move from Stage I Export
Capital goods	– Capital requirements – Large market required – Not enough employment – High management expertise – High level of technology needed	– Jumping directly from Stage I Industrial Import Substitution is very difficult – Political resistance and adjustment problems in move from Stage II Industrial – Import Substitution

SOURCE: Marc Lindenberg and Noel Ramírez.

expertise is required than many countries can muster initially. Less employment is often generated, and thus the contribution to overall unemployment reduction is less than in Stage I Import Substitution. The manufacturing economies of scale require a domestic market size that the more than 70 small countries with populations of less than seven million simply do not have. Finally, some critics argue that the need for foreign technology during IS2 ran the risk of even greater foreign domination.[46] Based on their analysis of the limitations of their own small market, and of the technical and capital requirements of IS2, Costa Rica's policy makers rejected this option.

Stage I Export Promotion: labor-intensive nondurable consumer goods. The logic of moving from Stage I Import Substitution of nondurable labor-intensive consumer goods to the export of similar goods has convincing arguments in its favor.[47] Proponents argue that this requires less technical sophistication for developing countries since much of the activity is simply assembly. At the same time more employment can be generated than in import substitution, since domestic firms can produce for a world market instead of a limited domestic market. The capital requirements of assembly industries are less than for intermediate and capital goods. Finally, this approach is said to build upon the skills base for both labor and management that was developed during Stage I Import Substitution.

Such an approach is not without its risks, however, which policy makers must consider. Some critics question whether there is sufficient room in world markets for lots of new producers of labor-intensive consumer goods.[48] The new wave of protec-

tionism in developed countries might block new developing country efforts in this area. Others argue that many third world countries do not have the capacity to match the cost, quality, and productivity levels of existing producers.[49] Finally, Stage I Export Promotion requires knowledge of foreign markets and consumer tastes that firms in many developing countries simply do not have. In spite of the risks, the Costa Rican government felt this option was the most appropriate given the country's specific situation.

Stage II Export Promotion: intermediate and capital goods. Virtually no countries have opted for a move directly from Stage I Import Substitution to Stage II Export Promotion. This would require a transition from production of, say, local shoes and shirts to the export of machinery in competition with Western Europe, the United States, and Japan. The arguments against this quick jump look fairly convincing. The capital, technology, management, and other requirements are simply too great for a Stage I Import Substitution country.

However, many countries appear to be making such a transition from either Stage II Import Substitution (Mexico and Brazil) or Stage I Export Promotion (Taiwan, Singapore, Korea, and Hong Kong).

Some critics note more transition problems in the move from Stage II Import Substitution or Stage I Export Promotion to Stage II Export Promotion.[50] They argue that it is harder to get domestic producers of intermediate and capital goods to make the quality and productivity transitions for the world market than it is simply not to have had those domestic industries at all.[51] Furthermore, they argue that these producers become such a strong pressure group that it is impossible to get them to make the transition. Finally, there is some evidence that the countries that, like Mexico and Brazil, have opted for Stage II Import Substitution have incurred larger levels of foreign debt than the export-promoting countries like Singapore and Taiwan, and that their next transitions will be far more difficult.[52] Based on the problems involved, Costa Rica rejected this option.

Managing Change

Once policy makers believe that a change in industrial strategy is necessary, they must make some educated guesses about whether this change can be effectively managed. While there are no simple recipes for managing the transition from one industrial strategy to another, lessons can be learned by analyzing other countries' experiences.

Country lessons about industrial transitions. *Many countries that made successful transitions to outward-oriented industrial strategy began with stabilization programs.* Countries like Taiwan between 1948 and 1961 began their surprising economic miracles from a position of economic collapse.[53] They had to combat hyperinflation, large government deficits, large spreads between official and black market exchange rates, and balance-of-payments crises. They did so with stabilization programs. Portugal, Greece, Spain, and Israel began their successful liberalization programs from a similar set of circumstances.[54] Essential to this process were control of the fiscal deficit, tighter monetary control, and devaluation of the exchange rate. These measures combined to reduce their trade imbalances. From this base they were able to move toward medium-term programs with an outward orientation.[55]

Countries that attempted stabilization and liberalization simultaneously were not very successful. Countries that completed their stabilization processes first appear to have been more successful at liberalization than ones that tried to do both at the same time. For example, one of the key elements of an outward orientation has been maintenance of a real exchange rate.[56] Countries like Chile and Argentina in the late 1970s and early 1980s allowed their exchange rates to appreciate in an effort to get control of inflation. At the same time, they tried to stimulate exports through tariff reductions and reforms in their capital markets. Appreciation of the exchange rate reduced the incentives to the export sector that they were trying to stimulate and caused the process to falter in Chile and to halt entirely in Argentina.[57] The Philippines attempted to engage in liberalization in the midst of high inflation, fiscal deficits, and increasing foreign debt. By 1983 it was forced to reverse the process.[58]

In spite of the accumulating evidence that it is easier to undertake stabilization and then adjustment sequentially, there are examples like Bolivia (1986–1988) and Gambia (1987–1988) where such efforts have occurred simultaneously with success. Managers need to think carefully about their own countries' circumstances before recommending simultaneous efforts.

While the idea of rapid liberalization is theoretically appealing, political considerations and market imperfections in developing countries have made a gradual, phased

approach more successful. Many students of liberalization argue "if a post-liberalization situation is superior to the initial position of a country, it would seem that a swift liberalization—leading to immediate realization of the benefits yielded by the superior new situation—would be desirable."[59] Furthermore, proponents argue that with rapid reform, political resistance to change does not have time to build up.[60] It is difficult, however, to find empirical evidence of any country that has been able to mount a successful liberalization program in a three-to-five-year period. The World Bank mentions the case of Chile from 1973 to 1978 as one of unprecedented speed and breadth.[61] However, subsequent analysis of Chile's collapse during the early 1980s has raised questions about the sustainability of the effort. The experiences of Bolivia and Gambia are too recent to evaluate their medium-term level of success.

Rather, there is less ambiguous evidence of successful 10-to-20-year transition periods from one industrial strategy to another in the cases of Taiwan, Singapore, and the Republic of Korea.[62] Those who have tried to identify the reasons for the occurrence of slower, multistage transitions cite problems of market imperfections and rigidities that make the necessary economic transformations take longer than imagined.[63] They also cite the critical importance of building and maintaining political coalitions and permitting groups time to adjust.[64] For this reason much of the recent literature cites the importance of decisive but gradual phased efforts.

Demonstrating early success has helped maintain public commitment to the process. Even though it appears to require time for a country to make the transition toward an outward orientation, it still appears to be necessary to demonstrate early success in order to make the public feel that the process is a serious and credible one. There is increasing evidence that countries that demonstrated success in stabilization efforts after a serious crisis, like Costa Rica in 1983–1984, or Taiwan from 1948 to 1961, had a better chance of continuing their efforts than countries that did not do so, like the Dominican Republic from 1982 and 1984 or Jamaica in 1978.[65]

Significant differences of opinion exist about whether industrial targeting and special subsidies should accompany macro liberalization measures. Students of the experiences of Taiwan, Korea, and Singapore like Lawrence Lau, Gustav Ranis, John C. H. Fei, and Yung Whee Rhee argue that much of these countries' success in moving toward outward-oriented policies and mobilizing their industrial sector in specific ways came not simply from macro measures, but from combining these with special incentives to stimulate the industrial sector.[66] These measures were used either while import barriers were still in place or while they were being dismantled in a more gradual fashion. They believe that choosing specific product lines (autos and steel in Korea, for instance, or textiles in Taiwan) and setting export targets made a difference.

In contrast those who oppose special measures argue that governments do not know enough about which products would respond to special incentives to justify industrial targeting. The World Bank, for example, questioned the effectiveness of industrial targeting in Brazil, Mexico, and Korea.[67] It also notes that export subsidies run the risk of becoming subject to countervailing duties and charges of dumping by other countries.

Some policy sequences appear to have worked better than others. Certain policy sequences seem to help marshal transitions from inward- to outward-oriented strategies more effectively than others. For example, both Michael Michaely and Anne Krueger suggest that the most successful liberalization efforts have begun with the attempt to maintain a real exchange rate, and with a liberalization of current account transactions.[68] At this stage some countries, like Ghana between 1966 and 1971, Israel from 1962 to 1967, and the Philippines between 1960 and 1965, successfully replaced quantitative restrictions and import controls with tariffs.[69] There followed a gradual reduction of rates of effective protection on all levels of goods.

Krueger suggests that liberalizing current account transactions should be followed by the phased reduction of producer and consumer subsidies on agricultural and other products, and by attempts to create more flexibility in wage rates.[70] These adjustments might be followed by attempts to gradually liberalize the domestic capital market by permitting local interest rates to adjust to their international level.

Finally, most writers warn that capital account transactions should be opened last.[71] They reason, on the basis of problems with experiences in Uruguay, Argentina, and Chile, that foreign capital markets have adjusted more rapidly than domestic ones and resulted in large inflows that have been difficult to absorb.[72] This has created a cluster of debt with an uneven repayment flow. It has also played a role

in revaluing exchange rates and distorting the local capital market.

There are some apparent dangers in certain policy sequences during liberalization. In theory liberalization efforts might proceed in any sequence. In practice policies have interacted to create special problems for firms, the government, and other key actors. Some of the most common problems have been caused by the interaction between appreciating exchange rates, which reduce the value of export sales at the firm level, and elements of the cost structure that have risen uncontrollably such as indexed wages (Chile, 1982), interest rates (Argentina and Uruguay, 1979–1982), and raw materials costs.

Other squeezes have taken place when governments, in their desire to stimulate exports before they have found alternative sources of revenue, have reduced export taxes on the one hand or ways to cut costs on the other. Their subsequent inability to control their fiscal deficits has set off a chain of distortions that eventually result in overvalued exchange rates and a bias against the exporters they initially tried to help.[73]

Finally, attempts to stimulate exports by reducing tariffs for raw materials and intermediate goods before reducing them for finished goods have sometimes produced the opposite effects.[74] It was hoped that in theory exporters would get new advantages through reductions in raw materials costs. But in practice, continued protection on finished goods provided an even greater incentive to sell in domestic markets.

Should we embark on a new industrial strategy? A policy maker might conclude analysis of whether to embark on a new industrial strategy by answering the questions that appear in the following checklist:

1. Is the strategy well thought out?

   - Does the country have or can it generate the conditions to permit a move from its current strategy to a new one? (Or do the factors in Table 9.8 present insurmountable barriers to changing the strategy?)
   - Do the product and market choices make sense?
   - Will the country have access to the key inputs necessary for the new strategy?
   - Can the country become an efficient producer?
   - Can the country become a quality producer?
   - Can the public- and private-sector institutions adapt?

2. Is the policy package internally consistent and paced in a realistic fashion?

   - Will wage, exchange-rate, commercial, fiscal, and monetary measures all move in the desired direction?
   - Are there contraditions?
   - Does the time frame selected permit industries a good chance of successful adjustment?
   - How can the contradictions be resolved?

3. Do the coalitions exist for successful adjustment?

   - Do the internal coalitions exist for implementation of new policies?
   - If not, can the internal coalitions be developed for successfully implementing them?
   - Do the external coalitions exist for successful implementation?
   - If not, can they be developed?
   - What specific coalition-building tactics can be used?

If the answers are positive, a change in industrial strategy may be worth exploring in more detail.

Notes

Works cited only by author and date are fully listed in the bibliography at the end of this book.

1. This definition is more restrictive than some that treat the industrial sector as the sum of activities in mining, manufacturing, construction, and utilities. However, it permits a more precise look at postwar policies and their results for manufacturing. Useful definitions of industrial policy appear in F. Gerard Adams and Lawrence Klein (1983: chs. 1–2). See also C. H. Kirkpatrick and F. I. Nixon (1982: ch. 1), and John Pinder (1982: chs. 1, 9).

2. World Bank (1988a: 47).

3. United Nations Industrial Development Organization (1979).

4. Hollis Chenery, Sherman Robinson, and Moshe Syrquin (1986: 356, 358).

5. World Bank (1988a: 49).

6. Sebastian Edwards (1986a) gives an interesting account of the Chilean experience. He goes further than his colleagues who believe that inconsistent policies exacerbated the effects of the 1982–1983 world recession on Chile. Edwards argues instead that policy inconsistency actually caused the recession within Chile. See also James Hanson (1986) and Arnold C. Harberger (1986a). Another good source, which also deals with Argentina and Uruguay, is Nicolás Ardito-Barletta, Mario Blejer, and Luis Landau (1983; see particularly pp. 56–70, 91–102).

7. See Edwards (1986a, particularly pp. 249, 265, 267–68).

8. World Bank (1988a: 105).

9. José María Dagnino Pastore (1983: 32; see also pp. 21–56 and 83–102). See also Carlos Rodríguez and Larry Sjaastad (1980) and Guillermo A. Calvo (1981). For more detailed discussion of the impact of interest rate policies on Argentinian firms in that period, see Celestino Carbajal (1980).

10. For a good overview of the issues, see Chenery et al. (1986: chs. 1–2). See also World Bank (1988: chs. 1, 3, 5) as well as Kirkpatrick and Nixon (1982: chs. 1–2).

11. More detailed discussions of these strategies and the policies which accompany them appear in Chenery et al. (1986: ch. 11) and in World Bank (1988a: ch. 5). See also Bela Balassa (1979b: 20–29; 1982). Also see Gustav Ranis (1988: 173–209) and Kirkpatrick and Nixon (1982).

12. Although there are many detailed accounts of the management of exchange-rate policy during liberalization one of the most practical is that of Yung Whee Rhee (1984, particularly pp. 13–22). Another good source is Anne Krueger (1984: 403–26).

13. Yung Whee Rhee (1984: 15). See also Jacob Frenkel (1983).

14. For a review of the basic dynamics of trade policy and liberalization, see Michael Michaely (1986). See also Anne Krueger (1981).

15. See World Bank (1988a: ch. 5) and Chenery et al. (1986, particularly pp. 320–25).

16. Michaely's (1986) discussion of these options provides a good overview.

17. A good methodological discussion of tariff reduction methods is by Harry H. Bell (1981; see particularly chs. 1 and 2).

18. See World Bank (1988a: ch. 5) and Chenery et al. (1986: ch. 11).

19. For a comprehensive treatment of issues of fiscal policy in developing countries, see David Newbery and Nicholas Stern (1987); see also Yung Whee Rhee (1984: 47–60).

20. Ibid.

21. See World Bank (1988a: ch. 7, particularly pp. 122–25).

22. Detailed accounts of these problems are reported in *La Prensa* (Panama City) and *La Estrella de Panama*, Nov. 8–14, 19, 21, 22, and Dec. 12, 1983, as well as Jan. 17, 18, and March 3, 4, 1984. Also see María Larraz de Quant (1983) and Iván Saballos (1984).

23. See chapter 10 of this book, "Singapore: Switching to an Export Orientation."

24. See Joan Nelson (1988).

25. This policy, for example, was discussed in detail in Panama in 1983–1984. See the sources in note 22, above, for reactions from the labor movement.

26. The following materials provide an overview of U.S. industrial policy: Robert Wescott (1983); William Diebold, Jr. (1982); Robert Reich (1982, 1983); and Ira Magaziner (1982). For a good overview of Guatemalan industrial policy, see Noel Ramírez (1987a).

27. For material on Costa Rica, see Iván Saballos (1985), and Joan Nelson (1988), who compares Costa Rica, Jamaica, and the Dominican Republic. See also Noel Ramírez (1986), as well as Marc Lindenberg (1988b). For sources on West German industrial policy, see A. Peacock et al. (1980). See also Organization for Economic Cooperation and Development (1976), Gerhard Wagenhals (1983), and Wolfgang Hager (1982).

28. For an overview of French industrial policy see Stephen S. Cohen (1983), as well as Francis DeWitt (1983), OECD (1971), Balassa (1979a), and C. Stoffaes (1980). For good summaries of industrial policy in Taiwan, see Shirley W. Y. Kuo, Gustav Ranis, and John C. H. Fei (1981), Lawrence Lau (1986), and C. Hsu (1977).

29. Malaysia (1969).

30. See Herbert Loebl (1987).

31. Saballos (1985).

32. See John Behrman (1984: ch. 3).

33. Ibid.

34. Boston Consulting Group (1978).

35. Chenery et al. (1986: ch. 11).

36. World Bank (1988a: ch. 5).
37. Chenery et al. (1986: ch. 10); World Bank (1988a: 52–53).
38. For discussions of the origins of thinking about import substitution, see Albert Hirschman (1968), W. Baer and I. Kerstenetzky (1964), and Gustav Papanek (1968).
39. For reviews of the literature evaluating the industrial import-substitution experience, see chapter 1 of Kirkpatrick and Nixon (1982).
40. Ibid.
41. See, for example, N. H. Leff and A. D. Netto (1966) and Carlos Díaz-Alejandro (1965).
42. See Kirkpatrick and Nixon (1982: ch. 1).
43. See, for example, W. Baer (1972) and G. Arrighi (1970).
44. The article by Gustav Ranis and Louise Orroch (1985) has an excellent discussion of these issues.
45. Ibid.
46. See for example M. Merhav (1969).
47. See Bela Balassa (1978, 1979b, 1980), as well as D. B. Keesing (1967).
48. Ibid.
49. Ibid.
50. See Ranis and Orrock (1985), and the special 1977 issue of *World Development* (vol. 5, no. 1/2) devoted to these problems.
51. Ibid.
52. Ibid.
53. Marc Lindenberg and Gustav Ranis (1985).
54. World Bank (1988a: ch. 6, particularly pp. 108–9).
55. Ibid.
56. Michaely (1986: 55) and World Bank (1988a: 98).
57. World Bank (1988a: 100–105) contains a good summary of these experiences. See also note 6, above, for sources on recent experiences in Chile, Argentina, and Uruguay.
58. World Bank (1988a: 98–108).
59. Michaely (1986: 44).
60. Ibid.
61. World Bank (1988a: 103).
62. See notes 28 and 50 above, for source materials, as well as Yung Whee Rhee (1984) and Silvio De Franco (1988).
63. See Mussa (1986), Edwards (1986b), and Michaely (1986).
64. See chapter 3 of this book.
65. Nelson (1987).
66. See notes 28, 50, and 62, above.
67. See, for example, World Bank (1988a: 93).
68. See Krueger (1986), Edwards (1986b), and Michaely (1986).
69. World Bank (1988a: chs. 6–7).
70. Krueger (1986).
71. See Krueger (1986), Edwards (1986b), Michaely (1986), and World Bank (1988a: 120–21).
72. Arnold Harberger (1986b).
73. This argument is developed in a paper by Henrik Dhal, Shantayanan Devarajan, and Sweder van Wijnbergen (1986).
74. World Bank (1988a: 109–12).

Singapore: Switching to an Export Orientation

. . . families without trouble are those in which grandfather rules firmly, telling the younger generations what to do. Even then there are petty complaints. The grandchildren will complain that Elder Uncle is very good, Second Uncle is alright, while Third Uncle is nasty. Grandfather is able to reply, "Do you have enough food to eat? Do you have clothes to wear, and a comfortable place to sleep? Do you go to a good school? If so, what more do you need?" . . . As a youngster, it seemed to me that a nation was like a large family, to be dealt with in a similar way.

—Tan Kok Seng
Coolie, resident of Singapore

In February 1966, Lee Quan Yew, Singapore's prime minister, received his second hammerblow in six months. The British Defense Review Board recommended closing its military installations by 1971—installations that covered 10 percent of Singapore's land surface. The decision would result in the loss of 43,000 jobs comprising 9 percent of the small island country's total employment and 9 percent of its GDP (see table 10.1). This bad news followed on the heels of Singapore's expulsion (in August 1965) from the Malaysian Federation, to which 19 percent of all its manufactured products were sold; indeed, the very future of Singapore's Malaysian market was in question.

In the past six years Lee Quan Yew's People's Action party (PAP) had been directing an economic strategy that had resulted in high GDP growth rates (see table 10.2).

But the country still had an 8 percent unemployment rate, and a labor force growing at 2.5 percent annually. In 1967 alone, 13,000 new jobs would be needed even without the loss of the British bases. What economic strategy might help overcome the crisis? How could the PAP consolidate its political base and continue to meet the needs of Singapore's 1.8 million inhabitants?

Background

Located off the southern tip of the Malay Peninsula and just to the north of Indonesia, the city-state of Singapore comprises one main island and some fifty small ones. The total land area is 236 square miles, or 586 square kilometers (see figure 10.1).

Singapore's modern history began in 1819 when the area, then virtually uninhabited, was claimed for Britain by Stamford Raffles, who perceived the great economic potential of the island's strategic location, magnificent deep-water harbor, and plentiful fresh

This chapter is based partly on an earlier case by Amarnath V. Bhide and Professor Bruce R. Scott of Harvard Business School. Professor Scott was kind enough to let me include here some of the material from that case.

TABLE 10.1 Singapore: British Military Withdrawal and Transition Plans, 1967

Facilities (10% of the land surface in Singapore)

H.M.S. Naval Base (2,400 acres) radio station, barracks, fuel depot, dock yards.

H.M.S. Simbang (870 acres) fleet amphibious forces base, runways, aircraft repair workshops, barracks, bungalows.

Nee Song Garrison Camp (300 acres) barracks, vehicle repair facilities, schools, churches, athletic facilities.

Kaatib Training Grounds (516 acres).

Seletar (1,800 acres) 5,000-foot runway, aircraft repair workshops, ammunition and fuel storage facilities, housing, schools, recreation.

RAF Changi (1,900 acres) 8,000-foot runway, hangars, workshops, warehouses.

Palau Blakang Mati (640 acres) already occupied by Singapore military.

Pasir Panjang Complex (3,000 acres) military hospital, fuel depot, engineering workshops for armaments, vehicle repair, warehouses.

Withdrawal plan employment levels

Date	Locally engaged civilians	Locally enlisted military	Domestic servants	Total employment
Apr. 1967	30,600	4,550	8,000	43,150
Dec. 1967	28,000	4,350	7,200	39,500
Dec. 1968	22,200	4,100	5,800	32,100
Dec. 1969	19,200	3,200	4,900	27,300
Dec. 1970	13,200	2,300	4,000	19,500
Dec. 1971	0	0	0	0

Transition plan compensation by British government (grants and loans)

Donation of all facilities and fixed assets.

Cash grant of 29 million dollars (25% for purchase of non-British goods and 75% for purchase of British goods).

Interest-free loan of 86 million dollars with 25-year repayment period and 7-year grace period (25% purchase of non-British goods and 75% British).

SOURCE: Singapore Minister of Finance, *Annual Budget Statement*, 1967.

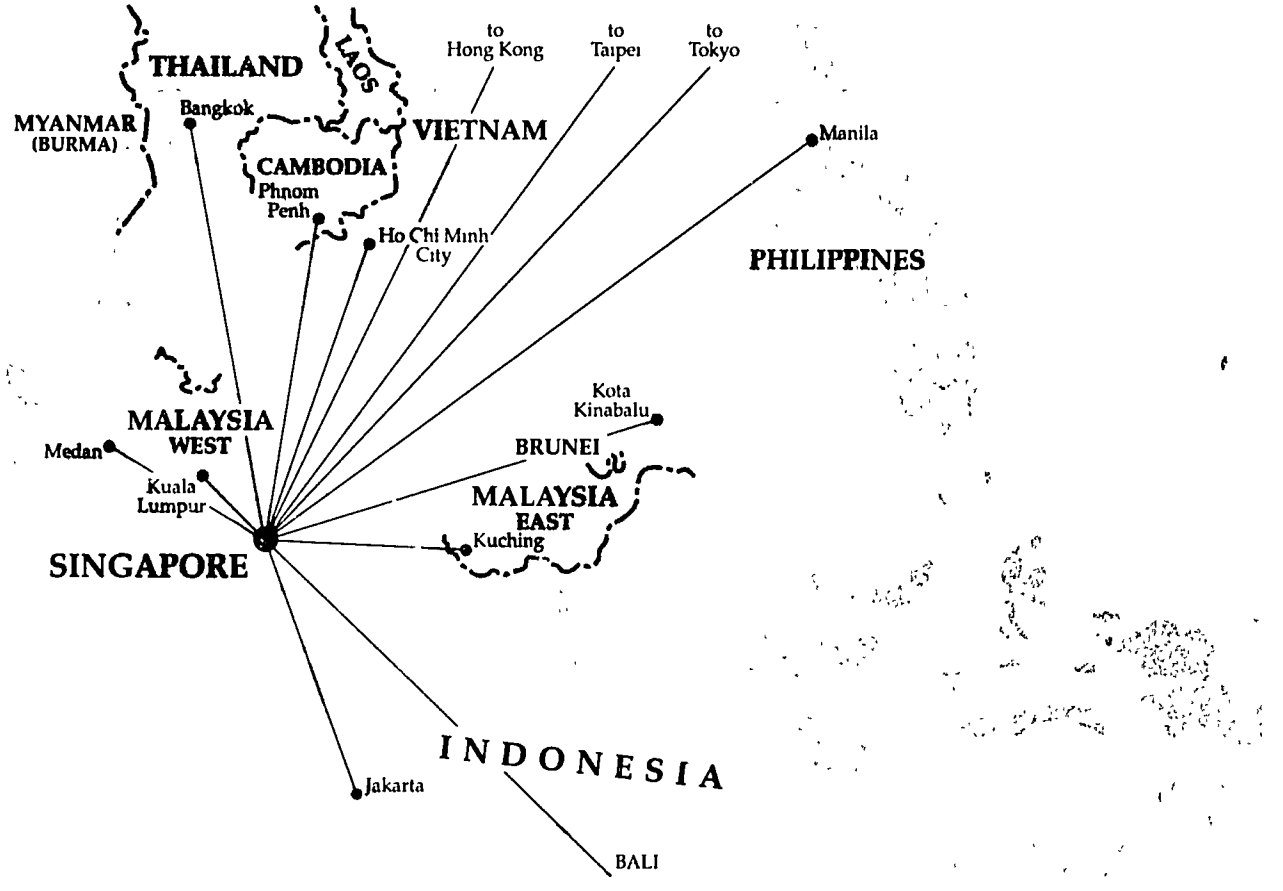
TABLE 10.2 Singapore: GDP by Sector, 1960 and 1966 (US$ million)

	1960		1966	
Sector	US$ (Million)[a]	Percent	US$ (Million)[a]	Percent
Agriculture	85	4	135	4
Manufacturing	276	13	572	17
Finance	233	11	437	13
Trade	658	31	1,009	30
Transportation	276	13	336	10
Construction	64	3	168	5
Other	530	25	708	21
Total	$2,122	100	$3,365	100

a. At 1985 prices.

SOURCE: Singapore Minister of Finance, "Economic Patterns in the Seventies," budget speech, March 7, 1972.

FIGURE 10.1 Singapore and Its Neighbors



SOURCE: Adapted from Buchanan 1972: 27, 247.

water supply. These attributes, plus Britain's policy of free trade, enabled Singapore to develop as an *entrepot* economy, that is, as one that serves a hinterland by collecting and sending out its exports and by funneling imports to it. Many years later, some results of playing such a role were described as follows.

> [An *entrepôt* economy's] importing and exporting activities inevitably require ancillary shipping, insurance, banking, and communications services, as well as the facilities, equipment, and supplies for carrying them out. Finally, retailing and other service enterprises are needed to meet the consumption needs of the people engaged in *entrepôt* activities. Thus, a successful *entrepôt* economy will inevitably develop a very wide variety of sophisticated economic activities. . . .[1]

Based on this "sophisticated" role, from the start of the twentieth century Singapore generally enjoyed—after Japan—the highest per capita income in the East.[2]

The opportunities offered by the island attracted immigrants from troubled neighboring countries, particularly China, including some immigrants "with capital and know-how."[3] By the 1920s the population was ethnically mixed. Thereafter it remained about 76 percent Chinese, 15 percent Malay, 7 percent Indian, and 2 percent "other."[4] Even within these major ethnic groups, language and dialects often differed so greatly as to preclude communication.

During World War II, Singapore was occupied by the Japanese. Especially among the Chinese population, a resistance movement got under way that was aimed at throwing off the foreign yoke. Nevertheless, at war's end Singapore reverted to Great Britain.

After ten years of colonial rule and four years of transition government, the British permitted elec-

tions. These resulted in independence and a victory for the PAP, whose leaders were middle-class lawyers, journalists, teachers, and prominent trade unionists of a social democratic perspective. Although the PAP won 54 percent of the vote, its victory had been clinched through an alliance with communist mass organizations, trade unions, and block organizations that left the PAP virtually captive. In 1963 the PAP was again reelected, but with only 47 percent of the vote, and its alliance with the newly formed Barison Socialist party, a Maoist-oriented communist party that gained 33 percent of the vote, became even more difficult (see table 10.3 for political information).

Nonetheless, during the six-year period of PAP rule, the party developed a strategy of economic development and political consolidation that was not altogether unsuccessful.

Singapore's Economic and Political Performance, 1959–1966

The PAP leadership searched for a strategy that would generate employment and economic growth on the one hand, and that, on the other, would provide the social services needed to consolidate its tenuous social base by attracting advocates from the communist mass organizations. Industrialization and employment generation would not be easy. As Dr. Goh Keng Swee, the minister of finance, saw it:

> The domestic market was small. Wages were then high compared with other Asian countries such as Hong Kong, Taiwan and South Korea. On top of this, a near endemic situation of labor-management conflict arose out of the showdown between the democratic and pro-communist forces.[5]

Yet other problems might be best tackled first, since job creation would take time. The new government needed to demonstrate concrete results to the population. Thus, housing and education were considered priority areas. But to produce results the government needed to gain control of the bureaucracy.

Winning the bureaucracy. The Singapore civil service was suspicious of the new postindependence politicians. The new prime minister went on an all-out campaign to win their support. He set up a political study center to help expose the civil service to postindependence values, and emphasized strongly that his party would reward efficiency and productivity. Lee Quan Yew in a speech to the civil servants noted:

> You and I have a vested interest in the survival of the democratic state. Whatever your views on socialism, capitalism, liberalism, communism, whether your views be progressive or conservative, your task and my task for the next five years are exactly the same, i.e. to demonstrate that the democratic system can produce results. . . .[6]

It is also useful to note that the Singapore civil servants were largely middle-class, English-educated Chinese whose social background was quite similar to that of the new leadership.

Building public housing. One of Lee's "major electioneering points" had been the ineffectiveness of the Singapore Investment Trust (SIT), the colonial housing body. Accordingly, one of his first steps was to replace the SIT with a new agency, the Housing Development Board (HDB). Its assignment was to raise housing output from SIT's level of 1,700 to 10,000 units a year for five years.

Unlike the SIT, the government decided that uniform rentals of S$20, S$40, S$60, and S$90 would be charged for one-, two-, three-, and four-room flats, respectively. The rentals were pegged at no more that 20 percent of the average wage earner's monthly income.

The concept of planning for housing estates was on the "neighborhood principle," whereby each family would ideally find all its needs—markets, shops, schools, etc.—within convenient walking distance. Where an estate had more than three neighborhoods or 75,000 people, there would be a town center to provide more sophisticated needs such as libraries, post offices, banks, department stores, and cinemas. "The sites . . . were . . . all chosen within a five-mile radius of the city, so that a worker need not travel more than half an hour each way or pay more than 50 [U.S.] cents (one Singapore dollar, or S$1.00) for transport daily."[7]

Food policy. Compared with housing, food prices and food costs were an area where the government could do little to demonstrate its concern, since nearly all food was imported. Yet, with no important farm sector to support, PAP encouraged foreign sources to dump food in Singapore (see table 10.4 for comparative data on consumer prices).

Education. Education was the second front on which the government sought to demonstrate its

TABLE 10.3 Singapore: Election Returns, 1959 and 1963, and Political Glossary

Year/election	Percentage of total valid votes						Seats in parliament
1959/Independence	Others	PAP	Alliance	LIB	SPA	Ind.	PAP: 43
	3.2	54.1	6.7	8.2	20.6	7.2	Opposition: 48
1963/Second election	Others	BS	PAP	UPP	SPA	Ind.	PAP: 37
	1.8	33.3	46.9	8.4	8.4	1.2	Opposition: 44

NOTE: Ind. stands for independent of parties, see Political Glossary.

Political Glossary

Alliance	A coalition made up of three traditional political parties: the Malaysian Chinese Association (MCA), whose supporters were usually upper- and middle-class Chinese non-English-speakers; the Malaysian Indian Congress (MIC), comprised of upper- and middle-class Indian supporters; and the United Malaysian Nationalist Organization (UMNO), whose supporters came from all classes of Malay society.
Barison Socialist (BS)	A dissident wing of the PAP, which broke away in 1954 to form its own procommunist party. The party had strong support from the Chinese working class and strong control of the labor movement through the Singapore Trade Union Congress (STUC), as well as strong influence over the PAP itself.
Chambers	The Chinese and Indian Chambers of Commerce as well as the expatriate chambers each represented upper- and middle-class businessmen on an ethnic basis.
Clan Associations	The Clan Associations were Chinese extended-family organizations that usually professed strong maintenance of cultural identity.
Labor Front	A coalition of middle- and upper-class intellectuals of all ethnic groups, which formed the first transition government in 1955. The coalition was led by David Marshall. The party had a social democratic ideology.
Liberal Socialist party (LIB)	A small splinter party connected with the Labor Front.
Malaysian Communist party	An outlawed pro–mainland Chinese communist party with ties to the Barison Socialist party.
Nan Yang San Pao	Chinese language newspaper, the chief organ of the Chinese-speaking community and with a conservative orientation.
National Trade Union Council (NTUC)	The umbrella labor organization of the PAP, which attempted to organize its own labor movement to counter balance the Barison Socialist group SATU.
People's Action party (PAP)	A party with social democratic ideology formed in the late 1960s by middle-class lawyers, journalists, and teachers, and by seven prominent trade unionists who represented the postwar generation of nationalist politicians who led the anticolonial movement. Among them were Lee Kuan Yew (the current prime minister), Dr. Toh Chin Chye, Dr. Goh Keng Swee, and Lim Chin Siong.
Singapore Trade Union Congress (STUC)	Barison-controlled trade union movement with enormous strength among the Chinese working class.
Singapore Herald	An independent progressive newspaper founded in the late 1960s.
Singapore People's Alliance (SPA)	A splinter party of the Labor Front representing a small group of intellectuals of Chinese and Indian origin.
Straits Times	The official newspaper representing the PAP position.
United People's party (UPP)	A small party with socialist orientation.

SOURCE: Marc Lindenberg.

TABLE 10.4 Singapore and Its Neighbors: Examples of Comparative Costs and Other Data, 1966

Country	Distance from New York	Cost of freight (U.S. $ per cubic meter)	Cost of communications (telephone, telex)	Wages (US$/hour)	Benefits (% of wages)
Singapore	9,090	60	*	US$ 0.31	30
Hong Kong	10,740	50	*	0.23	24
Taiwan	11,212	50	*	0.12	24
Japan	12,430	70	*	0.60	20
Philippines	10,571	50	*	0.20	16
Malaysia	9,090	60	*	US$ 0.25	20

Singapore

Consumer price index (1950=100)	No. of strikes	Person-days lost
1961: 98.0 1966: 106.7	1961: 116 1967: 10	1961: 410,889 1966: 41,322

NOTE: * means no country had an advantage.
SOURCE: Bhide and Scott 1980.

effectiveness. Dr. Goh commented as follows:

> Immediate action was taken to extend and improve the education system. School enrollment both at primary and secondary stages increased rapidly. Primary school enrollment increased from 266,625 to 336,163 between 1959 to 1963; secondary school enrollment from 48,723 to 84,425.[8]

Industrialization. Although efforts to attract industrial jobs could not yield a quick payoff, PAP still took several steps toward this goal. Thus, it implemented the Pioneer Industries scheme and the other industry ordinances passed by the previous administration to provide for investment. Like its predecessors it also called in a team of outside economic advisors, this time from the United Nations. This team made a forecast of ten-year job needs, and it gave specific advice on such industrial issues as tariff protection, safeguards for foreign investors, education for industry, infrastructural development, labor relations, and criteria for selecting industries to try to attract.[9]

In line with one of the U.N. proposals, Lee's government soon set up an Economic Development Board (EDB) "to make a success of industrial promotion and to be the instrument of the government's direct participation in industrial activity." The "nerve center" of the EDB was its Projects Division. This reviewed applications for loans, pioneer status, and tariff protection, processed applications under the control of Singapore's Manufacturing Ordinance, and prepared feasibility studies on projects and ideas that might attract investors as well as on commodities that might prove suitable for local production. Other divisions of the board had to do with underwriting and guaranteeing functions, financing, industrial site development, overseas promotion, etc. (Some of these activities were later hived off to more specialized organizations).[10]

During the 1959–1966 period, economic growth continued at 5 percent annually, value added in the industrial sector alone more than doubled, and industrial employment rose from 26,000 to 47,000 jobs (see tables 10.6–10.9 for data on economic performance, to be discussed in more detail below).

Financing the development effort. Until the PAP took office, one hindrance to effective development was the short time frame for budgetary planning. The PAP changed this with a four-year development plan drawn up by the Ministry of Finance and focused on the "pattern of financing government development expenditure." In addition the government passed the Development Loan Ordinance in August 1959, which permitted Singapore to borrow from domestic and foreign sources for development purposes.

With housing, schools, health facilities, industrial parks, and industrial infrastructure all being rapidly expanded, the government's development program was expected to require "vast sums of expenditure." Outlays of S$871 million were planned for the 1961–1964 period as compared with S$550 million spent from 1955 to 1960. To make

loans to Singapore attractive under these circumstances, the government sought to emphasize that a high proportion of its outlays would be "self-winding" or at least "revenue-earning." For example, planned outlays on housing, water, gas, electricity, and telephones were classed as self-funding, and these were put at S$330.5 million (38 percent of the projected S$871 million total). Planned outlays on sewers, roads, bridges, industrial parks, etc. were classed as revenue-earning, and these were put at S$97.8 million (11 percent of the total).[11]

Singapore found it needed to borrow less than initially projected, due to cumulative surpluses in its operating budget (see table 10.5). The government transferred substantial portions of the operating surplus to its development fund and borrowed only US$367 million between 1961 and 1965 from domestic and foreign sources.

Some 80 percent of the domestic total came from the Central Provident Fund (CPF), that is, from the social security system. Since the fund's money came from workers' and employers' contributions (both 5 percent of wages at that time), its resources represented savings. Therefore, as Lee Soo Ann pointed out, "private savings financed that part of government development expenditure which could not be paid for out of taxes."[12]

Fiscal policy. Under the PAP, Singapore's finances showed a surplus on current revenues less current expenditures, but generally showed a deficit in the overall balance after capital outlays were included. This deficit rose from about 6 percent of revenue in 1962 to 22 percent in 1966, but fell to 11 percent in 1967.

In the latter year, Singapore adopted the practice of borrowing much more than it required to finance its actual needs. The extra amount was used to build up cash balances and supplies of foreign exchange. When the United States and the IMF started selling gold in line with their objective of downplaying its role in determining international exchange rates, Singapore became a buyer of gold.

Monetary policy. As in colonial times, the exchange value of the Singapore dollar was tied to sterling throughout the 1960s. There was also a legal requirement that "gold, sterling, and other convertible foreign assets" be held "equal in value to at least 100 percent of the Singapore dollars in circulation."[13]

Available figures on the money supply and balance of payments (tables 10.6 and 10.7) show an increase of almost 10 percent a year from 1963 through 1967.

Reflecting Singapore's heavy dependence on

TABLE 10.5 Singapore. Government Current and Development Revenues and Expenditures, 1960–1965 (millions of U.S. dollars)

Item	1960	1961	1962	1963	1964	1965	Cumulative total	Cumulative surplus or deficit
Govt. operating budget								
Revenue	311	397	419	470	433	507	2,537	
Expenditure	223	275	322	370	409	430	2,029	
Surplus (deficit)	88	122	97	100	24	77	508	82
Govt. development fund								
Transfers from operating budget	20	110	30	230	16	20	426	
Domestic loans	NA	NA	NA	NA	NA	NA	257	
Foreign loans	NA	NA	NA	NA	NA	NA	110	
Subtotal fund revenues	NA	NA	NA	NA	NA	NA	793	
Development fund expenditure	36	106	120	138	166	182	747	
Fund surplus (deficit)							46	46
Combined operating & development fund surplus (deficit)								128

NOTE: NA = not available.
SOURCE: Department of Statistics, *Yearbook of Statistics* (Singapore, 1968) and *Monthly Digest of Statistics* (Singapore, March 1971).

TABLE 10.6 Singapore: Money Supply, 1963–1967 (millions of U.S. dollars)

	1963	1964	1965	1966	1967
M1	841	854	882	1,006	985
Quasi-money	643	704	767	886	1,227
M2	1,484	1,558	1,649	1,892	2,212
Other	217	183	237	285	276
Total	1,707	1,641	1,886	2,177	2,488
Change (%)	—	-3.5	14.9	15.4	14.3
Of which, due to:					
Foreign assets (net)	1,501	1,424	1,392	1,563	1,861
Domestic credit expansion	201	316	494	612	628
Claims on government	-745	-722	-618	-646	-728
Claims on private sector	946	1,038	1,112	1,258	1,356
Money/real GDP (%)	57.9	57.9	61.9	64.3	65.7

SOURCE: International Monetary Fund, *International Financial Statistics Yearbook 1979*, 364–65 and exhibit 18.

TABLE 10.7 Singapore: Balance of Payments, 1963–1967 (millions of U.S. dollars)

	1963	1964	1965	1966	1967
Trade balance (FOB)[a]	-203	-213	-248	-214	-297
Merchandise: exports (FOB)[a]	1,075	849	918	1,035	1,058
Merchandise: imports (FOB)[a]	-1,305	-1,062	-1,166	-1,249	-1,355
Other goods, serv. & income (net)	132	182	215	230	241
Private unrequited transfers	-12	-13	-12	-13	-14
Official unrequited transfers	2	-11	-14	-2	1
Current balance	-108	-55	-59	1	-69
Capital other than reserves	19	33	38	7	25
Net errors and omissions	121	18	16	42	143
Total changes in reserves	-32	4	5	-50	-99

NOTE: Minus sign indicates debit.
a. Free on board, i.e., less delivery to shipper.
SOURCE: International Monetary Fund, *International Financial Statistics Yearbook 1979*, 366, 367.

the international economy, the largest factor in the money supply continued to be net foreign assets, but the fastest-growing factor was the expansion of domestic credit.

Political consolidation. Besides trying to build support through social and economic performance, the PAP government — which had been elected on the popularity of the Communists — tried to weaken the hold of communism on key economic organizations. Trade unions were an obvious battleground. Trade union leaders, imprisoned under the previous regime, had been released, and they posed a powerful obstacle to setting up rival unions. Accordingly, the non-Communists had recourse to legislative weapons:

One of their first steps was taken in 1959, when the Trade Unions (Amendment) Ordinance was passed, giving the authorities power to refuse new unions and power to cancel the registration of existing ones. By 1960, 37 unions had their registrations canceled and 16 others had their registrations withdrawn. On May 13, 1960, a Trade Union Act replaced the Trade Union Ordinance. It provided, among other things, for compulsory affiliation of individual unions to the Singapore Trade Union Congress (STUC) and for the grouping of unions into suitable units according to occupation, trade, and industry.[14]

The Peoples Association (PA) was set up in 1960, technically as a statutory body (and therefore non-political), but the civil servants who staffed it re-

ported directly to the prime minister's office. One of several political secretaries appointed to the civil service handled the Peoples Association for the prime minister. The PA operated community centers, which provided services to the several local communities, such as kindergarten classes, community radios, and recreational facilities The object was to establish a line of contact with the grass roots.[15]

The Works Brigade was set up to reduce the pressure of mass unemployment among young people and thus to reduce revolutionary tensions The brigade was under the labor minister and his political secretary.[16]

During this period the PAP used a combination of effective economic performance with police powers and creation of parallel organizations, both in the trade union movement and at the block level, to break the hold of the Barison Socialist party over the population.

Barison fought back, but it reportedly failed to match Lee's skill:

> It soon became clear that the Barison's only strength was its mass popularity. At the leadership level it lacked both experience and shrewdness. One of the founders said, "The story after the formation of the Barison is a story of our retreat." As the party lost itself in the constitutional labyrinths of the merger move, it showed up inconsistencies which the alert prime minister was quick to exploit to the hilt. At the same time Lee projected an image of profound consistency, fortifying it with effective governmental performance.[17]

As a result, when Lee brought the merger issue to the population they voted overwhelming in favor. Singapore entered the Malaysian Federation in 1963; shortly after, Singapore returned the PAP to power in new elections.

Singapore Expelled from the Malaysian Federation, 1965

Over time, the PAP continued to suffer disappointment with the outcome of joining the Malaysian Federation. The failure to develop a common market and continued trouble with Indonesia were not the only problems. Ethnic confrontations were an added difficulty, with riots occurring in July and September 1964. Thomas Bellows reported:

> Whether in fact true, it was apparently widely believed among the Malay community that the PAP government (a Chinese-dominated government) was endangering the basic fabric of Malay society, most immediately by its urban redevelopment programs which entailed the resettling of some Malay families.[18]

Additional friction with Malaysia arose because of the PAP's desire to participate in the federal government, which the Alliance party, comprised of three racially based parties—the Malaysian Indian Congress (MIC), the United Malay Nationalist Organization (UMNO), and the Malaysian Chinese Association (MCA)—opposed and because of fundamental differences between the two parties. Dr. Chan commented:

> Generally, it may be said the PAP is a calculating democratic socialist party with a noncommunal structure based on a fairly homogeneous island. It is accustomed to open debate on nearly all political issues and swift implementation of policy. The Alliance party on the other hand is a nonideological party with a communal structure based on a plural society. It is accustomed to bargaining and balancing the interests of one racial group with the other. Especially, it is used to backroom bargains where communal demands are given private airing rather than public expression, since the leaders believe that open discussion of communal issues will only inflame racial feelings. In dealing with a heterogeneous society policy changes are of necessity gradual and slow. The PAP in attempting to impose the Singapore style of politics on Malays was destined to be unsuccessful. . . .[19]

The Alliance party members found the Singapore attitude incomprehensible. It characterized the Singapore leaders as "young men who want to rush things," who in the process "tread on everybody's toes, knock everybody's head and bring chaos, suspicions, misunderstanding, hatred, and trouble."[20] By mid-1965, the Malaysian leadership had had enough. They asked Singapore to withdraw, and Lee had no choice but to comply. Then in February of 1966 came the announcement about the closing of the British military bases in Singapore. The PAP government faced challenges it had never had to cope with before

The Values behind Singapore's Strategy

In order to understand the success of the PAP strategy from 1959 to 1966 and the values upon which past and future strategy might be built, it is impor-

tant to analyze some of the basic orientations of the party and its prime minister. The quotes below reflect some of these orientations.

> In performance no one could fault the government. Lee's method for mobilizing popular loyalty was not through conventional party organization, but through providing palpable achievement-oriented government. He sought to create legitimacy through prolonged effectiveness.[21]

> One of the first things Lee did on becoming prime minister was to call his parents and brothers around him and tell them that from then on they should expect no special consideration from him, that they were entirely on their own as ordinary citizens of the state.[22]

> Societies like ours have no fat to spare. They are either lean and healthy or they die.[23]

> If we want to mobilize human resources . . . no one has the right to slack. . . . The capitalists make people work through monetary incentives. . . . The communists do it through regimentation. . . . The democratic socialist is less ruthless and consequently less efficient, torn . . . by his desire to distribute the rewards more fairly and too soon.[24]

> I am [an] unrepentant socialist. But in my [own] state, I have to concede that, because it takes a long time to inculcate the high values of public duty . . . performance has been best only when workers are offered high incentives for high performance. . . . Our lowest productivity services . . . [are] where managers are on salary scales . . . and where our workers are on wage rates which apply equally between the proficient hardworking man and the mediocre and not so hardworking man. . . .[25]

Facing the Crisis

Early in 1967, David Bonavia of the *Far Eastern Economic Review* assessed Singapore's postindependence prospects under the caption, "Singapore's Dark Horizon." His article began by pointing out that Singapore had recently enjoyed prosperity from two unusual sources: the war in Vietnam, which "brought many export and reexport contracts," and China's 1966 reentry into the Singapore rubber market "in a big way." Clearly, the first could not be relied upon "as a long-term stimulus." As for the second, the "unreliability" of China as an export market showed up in the "fluctuations" of China's imports from Singapore in the past six years.[26]

Furthermore, Singapore's relations with Malaysia—its "traditional and natural hinterland"—were still not cordial. Exports to west Malaysia were in fact declining, "presumably because of tariff barriers." While Singapore had been hoping that renewed trade with Indonesia might "make up for any loss of trade with Malaysia," trade figures up through June 1966 still showed "a blank for Indonesian trade." Under these circumstances, Singapore was seeking to "take a leaf out of Hong Kong's postwar book"—that is, Singapore was trying to compensate for lost trade through industrialization. "Any analogy with Hong Kong, however, is a false one."[27]

> Postwar Hong Kong has been heavily dependent on textile and garment exports. It achieved its present high level of export earnings from these products before the developed importing nations — the markets that really count — took fright and imposed widespread quota systems. These importing nations — the U.S., the EEC and Britain — regard themselves as having reached the end of their tether with regard to low-cost textile imports. Hong Kong, Japan and other producers have in future to be content with the quotas they have been granted in accordance with previous performance levels. The chances for an outsider to break in to any significant extent are poor.

> This is not to say that the Singapore government has been seriously planning to establish a large textile industry for export. But what other lines of development does it have? There is still, admittedly, a good world market for cheap plastic products, though this does not seem to figure very prominently in Singapore's industrial development. There is also room for more development in the electronic [assembly] industry. But electronic assembly depends heavily on low wages and Singapore's wage structure is comparable with that of Hong Kong, which now seems likely to lose out to Taiwan, with its lower wages, in future competition for investment of this kind. Singapore also lacks entrepreneurial expertise on the light industrial side. Of course there are a host of light industrial consumer products—i.e., handicrafts, imitation jewelry, metal ware, footwear, etc.—which, taken together, can make up a useful mixed bag of export earners. But industrial fragmentation of this kind makes for inefficiency and duplication of effort in marketing, management, technological input and capital investment. This is compounded by the wide dispersal of markets. . . .

Singapore government leaders have talked blithely about developing the markets of the African and East European countries. Hong Kong's experience, however—and in this case it is valid—has been that these markets barely count.

More promising, in view of rising labor costs, are capital-intensive processing industries and heavy industries. But because of the high long-term capital involved, any investor or development agency needs to be thoroughly satisfied about the market prospects before launching into such enterprises. [Singapore's] Jurong industrial area was a farsighted project, but its basic market was Malaysia. Since politics intervened, the bottom has been knocked out of the idea. It is depressing to [visit] the windswept empty acres of the site-land at Jurong today, and reflect on what it might have been. Nearly 30 American investors are said to have called off plans last year to set up plants in Jurong after careful examination of the prospects. With the lavish provision of site facilities, this can only mean that investors see no substantial possibility of marketing the products if they set up in Jurong. [See figure 10.2 and tables 10.8 and 10.9 for information on the industrial sector.]

Singapore has to reckon with the competition of a host of other developing nations, all seeking to expand their exports. As an industrial nation, Singapore does not have enough head start or built-in advantages to assure it of success in this race, and it has virtually no natural resources or raw materials of its own. The only sensible answer is a fresh accommodation with Malaysia to restore the natural economic relationship. Failing this, it would be very much in Singapore's interest to throw all its diplomatic weight behind the tardy campaign for regional economic cooperation in South and East Asia.[28]

Britain's decision to pull its troops out of Singapore by the mid-1970s was still another blow in 1966. A *New York Times Magazine* article titled "Singapore Is Afraid That Time Is Running Out" noted that the economic impact of withdrawal would be great. British military personnel still numbered 28,000; their dependents, about 40,000. Some 45,000 local citizens were employed by these people, and about 45,000 more were indirectly supported.

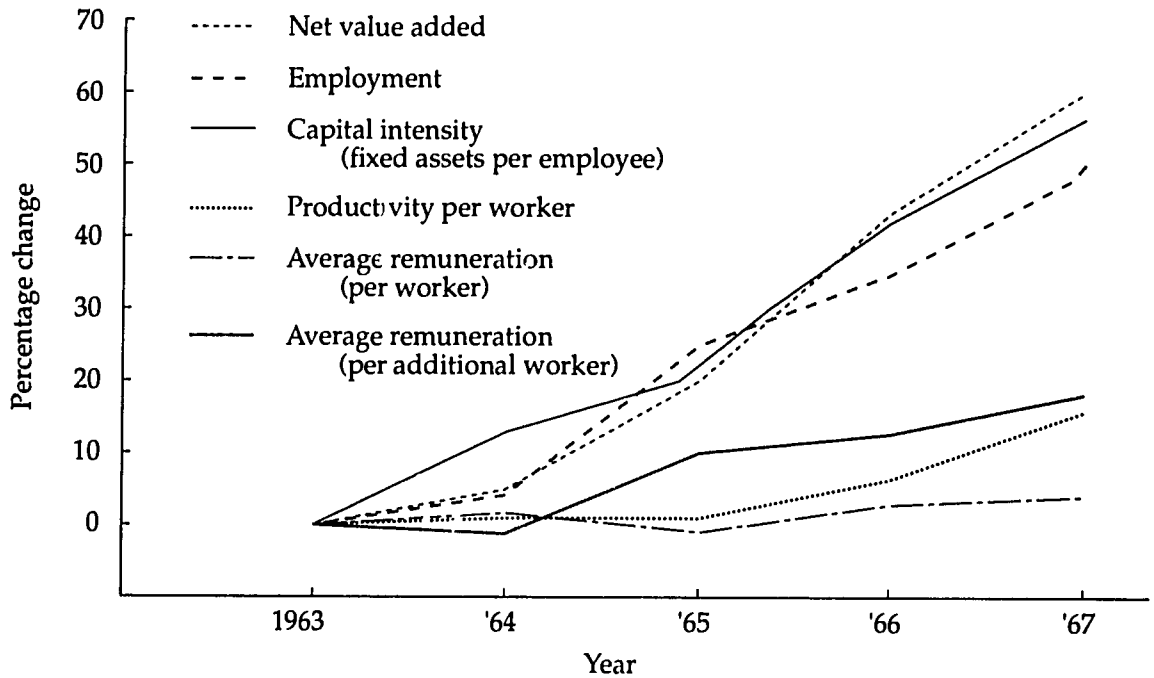
The 90,000 to 100,000 jobs that will be lost with the British pullout will be added to an already high

TABLE 10.8 Singapore: Distribution of Manufacturing Sales in Singapore and Foreign Markets, 1960–1965 (percentage)

Manufacturing category	1960	1963	1965
Singapore market			
Food manufacturing	69	71	66
Beverages	55	71	71
Tobacco	99	94	90
Textiles, footwear, and leather	71	44	27
Wood and cork	52	59	52
Furniture and fixtures	71	58	84
Paper and paper products	73	79	76
Printing and publishing	79	80	82
Rubber products	29	49	49
Chemicals, chemical and petroleum products	54	80	71
Nonmetallic mineral products	40	67	61
Basic metal products	43	47	55
Metal products	58	67	72
Machinery	76	74	66
Electrical machinery	21	40	39
Transport equipment	98	70	61
Miscellaneous manufacturing	96	98	95
All industries	64	73	67
Foreign markets			
All industries	36	27	33

SOURCE: *Singapore Census of Industrial Production*, 1972.

FIGURE 10.2 Singapore: Selected Data on the Expansion of the Manufacturing Sector, 1963–1967 (units employing ten or more workers)



SOURCE: Buchanan 1972: 86.

TABLE 10.9 Singapore: Industrial Value Added and Employment in Selected Years

	Value added (%)		Employment (%)	
Category	1959	1965	1959	1965
Food manufacturing	11	9	14	11
Beverages	14	8	7	4
Tobacco	3	8	3	2
Textiles	2	4	5	13
Wood and cork	6	6	9	10
Furniture	1	1	2	2
Paper products	1	1	1	2
Printing	16	10	14	10
Rubber	2	2	3	3
Chemicals and petroleum	7	17	6	5
Nonmetallic minerals	6	7	9	7
Basic metals	1	3	2	2
Metal products	6	8	5	9
Machinery	8	3	6	3
Electrical machinery	8	3	4	3
Transport	7	8	8	10
Miscellaneous	1	2	2	4
Total percentage	100	100	100	100
Total value	$143,000,000	$349,000,000	26,000[a]	47,000[a]

a. Thousands of people employed.
SOURCE: *Singapore Census of Industrial Production*, 1972.

> unemployment figure. It currently stands at 52,000, over 9 percent of the nation's labor force. One of the government's great tasks ahead is to spend public money in job generation. There is already under way an energetic drive to industrialize, but it is producing only 5,000 jobs a year.[29]

Finally one critic, Ian Buchanan, questioned the usefulness of the PAP's investments in the various social sectors. "None of these forms of investment," he said, "generate immediate national income." In housing, for example, "it took S$17 of investment to generate S$1 of income." Yet housing had "absorbed 22 percent of Singapore's fixed capital formation . . . over the decade 1955–65." Housing and education combined had accounted for almost 30 percent of public investment under the First Development Plan. Such an allocation of resources appeared to rest "heavily upon domestic political consideration for its justification." Its "real long-term contribution to economic development," however, was "hard to assess." Buchanan suggested that the chief payoff might be the "creation of a tightly disciplined and English-educated labor force attractive to foreign investors." Despite emphasis on the technical and vocational aspects of education, this had been the most decisive effect of the government's "social development" policy—not greater social welfare, but greater social control, and the creation of a cheap, disciplined labor force.[30]

Early success is not a guarantee of future performance. In 1966 and 1967 the leadership of Singapore's PAP began to reconsider their overall strategy.

Study Questions

1. Prepare a political map for Singapore in 1966. Who are the allies and opponents of the PAP? What strategies and tactics have been successful in consolidating power up to 1966? What may be the major political problems of the next few years?

2. What has been the PAP development strategy from 1959 to 1966? What have the objectives been? What sectors have been emphasized? What have been the successes and failures?

3. What should the government's new development strategy be? What sectors should be highlighted? What attention should be paid to social investments versus productive investments? What industrial policy might make sense? Design the strategy.

4. Which groups might support or oppose the strategy you propose? How might you manage the implementation process and build coalitions?

Notes

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173

11 MARC LINDENBERG

Industrial Policy in León: The President's Industrial Policy Commission

Business leader Juan González analyzed the proposals brought before the President's Industrial Policy Commission with a great deal of consternation. Six months ago he and other distinguished leaders from the private sector, the labor movement, and the government of León (a small Caribbean island country) had been asked to form a special commission to review alternatives in industrial development and to make recommendations about industrial policy for the next three to five years. The options (see table 11.1 for a summary) seemed hopelessly confusing.

Juan's sense of pessimism had mounted in the six months since the commission had begun its work. In the opening session the president had informed them of the facts that Juan now reviewed in his mind. The economic growth of the country this year had slowed to zero and was expected to be negative next year. The government, in an effort to continue to generate employment, in recent years had increased its fiscal deficit to more than 13 percent of gross national product (GNP) through public works programs and attempts to stimulate construction. (See figures A11.1 and A11.2 in the chapter appendix for basic data about León.) Four years earlier in 1980 the fiscal deficit had been about 5 percent of GNP. In the last four years total indebtedness in León had climbed from 50 percent to more than 75 percent of gross domestic product (GDP) and interest and amortization payments from 20 to 35 percent of GNP. The commercial banks had little appetite for lending and the multilateral lending institutions were skeptical. Certain bilateral donors were willing to help León for strategic reasons. León's traditional agricultural exports, sugar and coffee, had slumped hopelessly in recent years due to problems with international prices, while the price of oil and other imports had accelerated sharply. León's commercial sector, one of its principal economic motors, had slumped substantially as the rest of Latin America's economies had slowed.

León had also suffered from serious social problems in recent years. Unemployment according to official statistics had accelerated to almost 20 percent. Population continued to grow at an alarming 3 percent annually. The country needed more than 30,000 new jobs a year simply to maintain unemployment below 15 percent. As unemployment climbed and the government became less able to finance its jobs programs, political tensions and dissatisfaction had increased. The government maintained its 65 percent majority in the legislature, but the president had set up joint commissions of business, government, and labor that included both supporters and opponents of the government to look for solutions and to boost consensus.

Juan's commission had agreed recently on such admirable objectives for the next three to five years: (1) economic growth of 3–6 percent with generation of 30,000 new jobs per year; and (2) equitable distribution of the gains (or losses) of the next three to five

This case is about a real country situation; however, it has been disguised at the request of those interviewed.

TABLE 11.1 León: Proposed Alternatives for the Industrial Policy

Sector/policy area	Current situation	Alternative 1: rapid action	Alternative 2: transformation	Alternative 3: combined strategy	Alternative 4: inward strategy
Industry					
Tariffs	70% of products with 50% tariff	At international price levels in 5 years	At international price levels in 12–15 years	Retain tariffs Set up free zone Tax-free goods Tax rebates	Retain tariffs Simplify products
Interest rates	Subsidized	Liberalized in 5 years	Liberalized in 12 years	Subsidize	Subsidize
Available credit	Extensive	Extensive, but where there is profitability (real)	Extensive, real 10 years	Extensive	Extensive
Salaries	Minimum salaries	No minimum salaries	Salaries tied to productivity	Dual policy	Minimum wages
Taxes and profits	20% tax on profits	Exemption for 50% of profits + export sales	Exemption on employment and sales	Exemption in free zone and tax rebates	9% profit limit, more state production
Agriculture	Controlled prices	Liberate controlled prices	Release prices gradually	Liberate prices	Controlled prices
Producer-support prices	Above international prices	Liberate	Release gradually	Retain	Retain
Salaries	Minimum wages	No minimum wages	Salaries tied to productivity	Dual policy	Minimum wages
Government					
Expenditures	Deficit at 13% of GNP	Deficit at 6% of GNP	President cuts deficit to 6% of GNP	Deficit at 6% of GNP	Deficit over 6% of GNP
Unemployment	Increasing	Increased due to job cuts	Freeze jobs for 5 years	Freeze jobs	Continue increasing jobs in ministries and in public enterprises
Agencies	Diverse	More efficiency no new agencies	One agency provides all services	More efficiency	More public organizations
Debt service (interest plus amortization as % of GNP)	35%	30% in 3 years	30% in 5 years	30% in 3 years	Renegotiate or no payment

years. At the same time the president had reminded the commission members that the fiscal deficit would have to be reduced to below 6 percent of GNP in the next three years and interest and amortization payments cut to below 30 percent of exports (through renegotiation of debt) in order to convince international donors and foreign companies to both lend and invest once again in León. If such austerity criteria were maintained, resources might be forthcoming from international donors.

In their initial review of the industrial sector, Juan and others became convinced that it could not generate additional growth and employment if it continued to follow the strategy of import substitution of consumer goods. This strategy had served León successfully for almost 15 years. As a result, 88 percent of León's industrial sales were for the internal market. In 1984 the sector's strong industries were in the processing of food and beverages, clothing, shoes, and other consumer goods (see appendix table A11.1).

The industrial sector was dominated by a few family groups that controlled around 60 percent of the industrial sales. One of the groups was tied to joint investments with American and Japanese capital. The government had a few large enterprises (notably a match factory and a textile firm). The remaining industrial sales were generated by a variety of small- and medium-sized operators (see table 11.2).

On the positive side, the country's industrial development authority had identified highly promising markets for shirts and clothing in West Germany, electronic component assembly in the United States and Europe, furniture in the United States and Europe, canned and processed foods in Eastern Europe, the United States, and Latin America, and fresh vegetables and flowers in the United States. Many of the electronics assembly companies were seriously considering León as an option for new operations. León's population had an 80 percent literacy rate and good infrastructure.

On the negative side, some of León's costs were out of line with those of competitors from other countries (see appendix tables A11.2 and A11.3), and a bewildering array of government procedures slowed down and frustrated exporters. Current policies toward the industrial sector included a series of protective tariffs for local industrialists; investment incentives and tax holidays for new industry producing for domestic markets; and loans at preferential rates for industrial investors from the government development bank. During recent years, industrial wages had had a tendency to rise compared with rural wages and wages in other sectors (see table 11.3).

Productivity studies compared León's industries unfavorably to international standards (see appendix tables A11.2 and A11.3). In the agricultural sector the government had attempted to stimulate the production of basic grains unsuccessfully. The country remained a net importer and at the same time maintained price controls on basic consumer products (see table 11.4). Finally, industrialists complained of the government's inability to control smuggling of consumer goods and of excess factory capacity.

On the basis of their analysis, the commission believed that León's industrial sector would have no future in industrial import substitution of consumer goods. Instead, they believed that there were options in exports, and that as many as 10,000 of the 30,000 new jobs needed annually could be generated in the industrial sector. However, they disagreed substantially about how León might best develop a new industrial strategy. The commission had four proposals before it. The president asked Juan and the others to review the proposals and state their strengths and weaknesses. They were also asked to suggest which policy option might make the most sense for León for the next three to five years, and what steps would be needed to implement such a policy. Juan and others began to study the options carefully (see figure 11.1 for a political map and appendix tables A11.4 and A11.5 for more information).

León's Industrial Policy Options

***Alternative 1*: Rapid action to make the industrial sector competitive and to reduce government spending.** According to proponents of Alternative 1, León needed to take immediate advantage of interesting market opportunities and attract foreign investors. To do this the country had to streamline its government procedures to make it easy to invest and to export. They proposed a one-stop agency that would manage industrial promotion, industrial sites, tax benefits and certificates, and export procedures. At the same time, proponents of this viewpoint felt that local industrialists (possibly in combination with foreign investors) needed to make themselves competitive as rapidly as possible in the international market. To do this they had to become efficient and more productive, so that their prices and quality would be comparable with those of the international competition. To force the industrial

TABLE 11.2 León: Companies in the Industrial Sector by Size, Market Size, Type of Capital, and Type of Project, 1984

Companies		Markets				Companies	
		Local[a]		Foreign[b]			
Output	Size	Domestic capital[c]	Foreign capital[d]	Domestic capital[c]	Foreign capital[d]	Total	Percentage
Nondurable consumption goods[e]	Big[g]	36	8	3	2	49	12
	Medium[h]	60	6	6	3	75	18
	Small[i]	181	7	15	4	207	51
Durable consumption goods[f]	Big[g]	14	3	0	3	20	5
	Medium[h]	6	8	3	8	25	6
	Small[i]	22	2	3	0	27	8
Total companies		319	34	30	20	403	100
Percent companies		79	8	7	6		

a. 100–50% manufactured goods sold in domestic market.
b. 79% or less manufactured goods sold in local market.
c. 51% or more domestic.
d. 51% or more foreign.
e. Apparel, shoes, food items, consumer electronics, etc.
f. Machinery, transportation equipment, metal products, etc.
g. Sales over US$3 million.
h. Sales from US$1 million to US$3 million.
i. Sales under US$1 million.

TABLE 11.3 León: Terms of Trade in Agriculture and Industry, 1978–1984 (1978 prices)

		Agriculture			Industry			General	
Year	Basic daily consumption of goods	Farm products	Wages, farm sector	Unemployment, rural sector (%)	Industrial prices	Wages, industry	Unemployment, urban (%)	Export prices	Import prices
1978	100	100	100	24	100	100	12	100	100
1979	105	105	103	24	105	104	15	104	106
1980	110	106	105	27	110	106	14	106	110
1981	115	108	107	25	114	112	17	106	115
1982	120	109	107	28	118	114	16	105	120
1983	122	110	106	30	119	116	18	110	122
1984	128	110	107	29	120	116	20	110	121
End, 1984	125	110	107	30	120	116	20	110	121

TABLE 11.4 León: Support Price Policy and Agricultural Production, 1982–1983 (U.S. dollars)

Product	International price[a]	Support price[b]	Price to consumer[c]	Import quota for domestic consumption (percentage)
First-quality rice	12.50	24.00	20	40
Beans	20.28	28.00	25	60
Refined sugar	21	—[d]	30[d]	—[e]
Coffee	121	—[d]	136[d]	—[e]

a. Average import price.
b. Price set by Ministry of Agricultural Development.
c. Price established by Office of Price Regulation.
d. The government does not play a role in selling sugar or coffee, but it does establish a sales price. In the case of rice and beans, however, it both fixes the price and sells the products.
e. Quota in the international market has been filled. This has left an unsold surplus after domestic sales.

sector to adapt rapidly, these proponents said they would drop general tariffs rapidly within five years to force textile, food-and-beverage, and other industries to adapt themselves to international competition. They also proposed a raising of interest rates in the development bank over a period of five years to international market rates and the tying of all salary increases in the industrial sector to increases in productivity. To provide a cushion to industrialists and foreign investors in the transition period, they proposed a five-year tax holiday for investors who exported more than 50 percent of their sales.

In an effort to make up government tax losses from the dropping of tariff barriers and the five-year tax holiday, the proponents said they would lift government subsidies for basic products and permit the prices of local agricultural products to rise in an effort to stimulate demand. They argued that new tax revenues would be generated by the combination of cutting subsidies and new taxes generated through agricultural productivity. Finally, they argued that the program could be paid for through rationalizing government operating and capital expenditures, cutting waste, and putting a ceiling on public-sector employment as well.

Alternative 2: **Export promotion through gradual and guided transformation of the industrial sector.** Proponents of this viewpoint were encouraged by the market prospects mentioned in recent studies by the Industrial Development Authority and by the willingness of the government to streamline the export process. They agreed with the proposal to streamline the investment and export processes through the creation of a single promotion-and-investment agency. They agreed that León's current industrialists as well as new investors needed to become more productive and competitive in international markets. However, they believed that the process of adjusting the sector needed to be gradual, and that small, medium, and large companies in León needed assistance in making the transition. For this reason they proposed a new set of technical assistance services particularly to small- and medium-sized nationally owned firms to help them begin to export. In addition, they proposed reduction of tariffs but over a period of 12 to 15 years, along with the same increase in interest rates from the government development bank but over a 10-year extended period. They favored tax holidays for five years for new export industries based on criteria of both employment size and gross value exports. They proposed tying industrial wages gains to productivity but maintaining price controls for basic consumer products and gradually liberating them during a period of 10 years. They argued that the resulting tax loss would be compensated for by the general recovery of the industrial sector and eventual repayment of taxes after the five-year tax holiday was completed.

Alternative 3: **Import substitution and export promotion, a combined strategy.** Advocates of this viewpoint argued that it was possible to have the benefits of a new export policy while maintaining the existing industrial base. They proposed retaining the policy of import substitution, with its high tariffs, subsidized credit, investment incentives, and minimum wage policy. Simultaneously, they proposed the development of several special export zones for new industries where the attempt would be to produce at competitive prices and quality based on international standards. These zones would have no protective tariffs, credit would be provided at internationally comparable interest rates, and wages would be set equal to or slightly below León's current minimums and fringe benefits. Wage gains would be based totally on productivity

FIGURE 11.1 León: Political Map, 1984

	ANTISYSTEM	LEGAL OPPPOSITION	CENTRAL COMBINATION	LEGAL OPPOSITION	ANTISYSTEM
EXTERNAL SECTORS	Cuba USSR	W. Germany	USA Socialist International USAID	IMF World Bank	
SOCIAL SECTORS		Lower-class urban	Lower- and middle-class rural and urban	Upper-class industrial, farm, commercial	
REGIME			President		
POLITICAL PARTIES	FPL[a]	LCP[b] (15% of votes)	MOD[c] (65% of votes)	PRO[d] (20% of votes)	
PRESSURE GROUPS			Unions, neighborhood organizations, cooperatives	Trade unions Private sector Chamber of Industries	

a. A small radical group.
b. Communist.
c. Social Democratic.
d. Christian Socialist.

gains. The investors in these protected zones would have five-year tax holidays based on employment and sales volume. These could not sell in local markets. Those existing industrialists who wanted to export part of their existing production in textiles, shoes, furniture, or other existing industry could do so under current protection and receive tax credits equal to 20 percent of value of total sales exported. For example, if a shoe manufacturer was successful in exporting 40 percent of his total sales in any year, he would receive a tax credit equal to the value of 20 percent of the value of these sales.

In regard to the policy of agricultural price supports and support of basic food prices, advocates of the combined strategy split into two groups. One group felt that the government would not be able to afford to subsidize food prices at the same time as the new subsidies inherent in the combined strategy. Thus, they argued that consumer price controls for food would have to be abolished and that taxes would have to compensate for the new subsidies. Other groups argued that removing food price controls was politically explosive and recommended continuing with controls and adopting the new subsidies of the combined policy as well.

***Alternative 4:* Continued import substitution with a different focus.** A final group argued that the thrust at export promotion was a masked attempt by multinationals along with a few large León industrialists to destroy León's national enterprises and gain control of the industrial sector, increasing profits while taking advantage of León's cheap labor. They argued that the net effect of dropping tariff barriers would be to drive the majority of León's small- and medium-sized industrial operators out of business, thus providing an opportunity for two of the three large families to gain control of a larger piece of the industrial sector. They argued that because of wage rates and freight cost, León had little chance of competing with other countries, and that the markets identified by the Industrial Promotion Board were illusory. This group argued for continued protection but also simplification of the sector to a few industries to produce basic goods such as shoes, shirts, and simple consumer goods for mass consumption.

In general, they argued that the social function of production was to meet the basic needs of the population. They believed that investors' profits should be limited to a 7 to 9 percent return on their investments. In the event that the private sector and international capital were unwilling to respond, the government should play a more direct role in production. Finally, they argued that growth levels of about 3 percent in the whole economy were all that was really necessary to cover population growth in each sector. Concentration should be on national production to cover national needs. They recognized that foreign exchange would be necessary, but argued that this could be gained through producing traditional agricultural exports more efficiently, and forming international producers' associations to pressure for better prices. Finally, they argued that the international banking community could be pressured through coalitions of Latin American countries into restructuring interest and amortization payments, and that the burden of debt-service payments could be reduced, liberating resources for social programs and productive investments.

Juan González and other members of the President's Industrial Policy Commission studied the four proposals with the following questions in mind.

Study Questions

1. What were the strengths and weaknesses of each proposal?

2. Which groups in León would perceive that their interests were benefited or jeopardized by the proposals under discussion? Why?

3. Which general option seemed most reasonable for León? Which groups might attack the proposal and in what way? How might such groups be managed, compensated, or treated to reduce conflict?

4. What steps might be required to implement the new policy?

11

Appendix

TABLE A11.1 León: Composition of Industrial Production, by Value Added, Employment, and Percentage of Product Sold in Local Market, 1980 and 1984 (percent)

Item	Value added		Employment		% of León's domestically produced manufacturing sold in León	
	1980	1984	1980	1984	1980	1984
Food	11	20	24	15	90	85
Beverages	14	10	7	4	90	90
Tobacco	3	8	3	2	99	99
Textiles	2	4	5	9	90	60
Lumber	6	6	9	10	60	80
Furniture	1	1	2	2	90	80
Paper	1	1	1	2	90	90
Printing	16	10	14	10	80	80
Rubber	2	2	3	10	80	80
Chemicals	7	7	6	5	53	65
Nonmetallic	6	6	9	7	80	90
Metal	6	6	5	9	90	80
Machinery	8	3	6	3	76	66
Electrical	8	3	4	3	21	39
Transportation	7	8	8	10	98	80
Miscellaneous	1	2	2	4	91	95
Total percentage	100[a]	100[a]	100[a]	100[a]	88	88
Total value	422,000[b]	600,000[b]	26,000[c]	47,000[c]		

a. Columns do not add to 100 because of rounding.
b. US$ thousands.
c. Thousands of people employed.

TABLE A11.2 León and Four Neighboring Countries: Factor Costs and Profitability in the Apparel Industry

Assumed factor costs

	Costa Rica	Haiti	León	Jamaica	Mexico	
					Mexicali	Juárez
Direct labor						
Base salary per hour (US$)	0.558	0.310	0.880	0.7405	0.555	0.55
Hours per week	48	48	48	48	48	48
Payroll taxes						
Direct (%)	41.02	33.00	28.60	30.50	42.00	42.00
Indirect (%)	25.71	29.00	17.30	27.80	35.71	35.71
Number of operators	200	200	200	200	200	200
Productivity factors (%)[a]	5	15	5	10	5	5
Production level (dozen/year)	108,700	101,900	99,650	90,584	108,700	103,700
Compound rate per KWH/month (US$)	0.144	0.679	0.170	0.120	0.290	0.290
Rent (US$/m2)	3.50	1.50	1.30	3.42	3.75	3.75

Statement of earnings (thousands of U.S. dollars)

	Costa Rica	Haiti	León	Jamaica	Mexico	
					Mexicali	Juárez
Exchange rate[b]	43	1	1	2	118	118
Sales	6,930	6,496	6,353[c]	5,775	6,930	6,930
Direct labor	257	134	338	294	350	350
Manufacturing overhead	379	336	409	431	466	466
Raw material	3,968	3,719	3,637	3,306	3,968	3,968
Sales costs	4,604	4,189	4,384	4,031	4,784	4,784
Gross profit	2,326	2,307	1,969	1,754	2,146	2,146
General expenses	133	136	140	138	149	148
Interest	85	57	92	107	85	85
Transportation, insurance, and import duties	506	379	418	418	423	392
Transportation and shipping insurance	155	103	89	91	103	56
Total expenses	879	675	739	754	760	681
Net profit before taxes (before U.S. costs)	1,447	1,625	1,230	1,000	1,386	1,465
Net profit (percentage)	20	20	19	17	19	21

a. Based on Production Sharing International's experience of production to meet U.S. standards. b. Dollars in local currency. c. Projected sales for Free Zone tariff free.
SOURCE: Production Sharing International.

TABLE A11.3 León and Four Neighboring Countries: Factor Costs and Profitability in the Electronics Industry

Assumed factor costs

Item	Costa Rica	Haiti	León	Jamaica	Mexico	
					Mexicali	Juárez
Direct labor						
Base salary per hour (US$)	0.560	0.325	0.840	0.640	0.650	0.650
Hours per week	48	45	45	40	56	56
Payroll taxes						
Direct (%)	41.02	33.00	28.60	30.50	12.00	42.00
Indirect (%)	25.71	29.00	17.30	27.80	35.71	35.71
Number of operators	93	99	101	112	93	93
Productivity factors (%)[a]	5	15	5	10	5	5
Compound rate per KWH/month(US$)	0.144	0.679	0.17	0.123	0.029	0.029
Rent (US$/m^2)	3.50	1.50	1.30	3.42	3.75	3.75

Statement of earnings (thousands of U.S. dollars)

	Costa Rica	Haiti	León	Jamaica	Mexico	
					Mexicali	Juárez
Exchange rate[b]	43	1	1	2	118	118
Sales	3,250	3,250	3,250[c]	3,250	3,250	3,250
Direct labor	130	75	193	149	176	176
Manufacturing overhead	379	397	405	452	548	548
Raw material	1,500	1,500	1,500	1,500	1,500	1,500
Sales costs	2,009	1,972	2,098	2,101	2,224	2,224
Gross profit	1,223	1,278	1,152	1,149	1,026	1,026
General expenses	111	117	125	121	135	334
Interest	—	—	—	—	—	—
Transportation, insurance, and import duties	79	68	75	75	84	80
Transportation and shipping insurance	22	17	24	21	21	17
Total expenses	212	202	224	217	240	431
Net profit before taxes (before U.S. costs)	1,011	1,076	928	932	786	795
Net profit (percentage)	31	33	28	28	24	24

a. Based on Production Sharing International's experience of production to meet U.S. standards. b. Dollars in local currency. c. Projected sales for Free Zone tariff free.
SOURCE: Production Sharing International.

TABLE A11.4 León: Structure of Industrial Tariffs

Tariffs[a]	Percentage of industrial products with different levels of protection	
	1980	1984
Less than 30%	10	10
31–50%	40	40
50–100%	20	30
More than 100%	30	20

a. Percentage of nominal protection over average import price.

TABLE A11.5 León: Profits in the Apparel and Electronics Industries for Producers in Various Markets, 1984 (US$ thousand)

	Apparel			Electronics		
	Free zone	Local market	80% sales in local market + 20% exports	Free zone	Local market	80% sales in local market + 20% exports
Adjustment in sales tariffs	0	(1.15 × 6,353)	(1.15 × 0.80 × 6,353 + 1,271)	0	(1.30 × 3,250)	(1.30 × 0.80 × 3,250 + 650)
Sales	6,353	7,305	7,115	3,250	4,225	4,030
Sales costs	4,384	4,384	4,384	2,098	2,098	2,098
Additional costs	739	739	739	224	224	224
Profits before taxes	1,230	2,182	1,992	928	1,903	1,708
Taxes (20%)	0	436	398	0	380	341
Deduction CAT (–)	0	0	254	0	0	(130)
Net taxes	0	436	144	0	380	211
Profit after taxes	1,230	1,746	1,848	928	1,523	1,497
Profit as % of sales	19	24	26	28	36	36

NOTE: CAT = tax savings certificate.

FIGURE A11.1 León: Socioeconomic and Political Situation, 1983–1984

Context

International context

Temporary economic standstill, but first signs of recovery

Tension in Central America and Caribbean

Strong influence from USA

Debt crisis

National context

Population = 2 million

Caribbean island

GNP per capita = US$1,000

High literacy rate

Political tension in private and public sector

Economy

Sector	Share of GNP	Annual growth
GNP	100%	6%
Agriculture	40%	3%
Industry	10%	12%
Commerce, finance, transport, construction, other	50%	

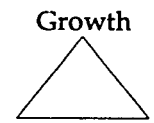
Activity

Objectives

Growth

Employment

Domestic industry



Strategies

Engines	
Agriculture	Support prices Consumer price controls for basic grains
Industry	Protection
Government	Stimulus to companies Construction Expenses ▲

Policies

Monetary	Money supply ▲
Foreign exchange	Parity with US$ Incentives to exports
Fiscal	Deficit
Salary	Industrial sector ▲

Results

Economic growth (%)

GNP	1983	1984
Agriculture	0	0
Industry	▼	0
Finance	▼	0
Commerce	0	0
Government	0	0
Construction	5	3
Other	4	▼
Foreign exchange government deficit as % of GNP	0.5▲	13
Interest plus amortization as % of exports		35
Foreign exchange balance		negative

Political

Tension ▲

Social

Actual salaries	▼	
Quality of life	▼	
Unemployment (%)	▲	20
Population growth (%)	▲	3
New jobs needed per year		30,000

NOTE: ▲ means rising; ▼ means declining.

FIGURE A11.2 León: Economic Situation, 1984 (US$ million)

GNP (US$ million)

Sector	1983	Projected growth (%) 1984	1985
Agriculture	2,400	—	—
Industry	600	(1)	—
Commerce	1,200	(2)	—
Construction	600	48	(3)
Services	1,200	(1)	2
Total GNP	6,000	negative growth	negative growth
Components of GNP and other indicators			
Consumption	4,620	2	2
Investment	1,380	2	0
Exports	2,340	2	2
Imports	2,700	4	2
Prices	100	103	105

Problem

- Stagnation (GNP growth = 0)
- Investment = 0
- Negative trade balance
- Government deficit
- High debt service
- Living standards declining

Objectives

- Growth in 3–6 years
- Equitable distribution
- 30,000 new jobs per year
- Fiscal deficit below 6%
- Debt service reduced to 30% of exports through renegotiation

Foreign debt

Item	1980	1984
Foreign debt	2,640	4,320
Debt as % GNP	50	75
Debt service	468	
Debt service as % of exports	20	35

Government income and expenses

Item	Value in 1980 (US $ million)	Percentage of GNP 1980	1981	1982	1983	1984
Current operating income	1,531	29	29	29	29	29
Operating expenses	1,310	25	28	28	28	31
Operating savings	221	4	1	1	1	1
Capital expenses	485	8	8	8	10	11
Deficit	264	5	8	8	10	13

NOTE: — means not available; parentheses indicate negative number.
SOURCE: Marc Lindenberg.

87

Industrial Policy in Costa Rica: Import Substitution or Export Promotion

In August 1984 Costa Rican policy makers evaluated their country's economic strategy. At the beginning of the 1970s, the country had abandoned its reliance on coffee and banana exports, industrial import substitution, and the development of a regional common market. Now, with a severe decline of the world economy and depressed local and regional markets, many Costa Ricans favored a new economic model based on the promotion of nontraditional exports to third markets. However, others thought that the country's economic development should be based on industrial production for local and regional markets. Still others felt that the two schemes were compatible.

According to Dr. Mario Carvajal, Costa Rica's minister of exports and investment, a development model based on industrial import substitution and the Central American Common Market (CACM) was totally insufficient for Costa Rica's requirements in the 1980s. Costa Rica's president, Luis Alberto Monge, supported Dr. Carvajal's viewpoint. Mr. Richard Beck, honorary president of the Chamber of Industries, stated:

> Costa Rica is clearly in a position to take advantage of the initiative that President Reagan and the U.S. Congress recently adopted. Due to our democratic traditions, social and political stability, and the educational and cultural levels of our people, we have all the essential elements to conquer the large U.S. market.

Dr. Eduardo Lizano, the former minister of economy and commerce and present executive president of the Costa Rican Central Bank, opposed this position. In a statement to *La Nación*, Costa Rica's largest newspaper, he stated:

> I believe that the engine of economic reactivation should be the domestic market and internal consumption, including the Central American Common Market (CACM). My approach is different than that of Dr. Carvajal. I give more priority to the CACM than third markets. I feel there is a greater economic potential in the region than in trying to reach new markets. I believe that nontraditional products sold in new markets will be nothing more than a residual and not something we can base our economic development on. Presently, our industrial infrastructure is designed to serve the domestic and Central American markets. We already produce traditional products efficiently. The economic potential of the CACM provides a real possibility of increasing our exports in the short run.

Carlos Araya, general manager of a leading industrial concern and president of the Chamber of Industries, felt that Costa Rican industrial activity deserved to be preserved and strengthened because it not only represented a direct source of income for more than 107,000 workers, but also substantially contributed to the national treasury through indirect, income, and property taxes. "Tariff protection,"

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he said, "is a political tool not exclusive to Costa Rica or Central America. On the contrary, all the more developed countries have protective measures."

In the middle of this controversy, some leaders advocated the implementation of a combined strategy substituting imports, on the one hand, and promoting exports to third markets and investment, on the other. The engineer Jorge Manuel Dengo, who replaced Mario Carvajal as head of the export and investment program, stated that it would be a mistake to concentrate resources to increase new exports without also paying due attention to "what we know how to do, and what we have available."

The Current Situation in Costa Rica

By the end of 1982, the Costa Rican economy was experiencing its worst crisis since the depression of the 1930s. Living standards fell. Social tension increased.

Economic aspects. During the 1970s, Costa Rica's strategy of industrial import substitution, support of the regional common market, and diversification of traditional exports began to pay off. Gross domestic product (GDP) grew at a rate that averaged 6 percent annually. Growth rates in the industrial sector were almost double that amount. The country continued to invest heavily in health, education, and nutrition. Income distribution improved. The country made gains in literacy and life expectancy. Infant mortality was reduced.

However, the downturn in the world economy after the second oil shock of 1978 had its impact on Costa Rica. Commodity prices fell. The country's dwindling foreign exchange earnings were further diminished as it paid for higher priced oil imports. Costa Rica experienced larger and larger negative commercial balances. To keep the economy moving the government increased its foreign borrowing, expanded the money supply, and ran increasingly larger fiscal deficits. Finally, GDP ceased to grow.

Costa Rica's GDP declined by 7.3 percent between 1981 and 1982 (see table 12.1). The value of agricultural production declined 4.7 percent and industry had a negative growth rate of 11.4 percent. Light metal, lumber, wood products, furniture, and chemicals were among the most severely affected products. The capacity utilization of most manufacturing firms declined as well (see table A12.1 in the statistical appendix to this chapter).

In spite of declining economic growth, internal credit grew 14.29 percent in 1981 and 34.75 percent in 1982. The fiscal deficit grew as well, from 4 to 9 percent between 1977 and 1980. As a result of Costa Rica's serious financial problems, its rate of inflation reached almost 90 percent in 1982.

When President Monge took office in May 1982 his economic team formulated and implemented a plan to achieve economic stabilization. At the end of 1983, the results looked positive. Inflation had been reduced to 10.7 percent. Parity between free and interbank exchange rates was established and modest GDP growth took place (0.88 percent).

Social aspects. Between 1978 and 1982, the living levels of Costa Ricans declined substantially (see table 12.2). In the words of Oscar Aguilar Bulgarelli, presidential candidate of the Social Christian Unity party (PUSC) in the 1986 elections:

> The country is developing a social confrontation which if not stopped in time will lead to the end of democracy. Not only do workers wish to recover their rights, but also businessmen want to develop productive activity.

Social dissatisfaction was widespread. Merchants gave the government a month to respond to 30 demands, which included breaking off diplomatic relations with Nicaragua, reducing public spending, and imposing controls on food prices. The banana workers went on strike for more than a week. Teachers demanded pay raises.

Political aspects. Costa Rica's political stability was seriously threatened (see figure A12.1 in the appendix for a political map). Both the National Liberation party (NLP) and the Social Christian Unity party (PUSC) were accused of trying to win the 1986 elections by mere electoral ploys and paying no attention to the needs of Costa Rica. One ex-president warned: "The lack of patriotism and cooperation among some government officials, congressmen and the presidency of the Republic is leading this country toward economic chaos and a national political setback."

The Industrial Sector

Key issues. The origins of the Costa Rican and Central American industrial sectors date back to a meeting during the fourth session of the Economic Commission for Latin America (ECLA) in November 1952, when the region's economic ministers committed themselves to achieving economic inte-

TABLE 12.1 Costa Rica: Gross Domestic Product at Producer Prices, by Sector of Origin, 1979–1982 (millions of 1966 colones)

GDP and origin	1979	1980	1981	1982	Composition by sector (percentage) 1979	1980	1981	1982	Growth rate (percentage) 1979/80	1980/81	1981/82
Gross domestic product	9,576.0	9,648.0	9,430.0	8,743.0	100.0	100.0	100	100.0	0.8	(2.3)	(7.3)
Goods	4,457.0	4,459.0	4,406.0	3,929.0	46.5	46.2	46.7	44.9	0.0	(1.2)	(7.3)
Agriculture	1,745.0	1,736.0	1,825.0	1,739.0	18.2	18.0	19.4	19.9	(0.5)	1.1	(4.7)
Manufacturing	2,103.0	2,120.0	2,109.0	1,869.0	22.0	22.0	22.4	21.4	0.8	(0.5)	(11.4)
Construction	609.0	603.0	472.0	321.0	6.4	6.2	5.0	3.7	(1.0)	(21.7)	(32.0)
Basic services	844.0	901.0	914.0	919.0	8.8	9.3	9.7	10.5	6.8	1.4	0.5
Electricity and water	201.0	225.0	242.0	253.0	2.1	2.3	2.6	2.9	11.9	7.5	4.5
Transportation, storage, and communications	643.0	676.0	672.0	666.0	6.7	7.0	7.1	7.6	5.1	(0.6)	(0.9)
Other services	4,274.0	4,289.0	4,109.0	3,895.0	44.6	44.5	43.6	44.5	0.4	(4.2)	(2.8)
Commerce, restaurants, and hotels	1,794.0	1,741.0	1,556.0	1,374.0	18.7	18.0	16.5	15.7	(3.0)	(10.6)	(3.5)
Financial institutions, insurance, and other services to firms	486.0	500.0	490.0	494.0	5.1	5.2	5.2	5.7	2.9	(2.0)	1.9
Real estate	649.0	665.0	676.0	682.0	6.8	6.9	7.2	7.8	2.5	1.7	0.6
General government	933.0	967.0	984.0	956.0	9.7	10.0	10.4	10.9	3.6	1.8	(4.0)
Other personal services	412.0	416.0	403.0	389.0	4.3	4.3	4.3	4.4	1.0	(3.1)	(8.0)

SOURCE: Central Bank of Costa Rica.

TABLE 12.2 Costa Rica: Selected Living Standards Indicators, 1979–1982 (indexes: 1978 = 100.0)

Indicators	1979	1980	1981	1982
Goods availability				
Production per inhabitant[a]	102.1	100.1	93.0	85.9
Import of consumer goods per inhabitant[b]	100.7	97.3	48.9	35.2
Overall supply per inhabitant	101.6	98.3	85.4	72.9
Consumption and imports				
Overall consumption per inhabitant	99.7	95.2	80.3	74.4
Exporters per inhabitant[c]	101.4	92.8	100.4	82.2
Revenues				
Average real wages[d]				
All employees on wage	107.6	103.7	87.4	66.9
From private sector	108.5	105.1	82.8	68.5
From public sector	105.0	97.2	84.1	62.7
Unemployment rate				
Total unemployment[e]	106.5	128.3	191.3	204.3
Urban unemployment	101.8	105.4	162.5	187.5
Rural unemployment	116.7	163.9	233.3	230.6
Per capita consumption of certain goods				
Basic food items per average wage[f]	2.4	2.2	1.9	1.1
Milk[g]	99.1	97.0	94.2	89.9
Meat[h]	94.6	75.4	87.9	NA
Electricity[i]	95.9	97.8	97.8	NA
Telephones[j]	93.8	105.5	94.0	94.0
Gas[k]	91.9	81.6	68.5	63.2
Cement	107.6	112.1	105.6	61.3

NOTE: NA = not available.
a. Colones at 1966 constant price. Production refers to gross domestic product.
b. According to an index of the volume of imported consumer goods.
c. Calculated by the Costa Rican Central Bank.
d. Calculated by the Social Security Institute and National Household Survey of Employment and Unemployment.
e. In July, according to the National Household Survey of Employment and Unemployment.
f. Refers hypothetically to the amount of foodstuffs that could have been acquired each year if the nominal wage had been spent entirely on "basic foodstuffs" at July prices. See Ministry of Labor and Social Security, La Canasta Basica Salarial y la Escala Movil de Salarios, alternativas para la definicion de la politica salarial" (San Jose, August 1982).
g. Per capita production of milk.
h. Based on the live weight of animals slaughtered for domestic consumption.
i. Electricity used in households.
j. Based on the 100 calls that each owner is entitled to.
k. Based on the national sales of gasoline per year.
SOURCE: Developed by the Academia de Centroamerica, San José, Costa Rica.

gration in the region. During this year intraregional commerce amounted to only US$9 million.

During the 1960s the region developed a common external tariff; tax exemptions on imports of machinery and equipment, raw materials, nonfinished goods, and fuel; and a tax exemption on assets and capital for industry. Between 1960 and 1982, industry's share of GDP grew from 13.8 to 21.1 percent while the agricultural sector's share diminished from 39.3 to 19.8 percent. During the same years, commerce increased only from 14.6 to 15.3 percent.

Structure. The industrial structure of Costa Rica in the 1960s and 1970s was characterized by concentration of production in light industries or nondurable consumer goods such as food products, beverages, tobacco, textiles, wood, and printing (see tables 12.3 and 12.4).

Ownership. Although there were some studies on foreign investment in the countries of the region—studies indicating that foreign industrial capital predominated by far—the ones on Costa Rica were not exhaustive. Partial studies, however, indi-

TABLE 12.3 Costa Rica: Value Added in Industrial Production, by Industrial Area, 1973–1982 (percentage)

Industrial sector	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Food, beverages, and tobacco	46.3	45.0	44.1	44.8	46.8	47.0	47.2	45.6	44.7	46.4
Textiles, apparel, and leather	11.6	11.5	11.7	11.7	11.2	10.8	10.0	10.1	10.5	14.3
Lumber, wood products, and furniture	6.8	8.5	9.3	9.9	7.8	7.3	7.2	7.1	6.0	4.8
Paper products, printing, and publishing	5.5	4.6	3.9	4.2	4.3	4.4	4.6	4.8	4.3	4.9
Chemicals, rubber, and plastics	14.3	15.5	16.9	14.8	14.8	14.9	15.5	16.8	18.1	15.7
Nonmetallic minerals	4.1	3.4	3.6	3.7	4.1	4.0	4.2	3.8	3.3	3.1
Light metal products	9.9	9.9	8.8	9.3	9.5	10.1	10.1	10.8	12.1	9.9
Other manufacturing industries	1.7	1.7	1.6	1.5	1.6	1.5	1.2	1.1	1.0	0.9
Total	100	100	100	100	100	100	100	100	100	100

SOURCE: Central Bank of Costa Rica.

TABLE 12.4 Costa Rica: Contribution of Consumer, Intermediate, and Capital Goods to Industrial Production (percentage)

	1960	1973	1982
Consumer goods	88.0	70.2	70.4
Intermediate goods	10.0	18.4	18.8
Capital goods	2.0	11.4	10.8
Total	100.0	100.0	100.0

SOURCE: Central Bank of Costa Rica.

cated that Costa Rica, like Guatemala and El Salvador, had an industrial structure dominated to a great extent by multinational companies. In 1982 an article in the *Social Science Journal* of the University of Costa Rica concluded that foreign investors owned more than 50 percent of firms in food products, beverages, transportation materials, drugs, office supplies, stationery, fertilizers, radios and electrical equipment, and furniture.

Location. While there were no industrial parks, approximately 80 percent of the manufacturing firms were located in the metropolitan area. This attracted rural migrants, contributed to rapid urbanization, and accelerated demand for basic services.

Employment. The employment level generated by the industrial sector was highly significant. In 1980, industry employed 110,000 people (16 percent of all employment) as compared to 34,000 in 1963.

Market. During the 1980–1983 period, Costa Rica decreased its sales to the CACM and Panama from 5 to 12 percent and increased its sales share in the rest of the world from 6 to 8 percent (see table A12.2 in the chapter appendix).

Table 12.5 shows the destination of industrial exports and hence the importance of Central America and Panama as consumers of Costa Rican industrial products. In 1980, 83 percent of those exports were sold to Central America and Panama, and only 17 percent to the rest of the world. By 1983, this share was 78 and 22 percent respectively. A great reduction in total industrial exports is also shown.

In 1980 Nicaragua was Costa Rica's major client. It purchased goods worth US$106 million, 43 percent of Costa Rica's total regional sales. Guatemala purchased US$63 million (25 percent), El Salvador US$51 million (21 percent), and Honduras US$28 million (11 percent). By 1983, however, Nicaragua's purchasing power had been reduced to US$40 million (22 percent of the total), Honduras's US$21 million (12 percent), and El Salvador's to US$37 million (21 percent), while Guatemala's increased to US$83 million (45 percent). It was expected that purchases from Nicaragua would drop to only US$1 million by 1983.

Beside the problem of declining industrial exports to Central America, a serious problem had emerged regarding repayment of the debt these countries had acquired with Costa Rica. Both the Ministry of Economy and the Central Bank had started bilateral negotiations with each country to find a solution to the problem. Central American countries owed Costa Rica US$210 million.

Costs and competitiveness. According to a recently published report by CINDE (Costa Rican Coalition of Initiatives for Development), Costa Rica's manufacturing costs were attractive to national and foreign investors (see table A12.3 in the chapter appendix for an example from the electronics industry).

TABLE 12.5 Costa Rica: Destination of Industrial Exports, 1980–1983 (millions of U.S. dollars and percent)

Destination	1980	1981	1982	1983
To Central America	248	227	162	181
(percent of total)	(72)	(63)	(60)	(68)
To Panama	38	44	35	27
(percent of total)	(11)	(12)	(13)	(10)
To rest of the world	58	90	72	57
(percent of total)	(17)	(25)	(27)	(22)
Total industrial exports	344	361	269	265

SOURCE: Central Bank of Costa Rica.

Pricing and controls. Official control of basic food product prices was under the jurisdiction of the Ministry of Economy, Industry and Commerce. In order to fulfill its obligation, the ministry was obliged to regulate not only the maximum prices for goods and services, but also the profit margins for production and merchandising of goods and services.

Producers argued that the system for adjustment of prices was very slow. They complained that by the time adjustments were approved, the business was already losing money. On the other hand, consumers felt that prices of the same product varied enormously depending on the location of the purchase. The producers of basic grains benefited most from price increases. Prices for the 1981–1982 rice crop increased by more than 50 percent and those for the 1982–1983 crop by 100 percent. Prices of basic grains to the consumer were set by the Ministry of Economy in cooperation with the National Production Council (CNP). New government policy was intended to eliminate subsidies in the light of dramatic deficits held by the CNP, as well as to liberalize prices even more, thus reducing the number of regulated products.

The legal context. In 1959 Costa Rica passed its first industrial law, Industrial Protection and Development Act of 1959 (No. 2426). Its main objective was to stimulate the sector through fiscal exemptions (sales and property taxes), tariff protection, and tax exemptions for importing raw materials, containers, packing materials, and machinery.

By 1959, the Multilateral Treaty on Free Trade and Economic Integration had established the Central American Common Market. The treaty was drawn up in Tegucigalpa in June 1958 and signed by the five Central American countries. The objectives of the treaty were the progressive integration of the economies of the signatory countries; expansion of their markets; development of production; and the exchange of goods and services.

In September 1959 the Central American Agreement on Import Tax Equalization established a common tariff policy. The external tariff was meant to accelerate an import-substitution process. It also provided governments substantial fiscal revenues. In practice, however, the increasing proportion of customs duty exemptions for raw materials and intermediate goods expanded the tariff protection for consumer goods. As can be seen in table 12.6, the nominal protection levels for the region as a whole evolved in many ways between 1959 (before the common tariff was adopted) and 1967 (after it was adopted).

TABLE 12.6 Central American Common Market: Nominal Protection Levels, 1959 and 1967 (percent)

Item	1959	1967
Nondurable consumer goods	65.8	113.6
Durable consumer goods	25.2	40.1
Agricultural raw materials	6.8	8.9
Industrial raw materials	32.7	35.5
Fuels and lubricants	65.2	45.6
Construction materials	20.3	63.5
Agricultural capital goods	7.0	10.2
Industrial capital goods	8.1	10.4
Transportation equipment	7.6	8.0
Total tariff	34.9	45.1

SOURCE: SIECA (Central American Economic Integration Secretariat).

In July 1962 the Central American Agreement on Fiscal Incentives to Industrial Development was drawn up in San José. Fiscal benefits granted by this agreement included (1) total or partial exemption of import taxes for machinery and equipment, raw materials, nonfinished goods, containers, and fuels; (2) exemption from income and profit taxes; and (3) exemption from asset and equity taxes. The levels of exemption varied according to the importance of the value added by the enterprise's production process; the higher the value added the higher the fiscal benefits were. This agreement superseded the Industrial Protection Act of 1959 (No. 2426), since it was an international agreement and could be superseded only by another at the same level.

The legal instrument (or legal contract) through which the government granted benefits to an enterprise was called the Industrial Contract. Once the minister of industry, energy, and mining approved the request of the enterprise to make use of the benefits of the agreement, the contract was published in the official government newspaper *La Gaceta*, and then signed by the president of the Republic and the minister of industry. The biggest concern in the Costa Rican industrial sector was the expiration, at the end of 1984, of the Industrial Contracts and Customs Policy initiative.

In the 1980s during the Monge administration a series of generalized policies to stimulate the export sector began to have their impact on manufacturing. According to Dr. Mario Carvajal, these changes were

1. Elimination of export taxes on nontraditional products.

2. A unified exchange rate (between the interbank and free-market rate) achieved in 1983 [which] meant the availability of an additional 2,020 million colones for the export sector.

3. Tax savings certificates (CATs) . . . granted to firms exporting to third markets. These credits allowed 30 percent of the value of the export sales to be applied to the payment of direct taxes. Although the CAT could be used 12 months after the export, it could be sold in the securities market allowing the exporter to receive cash immediately.

4. A 100 percent tax deduction on that part of the profits obtained from nontraditional exports to non-Central American markets.

5. Reduction of interest rates for exporters.

6. Creation of special processing for export credits in the national banking system.

7. Approval of a free-trade zone.

8. A 50 percent deduction from the amount paid for the purchase of registered stock of local corporations that exported 100 percent of their products.

In addition to these changes made in the early 1980s, the Central American ministers of economy were considering a regional tariff reform by 1986. The new tariff was intended, in the words of the project document, to "fully take the place of all tariff exemption systems for the production of goods and services, not only the Central American Agreement on Fiscal Incentives to Industrial Development, but also the ones granted through other regional or national legislatures." The following were the main features of the new proposal:

1. Every item not manufactured in Central America was assigned a 5 percent basic rate to cover the expense of maintaining the customs service.

2. Goods manufactured in Central America were assessed a scaled rate of 10, 20, or 30 percent depending on their degree of elaboration (primary, semifinished, or finished).

3. Capital goods manufactured in the region were assessed a 30 percent rate in the case of the final product, and their substitutes were given an effective protection of between 35 and 100 percent. As a result, the top nominal rate in the new tariff was 60 percent and there were a few goods with "free" rates because they were of special importance for development.

The federation of Central American Chambers and Industrial Associations offered three criticisms of the proposal:

1. The previously established rates, namely, between 10 and 30 percent for goods manufactured in Central America, did not allow the region's industrial base to expand. This promoted the transformation of the industrial sector into a consumer of raw materials, intermediate goods, and some capital goods.

2. The proposed 5 percent rate did not represent any protection for the production of industrial raw materials and capital goods that would help to integrate the manufacturing process.

3. There were mistakes within the proposal such as taxation of raw materials and final products at the same tariff rates.

There was also some resentment in the industrial sector because the new project had been formulated without input from the Central American industrial sector. Samuel Yankelewitz, vice-president of the Costa Rican Chamber of Industry, said:

> We are not willing to accept that our market, the main one in Central America, be given to foreigners. If this happens the consequences will be similar to those suffered by nations like Argentina and Chile when the liberal doctrines of the so-called Chicago Boys came into fashion.

On the other hand, advocates of the project argued that excessive protection of national industry had resulted in a noncompetitive industrial sector. Moreover, they claimed that capital was cheaper than labor, a situation that had encouraged a highly capital-intensive industry and had limited its capacity to absorb labor in the long run. Current local

production was inappropriate for a highly competitive world market that demanded quality. The industrialists who had been able to penetrate third markets had done so by improving the quality of their products. This required adjustment in production processes, quality controls and, in many cases, the purchase of new machinery.

Present Problems in the Industrial Sector

Businessmen in the industrial sector reported a number of problems. Because of the difficulties they were experiencing in paying for imported raw materials as a result of foreign exchange shortages, suppliers abroad were demanding advance payment. Direct credits from the supplier had been cut off. Moreover, the Costa Rican Central Bank was requesting a 100 percent deposit for imports as well as an additional deposit to guarantee that the product would enter the country. These deposits increased the need for working capital.

On the other hand, a producer of consumer goods for the domestic market stated that local legislation protected the importers too much. They made big commissions and offered poor service to their clients. If a producer wanted to import directly he would come up against legal restrictions designed to protect the interests of the importers.

Businessmen felt that the supply of domestic raw materials was highly unstable and of variable quality. A baby food exporter complained that the fruit he used was more expensive in Costa Rica than elsewhere. Producers of capital goods could not find either raw materials or needed intermediate goods locally.

Managers in the industrial sector complained that it was almost impossible to obtain financing. The average interest rate for the industrial sector was 25.5 percent during 1983. In addition, industrial credit from the national banking system had decreased from 26.1 percent in 1978 to 23.5 percent in 1982 (see table 12.7). The Central Bank was thinking of lowering the absolute amount of credit earmarked for this sector in 1984.

The problem of inadequate financing severely affected industrial exporters. The financial needs of the exporter were generally larger due to the greater time lag between the delivery of the goods and the receipt of income. Industrialists complained that local and regional markets had dried up.

Those who exported to third markets were better off. The demand for their products was beginning to increase due to the world economic recovery, which promised 4 percent growth in 1984. There was a general agreement that the only incentives left, especially the CAT (a tax savings certificate), were for exporting to third markets. An exporter of industrial goods stated that he viewed tax exemptions not as an incentive but rather as a way of returning to the industrialist a minimum profit on his investment.

> The CAT has allowed many firms to operate profitably and compete in third markets. Even so, there were exporters to third markets who felt that the CAT was not enough to compensate for the huge number of disincentives such as the tax burden, bureaucracy, lack of financing, local inflation, deposits, collateral for the importing of goods and intermediate goods, contraction of the market, and others.

Industrialists had mixed opinions about transportation. While some respondents stated that they did not have any problem with exports to the regional market or third markets, others had many problems. A baby food exporter to the regional market said that land transportation was a mess, since the big firms he had worked with traditionally did not want their trailers to cross countries such as Nicaragua or El Salvador. They feared equipment or merchandise loss due to violence or bureaucratic barriers. Because of this they had to depend much on small firms, which were very unreliable.

A capital goods exporter to third markets said that the problem with sea transportation was that it was

> designed for a trade flow from the center to the periphery and vice versa, such as New York–Limon, Limon–New York or Miami–La Guaira, La Guaira–Miami. But, sending something from Limon to La Guaira was almost impossible or the costs were incredibly high. The schedules were ridiculous and you were never on time with your deliveries.

There was a consensus among respondents for an INCAE survey for 1984 that there were few problems with labor and productivity. The "solidarity associations" (a widely used type of labor organization in Costa Rica) had been very successful in achieving excellent labor-management relations. Although sometimes it was difficult to find skilled labor, this was not considered a serious problem. On the other hand, Costa Rican labor was considered to be among the most skilled within the developing world.

TABLE 12.7 Costa Rica: Loans of the National Banking System by Activity, 1978–1982 (millions of colones and percent)

Activity	1978		1979		1980		1981		1982	
	Balances	Share (%)	Balances	Share (%)	Balances	Share (%)	Balances	Share (%)	Balances	Share (%)
Agriculture	1,850.0	22	2,133.3	21	2,569.5	22	3,009.1	23	4,679.0	29
Livestock	1,861.8	22	2,145.0	21	2,616.6	22	2,742.3	21	3,499.8	21
Industry	2,201.6	26	2,512.3	25	2,657.9	22	2,703.0	21	3,858.7	23
Commerce	411.7	5	665.5	7	840.7	7	953.7	7	1,081.2	7
Services, transportation, and storage	770.2	9	912.7	9	976.6	8	963.6	8	903.0	6
Housing	982.2	12	1,297.0	13	1,575.2	13	1,780.8	14	1,909.4	12
Personal credit	357.3	4	545.0	4	661.5	6	663.3	6	470.2	2
Total	8,434.8	100	10,210.8	100	11,898.0	100	12,815.8	100	16,401.3	100

SOURCE: Central Bank of Costa Rica.

Historically, wage increases in the public sector were made in absolute amounts "across the board." Percentage increases were given in the private sector according to negotiations between labor and management, subject to approval by representatives of the Ministry of Labor. In 1982 a new procedure called the "mobile wage range" was established. This system consisted of calculating wage adjustments in absolute amounts every six months in accordance with the total increase experienced by a given group of goods (basic food products) during the previous six-month period.

In spite of the substantial wage increases during recent years, real wages for all sectors had declined by 15.3 in 1981 and by 24.2 percent in 1982. Respondents felt that the institutional framework within which the firms operated was unstable; there were constant changes in the "rules of the game." One industrialist said:

> One day they change the requirements for importing; another day they change the list of items that one can import, and the same story is true for export regulations. One day it is easy to export to Central America and the next day they come up with another requirement.

Which Strategy for the Future?

The industrial sector benefited substantially from import-substitution policies in the 1960s and 1970s. However, political support for nontraditional exports to third markets had developed in recent years. Indeed, it could be said that new rules of the game were defined and a political base for these policies had been built.

Clearly, the export sector was becoming a favored group. But many business and government leaders had doubts about whether export promotion could coexist with import substitution. Would it be possible to adopt a combined approach using the positive aspects of both strategies? Could policies with incentives for both sectors be designed?

Study Questions

1. What industrial policy existed in Costa Rica at the end of the period described in this case? What were its strengths and weaknesses?

2. What options appear to make the most sense for the future in the area of industrial policy?

3. Which groups might perceive themselves to be winners or losers as a result of these options?

4. How might an economically and politically successful strategy be designed?

12

Appendix

TABLE A12.1 Costa Rica: Capacity Utilization of Industrial Production, by Industrial Area, 1975–1981 (percentage)

	Utilization[a]			
Industrial Area	October 1975	October 1976	October 1979	1981[b]
Food, beverages, and tobacco	68	80	71	69
Textiles, leather, and footwear	67	89	58	60
Lumber and furniture	73	80	79	57
Paper and cardboard	NA	96	77	71
Printing and publishing	87	87	86	71
Chemicals	NA	87	83	70
Rubber	95	100	83	70
Petroleum derivatives	NA	60	100	NA
Nonmetallic minerals	72	68	62	56
Light metal products	66	63	83	54
Other manufacturing industries	NA	78	77	33
Total	68	87	77	64

NOTE: NA = not available.
a Does not include coffee mills, meat, and sugar.
b. Second semester average.
SOURCE: National Planning Bureau (OFIPLAN), and Economic Research Institute of the University of Costa Rica (IICE).

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TABLE A12.2 Costa Rica: Destination of Industrial Sales, 1980–1983 (percentage)

Industrial Area	1980			1981			1982			1983		
	DM	CAPM	RM	DM	CAPM	RM	DM	CAPM	RM	DM	CAPM	RM
Food products, beverages, and tobacco	94	4	2	94	4	2	93	4	3	93	4	3
Textiles, confections, and leather	52	25	23	52	24	24	60	16	24	62	15	23
Lumber and furniture	59	23	18	61	15	24	62	14	24	58	15	27
Paper products, printing, and publishing	79	18	3	84	14	2	85	12	3	82	15	3
Chemicals, rubber, and plastics	71	25	4	72	24	4	76	19	5	77	19	4
Nonmetallic minerals	99	1	0	92	1	7	94	0	6	94	0	6
Light metal products	73	24	3	72	23	5	70	26	4	71	25	4
Other industries	68	32	0	77	22	1	76	23	1	78	21	1
Total	79	15	6	79	14	7	80	12	8	80	12	8

NOTE: Sales exclude meat, coffee, and sugar. DM stands for domestic market, CAPM for Central American and Panamanian markets, and RM for the rest of the world's markets.
SOURCE: Central Bank of Costa Rica.

TABLE A12.3 Costa Rica and Five Neighboring Countries: Factor Costs and Profitability in the Electronics Industry

Assumed factor costs

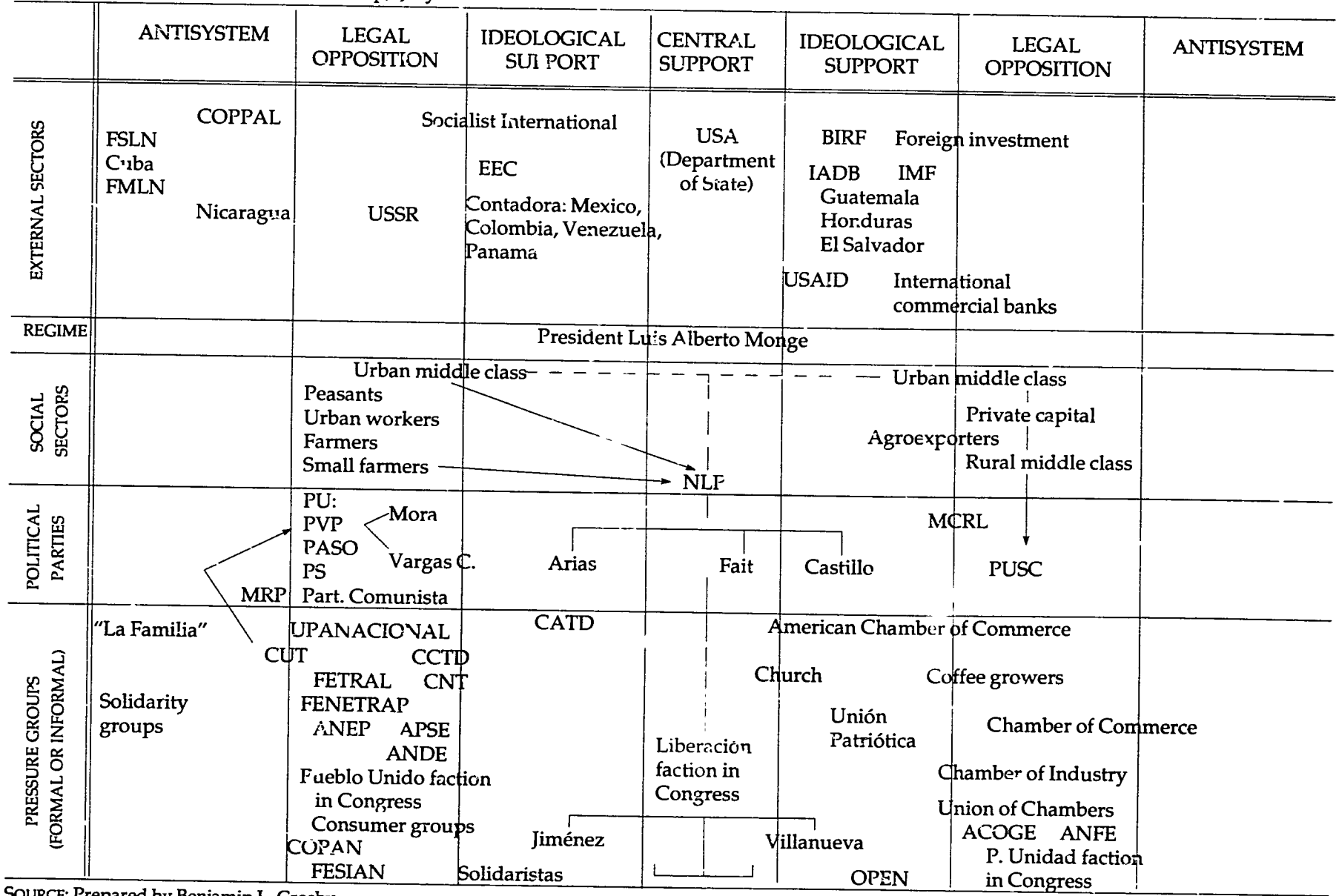
Item	Costa Rica	Haiti	Dom. Republic	Jamaica	Mexico		Panama
					Mexicali	Juárez	
Direct labor							
Base wage (US$)	0.560	0.325	0.840	0.640	0.650	0.650	1.093
Hours per week	48	45	45	40	56	56	48
Payroll taxes							
Direct (%)	41.02	33.00	28.60	30.50	12.00	42.00	43.00
Indirect (%)	25.71	29.00	17.30	27.80	35.71	35.71	27.40
Number of operators	93	99	101	112	93	93	93
Productivity factors (%)[a]	5	15	5	10	5	5	10
Compound rate per KWH/month (US$)	0.144	0.679	0.170	0.120	0.029	0.029	0.095
Rent (US$per m^2)	3.50	1.50	1.30	3.42	3.75	3.75	2.00

Statement of earnings (thousands of U.S. dollars)

Item	Costa Rica	Haiti	Dom. Republic	Jamaica	Mexico		Panama
					Mexicali	Juárez	
Exchange rate[b]	43	1	1	2.35	118	118	1
Sales	3,250	3,250	3,250	3,250	3,250	3,250	3,250
Direct labor	130	75	193	149	176	176	254
Manufacturing indirect cost	379	397	405	452	548	548	607
Raw material	1,500	1,500	1,500	1,500	1,500	1,500	1,500
Cost of sales	2,009	1,972	2,098	2,101	2,224	2,224	2,361
Gross of sales	1,223	1,278	1,152	1,149	1,026	1,026	889
Overhead	111	117	125	121	135	134	136
Interest	—	—	—	—	—	—	—
Transportation, insurance, and introduction duties	79	68	75	75	84	80	104
Transportation and shipping insurance	22	17	24	21	21	17	30
Total expenditures	212	202	224	217	240	231	270
Net profit before taxes (before U.S. costs)	1,011	1,076	928	932	786	795	619

a. Based on Production Sharing International's experience of production to meet U.S. standards.
b. Dollars in local currency.
SOURCE: Production Sharing International.

FIGURE A12.1 Costa Rica: Political Map, July 1984



SOURCE: Prepared by Benjamin L. Crosby.

Taiwan, 1986: Choices for the Future

Taiwan belonged to imperial China until 1895, received initial modernization as a colony of imperial Japan between 1895 and 1945, and after 1945 experienced rapid development under the largely mainlander Nationalist Chinese government. From the 1960s the island was successful in exporting light industrial products, particularly to the United States. By the mid-1980s, in the face of increasing Third World competition and First World protectionism, Taiwan has made some progress at upgrading its products and diversifying its markets. Meanwhile the Nationalist government faces continuing diplomatic challenge from the Chinese Communist party which, like the Nationalists, regards Taiwan as part of one larger China. The Nationalist government also faces some domestic challenge from a nascent opposition political party, the underlying issue being more political participation for the majority native Taiwanese.

—The Executive Yuan
Taipei, Taiwan
Republic of China
October 10, 1986

The following fictitious document pretends to be a memorandum from a senior Nationalist mainlander economic policy maker to his fellow cabinet colleagues, outlining the major economic policy problems before their ruling Nationalist party.

Dear Colleagues:

Today is the anniversary of the 1911 Revolution.[1] Our founder, Sun Yat-sen, defined modern Chinese Nationalism through the Three People's Principles of Nationalism, Democracy, and Livelihood. Our former leader Chiang Kai-shek advanced these principles on the mainland for many years. Today, perhaps for one of the last times, our present leader, an aging son, Chiang Ching-kuo, addresses the people of Taiwan. As he reasserts our party's mission to reunify China, his quaint mainland accent quavers up from the steps of the presidential office out over the marching troops and cheering crowd, both composed largely of native Taiwanese. "We have to join our minds and efforts and, in wisdom, unselfishness, and the spirit of the Chinese value of loyalty we will help our one billion compatriots to enjoy a life under the Three People's Principles in final victory."

However familiar the formulation, this is a moment to be savored, the end of an era full of the paradoxes of change. Here is a Chinese man, edu-

Edwin A. Winckler is a professor at the East Asian Institute, Columbia University. George C. Lodge is a professor at the Harvard Business School.

cated in the Soviet Union but allied with the United States, standing before a Japanese building and reaffirming our responsibilities toward our fellow Chinese. Here is a Chinese official who began his career in security work punishing capitalist speculators in Shanghai in the 1940s and suppressing potential dissidents on Taiwan in the 1950s; who as prime minister presided over the maturing of Taiwan's capitalist development in the 1970s; and who as president has inaugurated a political rapprochement with the Taiwanese in the 1980s. Here is a Chinese politician who, despite being our former leader's son, now promises that no member of the Chiang family will succeed him. Here is a man who presides over one of the most rapidly modernizing countries in the world by adhering to conservative development policies and traditional Chinese values, particularly loyalty to parents, compatriots and, above all, principles.

Well, we have much reason for satisfaction with our performance as the "ruling party" on Taiwan. To atone for our loss of the mainland, we vowed to make Taiwan a model of Sunist development, and so we have done. We remain independent of communism and have even retained some independence from our Western political patrons and capitalist economic partners. Much to our surprise, since 1950 a few correct policy choices have transformed Taiwan into an economic miracle of rapid growth, full employment, rising incomes, and low inflation. Having carefully cultivated the appearance of democracy these forty years, we are actually beginning to implement some of it. So far, traditional Chinese social values have continued to underpin political stability and economic prosperity. Per capita income has grown from $100 in 1950 to more than $3,000 in 1985.[2] The distribution of income among our 20 million people is as equitable as that of any country on earth. Industrial growth between 1950 and 1985 increased at an average rate of from 10 to 15 percent a year to produce a gross national product (GNP) of US$60 billion, about one-third that of Brazil (with a population of 136 million) and roughly three-quarters that of South Korea.[3] All this on an island the size of our early colonizer, Holland, with virtually no natural resources and a dense population, under early military threat and increasing diplomatic isolation.

We have always had faster economic growth and greater political stability than our rivals the Chinese Communist party (CCP), though many of us realize this is not surprising given the greater burden of poverty and backwardness they face. Consequently, as any likelihood of military recovery of the mainland has receded, we have been able to substitute the notion of moral recovery, in which we define victory as the mainland's following our example. This is not completely fanciful, as the CCP begins to lose faith in its own communism, and faces rising demands for more democracy from its own people. Like us in the 1960s, in the 1980s they have stimulated agriculture, promoted light industry, and encouraged both outgoing exports and incoming investment. Meanwhile, any immediate military threat to us continues to decline, as the People's Republic of China (PRC) deploys its troops against the Russians and their allies, and becomes more involved with the Americans and their allies.

However, we also have much reason for concern, and this will be the main focus of this memorandum. The first section summarizes the political and economic setting for our economic policy as a series of triangular relationships, one each for external security, foreign trade, and internal stability. Prospects for maintaining the long-run security balance against the mainland are problematic, as the Communists gradually expand their defense industries and pressure the Americans to reduce our access to advanced military equipment. Some pessimists think our foreign trade will be squeezed to death between more-developed nations that react against our economic success by hoarding their technology and closing their markets, and less-developed nations that imitate our economic strategy of cheap labor followed by technology upgrading. No one knows what will be the effect on domestic stability of the transition from low-tech to high-tech industries and from authoritarianism toward democracy, particularly if economic problems reduce support for the Nationalist party and increase welfarist demands on the budget. Many of us wonder how long traditional Chinese virtues can withstand such rapid and pervasive westernization.

The second section of this memorandum then reviews the history of Taiwan's development, noting the lessons of each period for the present. The final three sections discuss the issues we face in three areas of economic policy—production, marketing, and finance. In production we must adjust declining labor-intensive industries such as textiles, promote skill-intensive industries such as electronics, and modernize the managements of our mostly small, family firms. In marketing we must diversify our export markets beyond the United States, combat American protectionism, and bypass Japanese and American middlemen by selling more of our products abroad ourselves. In finance, we must define a viable role for ourselves in international economic

organizations and global capital markets; reform our domestic financial institutions to channel savings into investment more effectively; and reform our domestic fiscal system to encourage competitiveness, increase revenues, and meet possible future welfare demands.

Setting

Our economic choices are narrowly constrained by their broader geopolitical and political-economic setting.

Security triangle. Our external military security involves a triangular relationship between us, the PRC, and the United States. Basically, we are reducing our dependence on the United States for arms with which to defend ourselves from the PRC, but we can never fully defend ourselves on our own. Meanwhile the PRC tries to win through diplomacy in Washington what it would rather not have to win through battle in the Taiwan Straits. The United States tries to maximize its use of the PRC against the USSR, while trying to minimize the political-military costs to us. We try to involve Americans in our affairs in every conceivable way, while building our own independent military capabilities by diversifying our defense procurement and developing our defense industries. Though we would rather have American protection, we can get more defense for the dollar by focusing on defending Taiwan than by continuing to outfit ourselves as an American ally. Still, we seize any opportunity to be of service to the United States, such as training other third world security forces, and even contributing aid to the contras in Nicaragua.

For the next five to ten years, the main problem will continue to be maintaining air superiority over the Taiwan Straits, so that we can contain any communist invasion or blockade long enough for the West to rescue us—if it will. Some of us think we don't really need the most advanced fighters, which Washington refuses to sell us, but it would be nice to have them, and to maneuver Washington into flouting Peking. Fortunately the Americans are allowing private defense contractors to transfer the technology that the PRC demands the Pentagon no longer supply us, so our own all-weather defense fighter should come on-stream in the 1990s. In addition we buy arms from Western Europe and Saudi Arabia, and share technology with such international pariahs as Israel and South Africa. Consequently we can make or buy such items as artillery, patrol craft, small missiles, and even—though they would be useless to us—nuclear weapons.

Our struggle with the PRC is also psychological. We have refused any negotiation, contact, or concessions because they would only have undermined a viable status quo. However, we can no longer afford the appearance of utter obstinacy, so in practice we are now allowing more contacts, so long as they remain unofficial. Many mainlanders favor formal postal and telecommunications links so that they can communicate with their families on the mainland, and many Taiwanese businessmen favor formal trade relations as well. However, we do not want our citizens vulnerable to communist leverage as a result of their larger purchasing power, or our government vulnerable to procommunist constituencies. Our position is that we will negotiate with the Communists when they cease to be Communists, which should give us plenty of time. Meanwhile the attitudes of mainlanders and Taiwanese toward the PRC continue to converge. Mainlanders are so ambivalent about contacts with the PRC because in principle we favor reunification with it, but in practice we know that our present de facto independence is the best we can do. Native Taiwanese are not afraid of contacts with the mainland because in principle they favor formal independence, not reunification, but they realize that too much vocal assertion of the desire for independence may provoke the mainland to militarism.

Trade triangle. Our economy is overwhelmingly dependent on trade, and our foreign trade involves a triangular relationship between us, the United States, and Japan. Basically, we depend on the United States for marketing our output, and on Japan for upgrading our imports. Thus exports in 1985 totaled US$31 billion (see table 13.1), more than half of which went to the United States, to whom we are the fifth largest exporter. Our imports were US$20 billion, of which only one-fourth came from the United States. Washington complained about our US$11 billion trade surplus with the United States in 1985, and is complaining even louder about our US$15 billion surplus in 1986 (see table 13.2).

For its own geopolitical and economic reasons, around 1960 the United States provided the opportunity for our economic development by opening its markets to our light industrial products, providing about 40 percent of our foreign investment, and transferring much technology to its relatively large and advanced subsidiaries here. Consequently, as in defense, we have depended too much on the United States, pegging our currency to the dollar, waiting

TABLE 13.1 Taiwan: Foreign Trade, 1980–1986 (US$ million)

Year	Imports	Exports	Balance
1980	19,733.1	19,810.6	77.5
1981	21,199.6	22,611.2	1,411.6
1982	18,888.4	22,204.3	3,315.9
1983	20,287.1	25,122.7	4,835.7
1984	21,959.1	30,456.4	8,497.3
1985	20,102.0	30,722.8	10,620.7
1986 (est.)	24,185.0	39,682.0	15,497.0

SOURCE: Council for Economic Planning and Development, Republic of China, *Taiwan Statistical Data Book, 1986* (Taipei, 1986).

for American buyers to come to Taipei, and concentrating on the American market. Of course we have much raw material and capital equipment, and even some consumer goods and commercial services from the United States. However, since the 1970s these purchases, even when supplemented by a dozen government buying missions, have not been enough to prevent an increasingly embarrassing bilateral trade surplus with the United States.

Meanwhile we obtain even more of our capital goods and technology licenses from the Japanese, who cannily keep their domestic market largely closed to us. The more we produce and the more we upgrade, the more components and equipment we buy from them, resulting in a chronic deficit in our bilateral trade with them. In 1985 Japan contributed 27 percent of our imports but took only 11 percent of our exports (see table 13.3). As table 13.4 shows, Japan has provided about 30 percent of our foreign investment, and in the mid-1980s American resistance to Japanese imports has renewed Japan's interest in investing in us as a platform for exporting to the United States.

Meanwhile, Japanese trading companies market a large part of our exports, and Japanese industrialists are stingy about transferring technology, preferring narrow licensing agreements with our small firms to establishing large, advanced joint ventures like the Americans. The Japanese know our production and marketing better than we do, and they guarantee our firms a modest profit while assuming most of the risk and appropriating most of the rewards.

Formerly our bilateral trade deficit with Japan offset our surplus with the United States. In the mid-1980s, however, the shift of American purchases from Japan to us after upward revaluation of the yen has produced huge trade surpluses, even on a multilateral basis. Our success has become too conspicuous, and we can no longer pretend to be a poor underdeveloped country that needs protection for its infant industries and preferential access to foreign markets. Despite our skillful stonewalling, the Americans are finally imposing quotas on our exports, reducing our tariff favors, and insisting on reciprocal access to our domestic market.

Domestic triangle. At home, our economic and political stability involves a triangular relationship between the mainlander-led Nationalist government, the larger public and private companies that form the leading edge of our economy, and the largely Taiwanese general public. Though indispensable as an economic umpire, our state imposes too many bureaucratic procedures on economic activity. Though still generally prospering, our businessmen remain too dependent on the state for protecting old industries and initiating new ones. Though rela-

TABLE 13.2 Taiwan: Commodity Trade Balance, 1965–1986 (US$ million)

	Total[a]	USA	Japan
1965	–106	–81	–84
1966	–86	–50	–123
1967	–165	–79	–211
1968	–114	+39	–234
1969	–163	+107	–378
1970	–43	+200	–437
1971	+216	+451	–582
1972	+475	+708	–670
1973	+691	+725	–604
1974	–1,327	+357	–1,371
1975	–643	+171	–1,118
1976	+567	+1,241	–1,357
1977	+850	+1,672	–1,522
1978	+1,660	+2,634	–2,108
1979	+1,330	+2,271	–2,312
1980	+77	+2,087	–3,180
1981	+1,412	+3,393	–3,474
1982	+3,316	+4,195	–2,411
1983	+4,836	+6,687	–3,100
1984	+8,497	+9,826	–3,255
1985	+10,621	+10,027	–2,088
1986	+15.6	+13.6	NA

NOTE: NA = not available.
a. Taiwan's commodity trade balance with all countries.
SOURCE: *Taiwan Statistical Data Book*, 1986.

tively docile, our public is gradually becoming more demanding of the state for political participation and even economic security.

Many foreigners think that the relationship between government and business on Taiwan is actively cooperative, as in Japan. Actually the relationship is more problematic. Chinese businessmen are more suspicious of the state than Japanese businessmen, and Taiwanese businessmen are particularly suspicious of a mainlander-Nationalist state. Individualistic Chinese do not work together so easily as Japanese, either with each other or with the state. These problems are gradually diminishing, but they remain significant obstacles to increasing the investment, enlarging the scale, and upgrading the technology of our industries.

In the mid-1950s and 1960s, the state took the initiative in expanding infrastructure and promot-

TABLE 13.3 Taiwan: Shares of the United States and Japan in Taiwan's Foreign Trade, 1952–1984 (%)

	In Taiwan's total trade		In Taiwan's exports		In Taiwan's imports	
	USA	Japan	USA	Japan	USA	Japan
1952	29.5	39.4	3.5	52.6	45.7	31.2
1956	28.2	36.6	5.6	37.2	42.0	36.3
1962	32.3	29.8	24.4	23.9	38.0	34.1
1966	24.4	32.8	21.6	24.0	26.7	40.4
1972	32.6	25.8	41.9	12.6	21.6	41.6
1977	31.3	21.1	38.8	12.0	23.1	31.1
1978	31.1	22.1	39.5	12.4	21.5	33.4
1979	29.3	22.1	35.1	14.0	22.9	30.9
1980	28.9	19.0	34.1	11.0	23.7	27.1
1981	29.5	19.1	36.1	10.9	22.5	28.0
1982	32.5	17.4	39.4	10.7	24.1	25.3
1983	35.2	17.8	45.1	9.9	22.9	27.5
1984	38.0	18.4	48.8	10.5	23.0	29.3
1985	38.4	17.7	48.1	11.3	23.6	27.6

SOURCE: *Taiwan Statistical Data Book, 1985*, pp. 205, 210, 212; and the *Economic Yearbook of the Republic of China 1985*, Taipei, *Economic Daily News*, 1985, pp. 786–87. From Cheng Chu-yuan, "Economic Development on Both Sides of the Taiwan Straits: New Trends for Convenience," *Hong Kong Economic Papers*, September 1986.

TABLE 13.4 Taiwan: Sources of Foreign Investment, 1953–1984 (US$ thousand)

Year	Total	USA	Japan	Europe	Others
1965	35,140	31,104	2,081	0	1,955
1970	109,165	67,816	28,530	10,713	2,106
1975	70,940	41,165	23,234	4,193	2,348
1980	243,380	110,093	86,081	14,428	32,778
1981	356,294	203,213	64,623	12,636	75,822
1982	320,286	79,606	152,164	46,570	41,946
1983	375,382	93,294	196,770	20,746	64,572
1984	518,971	231,175	113,978	92,242	81,576
1985	660,703	332,760	145,236	100,011	82,696
1953–84 Total	3,985,352	1,718,333	1,130,427	533,305	605,257
Percentage	100.0	41.62	29.63	13.03	15.72

NOTE: Annual figures are yearly flow, and total figures are accumulated investment.
SOURCE: ROC Ministry of Economic Affairs, Investment Commission, "ROC Statistics on Overseas Chinese and Foreign Investment, Technical Cooperation, Outward Investment and Outward Technical Cooperation" December 1984 (from Cheng 1986).

ing light industry, first for meeting domestic needs and then for promoting foreign exports. Our businessmen responded to the state's concessionary loans, tax breaks, and tariff favors, at first hesitantly, and then with a rush. The public responded to the state's redistribution of land, positive real interest rates, and expanded educational opportunities with hard work, high savings, and a passion for education. In the 1970s and 1980s the state again took the initiative in further expanding infrastructure, and in promoting both heavy and high-tech industries. Though some of our businessmen invested in machinery making, petrochemicals, and other producers' goods, much heavy industry remained in the public sector, and most private businessmen stuck with light industrial consumer products. Fortunately the public responded to rising incomes and expanding employment and educational opportunities by continuing to work, study, save, and invest.

However, as we look toward the 1990s, the question for the government is whether it should continue to take the initiative by promoting specific industries, or restrict itself to improving the performance of the economy as a whole, particularly by improving the availability and processing of information about technology and markets. Of course, there remains some tension between security and development objectives, particularly when it comes to the free flow of information. Moreover, many of us believe that government red tape has been getting worse, not better. The recent placing of our formerly privileged planning agency under regular civil service bodes ill for the future quality of our planning staff and imaginativeness of our planning work.

As for our major private companies, they have had it too good and remain too small. They still depend too much on the state for initiative and protection, too much on foreigners for technology and marketing, and too much on family members and good luck rather than on professional management. Few of them spend enough on research and marketing to innovate or sell their own products. The older generation does not understand the newer technologies, and the younger generation does not understand old personal relationships. It is not clear how they can compete with Korean conglomerates, let alone Japanese giants.

As for the public, its work discipline, high savings, and environmental stoicism have been a cornerstone of our economic success, while its political docility, patience, and indifference have been cornerstones of our political stability. However, our own success in modernizing Taiwan is eroding these former assets, albeit creating some new ones. In the 1950s we could say that improvements in Livelihood had to be restrained in favor of Nationalism in order to maintain external defense and economic competitiveness. However, in the 1980s many of us recognize that implementing Sun's principles requires improving not only the cash standard of living but also the overall quality of life. In the 1950s we could say that progress toward Democracy had to be restrained in order to maintain internal security and domestic stability. However, in the 1980s some of us have begun to concede that continued stability requires more, not less, democracy.

Before turning from the political and economic setting to economic policy issues, let us briefly review how we got where we are today.

History

Those who doubt our future should remember one point about our past: we never knew the "success" we were creating. Our long-term performance has resulted as much from cautious attention to short-term stability as from ambitious visions of long-term possibilities. Moreover, as the world changed, we changed, so that our postwar development really has been a particular sequence of responses to particular situations, rather than a uniform, replicable "Taiwan model."

Pre-nationalist period. Taiwan has always been on the maritime fringe of the Chinese empire, and in fact was hardly noticed by China until about the time that Europe discovered America. Since then Taiwan has always been involved in trading relations that stretched north and south throughout East Asia. This involvement in foreign trade was intensified with the arrival of the Westerners. In the nineteenth century, in addition to exporting rice and fruit to mainland China, Taiwan began exporting tea and camphor to the West. Consequently, even before the Japanese took over in 1895, Taiwan had an export orientation. After 1895, Japan modernized Taiwan's agriculture and infrastructure, and even installed some industries.

The Japanese period provides some lessons for us and for those who would imitate us. First, Nationalist policy alone did not create Taiwan's economic development, and Nationalist policy alone cannot continue it. Second, although we mainlanders prefer involvement with Americans, the Japanese once had, and may have again, the principal external role in our development. Third, our role may well turn out to be what Japan originally envisaged for us,

namely, as an intermediary in Japan's relationship with the rest of the world, particularly Southeast Asia.

Early nationalist period. After Japan's defeat, we largely disappointed Taiwanese hopes during the late 1940s. Taiwan was now part, not of prospering prewar Japan, but of suffering postwar China, wracked by economic and military collapse. For us, Taiwan was at first a spoil of war, then a retreat in defeat, but always militarily precarious and economically unviable. The American government expected it to fall to the Chinese Communists and, in the interest of developing a relationship with them, was prepared not to intervene on our behalf.

However, the outbreak of the Korean War and subsequent confrontation between the United States and the People's Republic of China rescued us from oblivion. With U.S. help we secured our defenses and reversed inflation, revived agriculture and inaugurated industry, resettled our mainlanders and mollified the Taiwanese. Since the economy remained largely agricultural, land reform was important, both for giving the population a stake in economic development, and for consolidating majority rural political support for Nationalist rule. At first our major industrial assets were the facilities that our government had taken over from the Japanese, particularly the railroad, power company, sugar factories, and cement plants. Like that of most postwar underdeveloped countries, our objective first was import substitution, not export promotion. Few believed that Taiwan could provision itself, let alone others. The government initiated private production of consumer goods by delivering raw materials to the factory doors of our paralyzed entrepreneurs, and by purchasing the output for government use or resale.

By the late 1950s, however, our new light industrial plants had saturated the domestic market for consumer nondurables. Despite much domestic resistance, a series of exchange and investment reforms gradually integrated Taiwan into the world economy. We tied our exchange rates to the dollar to make productive investment more attractive than currency speculation. We devalued concessionary loans for export activities by domestic producers, and offered tax incentives and industrial parks to encourage investment by foreigners. We refunded the duties paid on any materials imported to be reprocessed for export, but continued to restrict imports for domestic consumption. The 1958 standoff of the second Taiwan Straits crisis finally convinced most of us that we would not soon recapture the mainland; clearly, we should devote ourselves to building a strong economy on Taiwan, where we were relatively secure, making both domestic and foreign investment feasible. By the early 1960s, because of the global economic boon, we had expanded markets abroad. New foreign investment concentrated in electronics and electrical appliances (table 13.5), as U.S. companies used Taiwanese labor to combat Japanese exports to America.

Obviously the 1950s showed that import substitution had its limits, and the 1960s showed that, at least for us at that time, switching to export promotion greatly expanded those limits (see table 13.6).

Nevertheless, the early Nationalist period offered still other lessons. First, domestic demand, particularly from a prosperous agriculture, was a major motor of our early development, and a broad distribution of income continued to fuel consumption, savings, and investment thereafter. Second, it was our early import-substituting industrialization that laid the foundation for later export promotion. Third, given the limits of global demand, we had to continue to stimulate as much domestic growth as possible, for example, by modernizing our domestic service sector.

Later nationalist period. By the late 1960s, some long-run consequences of our outward-oriented strategy were already visible. Revenues for reinvestment poured into industrialists' coffers, and wages from nonfarm employment filled our people's pockets. Labor-intensive production meant that, by around 1968, industrial growth had absorbed most of the surplus labor from around the island, including many female entrants into the labor force. This first spread income widely, then bid up wages in general. In 1968 we first achieved a surplus in our trade with the United States.

By the early 1970s, however, some long-run problems were also visible. Nixon signaled, not only that America's Pacific allies would have to defend themselves, but also that America intended to make friends with our worst enemy, communist China. The first oil crisis reminded us that not only could the cost of our imports rise, but also that global demand for our exports could fall. Other newly industrializing countries began to compete with our low-end products, adding urgency to our development of higher-value industries. Meanwhile our rapid industrialization and urbanization were further straining the power, transport, and other facilities we had inherited from the Japanese, despite the many infrastructural improvements we had made with U.S. aid. A package of ten government infrastructure and industry projects, originally intended

TABLE 13.5 Taiwan: United States and Japanese Investment in Taiwan, by Industry, 1952–1984 (percentage)

Industry	United States	Japan
Fishery & animal husbandry	0.3	—
Food & beverage processing	2.0	1.0
Textiles	1.5	3.3
Garments & footwear	0.3	0.8
Lumber & bamboo products	—	0.5
Pulp, paper & paper products	0.9	0.2
Leathers & fur products	0.1	0.1
Plastic & rubber products	1.8	6.0
Chemicals	17.6	8.4
Nonmetallic minerals	0.5	1.0
Basic metal & products	5.0	9.8
Machinery equipment & instruments	4.0	22.1
Electronic & electric appliances	51.9	31.1
Construction	0.6	0.1
Trade	0.1	—
Banking & insurance	2.9	0.1
Transportation	0.5	—
Services	9.0	11.3
Others	1.0	3.6
Total	100.0	100.0

NOTE: Readers may wish to calculate dollar amounts based on the percentages. Total U.S. investment was US$13,835,000; total Japanese investment was US$985,191,000.
SOURCE: ROC Ministry of Economic Affairs, Investment Commission, "ROC Statistics on Overseas Chinese and Foreign Investment, Technical Cooperation, Outward Investment and Outward Technical Cooperation" December 1984 (from Cheng 1986).

to promote heavy and defense industries, fortuitously helped us out of the recession that followed the oil crisis. Fortunately we did not invest or borrow as much in pursuit of heavy industry as South Korea did at that time.

By the late 1970s three difficulties with such industrial deepening were apparent. First, our light industrial exports rebounded much more quickly than our fears of competing suppliers and shrinking demand had led us to expect, and they also rebounded after recessions in 1980 and 1985. Second, heavy industry was capital-intensive; it did not produce as much, or as rapid, or as balanced growth as light industry. Third, contradi tions emerged between heavy industry and the supply of agricultural and residential land and the quality of air and water. Western economists advised us to concentrate on skill-intensive, nonpolluting, high-tech industries, which subsequently we did.

In the early 1980s our growth rate fluctuated with that of the American economy, but we continued to benefit from the intensifying struggle between America and Japan for industrial hegemony. The U.S. Congress increased its pressure on us to liberalize both our domestic economy and our domestic politics. The Chinese Communists offered to let us keep our military and our economy if we would recognize their sovereignty. They also began the process of absorbing Hong Kong as a model for absorbing us. All of this precipitated the orgy of soul-searching in which we are now involved.

In all, the later Nationalist period has taught us much. First, despite recessions, our old industries have survived longer than we expected, which is good in the short run, but may create problems in the long run. Second, despite some successes, new industries have not come on-stream nearly as rapidly as we hoped. Third, as a result, many people are questioning the effectiveness of the government's economic policy-making process itself. These problems are best pursued by examining the choices we face in our three policy areas of production, marketing, and finance.

TABLE 13.6 Taiwan: The Contribution of Exports to Output Growth, 1956–1976 (percentage)

Period	Output expansion due to export expansion	Output expansion due to import expansion	Output expansion due to export substitution
1956–61	70.8	22.5	7.7
1961–66	64.5	35.0	0.5
1966–71	51.4	45.9	2.7
1971–76	44.7	57.7	–2.4

SOURCE: Shirley W. Kuo, *The Taiwan Economy in Transition* (Boulder, Colorado: Westview Press, 1983), p. 149, table 7.6.

Production

The first general area in which we face critical choices is that of "production"—adjusting declining industries, promoting rising industries, and modernizing family management. The underlying problem here is one of maintaining our role in the international division of labor, achieving upward mobility, and preventing downward mobility. The basic issue is the extent to which the state should intervene with attempts to shape our comparative advantage, and the extent to which it should allow the market to tell private firms what our comparative advantage is. The practical issue is how fast to alter the proportions between the components of our economy—light, heavy, and high-tech industries, commercial and personal services—in view of both foreign and domestic realities on the one hand, and economic and political realities, on the other.

Sun Yat-sen wisely counseled us to maintain our independence of Western countries but to take advantage of opportunities for expanding trade and obtaining investment. Although our form of nationalism continues to require some independence from western imperialism, the global political economy and our position in it are quite different from the nineteenth-century conditions Sun had in mind. Companies are now as important as countries, and the early industrialized countries are now as dependent on the newly industrialized countries as we are on them. Particularly given our precarious international political status, our best course is to continue enmeshing ourselves in the global web of transnational corporations as inextricably as possible.

Thus our role in the world is "associated and intermediate," that is, associated with core corporations and specializing in intermediate technologies. Despite our strong educational system and large engineering corps, the earlier developers will remain ahead of us for the future. Since we cannot mobilize enough capital and technology to challenge them, we must remain cautious about state-led plunges into expensive industries.

Adjusting old industries. Inevitably one thinks of policy choice in terms of declining and rising industries. In Taiwan, governments have radically changed the terms of comparative advantage over the past half-century—from rice and sugar in the 1930s, to specialty agricultural products and labor-intensive light industry in the 1960s, to more skill-intensive products and services in the 1980s. The cost of land is now so high that in agriculture not even gourmet foods are profitable. The cost of labor is now so high (table 13.7) that in light industry the only really profitable items are boutique ones.

TABLE 13.7 Selected East Asia Countries: Comparative Monthly Wages in Manufacturing, 1984 (US$)

Country	Monthly wage
Hong Kong	270
South Korea	304
Taiwan	325
Singapore	260
Malaysia	190
Thailand	270
Indonesia	60
Philippines	72

SOURCE. International Labor Organization, 1984; *Business International*, 1985; *Asian Business*, 1985.

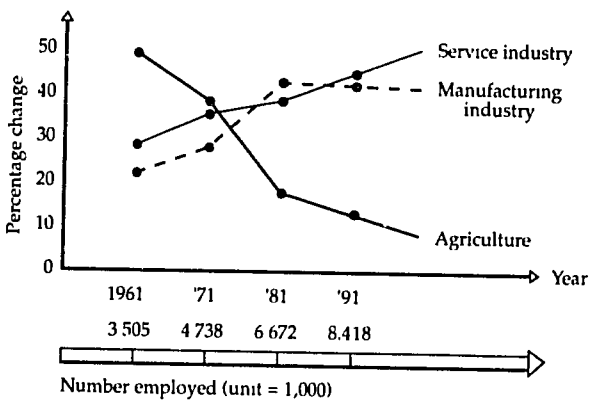
Nevertheless, our firms have continued to wring marginal profits from low-value products, making difficult any shift from proven old to promising new products. Fortunately, by the mid-1980s, stagnation of global demand for the old products has finally squelched investment in them. Of course the problem is not so much to move out of consumer nondurable industries as to upgrade products within them. Fashion footwear and designer garments for which we have already established markets can be just as profitable as consumer electronics or computer parts.

In addition to declining light industries, we also have problematic heavy industries such as metals, petrochemicals, and ships. Historically most of our large-scale capital-intensive industries originated as state enterprises, and they have remained so. The recent expansion of private industry has reduced state enterprises from 80 to 20 percent of industrial output, but public firms remain important beyond their proportion because they provide such basic inputs into the economy as fuel, power, metal, and chemicals. State firms long got the lion's share of government and bank investment, while producing a much smaller proportion of economic growth. So we reduced investment in them, which lowered our investment rate—not only in state firms but in complementary private industry as well. Although some of us favor closing companies in shipbuilding, where there is global oversupply, we have made little progress, partly because state workers oppose layoffs.

In fact labor poses several problems. Our labor force is famous for its high skills, hard work, low demands, and weak organization. Even though

unions are weak and strikes illegal, the economic boom has brought expanding employment and rising wages. However, we now need to transfer labor as well as capital from old to new sectors (figure 13.1). Yet, when a sector's economic luck runs out, neither social values nor state repression can stifle worker demands. Besides, with the prospective lifting of martial law, even strikes may no longer be illegal.

FIGURE 13.1 Taiwan: Changes in Work Force Composition, 1961–Present and Projected (percentage)



SOURCE. Council for Economic Planning and Development, Executive Yuan, Taiwan.

Promoting New Industry

Rapid global technological change is creating new opportunities for us. In the mid-1980s, though, the very rapidity of change and the uncertainty of outcomes has inhibited our investment in these opportunities. Earlier, in the 1950s and 1960s, the pattern of new investment on Taiwan was the "swarm of bees" phenomenon. One or a few firms would enter a new product line, usually only after receiving state help in identifying the opportunity, organizing the project, obtaining financing, facilitating imports, cornering the domestic market, and licensing foreign sales. Early entrants would make exorbitant profits, but were soon followed by a swarm of imitators who usually undercut the originators in price and quality. This redundancy was exacerbated in the 1970s, when large revenues from foreign sales enabled firms entering apparently profitable export product lines to multiply. However, virtually none of these companies invested in research, preferring to buy or steal technology. Today's entrepreneurs know better, but remain uncertain in what products to invest.

Of course, the government has tried to point the direction. We are all familiar with the fine work of our National Science Council and its Industrial Technological Research Institute (ITRI), particularly the latter's Electronic Research Service Organization (ERSO), in promoting the electronics and information industries. The basic principles that ITRI is using to promote hi-tech industries—combining foreign and domestic resources—are the same principles that we followed for light industry in the past, namely:

1. *On the one hand attract capital, technology, and management from abroad, particularly from overseas Chinese, and study the strategies of major foreign countries and companies, particularly in the United States and Japan.* Thus ITRI's own Chinese director was formerly the head of R & D at Texas Instruments Inc.; ITRI's Taiwan Semiconductor Manufacturing Company has investment from Philips Electrical Industries; and IBM is increasingly an active participant on Taiwan. Recently our colleague, Planning Minister Chao Yao-tung, visited Japan with task forces to study their telecommunications, software, and hardware industries.

2. *On the other hand, mobilize domestic capital, foster domestic technology, and train promising domestic managers. When government pay scales and work rules hobble progress, use quasi-government organizations that can pay high and act fast.* Thus eight private Taiwan companies put up 85 percent of the capital for ITRI's United Microelectronics Corporation to make integrated circuits, and UMC's head was trained by ERSO after graduating from National Taiwan University. Meanwhile several domestic firms are making personal computers with the input-output system developed by ERSO to avoid infringing IBM's patent rights.

These real accomplishments bode well for other ITRI initiatives in optoelectronics and biotechnology. Nevertheless, we must be realistic about the limits of our success. Though it is natural that the government should have to twist arms to recruit the

initial tenants in our Science Park and to obtain investments in high-tech ventures, we have to recognize that the reluctance we have encountered among our businessmen may well persist. The government may be right about the general need to upgrade technology in the long run. But in the short run the government itself has shown much uncertainty over exactly which products to back and how to do it, as in the automobile and machine tool industries. And it is in the short run that individual private entrepreneurs can lose their investments. Most of our businessmen simply do not believe that underpaid and inexperienced government bureaucrats know more than they about their own products and markets. In recent cases, the government cannot guarantee the purchase of any large share of the output. So our companies may be right to question the viability of our products and the availability of foreign markets.

Modernizing family management. In any case, we still need to accelerate the modernization of our management. No matter what opportunities the government may make available, our private companies will not seize them unless equipped to do so. Here, the question is what initiatives the state can take without exacerbating the basic problem that our entrepreneurs already depend too much on the state. Consider the changes already under way both within and without our still mostly family firms.

Within, already the generation of entrepreneurs who founded most of our larger companies in the 1950s and 1960s are passing their firms on to their sons or other successors. This has both advantages and disadvantages. The fathers have usually proceeded by intuition, showing a willingness to gamble when the opportunity seemed right, but an unwillingness to analyze alternative strategies. The sons are better trained in both technological and financial analysis, but often lack the human sensitivity and experience of economic hardship that guided their fathers. Yet there is continuity. Sons remain Chinese under their veneer of Western training, and fathers continue to run things from behind the scenes.

Outside, some of our leading industrialists have already taken initiatives to improve management by improvising management information systems. Most managers still have little idea of cost structures, cash flows, and sales prospects. Partly they don't want to think about them, partly the finances of different firms and families are intermixed, and partly they keep multiple sets of books to fool their business partners, banking creditors, and tax collectors. The government may have to lower effective corporate tax rates before businessmen will be willing to reveal their true incomes, even to themselves.

Then there is another concern I have about our business managers that I must frankly share with you. Happily we have begun to overcome China's traditional lack of respect for business people who in days gone by, as you know, ranked well below scholars, government officials, and even farmers. We realize that our managers are essential to meeting the needs of the community. Yet there is reason to wonder now whether the new breed of young entrepreneurs fully appreciate their responsibilities to the community. Eager for relief from government, they seem less concerned with the fulfillment of its objectives.

Marketing

The second general area in which we face critical policy choices is marketing, broadly defined to include diversifying markets, combating protectionism and selling our own products abroad. The underlying problem is the combination of overproduction by our newly industrialized competitors and underconsumption by the earlier industrialized countries. The basic issue here is what economic philosophy to follow—a liberal philosophy maximizing the economic opportunities from free trade, or a conservative philosophy minimizing any threat to us from the political uses of economic power. The practical issue is how fast to make the transition from a backward country that relies on intraindustry trade (in which we forbid imports of the kinds of products we export), to an advanced country that flourishes on intraindustry trade (in which the products of all trading partners compete in all markets). As with our production structure, the practical obstacles to upgrading our trading structure are both economic and political, as well as both foreign and domestic.

In maintaining our foreign markets, the good news is that we have but a small share of total world trade. Since our numerous small firms are good at shifting rapidly from one product line to another, the prospect is good that we will continue to identify niches for ourselves. The bad news is that our small share of world trade is highly concentrated on one market—the United States—and on only a few products, such as textiles and electronics (table 13.8 and figure 13.2). Consequently our impact is felt, the reaction is sharp, and we are vulnerable.

Western trade theorists assure us that we have

nothing to worry about in an efficiently functioning global market, so long as we keep shifting our product lines upward ahead of our competitors. However, global markets do not always function efficiently; some players sometimes gain excessive power over the market. For example, Japan already indirectly controls half our production and marketing and now, after upward revaluation of the yen, is resorting to a new wave of direct investment, using us as an export platform for maintaining its competitiveness in the American market. Moreover, we face not just economic competition from a fresh gaggle of newly industrializing countries (NICs), but also political war from the biggest NIC of them all, the PRC. Since the PRC is trying to drive us into political submission, it may try to put our industries out of business. Thus, contrary to the views of Western economists who admire us so much, the world is not a benignly competitive marketplace. That misconception explains why our former president never allowed economists to control our policy, and why—despite appearances—our current president wisely still does not either.

TABLE 13.8 Taiwan and World Trade: Exports and Imports, by Country, 1985 (percentage)

Exports from Taiwan to	Share (%)
USA	43.1
Japan	11.3
Hong Kong	8.3
Canada	3.1
Singapore	2.9
West Germany	2.6
Australia	2.4
UK	2.1
Saudi Arabia	1.9
Indonesia	0.9
Others	21.4
Total: US$30,722.8 million	100.0
Imports to Taiwan from	**Share (%)**
Japan	27.6
USA	23.6
Saudi Arabia	4.2
West Germany	4.0
Australia	1.6
Kuwait	1.4
Indonesia	2.1
Canada	1.8
Hong Kong	1.6
Singapore	1.4
Others	30.7
Total: US$20,102.0 million	100.0

SOURCE. Political and Economic Risk Consultant, Ltd., *Quarterly Country Risk Survey on Taiwan, Republic of China: Outlook for November 1986 through April 1987*, no.1 (Oct.), 1985.

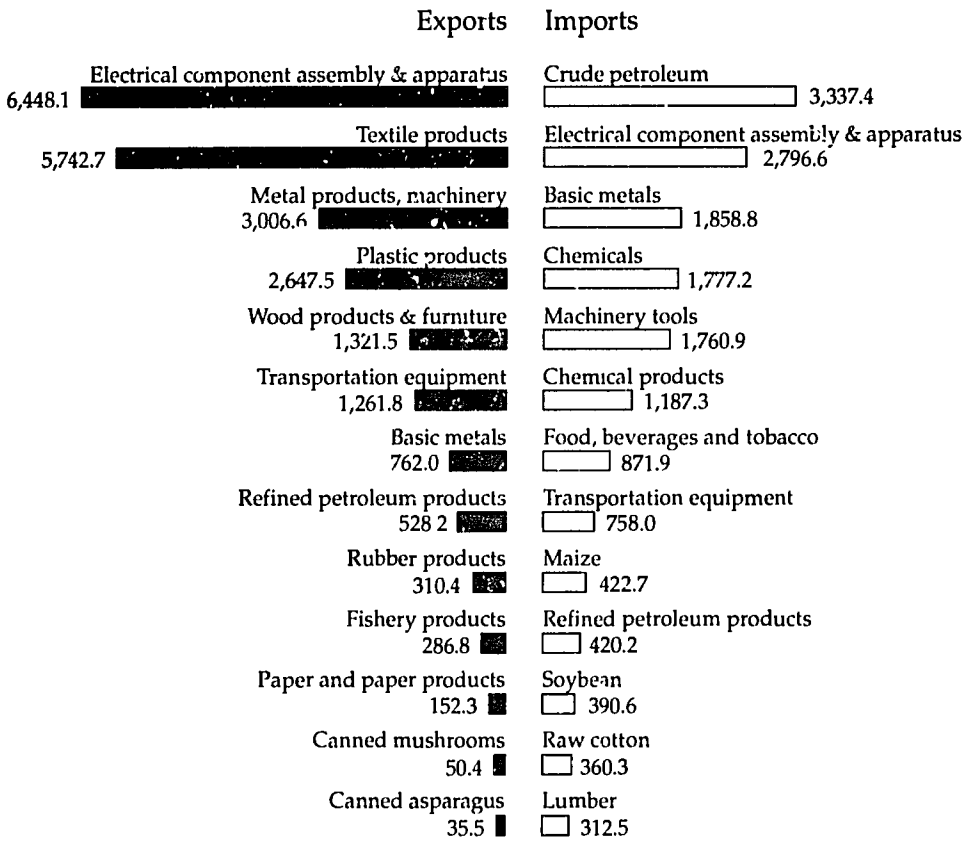
Diversifying export markets. We must do our best to diversify our foreign markets, and we have made significant efforts. Government trade missions, and even a few of our larger companies, have canvassed the world for potential sales—in Western Europe, in all corners of the third world, and recently in Eastern Europe. These efforts must be redoubled. But if we are to be realistic both in allocating our efforts and in assessing the results, we must remain aware of the economic and political constraints.

Economically, the fact remains that the developed countries, particularly the United States, provide the biggest markets, and are by far the easiest places to expand sales. Europe remains difficult, partly because it does not accord Taiwan the tariff preferences that our competitors receive. But no number of trade missions to Europe could overcome the fact that our currency has been pegged to the U.S. dollar, making our goods cheap in the United States but expensive elsewhere. After 1985 our currency fell along with the dollar, making our exports more attractive to Europeans. Unfortunately, however, more currency realignments will not automatically create in Western Europe the historic ties, diplomatic relations, marketing channels, cultural affinities, and expatriate population that we have in the United States.

Like the rest of our fixation on the American market, our dollar-based exchange rate is not simply an economic matter; it is also the legacy of our previous geopolitical alliance, and a continuing symbol of foreign political connections and domestic political stability. Of course, now that the Americans insist we let our currency appreciate against theirs, we have no choice, even though this threatens to bankrupt marginal firms exporting primarily to the United States.

As regards new markets in the third world, here too we must be realistic about both economic and political constraints. It is an attractive idea that as an intermediate country we can play a mediating role between the advanced core and backward periphery of the world economy, taking over old product lines from the core and selling them to the periphery. However, the fact remains that so far our sales of

FIGURE 13.2 Taiwan: Major Trade Items, 1985 (US$ million)



SOURCE: George Lodge.

goods and services to developing countries represent a small portion of total exports. Unfortunately, there are good economic reasons for this. The poor countries are much poorer than the rich countries, and just when we tried to sell them more they got even poorer owing to the 1980s debt crisis. As for the future, despite the optimism of Western economists, in a world already awash in overproduction, it remains to be seen how large third world economic growth will be, and how much trade with it the first world will leave to us.

Concerning political constraints, we have learned from our own takeoff that economic growth is more than a matter of comparative economic advantage; it is also a matter of political connections. Much of our trade with the third world is with conservative regimes that still find us ideologically compatible (such as Indonesia, Saudi Arabia, and Paraguay), or with countries in regions where the Americans encourage our participation (such as Central America and the Caribbean). These are among the few countries that still maintain diplomatic relations with us, and also countries in which the Americans are happy to see our military training missions and growing arms sales.

Serious economic and political questions arise in our relations with the PRC. So far it has snapped up our consumer goods and production technologies, and to some extent the economic complementarity is genuine. But we do not know how much of this demand has been politically induced, or how much it could fluctuate because of socialist economic mismanagement or communist political manipulation.

Combating foreign protectionism. Given the restraints on diversification, we will remain largely dependent on the American market. That means continuing to wrestle with rising American protectionism. Of course, we hope that in the United States and Europe, economists advocating free trade will prevail over politicians advocating import restrictions. However, since we expect more "voluntary" restraints on our exports, we must do a better job of reallocating our quotas to those domestic manufacturers who will use them most effectively. (In this

regard the special pleading of our older textile makers and their government supporters has been disgraceful.) Moreover, we must actually reduce output, through mergers and closings, however economically and politically difficult. The Japanese have done it but, though we have talked about it, we ourselves have not yet really tried.

Meanwhile, the best defense against foreign protectionism is not to appear protectionist ourselves. We must remove obvious irritants, such as tariff barriers and product piracy, while bolstering our firms to retain as much of our domestic market for consumer goods and commercial services as possible. It is obviously absurd for us to maintain restrictions on consumer imports installed in the 1950s when we were an embattled fortress.

Here we cannot but note that it is branches of our own Nationalist state that put up the most effective political resistance to import liberalization, not only blocking policy change but also delaying policy implementation. Because we require our own industrial base for both defense and development, we have labored long and hard to create our existing industries. Painful as contracting them might be to our colleagues in the industrial bureau of the Ministry of Economic Affairs, we simply cannot afford to provoke the American executive into trade actions against us by inundating America with textiles, shoes, steel, and computers. Because we are reluctant to tax Taiwanese incomes directly, we have long relied for government revenues on indirect sources such as tariffs on imported consumer goods and profits from government monopoly sales of liquor and tobacco. Painful as the reduction of such revenues may be to our colleagues in the Ministry of Finance, we simply cannot allow the U.S. Congress to shut down our access to American markets on the excuse that our tariff rates are higher than theirs and Japan's, or that we will not buy California wine and Virginia cigarettes.

Our own economic strategy calls for us to "internationalize, liberalize, and systematize." The question is whether all of us understand this slogan the same way or, for that matter, understand it at all. To me it means that liberalization of imports will challenge our domestic producers, and that systematization will enable them to meet this challenge. We must follow through on the promise of this strategy, and not allow "systematization" to mean erecting new protectionist barriers of our own. Here the Western economists may be right when they say that market competition often generates benefits that state planners have failed to anticipate. For example, in the service industries, who would have dreamt that American fast food chains, rather than just putting our small peddlers out of business, would prove a national craze and promote the upgrading of our own entire food service industry in imitation? Hopefully, the same may occur in such commercial services as accounting and advertising or banking and insurance, all of which badly need improvement.

Selling ourselves abroad. At a time when Americans blame us for sending them too many goods, many of us blame ourselves for not selling them more by doing our own marketing rather than relying on Japanese trading companies, Taiwan-based American companies, and middleman American buyers. We could do a better job. Certainly most of our firms are too small and too provincial to scan the entire world for potential markets. In fact, most of them hardly lift their sights beyond the American market where they already have contacts and representatives. The government has helped somewhat by collecting and disseminating information on market opportunities, though how timely and specific such information can be remains a question.

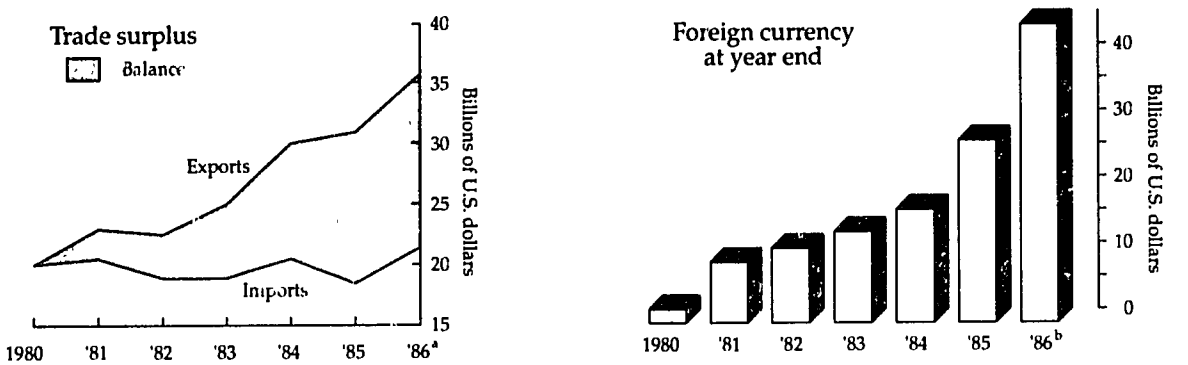
The remedy repeatedly proposed has been that the government should aid formation of large trading companies like the Japanese have. However, the fact that not much has happened suggests that not much will happen. It also suggests some reasons why. The existing system is cost-effective and functions adequately, at least so far. Moreover, everybody wants to start his own trading company, nobody wants to cooperate, and manufacturers do not want to place their marketing in other Chinese hands.

However, both the American complaint about us and our complaint about ourselves miss a basic fact: essentially, Americans commission us to produce stuff on Taiwan and then sell it in America, either through American middlemen or inside transnational firms. More than half our exports to the United States are by U.S. companies on Taiwan. Apparently, neither the Americans (for production) nor we Chinese (for marketing) could much alter this arrangement, even if we wanted to.

Finance

The third general area in which we face critical policy choices is finance—our place in international financial markets, our domestic financial institutions, and our domestic fiscal policy. The underlying problem is that our archaic financial system prevents us from putting our burgeoning resources to

FIGURE 13.3 Taiwan: Growth in Trade Surplus and Foreign Currency Holdings, 1980–1986



a. First 11 months.
b. End of November.
SOURCE: *New York Times*, December 21, 1986, Nicholas D. Kristoff, "Taiwan's Embarrassment of Riches," © 1986 by The New York Times Company. Reprinted by permission.

the most productive uses. In each case, the basic issue is to what extent we must stick to long-standing conservative practices in order to maintain government control, and to what extent we can embrace progressive current Western practices maximizing economic efficiency. The practical choice is between how long we can continue to "work around" existing practices and how fast to reform them. Here again of course we face both economic and political obstacles, both at home and abroad. Not the least of these obstacles is the unfortunate fact that many of us simply do not understand the accelerating changes abroad.

International financial role. Internationally, the basic choice we face is whether to muddle along as merely a producer of widgets with an embarrassing trade surplus and little other external role or whether, as our policy slogan recommends, to "internationalize" by making Taiwan fully part of world finance and by carving out our own financial role abroad. While only the most reactionary security administrators deny that internationalization provides the better course, in practice following that course requires more understanding, imagination, and courage than many of us display.

At the moment, we are mired in successes. The double windfall of low oil prices and a high Japanese yen lowered our import bill and has increased our export earnings, swelling our foreign exchange reserves by US$1 billion a month (figure 13.3).

Today these reserves exceed US$44 billion, more than those held by the United States (US$36 billion) or Japan (US$41.7 billion), or indeed by any country except West Germany (US$52.9 billion)—and soon Taiwan will top even that. Our conservative financial authorities put these reserves into U.S. government bonds, which are not particularly profitable, and have declined in value with the decline of the U.S. dollar. Excess foreign reserves become excess domestic money supply because of our requirement that exporters turn in their foreign exchange earnings to the Central Bank for local currency. Memories of past capital flight make us reluctant to loosen controls. Nevertheless I believe we need to place more foreign exchange in private hands and to embark on a positive program of investment and acquisitions abroad. International banks will help, as with recycling petrodollars, but not until we begin to believe that Taiwan will remain attractive to both domestic and foreign investors will capital remain here when it is free to leave.

Turning to political dilemmas: How can we hope to expand our participation in international financial organizations—the single most important form of participation in international organizations that we have left—when some still want to withdraw from any organization that the PRC enters? Those who favor accepting some change of name in order to remain won only a partial victory in the most important case—our membership in the Asian Development Bank—where we refused to withdraw, but suspended our participation anyhow! How can we hope to turn Taipei into an international financial center when our security administrators refuse to permit the free movement of telecommunications, capital, and personnel that are vital to contemporary financial transactions? Those of us who had hoped that Taiwan might take over some of Hong Kong's financial functions as the PRC

asserts control there could not move fast enough, and we had to watch those functions redeploy to London and Tokyo.

Domestic financial institutions. Our antiquated domestic financial system is also an obstacle, not only to successful participation in international capital markets but also to the successful operation of domestic capital markets. In the early postwar garrison-state days, we deliberately compartmentalized financial institutions, narrowing each function and preventing unauthorized movement of funds between them. We nationalized the banks, appointed bureaucrats to run them, and threatened dire punishment for any mistakes. The results were predictable. Savings piled up in the Post Office but could not be used where they were needed, for instance by the small business bank. Cautious banks lent only to large firms, particularly public ones, driving even large private companies to the curb market for working funds. Families, not banks, provided venture capital, and our small stock market was—and is—easily manipulated and highly volatile. When from the mid-1970s we did allow private trust companies to undertake more functions, firms abused the privilege by speculating in real estate and other areas. The resulting bankruptcies and scandals strengthened opposition to financial deregulation.

Of course, we have made some progress, again mostly under foreign prodding, foreign assistance, or foreign influence. We admitted foreign banks who began performing such modern functions as tapping overseas credit, identifying foreign markets, and even recommending sources for inputs from abroad. With foreign participation, we set up a venture capital fund, to foster the formation of new high-tech domestic firms. Meanwhile, our younger people familiar with foreign banking found ways to use the existing system to achieve reformist objectives by detecting loopholes in existing laws, processing cases under the least restrictive laws, and expanding existing laws by setting new precedents. However, we still have not fashioned channels through which to apply either our foreign exchange surplus or our domestic savings deposits to domestic investment.

Domestic fiscal policy. As for domestic fiscal policy, looking at the revenue side (table 13.9), like other governments, we can see we need more tax revenues.

Downturns in exports produce downturns in business profits and therefore downturns in government revenues, just when we need upturns of spending to restimulate the economy. Moreover, we need to replace regressive and distorting taxes, such as tariffs on imported consumer goods or profits from government consumer monopolies, with progressive and rational ones. An underlying problem here is that under the conservative fiscal philosophy that pervades our bureaucracy, Ministry of Finance officials do not want to be punished for any shortfall of revenues that might occur during their tenure. Consequently, they fear change. One important example of a tax reform that we have already implemented is the value-added tax on businesses, which we have truthfully advertised as less distorting, but which in the long run will also increase revenues. One important example of a reform as yet unmade is corporate and personal income taxes. At present they overlap, the rates are too high, and compliance is low. If the taxes were merged and the rates realistic, people might really pay them. However, the Ministry of Finance has delayed implementation.

Looking at the expenditure side (table 13.10), like other governments, we must decide whether to entertain deficit spending. So far, we have insisted on balancing our budgets every year, even when we

TABLE 13.9 Taiwan: Consolidated Public Revenues of All Levels of Government, 1981–1985 (new Taiwan $ billion)

Revenue source	FY1981	FY1982	FY1983	FY1984	FY1985
Tax receipts	279.1	299.6	304.3	334.7	348.7
Monopoly profits	34.0	37.9	40.0	40.2	41.7
Surplus of govt. enterprises & public utilities	41.1	55.6	60.5	63.0	76.8
Public debt raising	7.7	20.2	30.1	15.8	31.2
Other	75.8	77.8	68.2	72.0	76.1
Total	437.7	491.1	503.0	525.6	574.5

SOURCE. *Taiwan Statistical Data Book, 1986.*

TABLE 13.10 Taiwan: Consolidated Public Expenditures of All Levels of Government, 1981–1985 (new Taiwan $ billion)

	FY1981	FY1982	FY1983	FY1984	FY1985
General administration	146.8	169.8	188.6	177.1	197.2
Education, science, & culture	75.6	87.7	96.6	98.8	111.9
Economic reconstruction	145.4	147.5	121.2	138.6	138.0
Social welfare	51.1	71.5	75.5	81.7	88.4
Other	14.3	17.2	16.3	22.8	28.2
Total	433.3	493.7	498.2	519.0	563.7

SOURCE: *Taiwan Statistical Data Book*, 1986.

used public works projects to stimulate our economy. Every time our annual growth rate falls below 5 percent our companies scream recession, and Western economists propose a temporary deficit to renew growth. Fortunately, so far, exports have always rebounded to make that unnecessary.

By the end of the century, however, we foresee more serious demands on the budget. We will face the cost of industrial adjustment, such as reduced revenues, unemployment support, and retraining and retooling. Our generally rising standard of living may call for complementary expenditures such as income support for the few left out of the economic miracle, and greater public expenditures on such collective amenities as environmental cleanup, recreation, and culture. Most fundamentally, our population will begin aging, with more older people in need of retirement support and fewer younger people to support them.

These demands on the budget will probably be amplified by political liberalization. In the past, our "ruling party" could decide its objectives and simply pursue them without much public challenge. In the future, by its own design, our party will face the challenge of an organized opposition that is likely to advocate more welfare measures to attract votes. This makes our apparently rigid adherence to balanced budgets quite rational. Of course, one or two years of deficit spending would not hurt, provided the resulting debt were repaid in years of surplus, as Keynes intended. But would that happen? Certainly we do not want to go down the deficits-for-welfare and deficits-for-defense roads taken by England and the United States.

Conclusion

Our founder, Sun Yat-sen, blamed Chinese for discarding their nationalism for premature cosmopolitanism, like the coolie who, thinking he had become rich, threw his carrying pole into the sea. Taiwan is a mere pole in the sea that China once discarded, but for us it has become the staff of life, and a signpost for the mainland. Proud to be Chinese, we must define a futurist form of our ancient nationalism that will unite mainlanders and Taiwanese, Nationalists and Communists, at home and overseas.

After all, we are a quarter of the human race, flourishing in all quarters of the globe. The Japanese sun is rising, but heaven has only one sun, and it never sets on *our* empire. As we look beyond the year 2000, let us only hope that the Pacific century remains truly pacific.

Study Questions

1. What are the major economic and political problems Taiwan faces in 1986? How are they different from the problems faced in 1961?

2. What economic strategies would you recommend? Who in Taiwan might support or oppose these strategies?

3. How would you recommend that the government manage its supporters and opposition?

Notes

1. The revolution marked the downfall of the Manchu dynasty in China and the coming to power of China's George Washington, Sun Yat-sen.

2. Per capita income on the mainland was about $300.

3. In 1984 Brazil's GNP was US$187 billion and South Korea's (population 41 million) was US$83 billion.

13

Appendix

TABLE A13.1 Taiwan: Growth of United States–Taiwan Commodity Trade, 1952–1984 (US$ million)

Year	Total	U.S. exports[a]	U.S. imports[b]	Balance
1952	90	36	4	+82
1956	88	81	7	+74
1962	168	115	53	+62
1966	282	166	116	+50
1972	1,794	543	1,251	–708
1976	4,837	1,798	3,039	–1,241
1977	5,600	1,964	3,636	–1,672
1978	7,386	2,376	5,010	–2,634
1979	9,033	3,381	5,652	–2,271
1980	11,434	4,674	6,760	2,086
1981	12,924	4,766	8,158	–3,393
1982	13,321	4,564	8,758	–4,195
1983	15,980	4,646	11,334	–5,688
1984	19,909	4,041	14,868	–9,827
1985	19,512	4,746	14,773	–10,027

a. Export values are CIF (cost, insurance, freight).
b. Import values are FOB (free on board).
NOTE: All values are at current prices.
SOURCE: ROC Council for Economic Planning and Development, *Taiwan Statistical Data Book, 1985.*

TABLE A13.2 Taiwan: Changes in the Shares of Leading Industries in Manufacturing, 1952–1980

	Share of gross output (percentage)				
Industry	1952	1961	1971	1976	1980
Textiles and footwear	17.0	16.9	21.5	18.3	14.9
Machinery	1.5	1.9	2.8	2.9	2.6
Electrical machinery	0.7	1.8	9.4	10.3	11.5
Transportation equipment	0.7	2.1	3.4	4.0	6.2
Total	19.9	22.7	37.1	35.5	35.2

SOURCE: Adapted from Directorate-General of Budget, Accounting and Statistics, Executive Yuan, *National Income of the Republic of China*, various years.

TABLE A13.3 Taiwan: Investment in the United States by Industry, 1959–1984 (US$ thousand)

	Amount	Percentage
Food and beverage processing	240	0.3
Pulp paper and products	500	0.6
Plastic and rubber products	6,000	7.4
Chemicals	24,000	29.4
Nonmetallic minerals	461	0.6
Basic metals and metal products	740	0.9
Machinery equipment and instruments	250	0.3
Electronic and electric appliances	33,958	41.7
Trade	10,350	12.7
Service	4,430	5.4
Other	570	0.7
Total	81,499	100.0

SOURCE: *Taiwan Statistical Data Book, 1985.*

TABLE A13.4 East Asian Market (excluding China) in the Year 2000 (constant 1984 U.S. dollars)

	GDP (US$ billion)	Population (millions)	Per capita income (US$)
Hong Kong	81.66	7.2	11,279
South Korea	257.34	50.0	5,207
Taiwan	98.80	23.0	4,299
Singapore	52.37	3.2	16,064
Malaysia	97.80	23.0	4,822
Thailand	120.84	80.0	1,665
Indonesia	212.99	220.0	970
Philippines	86.47	80.0	1,218
Total population		485.0[a]	

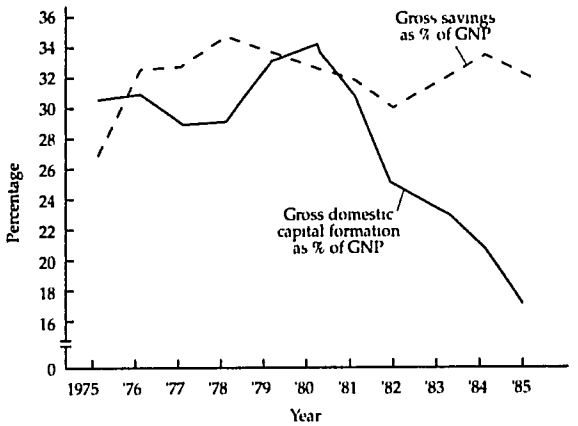
a. Figures do not add due to rounding error.
SOURCE: Asian Development Bank; Center for Research and Communications, *Overview of Asia-Pacific*, Manila, 1984.

TABLE A13.5 Taiwan: National Government Revenue and Expenditure, 1982–1985 (billions of new Taiwan dollars)

	1982	1983	1984	1985
Revenue	476.8	505.7	547.7	573.3
Current	434.3	471.9	515.6	526.6
Capital	42.5	33.8	32.1	46.7
Expenditure	512.7	504.8	564.0	600.8
Current	340.3	358.9	385.6	422.7
Capital	172.4	145.9	178.4	178.1
Surplus	–35.9	0.9	–16.3	–27.5
Revenue/GNP (percent)	25.7	24.7	24.0	23.9
Expenditure/GNP (percent)	27.6	24.7	24.8	25.1

SOURCE: *Taiwan Statstical Data Book, 1986.*

FIGURE A13.1 Taiwan: Savings and Investment as Percentage of Gross National Product, 1975–1985



SOURCE: *Taiwan Statistical Data Book, 1985.*

225

Malaysia Planning Exercise: The Dilemma of Employment Policy

Imagine that at the end of 1969 you became a staff member of the Malaysian National Operations Council (NOC). This was a very critical period in Malaysian history (see table A14.1 in the chapter appendix for a fact sheet). In May 1969 the country experienced bitter racial riots, primarily in most urban centers and towns, in which 6,000 people were reportedly killed. Immediately after the riots, the Malaysian supreme head of state formed the NOC by decree (see table A14.2 for a brief description of Malaysian government structures). The NOC, chaired by the deputy prime minister, was given the authority to manage all civil and police functions, and to develop a new economic policy that would provide better opportunities for the "have nots." The NOC was also given the power to replace the legislature; in practice, it subsumed the functions previously held by the prime minister, who became an advisor to it.

In Malaysia race has traditionally been identified with economic function. The country registered an impressive rate of economic growth during the 1960s, but development programs mirrored the existing economic imbalances between the races. Malaysia is inhabited by three racial groups: Malays (including Indonesians and aborigines), Chinese, and East Indians. In West Malaysia, for example (see figure A14.1), the Malays who comprise 51 percent of the population are involved primarily in subsistence agriculture and fishing. The Chinese, 36 percent of the population, hold most of the jobs in manufacturing, trade, commerce, and tin mining, and own more share capital than any other Malaysian ethnic group (see table A14.3 for data on ownership in the manufacturing sector). The Indian community, 12 percent of the population, are involved in subsistence agriculture, small-scale retail trade and commerce, and unskilled laborers' jobs. Malays dominate most political appointments and the civil service. (See table A14.4 for the geographic distribution of the labor force in West Malaysia.)

In the riots that occurred after the 1969 national elections (see tables A14.5 and A14.6 for data on voting and political parties), Malays fought against Chinese and Indians. One of the major issues was "who was benefiting from economic development." Here, the NOC has major responsibility for developing a new economic policy. Since NOC members think that urban unemployment among Malays was one of the major causes of the riots, they want to focus first on strategies for restoring ethnic balance in manufacturing employment and ownership. One alternative is to call for employing Malays in all sectors proportional to their representation in the national labor force by 1975, and for Malay ownership in proportion to their representation by 1990.

The deputy prime minister has put you in charge of examining the feasibility of this and other alternatives for the southwest zone. He has given you all the available information and he wants you

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to make a preliminary presentation within one week. (Examine the entire chapter appendix for pertinent information.) He wants you to try to address the following questions and perform the following tasks:

1. Since outsiders will be at the NOC briefing sessions, you will need to be able to describe quickly and succinctly the country, its parties, problems, and prospects. Prepare a political map.

2. The NOC in preliminary discussions has favored the goal of 51 percent Malay employment in southwest sector manufacturing by 1975. What are the strengths and weaknesses of this alternative? The deputy prime minister also wants you to look at the strengths and weaknesses of three other options: doing nothing, trying to achieve a 31 percent Malay employment target by 1975, and a 36 percent target by the same date. (The chapter appendix includes a worksheet, table A14.9, to help you analyze some of the alternatives.)

3. What policies and programs would be necessary to accomplish each of the alternatives, and which government ministries would have to be involved? (You do not have detailed information at hand about the supply capacity of various educational institutions or more than the information presented in table A14.10 on ministry activities, and there is little chance of getting the information before you must make your briefing.)

14

Appendix

TABLE A14.1 Malaysia: Country Fact Sheet

Population

Total, 1970: 10.3 million in Malaysia

8 million in W. Malaysia
Rate of population growth, 1970: 2.9%

Population groups	Malaysia	W. Malaysia
Malays	54%	51%
Chinese	35%	36%
Indians	10%	13%
Other	1%	0%

Geography

Divided into two main segments separated by hundreds of miles of sea. West Malaysia occupies the southern third of the Malay Peninsula. East Malaysia occupies the northern strip of the island of Borneo

Economy

Sectoral proportions of GDP	Percent	Avg. annual growth, 1965–1970 (%)
Agricultural and mining	37	5
Manufacturing	12	10
Construction	4	8
Government	7	5
Trade	13	
Other	27	

Highlights:
1. GDP per capita, 1970: $350
2. Avg. annual GDP growth rate, 1956–1970: 6.5%
3. 1965–1970 Labor force avg. annual growth: 2.9%.
4. 1965–1970 Annual rate of growth of available jobs: 2.6%
5. More than 60% of all exports are in agriculture and mining. Chief exports are rubber, tin, timber, and, palm oil.
6. During the 1960–1970 period the country moved away from manufacturing that simply upgraded agricultural raw materials and toward import replacement.
7. The government's major contributions were in infrastructural development and some special land development schemes for Malays.
8. Of all investment in 1969, 32% was public-sector investment and 68% was private.

SOURCE: Marc Lindenberg.

TABLE A14.2 Malaysia: Government Structures

Actors	Tenure	Powers
Supreme Head of Malaysia	5-year term, elected from the 9 traditional rulers of the Malay States	1. Constitutional monarch who performs most normal activities with the advice and consent of the prime minister and cabinet 2. Summons and dissolves Parliament 3. Appoints the prime minister usually upon strong recommendation of the ruling party or coalition 4. Head of the Islamic State
Prime Minister	Serves at the discretion of the supreme head but depends more on the consent of the ruling coalition	1. Chief executive officer 2. Appoints the cabinet 3. Chief articulator of ruling coalition policy
Cabinet	Serves at the discretion of the prime minister although nominally approved by the supreme head	1. Chief policy maker for each ministry. 2. Ultimately responsible for implementation at the ministry level. 3. Participates in overall policy formulation and coordination.
National Operations Council	Formed on an emergency basis after the May 1969 riots to replace the legislature	1. Responsible for developing a new economic policy that placed greater emphasis on better distribution of income, wealth, and services 2. Managed all civil and police functions 3. Made policy for state level
Parliament	58 members serving 6-year terms	1. Both Senate and House members can introduce and vote upon legislation. 2. All budget appropriations and authorizations are introduced in the House first. 3. The Parliament does not have the right to approve cabinet appointments.
Senate	26 elected members and 32 appointed by supreme head with advice from prime minister	
House	144 members elected for 5-year terms	
Ministries	Ministry positions are civil-service. Each ministry has a permanent secretary who manages ministry activities.	1. Responsible for translation of policy into program, for implementation and evaluation
Judiciary	Appointed for life by supreme head with advice from prime minister. Federal system only	1. Hears all legal matters

SOURCE: Marc Lindenberg.

TABLE A14.3 Malaysia: Ownership of Share Capital of Limited Companies in West Malaysia, 1969 (US$ thousand)

	All industries	
Companies incorporated in West Malaysia	US$1000	Percent
Residents	2,050,006	43.9
Malays	49,294	1.0
Malay interests	21,339	0.5
Chinese	1,064,795	22.8
Indians	40,983	0.9
Federal and state governments	21,430	0.5
Nominee companies	98,885	2.1
Other individuals & locally controlled companies	470,969	10.1
Foreign-controlled companies in Malaysia	282,311	6.0[a]
Nonresidents	1,235,927	26.4[a]
Foreign branch offices[b]		
Net investment by head office	1,391,607	29.7[a]
Total	4,677,540	100

NOTE: Table shows the predominance of foreign ownership of share capital in limited companies in west Malaysia. Of the total $4.678 million share capital, 62.1% was accounted for by foreign interests compared with 22.8% by Chinese, 1.5% by Malays, and 0.9% by Indians.

a. These items show foreign ownership totaling 62.1%.

b. i.e., branches in West Malaysia of companies incorporated abroad.

SOURCE. Adapted from *Second Malaysia Plan 1971–1975*, (Kuala Lumpur: Government Printer, 1971), p. 38.

TABLE A14.4 Malaysia: Racial Composition of Labor Force by Geographic Zone, 1970

Geographic zone	Labor force and race					Percentage of total				
	Total	Malay	Chinese	Indian	Other	Total	Malay	Chinese	Indian	Other
North	463,251	252,820	156,930	43,053	10,441	100	55	34	9	2
Central	471,807	174,003	225,002	69,252	3,550	101	37	48	15	1
East	539,157	433,721	71,496	17,701	6,239	99	82	13	3	1
South	493,816	227,845	201,846	60,358	3,767	100	46	41	12	1
Southwest	630,373	192,876	282,036	149,196	6,265	101	31	45	24	1
Total	2,598,404[a]	1,281,265[a]	937,310[a]	339,560[a]	30,262[a]	100	50	36	13	1

a. Estimated annual growth rate 1971–1975 was 3%.
SOURCE: From *Socio Economic Sample Survey of Households* (Kuala Lumpur: Government Printer, 1970), vol. 2, pp. 26–30.

TABLE A14.5 Malaysia: Political Parties, 1970

Party	Description of supporters and their ideology
Alliance party	Made up of three racially based political parties: the UMNO, which represented upper- and middle-class Malay interests and pushed for improvements for lower-class Malays; the MCA, which represented upper- and middle-class Chinese interests; and the MIC, which drew support from upper- and middle-class Indians. Formed in 1954, it proved to be the major force for independence and ruled from 1957 onward. It pursued a policy of economic growth with heavy emphasis on private initiative.
UMNO	United Malay Nationalist Organization; part of the Alliance party. Favored modernization, racial cooperation, and largely secular approaches, but defends the special Malay position.
MCA	Malaysian Chinese Association; formed in the preindependence period. Became the voice of the Chinese business community. Part of the Alliance party.
MIC	Malaysian Indian Congress; formed in the preindependence period, it serves as a voice for upper- and middle-income Indians. Part of the Alliance party.
PMIP	Pan Malayan Islamic party; serves as a voice for more traditional Malays. Gets its strongest support from the northern and eastern regions and from lower-class urban and rural Malays. Favors active policy of special Malay rights and a less secular state.
DAP	Democratic Action party; largely a voice of lower- and middle-class urban Chinese. Follows a democratic socialist platform and opposes special privileges for Malays. Closely allied with the People's Action party (PAP) of Singapore.
Gerkan Ra'ayat Malaysia party	Gerakan was formed in 1969 as a breakaway from the Labor party (the trade union association) and the Malaysian Chinese Association. It represents largely Chinese urban workers and middle class.
Labor party	Party founded in 1954 by trade unionists and academic socialists. Largely Chinese in membership, it has been unable to build significant alliances with other racial groups.
Party Ra'ayat Malaysia	A small multiracial socialist party with some ties to rural Malays.
PPP	People's Progressive party; formed by two brothers of Ceylonese origin. Its activities have been confined largely to the state of Perak and its base is primarily Chinese lower and middle class from the mines and the cities.
MCP	Malaysian Communist party; a strong force in the 1940s and 1950s, its primarily Chinese members collaborated with the British to help defeat the Japanese during WWII. It strongly opposed the British plan for independence and engaged in armed struggle in the late 1950s during a period the British call "the emergency." The party continues its activities in both urban and rural areas on a clandestine basis.

SOURCE: Marc Lindenberg.

TABLE A14.6 Malaysia: Voting Data for the 1964 and 1969 West Malaysian Elections, by Party

	Number of seats in House of Representatives		Percentage of poll	
	1964	1969[a]	1964	1969[a]
Alliance party				
United Malay National Organization (UMNO)	59	51	38.4	34.5
Malaysian Chinese Association (MCA)	27	13	18.6	13.0
Malaysian Indian Congress (MIC)	3	2	1.5	1.2
Total	89	66	58.5	48.4
Pan-malayan Islamic party (PMIP)	9	12	14.6	23.8
Democratic Action party (DAP)	1[b]	13	20[b]	13.7
Gerakan Ra'ayat Malaysia	1	8	4.3[c]	8.6
People's Progressive party (PPP)	2	4	3.4	3.9
Party Ra'ayat	(Part of socialist front)	—	(Part of socialist front)	1.2
Other	2[d]	—	0.0	0.4
Total, all parties	104	103	110[e]	100.0

a 1969 federal elections in West Malaysia only.
b. People's Action party (PAP), Singapore only. In 1964 Singapore PAP was still part of Malaysian elections.
c. United Democratic party (UDP).
d. Socialist front.
e. Column does not add due to rounding error.
SOURCE: *Malaysian Electoral Commission 1965.*

TABLE A14.7 Malaysia: Employment of Malays and Other Groups in the Labor Force, the Manufacturing Sector, and in Manufacturing in the Southwest Zone, 1969

Sector	Malays	Chinese	Indians	Other
Labor force	50%	36%	13%	1.0%
Manufacturing	29%	63%	7%	0.5%
Manufacturing in Southwest Zone[a]	27%	64%	9%	0.6%

a. In 1970, 100% manufacturing employment equaled 102,896 jobs in the southwest zone. The government estimates that 108,000 new jobs will become available in manufacturing from 1971 to 1975 and that 29% of them will be in the Southwest zone.
SOURCE: *Second Malaysia Plan 1971–75* (Kuala Lumpur: Government Printer, 1971).

TABLE A14.8 Malaysia: Racial Composition of Manufacturing Firm Employment in the Southwest Zone, by Job Category, 1970 (percentage)

Type of firm and job classification	Racial composition					
	Malays	Chinese	Indians	Other	Total	Non-malaysians
Managerial	12	80	5	2.5	76	24
Technical & supervisory	15	76	7	1.2	90	10
Clerical & related positions	10	82	5	2	95	5
General workers (office boys, telephone, etc.)	34	47	17	2	95	5
Skilled workers	23	69	7	1	93	7
Unskilled workers	38	54	7	1	96	4

NOTE: Of the 102,896 jobs within the manufacturing sector, 6% were managerial, 15% technical and supervisory, 8% clerical, 8% general workers, 23% skilled, and 40% unskilled (these data are provided for teaching purposes only).
SOURCE: All data from *Supplement to the Survey on Employment in Manufacturing Industries, West Malaysia* (Kuala Lumpur: Government Printer, 1970), pp. 21, 37.

TABLE A14.9 Malaysia: Calculation of Alternative Employment Targets for Southwest Zone Manufacturing Activities by 1975

Jobs	Alternative employment policies			
	Alternative 1: 51% of the jobs for Malays by 1975	Alternative 2: 36% of the jobs for Malays by 1975	Alternative 3: 31% of the jobs for Malays by 1975	Alternative 4: No change in the job distribution by 1975
A. Mfg. jobs in the S. W. zone in 1970 (Dec.)	102,896	102,896	102,896	102,896
B. Projected S. W. zone mfg. jobs in 1975	134,216	134,216	134,216	134,216
C. Number of Malay S.W. zone mfg. jobs in 1970 (see table 14.7)				
D. Number of total Malay S. W. zone mfg. jobs necessary in 1975 to reach the employment target of each alternative (% set by alt. × row B)				
E. New mfg. jobs available according to the estimates	31,320	31,320	31,320	31,320
F. Possible number of jobs for Malays in 1975 (rows C + E)				
G. Job surplus or deficit				
H. Are jobs available for non-Malays?				
I. Non-Malay jobs 1971–75 available due to retirement or attrition (estimated)	7,500	7,500	7,500	7,500
J. If row I jobs are used for Malays, will additional non-Malays have to be disemployed? How many?				

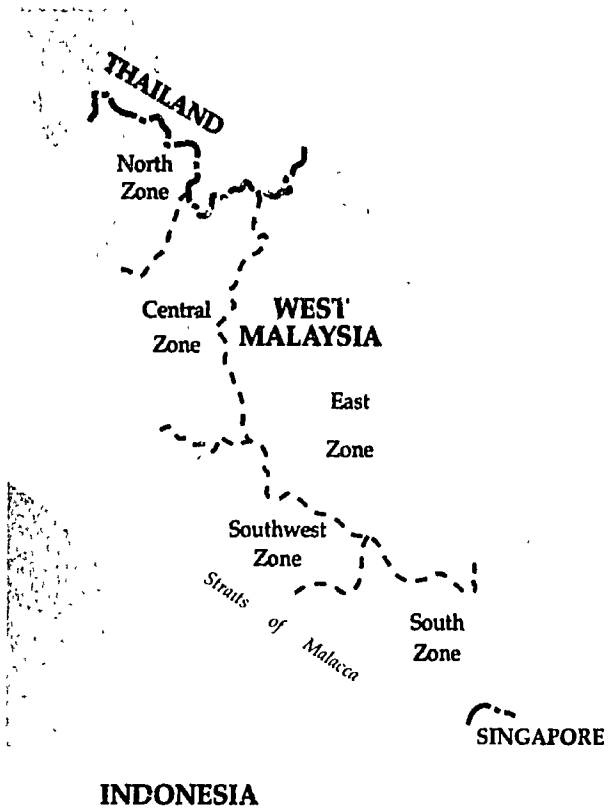
NOTE: Rows C, D, F, G, H, and J are to be computed by readers analyzing the case as part of the case study process.
SOURCE: Marc Lindenberg.

TABLE A14.10 Malaysia: Government Ministries and Their Duties, 1969

Governmental actors	Selected activities
Ministry of Labor	1. Enforcement Division (two people) responsible for checking compliance with labor and other laws. 2. Training Division (staff of four) performs 30 two-week vocational education classes per year.
Ministry of Commerce and Industry	1. Grants operating permits to new industries. 2. Grants tax exemption privileges to new industries that meet certain legal requirements. 3. Attempts to attract new industry. 4. Coordinates industrial development planning.
Federal Industrial Development Authority (FIDA)	1. Plans and builds infrastructures for special industrial estates. 2. Helps attract new industry to industrial estates. 3. Cosigns special tax exemption privileges for new industries that meet certain legal requirements.
Malaysian Industrial Development Finance Authority (MIDFL)	1. Provides loans to new industries.
Ministry of Education	1. Controls primary, secondary, and tertiary education, including the University of Malaysia and University Science of Penang.
MARA	1. A special agency that performs job and skills training for Malays. 2. MARA has its own vocational training institute
Federal Land Development Authority (FLDA)	1. Designs and implements land development schemes for poor farmers in rural areas. The schemes include palm oil cultivation and processing and rice double cropping.
Ministry of Agriculture	1. Performs a full range of extension, research, and other activities.

SOURCE: Marc Lindenberg.

FIGURE A14.1 Malaysia: Geographic Zones of West Malaysia



NOTE: East Malaysia consists of the northern coastal states of Borneo.
Zone information: North Zone: Penang, Kedah, and Perlis
Central Zone: Perak
East Zone: Kelantan, Trengganu, and Pahang
South Zone: Jahore and Malacca
Southwest Zone: Negri Sembilan and Selangor
SOURCE: *Second Malaysian Plan 1971–75* (Kuala Lumpur, Government Printer, 1971), Appendix.

PART IV

Designing Agricultural Strategy

Part IV, "Designing Agricultural Strategy," applies the framework articulated in part I to the analysis of agricultural policies. Chapter 15, "An Approach to Formulating Agricultural Strategy," describes the special characteristics of the agricultural sector, identifies short- and medium-term agricultural strategies, and looks at how the sequencing of policy changes can influence the effects of policies. Unlike the other parts of this book, part IV gives special attention to one country's agricultural sector (Costa Rica). The purpose of this special focus is to allow readers to look at the overall sector as well as specific problems in export versus domestic products.

The cases in this part provide the reader with a chance to participate in the problems of designing and implementing new agricultural strategies. They begin with an overview case, "Costa Rica: The Agricultural Sector and Structural Adjustment" (chapter 16). It is followed by "Rice Subsidies in Costa Rica" (chapter 17) and by "The Banana Industry in Costa Rica in 1985" (chapter 18), which provide a look at the problems of export versus domestic agriculture. It finishes with "The Agricultural Sector of San Marcos" (chapter 19), the disguised case of a real country facing the problem of integral rural development and small basic grains producers.

An Approach to Formulating Agricultural Strategy

Industrial prosperity in Argentina is based on two conditions which are clearly detrimental to agriculture . . . first, high levels of tariff protection and, second, low prices for imported industrial inputs and equipment and overvalued exchange rates.

Conversely . . . agriculture finds in exports those possibilities denied by the domestic market. Its earnings rely . . . on securing cheap inputs and receiving high prices in foreign sales. In other words, it requires a lower tariff protection on its inputs and a real exchange rate. That is to say, [it needs] exactly the opposite of what industry seeks.

—*La Nación*, Buenos Aires, August 25, 1988

These comments from Argentina's leading newspaper reveal, on the one hand, the importance of economic policy in developing agricultural strategy and, on the other, the conflicts that can arise between agriculture and industry. The purpose of this chapter is to help managers understand the role of agricultural policy in national economic strategy. Reading it should enable them to recognize the strengths and weaknesses of the options normally proposed, as well as the problems that arise when there are major inconsistencies between national and sectoral policies.

The chapter addresses the same general set of issues that oriented the earlier discussion of industrial policy in chapter 9:

1. *Definitions.* What characteristics make the agricultural sector special? What objectives do governments commonly set to guide the development of agricultural strategy?
2. *Reconstructing the past and understanding the present.* What agricultural strategies have been successful in expanding production and employment in the past?
3. *Shaping the future.* What type of strategy might be desirable in the future (given the special characteristics of the specific country under discussion)?
4. *Managing change.* What potential conflicts might arise when a country attempts to alter its agricultural strategy and how might they be managed?

What Are the Objectives of Agricultural Strategy and the Special Characteristics of Agriculture?

Agricultural policy objectives. Just as there are fundamental objectives at which national macroeco-

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TABLE 15.1 Coffee: International Prices per Quintal, Production Profitability and Devaluation over Four Periods (hypothetical data)

	Period			
	1	2	3	4
Exchange rate	10 x 1	10 x 1	10 x 1	20 x 1
Dollar prices	$180	$140	$140	$100
Local currency prices	1,800	1,400	1,400	2,000
Profit	400	0	300	500
Local currency costs	1,400	1,400	1,100	1,500
Imported costs	400	400	400	400[a]
Local costs	700	700	700	700[a]
Taxes	300	300	0	400

a. In this case we assume devaluation after incurring the costs preceding the fourth-period harvest. This way, the cost effect of devaluation will show only in the next period.
SOURCE: Noel Ramírez.

nomic policy is aimed, so too are there specific objectives for which governments attempt to develop agricultural policies. Among these objectives are (1) agricultural growth and efficient production; (2) improved functional income distribution in rural areas; and (3) adequate levels of national nutrition and food supply. Attaining the first two objectives sometimes helps to reduce rural-urban migration.[1]

Complementarity between sectoral and national policies is important if overall objectives are to be achieved. Conflicts often arise when sectoral policies are managed independently from national macroeconomic strategy. For example, in the short run the government might try to implement a stabilization program to fight inflation. Reducing fiscal deficits might be a part of the program. However, the policy makers may also want to control inflation by maintaining consumer subsidies for basic foodstuffs in urban areas even though, in so doing, they might jeopardize the overall stabilization program.

While most conflicts could be avoided through better coordination of national and sectoral policies, the complexity of the policy process, the short-term perspective that governments frequently adopt, and the strength of interest groups make such consistency difficult to achieve. Managers need to be aware of both national objectives in agriculture and the potential conflicts between national and sectoral policies and their implications.

The special characteristics of agriculture. *Seasonality, geographic dispersion, and high risk.* Agricultural production has three fundamental characteristics that make it different from other sectors: seasonality, geographic dispersion of its production units, and high risk level due to weather. The failure to consider these factors in the policy process can lead to serious problems. For example, when governments take control of the distribution of key inputs, they sometimes fail to consider the seasonal nature of production and end up creating input scarcities at the very moment when producers need fertilizer, insecticide, and seeds at planting time.

Seasonality is also an important problem in the management of the supply of basic grains. For example, some governments allow agricultural prices to fluctuate on a seasonal basis. During times of high prices some low-income consumers may get priced out of the market entirely and seek cheaper but less nutritional substitutes. To correct such problems other governments try to even out supply fluctuations by managing stocks of stored grains. Poorly managed market interventions create distortions, and the failure to intervene at all may result in wide fluctuations due to seasonality. Managers need to know the implications of the policy options that respond to such problems as seasonality in agriculture.

Price-taking in the international market. Another special characteristic of small agricultural exporting countries is that they are "price-takers" in the international market. Declines in international prices are often offset, at least in the short run, by domestic actions that affect other sectors of the national economy. Exchange-rate adjustments and tax shifts from the export sector to other sectors are often used, unless the price fluctuation is short-lived and can be temporarily countered through foreign resources.

Table 15.1 shows how exchange-rate adjustments might be used to compensate for a drop in international prices of agricultural export commod-

TABLE 15.2 Nominal Protection Coefficients (NPC) for Producer and Consumer Prices of Selected Commodities in Industrial Countries and Regions, 1980–1982

Country or region	Wheat		Rice		Beef and lamb		Dairy products		Weighted average[a]	
	Producer NPC	Consumer NPC	Producer NPC	Consumer NPC	Producer NPC	Consumer NPC	Producer NPC	Consumer NPC	Producer NPC	Consumer NPC
Australia	1.04	1.08	1.15	1.75	1.00	1.00	1.30	1.40	1.04	1.09
Canada	1.15	1.12	1.00	1.00	1.00	1.00	1.95	1.95	1.17	1.16
EEC[b]	1.25	1.30	1.40	1.40	1.90	1.90	1.75	1.80	1.54	1.56
Other Europe	1.70	1.70	1.00	1.00	2.10	2.10	2.40	2.40	1.84	1.81
Japan	3.80	1.25	2.90	3.30	4.00	4.00	2.90	2.90	2.44	2.08
New Zealand	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
United States	1.15	1.00	1.00	1.30	1.00	1.00	2.00	2.00	1.16	1.17
Weighted average	1.19	1.20	2.49	2.42	1.47	1.51	1.88	1.93	1.40	1.43

a. Averages are weighted by the values of production and consumption at border prices.
b. European Economic Community. Excludes Greece, Portugal, and Spain.
SOURCE World Bank, *World Development Report, 1986* (Washington, D.C., 1987).

ities. In the example, the international price for coffee has gone down from US$180 per quintal in period 1 to only US$100 in period 4. In order to maintain producers' profitability the government has devalued the local currency from 10 per U.S. dollar to 20. Such a devaluation may sharpen the conflict between agricultural producers and industrialists, since the latter's imported inputs suddenly become more expensive.

The threat of protectionism. A final special problem of world agriculture in the 1980s has been the threat of protectionism from the industrial countries. According to such international organizations as the World Bank, serious imbalances have taken place in the 1980s because many industrial countries have not only restricted their agricultural imports, but have also created large domestic agricultural surpluses that have increased the instability of world markets.[2] Countries have used a combination of support prices for producers and public investment in infrastructure and technology to artificially encourage production for domestic markets and subsidize agricultural exports. They have also used tariffs, nontariff barriers, and quantitative restrictions such as health regulations and quotas to protect domestic agriculture. One indicator of protection levels in industrialized countries is shown in table 15.2, where protection is measured as the ratio of domestic to international prices.

Reconstructing the Past and Understanding the Present

Before managers and policy makers attempt to analyze new options for their country's agricultural sector, they should get an overview of its strategy for the agricultural sector and see how successful that strategy has been compared to other countries'. Agricultural strategies can be characterized by their stage of development, by the kinds of products and markets they emphasize, by the role assigned to markets versus state intervention, and by the way they have integrated modern and traditional sectors. Let's take a brief look at each of these approaches.

Peter Timmer provides a classification of four stages in a country's agricultural development that is useful for managers who want an overview of the strategic dilemmas facing their country's agricultural sector.[3] For example, in stage 1, called "getting agriculture moving," the primary policy problem is transforming traditional agriculture through expanding both production and efficiency. Stage 2

TABLE 15.3 Costa Rica: Agricultural Strategies, 1900–1988

Product type	Type of market: Domestic	Type of market: Export
1. Export—traditional		1900–1960 Coffee and bananas
2. Basic grains	1974–1982 Rice and others	
3. Export—nontraditional		1983–1988 Flowers and others

SOURCE: Noel Ramírez.

takes place when efficiency and productivity levels are great enough to permit the sector to make substantial contributions to the growth of the gross domestic product (GDP), and to allow a transfer of resources to other sectors through taxes or other mechanisms. At this stage sharp conflicts take place between agricultural and industrial producers, as were noted in the quotation at the head of this chapter. During stage 3 a country attempts to integrate its agricultural sector more effectively with the rest of the economy through the development of efficient markets for labor and credit, as well as forward and backward linkages. Agriculture at this stage becomes less important as an overall contributor to GDP growth. Finally, in stage 4, agricultural overproduction takes place, as has occurred in Europe and the United States. At this point the dilemma is to reduce subsidies and transfer resources to more efficient uses in the economy.

Once managers have a sense of the problems countries face at different phases of their agricultural development, it is useful for them to see in more detail what products are produced for what markets. Agricultural strategies can stimulate production for primarily domestic or export markets or for a balanced combination. They can also give priority to traditional or nontraditional export commodities, or basic grains. Costa Rica, for example, has attempted different strategies at different times (see table 15.3). For example, in the late 1800s and until the late 1950s, it emphasized coffee and then banana production for European and U.S. markets. In the 1970s, particularly after the oil crisis, Costa Rican policy makers encouraged self-sufficiency in basic grain production. More recently, especially since 1983, nontraditional export crops have been strongly encouraged.

During the first stage, coffee and banana exporters received subsidized credit. No additional encouragement was needed due to the country's excellent growing conditions and the buoyancy in the world market. In the second period producers of basic grains received subsidized credit, crop insurance, and favorable support prices. Finally, during the last period, nontraditional agricultural producers of, for example, flowers or fresh fruits and vegetables benefited from minidevaluations, fiscal incentives, and the support of private and public marketing organizations.

Another useful way to classify agricultural strategies is by the level of government intervention. For example, Timmer distinguishes between (1) free-market strategies; (2) integral rural development; and (3) price-based strategies.[4] Free-market strategies are based on the assumption that agricultural markets in developing countries function in an efficient manner and that economic actors perform in an atmosphere of rational expectations. Therefore, except in the very short run, economic policy becomes irrelevant to farmers. This approach is consistent with the thesis that open economies will show a better performance than ones that significantly restrain international trade. Consequently, in the long run, economic growth will implicitly involve a waning in the importance of the agricultural sector within the national economy. The greatest strength of this approach is that it prevents the distortions typically created through state intervention. Its greatest weakness lies in the unreality of its premises since, as we have seen, agricultural activity is plagued with distortions not only in developing countries, but also in industrialized countries.

The integral rural development strategy calls on agriculture to play a fundamental role in economic

development as a demand generator and food provider. That is why it is concluded that this strategy should be managed by government officials, leaving little or no space for the private sector, except small farmers. To be successful, this strategy needs a large investment in human resources in the form of nutrition and health, the development of a suitable organizational structure, and the investment needed to make a quick and adequate technological change. The greatest weakness of this approach lies in the fact that it overlooks the very nature of the productive system prevailing in the agricultural sector. In this sector, the decision-making process may be in the hands of too many economic agents for centralized guidance to be efficient.

Finally, the price-based strategies recognize not only the inefficiencies prevailing in agricultural markets, but also those stemming from state intervention. This approach advocates state intervention in pricing policy, while granting that the best vehicle through which to spread economic policy interventions is the market operating in the hands of the private sector. The major strength of a price-based strategy is that it acknowledges the structural characteristics of the decision-making process prevailing in agriculture.

Given the large number of farmers within a typical developing country, government extension agents cannot teach each individual farmer new agricultural techniques. Price policy for farm crops and agricultural inputs, on the other hand, is an intervention that reaches most farmers quite directly while being amenable to effective government control. Consequently, knowing the role of relative prices in influencing the behavior of farmers is extremely important.[5]

The weaknesses of price-based strategies stem from their inability to take into account the serious imperfections in the markets for agricultural products, capital, and labor in developing countries.

Finally, Theodore Schultz, B. F. Johnston, and others have divided agricultural strategies into two broad categories: unimodal and bimodal, based on the type of producer and technology used.[6] The unimodal strategy is dominated by small producers who use labor-intensive production techniques. Taiwan is one of the best examples of unimodal production. In this context, centralized decision making would be extremely counterproductive. On the other hand, in the bimodal strategy many poor, small farmers exist side by side with large agricultural production units that use capital-intensive technology. Mexican agriculture is a frequently cited example of bimodal production.

After getting a better sense of a country's agricultural strategy and structure, it is useful to compare its recent performance with that of other countries. An example of a good basis of comparison appears in table 15.4.

The exhibit helps underscore the importance of agriculture to overall GDP for countries in the 1970s whose agricultural sector was more than 20 percent of GDP. Countries with higher rates of overall GDP growth had higher rates of agricultural growth as well. Using such a chart, managers can see quickly where their countries' agricultural sectors fit in recent years.

Shaping the Future: Short-Term Agricultural Strategy

Many countries are involved in the difficult process of transforming agriculture to ensure more productivity in the future. These transformations often begin with short-term policy changes in moments of economic crisis such as occurred in the early 1980s. According to one source:

> A major constraint limiting agricultural development has been policies that impeded rather than induced appropriate technical and institutional innovations. As a result the gap widened between the potential and the actual productive capacities of LDC [less developed countries'] agriculture.[7]

These constraints increase when national and sectoral policies conflict. This section may help managers and policy makers become more aware of (1) the way in which national strategy helps shape sectoral policy; (2) the potential conflicts that can arise when sectoral policy is defined independently of national strategy; and (3) recent experiences that show the complexity of designing and implementing agricultural policy. The section specifically addresses the problems agricultural producers encounter when governments opt for short-term inflationary policies, and the additional problems these producers experience when major inconsistencies between national and sectoral policies develop during the process of stabilization that often follows.

Inflationary policies and the agricultural sector. When an inflationary process is generated, if all prices adjust in the same proportion and with the same speed, relative prices remain unchanged. However, typically distortions are created because exchange rates, interest rates, and agricultural commodity prices

TABLE 15.4 Growth of Agriculture and GDP in the 1970s for Countries Where Agricultural Sector Exceeded 20 Percent of GDP

Agricultural growth	GDP growth			
	Above 5 percent		3–5 percent	Below 3 percent
Above 3 percent	Cameroon China[a] Colombia Dominican Rep. Guatemala Indonesia Ivory Coast Kenya Korea, Rep. of	Malawi[a] Malaysia Paraguay Philippines Thailand Tunisia Turkey Yemen Arab Rep.	Bolivia Burma[a] Mali[a] Somalia[a] Tanzania[a]	Liberia Nicaragua Senegal
1–3 percent	Costa Rica Ecuador Egypt Lesotho		Bangladesh[a] Central Africa Rep.[a] El Salvador Haiti[a] Honduras India[a] Pakistan[a] Sri Lanka[a] Sudan[a] Upper Volta[a] Togo[a]	Burundi[a] Sierra Leone[a] Zaire[a]
Below 1 percent	Morocco Nigeria			Angola[a] Chad[a] Congo Rep. Ethiopia[a] Ghana Madagascar[a] Mauritania[a] Mozambique[a] Nepal[a] Nigeria[a] Uganda[a]

a. Low-income countries.
SOURCE: World Bank 1987: 45.

lag behind due to government decisions or market rigidities. These distortions often result in reduced agricultural production and productivity. Here are some of the more common problems.

Fiscal policy. The existence of a large fiscal deficit is not only common during an inflationary process, but is considered one of its main causes by those who propose orthodox stabilization programs. Often governments faced with an inflationary process extend price controls on food and maintain large producer subsidies. When consumers are protected through food price controls that increase fiscal deficits financed by fiat monetary emission, this actually fuels the inflationary process further—as occurred, for example, in the early 1980s in Costa

TABLE 15.5 Tanzania: Official and Unofficial Prices for Selected Crops in 13 Villages, 1979–1981 (Tanzanian shillings per kilogram)

	Official price		Parallel price	
Crop	1979–1980	1980–1981	1979–1980	1980–1981
Maize	1.00	1.00	3.08	4.98
Paddy rice	1.50	1.75	2.31	4.23
Cassava	0.65	0.65	1.99	2.90
Sorghum	1.00	1.00	2.96	4.68
Millet	2.00	1.50	4.73	6.95

SOURCE: World Bank 1987: 75.

Rica. When the new International Monetary Fund agreement and the Economy Emergency Law went into effect in March 1984 in that country, authorities noted that a large percentage of the fiscal deficit that had helped accelerate the inflationary process in that period was due to increased consumer and producer subsidies for basic grains managed by the National Production Council.[8]

Monetary policy. Another problem for agricultural producers during an inflationary process is that credit dries up in real terms. Without this credit agricultural production is reduced even further. As noted earlier, in chapter 2, real interest rates often fall during an inflationary process. This often results in a decline of domestic savings and, therefore, in credit availability. When this situation also includes an overvalued exchange rate, price controls on basic consumer items, and a preferential interest rate for the agricultural sector, access to institutional credit is most likely to be denied to the sector because the banking system has little incentive to finance agriculture.[9] This took place, for example, in Brazil between 1975 and 1978. By the end of the period, less than 25 percent of the country's existing five million farms were receiving institutional credit.[10]

Trade policy. Many potential conflicts related to national macroeconomic policy stem from sectoral policy decisions. For example, food price controls not only contribute to fiscal deficits; they often provide disincentives to producers, which can result in a reduction in overall food production and more serious balance-of-payments problems due to increased food imports. For instance, in Tanzania the government attempted to maintain cheap food for urban consumers through price controls. The result was a generalized drop in real farm prices. By the end of 1984 the amount of corn commercialized through official channels was less than one-third the quantity marketed in 1979. Something similar happened to rice and other commodities.[11]

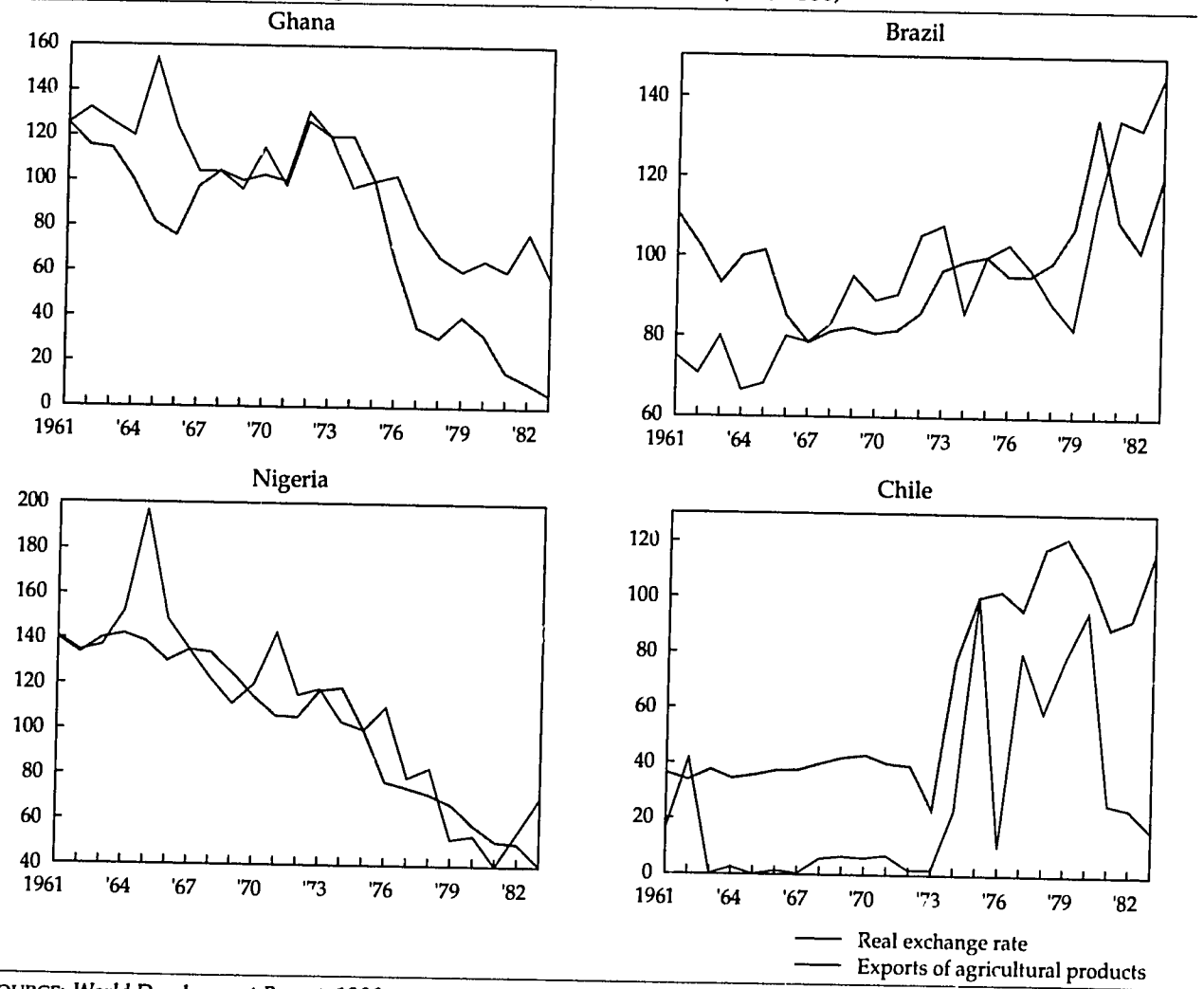
Food imports had to be increased to maintain supply and this put pressure on the balance of payments (see table 15.5).

Labor policy. During inflationary cycles most governments respond by authorizing wage increases. Some even allow salary increments to be fully indexed to inflation. Difficult contradictions result for farmers when price controls are placed on consumer agricultural products at the same time as urban wages increase. Demand for food is stimulated while the incentive to produce it is reduced drastically for those who do not want to sell in the black market. Once food imports cannot be financed through further borrowing or reducing foreign reserves, the inflationary cycle accelerates.

Exchange-rate policy. In the 1970s and early 1980s, many countries allowed their real exchange rates to appreciate. Appreciation was sharpest in the sub-Saharan countries of Africa.[12] Overvalued exchange rates during an inflationary cycle produces major problems for the agricultural sector. Agricultural exports generally lose their competitiveness in world markets, as can be seen from the data about Ghana, Nigeria, Brazil, and Chile that appear in figure 15.1. The prices of agricultural inputs also increase. If agricultural wages are also indexed by the government based on inflation, the farmers will be caught in a squeeze between reduced prices on the one hand and increases in their costs on the other.

Once the distortions caused by inflationary policies become serious, governments often resort to stabilization programs. However, contradictions between national stabilization policies and sectoral policies can damage the agricultural sector still further.

FIGURE 15.1 Indexes of Real Exchange Rates and Exports of Agricultural Products in Ghana, Nigeria, Brazil, and Chile, 1961–1982 (1975=100)



SOURCE: *World Development Report, 1986.*

Orthodox stabilization and the agricultural sector. Orthodox stabilization programs usually include measures to reduce fiscal deficits and control monetary expansion. Typical measures are reductions in subsidies; readjustments of controlled prices and public utilities rates; and correction of overvalued exchange rates. Inconsistencies in stabilization programs also create new contradictions in the policy areas that follow.

Fiscal policy. Although the inflationary process has already distorted the cost structure in agriculture, governments often try to reduce their fiscal deficits by increasing taxes on agricultural exports while maintaining the nominal exchange rate. While such taxes look attractive because they are easily collected, they may result in a further disincentive to agricultural recovery. The potential conflict might disappear if agricultural product prices went up in the international market, but most agricultural producers are price-takers, so price increases are unlikely. The new taxes might also reduce capital investment and development of new technology.

Countries that have levied new export taxes have experienced large and rapid declines in production and their world market share. Examples of such declines are Ghana and Nigeria (cocoa); Nigeria and Zaire (palm oil); Burma (rice); and Egypt (cotton).[13] In Ghana, for example, the effective export tax rate increased from 54 percent in the late 1960s to 1989 percent in the late 1970s. As a result, the country's exports dropped from 40 percent of world market in 1961–1963 to 18 percent in 1980–1982.[14] The impact of fiscal policy on relative cocoa prices for Ghana and other cocoa suppliers is shown in table 15.6.

New export taxes often elicit strong reactions among agricultural producers. Typical of such reactions is the one that appeared in an Argentinian newspaper in 1988:

> The measures adopted to contain incipient hyperinflation are based on the unilateral transfer of 1.0 to 1.2 billion dollars a year from agricultural producers to the state. In the long run, these measures mean that we will continue with an antiexport biased policy that started as long as four decades ago with stringent exchange controls and differential exchange rates discriminating against agricultural products, export value retentions, high taxes on land, farms and agrarian equipment and disproportionate real interest rates in relation to meager agricultural profitability. All of them aimed at extracting producer surplus from agriculture for the government.
>
> Should we have continued on the natural path of agricultural development of 40 years ago, at the vanguard of technological breakthroughs in agrarian production, on an equal footing with the United States and Canada, nowadays Argentina would export not 7, but 30 billion dollars a year and more than half that value would come from agricultural activity and agribusiness. Instead of continuing on this course, our country became stagnant. Today it remains the largest reserve of idle fertile lands existing on the planet. Thirty million hectares of fecund countryside are still virgin as to tilling in Eastern and Western Chaco park, whereas an additional 30 million hectares of fruitful land, lacking enough profitability, barely produce a fraction of the wealth they could be capable of generating.[15]

While it is difficult to find ways in which governments can reduce their fiscal deficits during stabilization, there are some innovative examples of new sources of revenues. For example, the Japanese used a land tax fairly effectively:

> In sharp contrast to the case in many of today's developing countries, taxes were levied by a direct land tax. This did not undermine agricultural incentives by lowering producer prices. On the contrary, agriculture's terms of trade generally improved from 1888 until the 1930s. Furthermore, the level of agricultural taxation was low in comparison with the tax burdens common in developing countries.[16]

Monetary policy. When interest rates rise because of the effort to reduce overall liquidity during stabilization, they may actually contribute to a further reduction of agricultural credit. In contrast, where interest rates remain low but where capital transactions are liberalized, capital flight may take place and domestic savings may be reduced. This may reduce access to agricultural credit even further. These distortions tend to decrease once inflationary expectations diminish and if the overall policy does not discriminate against the profitability of the agricultural sector.

TABLE 15.6 Relative Price Incentives for Cocoa Farmers in Ghana, Togo, and Ivory Coast, 1965–1982

Year	Ratio of Ghana price to Togo price	Ratio of Ghana price to Ivory Coast price
1965	0.97	0.97
1970	0.56	0.60
1975	0.74	0.48
1980	0.23	0.18
1981	0.36	0.26
1982	0.40	0.30

SOURCE. World Bank 1987: 76.

Trade policy. Agricultural producers may benefit initially from changes in trade policy during stabilization particularly if price controls on basic grains are lifted. If producer subsidies have been great, however, a reduction may provide new disincentives. Governments have tried to ease the difficulty of adjustment for producers by extending the time horizon for subsidy reduction to give them a chance to adjust. They also try to make the schedules and rationale for adjustment explicit and to provide technical assistance for those producers who want to improve their productivity.

Labor policy. Normally, during an orthodox stabilization program, real wages fall and unemployment increases in the short run, thereby reducing domestic demand. Since the demand for domestic foodstuffs is relatively inelastic, it will probably be maintained even during a stabilization process. However, where wages for agriculture are indexed or special programs for poverty groups are implemented, there may be a negative effect on the cost structure in agriculture.

Some governments attempt to reduce the negative impact on producers by tying wage readjustments to labor productivity increases; by using voucher programs to help poverty groups get food without distorting prices; and by seeking agree-

ments between government, producers, and wage earners to temporarily freeze key prices and wages.

Exchange-rate policy. One of the most serious inconsistencies for agriculture during stabilization programs occurs when governments allow the exchange rate to become overvalued again. The profitability of agricultural exports drops, the balance of payments deteriorates, and disincentives for new agricultural investment increase once again.

A second difficulty occurs when governments use a dual exchange rate set lower than the real rate to extract resources from agricultural exporters. By paying exporters less than the real exchange rate for their export earnings, they in effect levy the equivalent of a direct tax. If this tax is large enough there will be new disincentives for agricultural production.

Heterodox adjustment and the agricultural sector. In order to make the adjustment process more gradual and minimize the costs to high-risk groups, some governments attempt to control key prices or reduce them gradually. These heterodox programs have all of the risks of the normal stabilization process as well as the additional problems of inconsistencies due to phasing. In the worst-case scenario new distortions are created because programs have been designed without considering the relations between the key prices to be controlled or their impact on the cost structure of producers. Sometimes the new distortions become so great that even harsher stabilization programs must be adopted later.

For example, between 1984 and 1987, Nicaragua experienced a severe economic collapse with hyperinflation. The causes of this situation included military conflict, friction between the government and the private sector, earlier problems in economic policy management, and finally, a deterioration in terms of trade. As a result, real production in 1987 dropped to 75 percent of what it had been ten years before. Exports were reduced to a third of 1977 levels. The fiscal deficit rose to more than 30 percent of GDP and was financed by fiat monetary emission. Inflation rose to more than 1,000 percent annually. Large price distortions appeared and an active black market developed for many goods. Real wages dropped by more than 70 percent between 1981 and 1986.

To stop the collapse the government implemented a heterodox stabilization program in February 1988. The objectives were to sharply reduce inflation and price distortions, introduce efficiency in the productive system, increase exports, and reduce speculation. Nevertheless, real wages were to be protected simultaneously. According to the president of the Central Bank of Nicaragua, these reforms would protect wage earners, "unlike the orthodox measures imposed on many countries by the IMF, which are characterized by significantly harming workers."[17]

The government adopted the following measures to achieve its objectives.[18] The exchange rate was devalued from 300 cordobas per dollar to 10,000 for imports, and from 5,000 cordobas per dollar to 10,000 for exports, and the official and black market rates were unified. Nominal wages had a fivefold increase, and finally, prices for consumer goods were increased 2.5 times. The resultant new prices became the official ones for foreign exchange transactions and factor markets.

Because of the relationship between the different price increases, the cost of imported inputs increased more than 30 times and labor costs 5 times. However, the price of agricultural exports only doubled and domestic agricultural product prices increased only 2.5 times, creating a squeeze for agricultural producers.

While the new heterodox program began as an attempt to stabilize the economy while protecting real wages, it actually created further disincentives for agriculture and more strain on the balance of payments and the government budget. Subsequently, the government had to adopt even more severe stabilization measures. It sharply devalued the exchange rate and adjusted prices again, causing an additional decline in purchasing power.

Shaping the Future: Medium-Term Agricultural Strategies

Many countries today are attempting to move from an inward to an outward trade orientation. This transition requires changes in the role of agriculture and the policies that affect it. Managers need to be aware of how these major national orientations have traditionally affected agriculture and the special problems that sector may have during the transition.

Inward-oriented policies: import substitution and the agricultural sector. In the 1950s and 1960s some countries adopted import-substitution policies that created strong disincentives for agriculture. The following analysis by William James, Seiji Naya, and Gerald Meier provides a quick summary of the import-substitution policy package and its impact on agriculture in India and Pakistan:

> [These countries] restricted imports by means of high tariffs, exchange controls, and a system of

TABLE 15.7 Protection of Agriculture Compared with Manufacturing in Selected Developing Countries, Selected Years 1960–1983

Country and period	Year	Relative protection ratio[a]
In the 1960s		
Mexico	1960	0.79
Chile	1961	0.40
Malaysia	1965	0.98
Philippines	1965	0.66
Brazil	1966	0.46
S. Korea	1968	1.18
Argentina	1969	0.46
Colombia	1969	0.40
In the 1970s and 1980s		
Philippines	1974	0.76
Colombia	1978	0.49
Brazil[b]	1980	0.65
Mexico	1980	0.88
Nigeria	1980	0.35
Egypt	1981	0.57
Peru[b]	1981	0.68
Turkey	1981	0.77
S. Korea[a]	1982	1.36
Ecuador	1983	0.65

a. Calculated as (1 + ERP) / (1 + EPR), where ERP and EPR are the effective rates of protection for agriculture and the manufacturing sector, respectively. A ratio of 1.00 indicates that effective protection is equal in both sectors; a ratio greater than 1.00 means that protection is in favor of agriculture.
b. Refers to primary sector.
SOURCE: World Bank 1987: 62.

import licensing. Protected industrial firms were encouraged to adopt capital-intensive techniques by government policies that underpriced capital and raised the cost of unskilled labor. Artificially low interest rates and underpricing of foreign exchange enabled privileged firms (often public enterprises) to avail of cheap government credits and to import capital equipment "inexpensively." Of course, unprivileged firms and producers in other sectors were unable to get credit except from moneylenders at much higher interest rates. Exports and savings were discouraged. Investment was inefficient and consumers faced limited choices—to buy low-quality domestic goods at high prices, or to do without.

Farmers had little incentive to increase marketable supplies of food or primary exports. Agricultural production growth in Pakistan was under 2 percent in the 1950s. Domestic markets for manufactured goods produced by protected firms failed to expand. Growth slowed and underemployment increased. Slow structural transformation resulted. Similarly, Indonesian farmers until the late 1960s labored under the weight of high inflation, an overvalued rupiah, acute shortages of credit, and deteriorating internal terms of trade (caused by the setting of artificially low food prices in urban markets). Between 1958 and 1966 agricultural exports fell by a third and agricultural production growth of 1.6 percent failed to keep pace with population growth.[19]

Managers can learn a great deal about the relative impact of policies on industry versus agriculture through calculating the terms of trade between one sector and another and also by comparing the relative levels of protection for each one. Terms-of-trade calculations permit analysts to compare the prices of import and export products and inputs between countries or sectors on the basis of some standardized baseline data. For example, table 15.7 shows some of the standard problems of terms of

TABLE 15.8 Import Substitution and the Terms of Trade between the Agricultural and Industrial Sectors

Economic measures	Market type	Effects on terms of trade
Agricultural product price control/tariffs on importable products	Goods	Industrial products turn more expensive compared to basic agricultural consumer products.
Subsidized interest rates	Financial	Return on domestic savings generated by agricultural sector decreases and credit cost is cheaper for industrial sector.
Overvalued exchange sectors	Foreign exchange	Agricultural exporter income in local currency is reduced and industrial raw materials for imports become cheaper.

SOURCE: Noel Ramírez.

trade between agriculture and industry in a country that used industrial import-substitution policies and agricultural price controls for basic grains.

Analysts can also compare the relative protection given to each sector using international prices as a reference point.

The ways in which import-substitution policies help to turn the terms of trade against agriculture are summarized in table 15.8. These impacts are similar to the ones described earlier in this chapter during the discussion of short-term policies.

Since many managers move from country to country, it is worth recognizing some differences in the way import-substitution policies have been applied in different continents. For example, Gustav Ranis and others have noted that Latin American countries have showed a more consistent bias against agriculture in the last 20 years than their Asian neighbors.[20] Jeffrey Sachs, for example, argues that this occurred because (1) Asian populations have been more rural than those in Latin America; (2) levels of organization have been higher in the urban sector; and (3) therefore, Latin American governments have found their main constituencies in urban workers and industrialists, because they are better organized whereas Asian governments have enlisted support from the rural sector.[21] By implication the coalitions required for carrying out the liberalization policies to be described next will be much more difficult to achieve in Latin America than in Asia.

Outward-oriented policies: structural adjustment and the agricultural sector. As was shown earlier, import substitution not only discouraged export growth and deterred labor absorption in industry but also created a strong policy bias against agriculture. In recent years some governments have attempted to reverse this bias and move to an outward orientation.

Indonesia presents an interesting example of a successful reversal in favor of national policies that helped make its agricultural sector more dynamic. As noted above, until the end of the 1960s, Indonesian farmers faced high inflation, an overvalued rupiah, credit shortages, and deteriorating internal terms of trade due to artificially low food prices. Agricultural exports dropped by a third between 1958 and 1966 and agricultural production growth of 1.6 percent could not match population growth. However, in the 1970s and 1980s, Indonesia turned its macroeconomic policies around. For example, it brought its fiscal deficit under control, and adopted realistic exchange rates. Its agricultural growth rates moved

> from less than 2 to almost 4 percent. . . . The intersectoral terms of trade became reasonably stable, inflation was kept under control, a liberal exchange-rate policy was adopted, interest rates were raised to economic levels encouraging an increase in the supply of funds, wage rates were left to market forces, taxation was moderate, and the pattern of protection, though far from ideal, allowed producers to respond to international market opportunities.[22]

Such policy reversal is part of the process of structural adjustment many countries have pursued

to permit a better allocation of their resources based on their overall comparative advantage. According to its advocates,

> when macro prices are freed from excessive distortion, more efficient resource allocation is one result. But market-priced foreign exchange and interest rates also expand the total supply of foreign exchange and savings available. More investment and employment become possible. With a reduction in trade protection and lower relative cost of labor, more producers have access to more and cheaper inputs. Income distribution improves, which tends to lead to a pattern of consumer demand that favors producers of food and labor-intensive commodities. The positive linkages between agriculture and industry are stimulated.[23]

Unfortunately transitions from one policy orientation to another are not that easy. For that reason it is useful for managers to understand how liberalization policies might affect the agricultural sector and some of the potential conflicts that might ensue.

Fiscal policy. Liberalization normally includes reduction of fiscal deficits through expenditure reduction, tax increases, subsidy reduction, privatization of state-owned enterprises, and increased fees for public services. Two dimensions of fiscal policy that have created conflicts between agricultural policy and national strategy have been the reduction of agricultural export taxes and the use of tax rebate certificates to stimulate agricultural exports.

The reduction of taxes on agricultural exports seems like a straightforward policy measure to reduce disincentives for farmers. Yet if export taxes are reduced without subsequent reductions in public expenditures, fiscal deficits can actually increase. If these deficits are financed by fiat monetary emission, a new inflationary cycle can start, exchange rates can become overvalued, and exports can lose their competitive edge once again.[24] For this reason, some students of the subject recommend not cutting export taxes without making sure that equivalent cuts in public expenditure can be made elsewhere or some compensating additional tax revenues be devised.[25] Other recommendations include reducing tax rates and increasing the tax base; improving the efficiency of tax collection procedures; and selecting taxes that do not distort production incentives.

Tax rebate certificates for export production are often thought of as a way to counterbalance the antiexport bias of import-substitution policies while tariffs are being reduced more gradually. They provide agricultural exporters with a tax credit of some given percentage of the value of what they exported. Often exporters sell these certificates at a discounted value rather than use them as a credit against their taxes. Several major problems have developed with the rebate certificates. First, foreign producers of the same products accuse third world producers of dumping when they sell products in their countries and these products have received a government subsidy through tax rebate certificates. Second, if the value of these rebates is large enough, third world producers run the risk of developing inefficient cost structures that would result in their firms' bankruptcy if the government canceled the program.

Monetary policy. During structural adjustment monetary expansion is often geared to the rates of growth of real GDP. In addition policy makers liberalize interest rates and remove quantitative credit restraints. Sometimes, even though it conflicts with the overall policy of generalized liberalization, a preferential credit policy has been pursued to benefit the nontraditional export sector. The greatest potential risk is that, early in the financial liberalization process, real interest rates may become excessively high to the point of discouraging the productive sector in general, and agriculture in particular, because of this sector's structural characteristics.

Trade policy. During liberalization, policy makers normally recommend removing quantitative restrictions on trade, replacing quantitative restrictions with tariffs, making tariff levels more uniform, reducing levels of protection, and removing producer and consumer subsidies. Major problems can emerge due to inconsistency in the phasing of policies and to improper handling of tariff reduction.

One example of the danger of incongruence between trade and other macroeconomic policies for farmers took place in Chile between 1980 and 1982.[26] During that period tariff protection was reduced but the nominal exchange rate remained fixed, wages were fully indexed and real interest rates climbed sharply. At the same time farmers found themselves unable to compete in international and domestic markets.

Another source of incongruence due to changes in trade policy might occur due to lack of clarity in measuring levels of nominal and effective protection and the size of distortions due to existing policies.[27] In the worst-case scenario major sectors may have no protection or little adjustment time to

TABLE 15.9 Protection, Distortions, and Comparative Advantage

	Income	Costs: Traded inputs	Costs: Domestic factors	Profits
Domestic prices	A	B	C	D
International prices	E	F	G	H
Policy effects	I	J	K	L

NOTE: A/E = nominal protection coefficient.
(A-B)/(E-F) = effective protection coefficient.
J = distortion in traded inputs.
K = distortion in domestic factors.
SOURCE: Noel Ramírez.

change conditions. One way to avoid this difficulty might be found by using the statistical procedure displayed in table 15.9. The procedure is as follows.

First, compute the domestic market value of total income, internationally traded inputs, and other factors of production not traded internationally and convert them into their equivalent foreign exchange value (using the applicable effective exchange rate for each category). Second, calculate the value of production and inputs (for both tradeables and nontradeables) at border prices. Third, estimate the profits gained at domestic prices versus those obtained at border prices. This process permits the observation of not only nominal and effective protection, but also of existing distortions in internationally traded inputs or other factors of production.[28]

Such an analysis, despite its limitations, permits correction of more than just end-product distortions, thus reducing the risk of effectively leaving major producing sectors of a national economy unprotected. As can be seen in table 15.9, it is possible for *A* to be greater than *E*, although *D* will not necessarily be greater than *H*.

Labor policy. During structural adjustment, policy makers attempt to ensure that increases in labor costs do not destroy the productive sector's competitiveness. Attempts are made to reverse policies that adjust wages simply on the basis of inflation indexes. Two of the alternative methods used are relating wage increases to productivity gains and the voluntary wage restraint agreements discussed earlier. Chile, for example, after the 1982 crisis, abandoned its automatic wage-indexing policy that had prevailed since 1979 and had strongly contributed not only to exchange-rate overvaluation but to the development of the crisis itself.

Exchange-rate policy. According to its advocates, one of the most important aspects of the transition to export-led growth is the maintenance of realistic exchange rates. Maintaining such rates permits the agricultural export sector to stay competitive. Exchange-rate adjustments can be made through large, infrequent devaluations or a series of more frequent minidevaluations.

The management of exchange-rate policy can create conflicts for agriculture during liberalization. For example, some governments attempt to use exchange-rate differentials to extract part of the value of new agricultural export sales for government uses. If these exchange-rate differentials become high enough, they create a strong disincentive for exporters.

Two additional types of conflict are more likely to create problems for agriculture. First, governments that attempt to increase public confidence and reduce inflationary expectations by pre-announcing a series of decreasing minidevaluations (called the *tablita* in Spanish) may find that producers and merchants actually raise prices in anticipation. This may actually quicken the inflationary process and help create an overvalued exchange rate. Once the exchange rate becomes overvalued again, agricultural exporters will be less competitive.

Finally, policy makers may liberalize the foreign exchange market without realizing that speculators can create distortions. Foreign exchange markets might operate without distortions under the following conditions: (1) the existence of a foreign exchange futures market; (2) the absence of monopolistic structures that manipulate the marketplace; and (3) free determining of other key prices. These conditions are not easily found in developing countries.

Structural adjustment and Costa Rican agriculture. Sometimes it is difficult to get a real feeling for the way that abstract medium-term policies like structural

adjustment might really work. The following brief discussion of the Costa Rican adjustment program between 1985 and 1988 and its impact on the agricultural sector may provide some additional insight.

Collapse and stabilization, 1980–1984. Between 1980 and 1982 Costa Rica suffered a severe economic collapse. The world economy was in recession. Prices for Costa Rica's key exports of coffee and bananas were in decline. GDP growth rates in Cost Rica were negative, the fiscal deficit had reached 35 percent of GDP, interest and amortization payments on the country's foreign debt as a percentage of exports had climbed, and inflation had reached 100 percent a year.

The Monge administration took office in Costa Rica and implemented a successful stabilization program in the 1982–1984 period. GDP growth became positive by the end of the period, and inflation dropped to 20 percent. The fiscal deficit was reduced and the first steps had been taken in a structural adjustment process aimed at promoting exports, especially nontraditional ones.

Structural adjustment, 1985–1988. In April 1985, to further the new policy, the first structural adjustment program underwritten by the World Bank went into effect. Some of the objectives were reduction of the public-sector deficit; elimination of quantitative credit ceilings; subsidy reductions for basic grain producers; lifting of price controls on some basic consumer products; promotion of nontraditional exports through tax rebate certificates; initiation of a process of tariff reduction; and maintenance of a competitive exchange rate through periodic devaluations. Three years later, in late 1988, the government was trying to complete negotiations for the implementation of a second program covering four basic areas: the financial system, the performance of the nonfinancial public sector, foreign trade, and the agricultural sector.

Some of the results, 1985–1988. Most evaluations indicated that a process of adjustment had begun but had by no means been consolidated. GDP growth rates were above 3 percent for each year of the period. The fiscal deficit was further reduced. Exports recovered to more than 120 percent of their 1979 levels and nontraditional exports grew even faster. Inflation remained below 1982 levels.

The results in the agricultural sector were more complex. Between 1984 and 1987, the agricultural sector had seen its share in GDP reduced from 20.5 percent to 18.0 percent due partially to a sharp decline in the production of basic grains. According to some analysts, basic grain production had been overdimensioned in the past because of excessively high support prices, generalized crop insurance, and subsidized credit, all of which, from 1985 onward, were reduced as part of the adjustment program. However, quite the opposite was happening in the agricultural export sector and, in particular, that of nontraditional products, basically owing to the existence of such instruments as the tax rebate certificates and the minidevaluation policy.

Adjustment appeared to be working to provide incentives to move resources from less to more profitable areas of production both in and outside agriculture. However, the conflicts during adjustment were not simply between agriculture and industry but within agriculture as well—between those farmers who produced for the local market and those with export capacity.

Managing the Process of Change

Policy makers will not know whether new agricultural strategies are feasible until they have decided whether the potential winners and losers from the policy changes can be managed effectively. Since new strategies produce different reactions in different countries, this section will focus on the identification of possible supporters and opponents of one medium-term strategy, structural adjustment in Costa Rican agriculture from 1985 to 1988. The analysis provides another example of the issues policy makers need to consider before embarking on a process of change.

Potential costs and benefits of adjustment in agriculture. As noted in chapter 3, it is useful to identify the measures to be implemented and to review the potential benefits and costs that might result. In this case the measures were reduction of the fiscal deficit; elimination of quantitative credit ceilings; subsidy reductions for basic grains producers; lifting price controls on consumer foodstuffs; promotion of nonexports through tax rebates; initiation of a process of tariff reduction; and maintenance of a realistic exchange rate.

One potential benefit from structural adjustment that policy makers hoped for in Costa Rica was a more efficient use of overall economic resources. They speculated that a reallocation of resources might take place in agriculture itself, away from crops with less potential profitability. Other benefits might be more foreign exchange and eventual new employment due to new exports.

The potential costs of the strategy might be high unemployment on a short-term basis as inefficient production units shut down. At the same time, depending upon the conditions of international food production, reduced production of basic grains might make the country more vulnerable to food shortages. Finally, key pressure groups in agriculture, like the chamber of rice growers, might have the strength to weaken the government's political base.

Potential sources of support and opposition in agriculture. An analysis of the specific measures might help produce the following list of potential sources of support and opposition. Potential opposition might come from employees in the Ministry of Agriculture protesting expenditure cuts for agriculture and job losses. Both export and domestic producers' associations might protest the loss of credit due to reduction of quantitative credit ceilings. Domestic producers, like the rice growers' association, would probably energetically protest reduction of producer subsidies. The less efficient rice producers, possibly the smaller ones, might protest even more extensively since they might have to cease rice production completely. Urban consumers would complain about the lifting of price controls on food. Since community groups in Costa Rica are better organized than in many parts of Latin America, the government would need to look at their potential opposition with a great deal of care.

At the same time the government might find allies for its policies in the agricultural sector. Producers might respond positively to the lifting of price controls for food particularly if the international price had been substantially higher than the local price. Exporters of nontraditional agricultural products would probably have responded positively to tax rebates for new exports. However, their positive response might have been tempered by the relative level of incentives given to them versus industrial producers. Finally, exporters of both traditional and nontraditional agricultural producers would be supportive of maintenance of a realistic exchange rate.

Seriousness of the opposition and support. The government's ability to maintain itself in power during policy change depends upon its capacity to manage its allies and opposition effectively. The more that policy changes provide potential for broad-based opposition, the more dangerous they become for the government.

One issue, the loss of overall access to credit, had the potential to create sector-wide opposition through the agricultural chambers and one other issue, the lifting of food price controls, possibly supplied a basis for serious multisectoral opposition. Other issues touched specific subgroups. While they were capable of producing serious opposition, it also seemed possible to negotiate special arrangements with each group. For example, the domestic producers who comprised the great majority of the agricultural production units but less than 30 percent of overall production were likely to be particularly hostile to the reduction of their subsidies. They probably represented the most serious source of opposition. Exporters of traditional and nontraditional products could be particularly concerned about why their subsidies were not as high as those of the industrialists. However, adjusting the magnitude of these subsidies might provide the government with room to negotiate a broader base of support. Finally, producers in foreign countries, like flower growers in the United States, were likely to accuse Costa Rican producers of unfair competition due to the government's provision of tax rebates for exports.

At the same time the potential existed for broad-based support from both traditional and nontraditional exporters as realistic exchange rates were maintained and if tax rebates for nontraditional exports were increased.

Strategies for reducing the opposition. As a general rule, the government might consider ways to keep multisectoral opposition from forming. This might be done by trying to identify potential sources of multisectoral opposition and to negotiate with separate groups before they had a chance to form coalitions. By maintaining a realistic exchange rate, the government might be able to keep most exporters (industrial, traditional, and nontraditional agricultural) within their base of support. By maintaining and increasing tax incentives for exports they might further solidify their base in agriculture.

Three sources of opposition might require very special treatment: groups who might react to the lifting of price controls on food, agricultural producers for the domestic market such as rice farmers, and foreign producers. With the first problem, the government might attempt to soften the blow of price increases for food through special quick-disbursing programs for high-risk poverty groups, through voucher systems, and through a gradual, more phased process of price changes. It might be possible to reduce producer subsidies gradually. Farmers might be helped to make adjustments and improve productivity through technical assistance. High-risk

groups like small, poorer farmers might receive special assistance during the transition. Finally, the government might try to manage foreign producers who accuse it of dumping through special negotiations with their governments. In the case of Costa Rica the country used the first method and also sought admission to the General Agreement on Tariffs and Trade (GATT).

The Order of the Liberalization Process and the Agricultural Sector

As noted in previous chapters, the cost of adjustment, and therefore its political feasibility, is not independent of the way it is carried out. In an effort to demonstrate some of the costs incurred when problems in policy sequencing take place, consider the following hypothetical examples (which have, in fact, arisen in a number of countries).

> *Example I.* What might happen to the agricultural sector if interest rates are liberalized before prices for agricultural products are adjusted? It is probable that domestic savings would be stimulated, but that farmers producing for the domestic market would not be able to compete for these resources. Something similar happened to Costa Rican basic grains producers who sold primarily in the domestic market between 1986 and 1987.
>
> *Example II.* What will take place in the agricultural sector if foreign trade is liberalized, while the exchange rate remains overvalued and before domestic inflation is brought under control? Farmers producing for the local market will probably not be able to compete with imported products. This is what happened to Chilean farmers between 1981 and 1982.
>
> *Example III.* How might farmers be affected if the government lifted quantitative credit ceilings as part of its process of liberalizing the financial market, while it maintained preferential interest rates for the agricultural sector? It would be rational for credit institutions to discriminate against the agricultural sector. This happened in Costa Rica in 1987.
>
> *Example IV.* What might happen to the agricultural sector if the capital account of the balance of payments were liberalized before stabilizing the national economy and liberalizing the domestic financial market? Capital flight might erode the overall level of resources of the national financial system and make credit scarce for agriculture.

Conclusions

This chapter has provided managers and new policy makers with an overview of the agricultural sector and some of the short- and medium-term policy issues they will encounter in developing countries today. The chapter has reviewed the special structural characteristics of agriculture due to its production processes and international market conditions. It has also warned managers about the importance of keeping macroeconomic and sectoral policies consistent. Finally, it has emphasized the assessment of both the economic and the political feasibility of new agricultural strategies.

Notes

Works cited only by author and date are fully listed in the bibliography at the end of this book.

1. There are a number of excellent general sources on agricultural strategy. Among them are Peter Timmer (1988); Peter Timmer, Wallace Falcon, and Robert Pearson (1985); Arthur Mosher (1961); Booth S. Johnson and Peter Kirby (1975); Theodore Schultz (1964); and Guy Hunter (1969).
2. For interesting discussions of the problem of protectionism and agriculture, see World Bank (1988a: chs. 1, 7). See also J. Michael Finger and Andrzej Olechowiski (1987: ch. 21) and World Bank (1987).
3. See Timmer (1988).
4. Ibid.
5. Ibid., p. 294.
6. B. F. Johnston and W. Clark (1982) and Theodore Schultz (1964).
7. Y. Hayami and V. Ruttan (1985: 416).
8. Xavier Argüello (1987a).
9. Claudio Gonzalez-Vega (1977).
10. World Bank (1986: 98).
11. Ibid., p. 75.
12. Ibid., p. 71.
13. Ibid., p. 75.
14. Ibid., p. 76.
15. *La Prensa* (Buenos Aires), Aug. 25, 1988.

16. World Bank (1987: 81).

17. *La Prensa* (Managua), Feb. 16, 1988.

18. *La Gaceta*, (Managua), Feb. 1988: Decreto 304 (concerning monetary policy); Decreto 306 (concerning currency conversion); Decreto 307 (regulating inflow and outflow of national currency); Decreto 308 (eliminating the monetary stabilization rate); Decreto 309 (condemning debtors); Decreto 310 (providing for charging freely convertible foreign currency for exports).

19. W. James , S. Naya, and G. Meier (1987: 178, 199). See also I. Little, T. Scitovsky, and M. Scott (1970).

20. See for example, Gustav Ranis and Louise Orrock (1985). See also Shirley Kuo, Gustav Ranis, and John Fei (1981) and (1986).

21. Jeffrey Sachs (1988).

22. James et al. (1987: 179). See also Little et al. (1970).

23. James et al., p. 180.

24. David Newbery and Nicholas Stern (1987).

25. Ibid.

26. Noel Ramírez (1982).

27. Normally, the way to measure distortions existing in the local market has been to compare the domestic prices of end products and inputs traded in the world market at international prices (known as "border prices"). Production is valued at the price a country must pay to import that product or the price received if exported. Similarly in the case of inputs that can be purchased or sold in the international market, their cost must be valued at the international price. In order to determine both prices (domestic and international) in the same currency unit, the conversion factor to be used is the "real and effective" exchange rate.

28. D. J. Jansen, "Government Policy and the Manufacturing Sector," unpublished manuscript, April 1983.

16 ESTEBAN R. BRENES

in collaboration with NOEL RAMÍREZ

Costa Rica: The Agricultural Sector and Structural Adjustment

In May 1988, after repeated conversations with members of the Costa Rican agricultural sector, Mr. Eduardo de-la-Espriella, general manager of the Private Agricultural and Agroindustrial Council (CAAP), wondered how structural adjustment policies would affect the agricultural sector. He had heard different viewpoints from Costa Rican leaders and members of his own organization. For instance, Dr. Eduardo Lizano, president of the Central Bank, had recently commented that protectionism was responsible for the low profitability, slow technological development, and low productivity of many agricultural operations. On the other hand, many farmers opposed liberalization, since they felt that other countries subsidized their own agricultural sectors. This made it difficult for Costa Rican farmers to compete internationally.

Mr. de-la-Espriella was preparing for a meeting with members of the Costa Rican agricultural sector. He decided to review the evolution of the sector as well as current policies before he got together with his colleagues.

The Evolution of the Agricultural Sector

The agricultural sector had traditionally represented an important part of the gross domestic product (GDP). However, its contribution to GDP had declined recently (see table 16.1). While in 1980 agricultural production represented 25.2 percent of GDP, by 1987 the corresponding figure was 17.9 percent, although the sector had a national value added of 70 percent. It contributed 27 percent of national employment, 73 percent of exports, and 7 percent of gross capital formation during 1986 (see table 16.2 and table A16.2 in the chapter appendix).

Mr. de-la-Espriella divided his study of the evolution of the agricultural sector into three recent stages: (1) 1974–1980, which paralleled the period of world inflation and crisis; (2) 1981–1984, the stabilization period; and (3) 1985–1987, the period of structural adjustment in agriculture. This took place with the assistance of structural adjustment loans (SALs) with the World Bank, and an economic stabilization plan with the International Monetary Fund (IMF) (see appendix, exhibits 16. 1–3). Table 16.3 summarizes the evolution of the agricultural sector between 1974 and 1987.

The 1974–1980 period: inflation and crisis. In 1974 agriculture contributed 21 percent of GDP, 72 percent of total exports, and 32 percent of total employment. It was a major foreign exchange earner; in fact agricultural exports represented 89 percent of total exports. By 1980, however, agriculture's contribu-

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This chapter was translated from the Spanish by Orlando García-Valverde. Quoted material in this chapter comes from the author's interviews with policy makers.

TABLE 16.1 Costa Rica: Gross Domestic Product (GDP) by Sector (millions of 1966 colones)

Year	Agricultural	Industrial	Trade	Construction	Services	Central government	Total
1970	1,343.6	1,036.3	1,109.5	229.1	1,305.8	549.2	5,573.5
1971	1,405.6	1,120.3	1,159.3	268.6	1,403.4	594.1	5,951.3
1972	1,481.8	1,238.3	1,248.0	327.6	1,499.7	642.6	6,438.0
1973	1,565.5	1,364.8	1,354.8	337.7	1,633.0	678.5	6,934.3
1974	1,539.0	1,538.4	1,345.0	364.0	1,786.3	746.1	7,318.8
1975	1,585.7	1,587.1	1,288.0	384.7	1,857.2	769.8	7,472.5
1976	1,593.6	1,679.2	1,402.0	464.7	1,946.2	799.1	7,884.8
1977	1,628.7	1,893.0	1,653.2	482.8	2,090.1	839.1	8,586.9
1978	1,736.2	2,043.2	1,722.6	510.8	2,226.2	881.1	9,120.1
1979	1,744.8	2,102.8	1,794.0	609.4	2,392.1	932.7	9,575.8
1980	1,736.1	2,119.6	1,740.8	602.7	2,481.9	966.7	9,647.8
1981	1,824.6	2,109.0	1,556.3	471.9	2,483.5	984.3	9,429.6
1982	1,738.8	1,868.6	1,374.2	321.4	2,483.8	955.8	8,742.6
1983	1,806.6	1,891.0	1,423.7	330.1	2,555.8	940.5	8,947.7
1984	1,909.3	2,100.0	1,580.0	416.0	2,674.0	955.0	9,634.3
1985	1,880.4	2,142.2	1,652.6	439.2	2,680.8	959.4	9,754.6
1986	1,959.8	2,297.1	1,812.9	451.1	2,827.6	969.0	10,317.5
1987	1,887.1	2,407.4	1,936.2	471.1	2,883.8	983.5	10,571.1

SOURCE: Costa Rican Central Bank.

tion to the Costa Rican economy was reduced. For example, its role in GDP dropped to 18 percent. It contributed only 28 percent of total employment by the end of the period. While agricultural productivity had increased, farm employees generated 35 percent less than the national GDP productivity per capita.

Between 1974 and 1980 the product composition of the sector changed. The importance of basic grains production grew substantially.

The 1981–1984 period: stabilization. In contrast to the earlier period, agricultural GDP grew more rapidly than total GDP. This was due partially to the strong producer subsidies and the contraction of other sectors as a result of the world economic crisis and collapse of the Central American Common Market (CACM). Farming grew more rapidly than cattle production and basic grains production grew more rapidly than all other agricultural activities. The sector as a whole improved its productivity and maintained its role in employment and exports.

The 1985–1987 period: structural adjustment. Between 1985 and 1987 agriculture's role in GDP di-

TABLE 16.2 Costa Rica: Agricultural Employment (thousands of persons)

Year	Total employed	Agricultural sector	Percent[a]
1973	543.3	207.1	38.2
1977	631.9	213.8	33.8
1978	667.7	216.1	32.4
1979	686.4	206.0	30.0
1980	722.4	200.5	28.0
1981	719.7	199.1	28.0
1982	746.5	220.9	30.0
1983	739.1	206.3	28.0
1984	770.4	210.5	27.0
1985	827.3	225.8	27.3
1986	854.2	229.8	26.9
1987	NA	NA	NA

NOTE: NA = not available.
a. Of employed population.
SOURCE: Executive Secretary of Planning of the Agricultural Sector (SEPSA).

TABLE 16.3 Costa Rica: Evolution of the Agricultural Sector, Selected Indicators, 1974–1987 (%)

Indicator	Moderate 1974–1980	Expansion 1980–1984	Decline 1984–1987
AGDP as percent of GDP	21.0	18.0	17.9
Annual growth of GDP	4.7	0.18	3.2
Annual growth of AGDP	2.0	3.0	–1.8
Annual growth by subsector			
Farming	2.0	4.8	–1.0
Cattle ranching	1.5	2.0	–7.5
Other	4.4	–5.0	12.0
Growth during entire period			
Growth of internal consumption products	50.7	23.3	–33.9
Growth of traditional exports	8.3	18.7	–1.7
Growth of AGDP	12.8	14.6	–5.5
Annual growth of total exports	14.8	0.1	5.0
Annual growth of agricultural exports	13.0	0.02	10.4[a]
Change in productivity of agricultural labor	16.6	9.0	–13.0
Increase in generation of foreign exchange by agricultural laborer	160.0	–4.8	12.0[a]
Change in agricultural employment	–0.5	1.2	4.5
Change in total employment	4.3	1.6	5.4

NOTE. AGDP stands for agricultural gross domestic product.
a. Years 1984–1986.
SOURCE: Esteban Brenes.

minished once again. In 1984 the agricultural sector represented 20.5 percent of the GDP, while in 1987 it represented only 17.9 percent. In contrast to earlier periods there was an important decline in basic grains production. On the other hand, the role of both traditional and nontraditional exports increased. Total exports grew by 5 percent per annum throughout this period, while agricultural exports grew by 10.4 percent annually from 1985 to 1986.

Changing Agricultural Policies

As part of the overall liberalization efforts, national agricultural policy had changed a great deal. Mr. de-la-Espriella tried to remember how the initial policy apparatus functioned and what changes took place.

Trade policy. *Prices.* Before adjustment policies began, the Ministry of Economy and Commerce (MEC), the National Production Council (NPC), the Coffee Institute (ICAFE), the Agricultural Industrial Sugar Cane League (LAICA), and the National Banana Association (ASBANA) traditionally determined prices. The MEC, for example, set the maximum retail prices of basic consumer food products. It also set producer prices, based on the information that the producers' associations submitted, and conducted its own studies in order to cross-check producer proposals.

The NPC attempted to maintain Costa Rica's self-sufficiency in food. It defended producers' rights through support prices set on a cost-plus-benefit basis. However, because of the huge deficits due to its pricing policies the NPC's role in price-setting was discontinued. Tables 16.4 and 16.5 show the local and international prices for basic grains, as well as the level of protection afforded during the period of surpluses.

The government had not set milk prices between 1960 and 1973. After 1973, however, it established prices that were traditionally higher than those of the international market (see table A16.5).

Domestic prices for sugar and coffee were set based on studies by LAICA and ICAFE. Final prices were later negotiated with the MEC. The domestic price of sugar had traditionally been higher than the international price while the opposite was true for coffee and beef. The government's objective was for exports to subsidize the local market. In the case of meat, the prices of the so-called common cuts were

TABLE 16.4 Costa Rica: Local and International Prices of Basic Grains and Legumes, 1980–1985

Commodity	1980	1981	1982	1983	1984	1985
Sorghum[a]						
Local price	186.8	130.3[b]	167.1	297.6	240.8	238.1
International price	195.1	174.3	149.8	172.8	158.9	140.8
Nominal protection	0.96	0.75	1.11	1.72	1.51	1.69
Yellow corn[c]						
Local price	230.7	108.1	174.1	245.3	226.4	228.0
International price	194.7	176.3	151.7	180.6	178.9	150.5
Nominal protection	1.18	0.61	1.15	1.36	1.26	1.52
Beans[d]						
Local price	642.6	298.9	506.6	604.8	631.4	629.2
International price	—	—	525.7	549.2	513.8	609.9
Nominal protection	—	—	0.96	1.10	1.23	1.03
Rice						
Local price	400.8	205.4	257.8	508.6	496.6	435.4
International price[e]	528.2	588.0	357.3	337.2	307.2	263.1
Nominal protection	0.76	0.35	0.72	1.51	1.62	1.65

NOTE: The international price is the price of the product delivered to San Jóse, and the local price is the wholesale price set by the Ministry of the Economy and Commerce, except for the price of sorghum, which is equal to the price paid to the producer by the National Production Council, plus 15 percent. The rate of exchange is equal to the daily average of the purchasing interbank exchange rate.

a. No. 2 U.S. sorghum.

b. The price set by the ministry was established for the first time in 1982. The 1980 price is the council's average sales price.

c. No. 3 U.S. yellow corn.

d. Black turtle beans for 1982, 1983, and 1984; Chilean no. 1 and U.S. no. 2 beans were used for 1985. It was not possible to find any information for black beans for 1980 and 1981 (only red bean information was available).

e. For 1980 to 1984 IMF *International Financial Statistics* were used. For 1985, the *Rice Market News* price was used, which is 15% fractioned.

SOURCE: Consultores Economicos y Legales (COUNSEL), San Jose, Costa Rica.

set by the MEC. However, this situation had changed at the beginning of 1988 after the price of beef was left to the market. The local banana market functioned in a similar manner.

ASBANA, LAICA, and ICAFE determined, through the commissions, how exporters had to pay the producers according to the preestablished margins, the export quotas (for coffee and sugar), and the market prices. In the case of bananas, the commissions were comprised of ASBANA, the MAG (Ministry of Agriculture), the Ministry of the Treasury, the Central Bank, and the Banana Producers Chamber. But the "rules of the game" for this product became clearly defined as of 1985, and at least until 1989, through Executive Decree No. 16564-P-H-MEC.

The government maintained high tariff levels on agricultural inputs and equipment; for example, the nominal protection for fertilizer was over 15 percent in 1985–1986.

In accordance with the government's plans, a gradual price liberalization was expected in the Costa Rican economy. In general, the prices of domestic products were to begin to find equivalence with international prices.

Crop insurance. Before 1984 it had been easy to obtain crop insurance from the National Insurance Institute (INS). Over the past few years, however, stricter requirements have had to be met. Furthermore, insurance for nonirrigated crops has become more expensive.

Marketing. Since Costa Rica's main goal had been self-sufficiency in basic grains, the NPC had guaranteed the purchase of grains at predetermined prices. Because of large deficits, however, the NPC stopped guaranteeing the purchases of rice and sorghum in 1985–1986 and liberalized domestic marketing entirely, though it maintained control of international marketing until 1988. The NPC continued to set support for and guarantee purchases of corn and beans, since the government felt the producers of these commodities were small farmers

TABLE 16.5 Costa Rica: Effective Protection and Net Effective Protection Rates for Staple Grains, 1980–1985

	1980		1985
Commodity	EPR	NEPR	EPR
Sorghum	-9	-20	137 to 146[a]
Corn	23	8	106
Rice	-34	-43	108
Beans	-6 to 16[a]	-12 to -22[a]	-1 to 2

NOTE: EPR stands for effective protection rate.
NEPR stands for net effective protection rate.
a. Protection rate calculated for the different costs associated with the different techniques of production.
SOURCE: Consultores Economicos y Legales (COUNSEL).

with limited financial resources. The marketing of the remaining local-consumption commodities was basically in the hands of the private sector.

The government allowed coffee and sugar exports to be totally coordinated through their respective institutions, namely, ICAFE and LAICA. Several private exporting companies took care of meat. In the case of bananas, exports had been controlled by a transnational corporation, and so were totally integrated into the world market.

During the early 1980s, the government approved the Law for the Promotion of Non-Traditional Exports, which included tax savings certificates (CATs), export contracts, and the development of a free zone.

Monetary policy. Until the mid-1980s agricultural credit was allocated through the National Banking System (SBN). The agricultural sector received 52 percent of all credit. Most went to basic grains producers.

In 1984 the government switched from sectoral and subsectoral credit allocation (microeconomic), to a monetary allocation (macroeconomic) system. It eliminated maximum portfolio lending schedules. By 1987 the banks were managing bank credit allocation in a discretionary fashion. Although the banks were free to determine the rates of interest in accordance with their own objectives, interest rates for the agricultural sector continued in general to be lower than those for the industrial sector by one to three points.

Since traditional agriculture was a high-risk activity, the banks had been forced to reduce agricultural credit as a percentage of total credit to 36.5 percent in 1986 (see table 16.6). The reason was competition for money on the part of other sectors where risks were lower. In addition, the SBN had decided, in consideration of the sector's characteristics, to require real guarantees and to invest only in low-risk activities (that is, irrigated areas). In accordance with its new position, the SBN began to authorize credit based on cost assessments per hectare. For instance, in the case of rice, the lending allowance was 57 percent of the estimated cost, while prior to that it was 80 percent (see table 16.7).

The policy of financing nontraditional exports continued to be an important goal for the SBN. Credit had been relatively stable for traditional exports. Of the traditional producers only cattle ranchers lost access to credit as a result of the changes.

Fiscal policy. During the 1970s and early 1980s, direct and indirect export taxes had been increased. In 1985, however, a number of these taxes had been reversed. Furthermore, the trend was clearly to eliminate or lower them. In addition, reductions in tariff schedules were negotiated with the member countries of the Central American Common Market.

Wage policy. Between 1980 and 1984 salary increases were substantial, although they never reached 1980 real wage levels. As of 1986 salaries were adjusted when the consumer price index (CPI) increased by more than 7 percent.

After reviewing agricultural policies in the 1970s and 1980s, Mr. de-la- Espriella concluded that until 1984 farmers producing for the domestic market had benefited from favorable policies. They had received high support prices, guarantees of purchase, subsidized credit, crop insurance, and support for nontraditional exports. Traditional export producers, on the other hand, had been exposed to less favorable conditions. They had paid export taxes, labored under overvalued exchange rates, and had indirect taxes on exchange differentials.

TABLE 16.6 Costa Rica: Agricultural Credit as a Percentage of Total Credit, 1975–1987

Item	1975	1980	1981	1983	1984	1985	1986	1987
Total of new placements (millions of current colones)	4,466	6,767	8,278	25,157	23,556	23,120	31,979	NA
Participation of agricultural sector (percentage)	36	42	43	57	52	35	36	NA
Participation of farming subsector (percentage)	71	59	71	71	72	78	77	NA
Participation of cattle-raising subsector (percentage)	29	41	29	29	28	22	23	NA
Total agricultural investment (percentage)	33	35	28	31	29	22	25	NA
Total new placements in macadamia, melon, and ornamentals (millions of current colones)	NA	NA	NA	NA	63	29	54	126
Credit growth rate (percentage)	NA	NA	NA	NA	NA	–54.0	86.2	133.3

NOTE: NA = not available.
SOURCE: Central Bank of Costa Rica.

They had less access to credit and suffered from internal prices that were lower than those in the international market.

In 1984 domestic grains producers began to suffer the consequences of policy changes. In contrast, traditional and nontraditional exporters began to benefit from export tax reductions and devaluations.

Opinions by Leaders of the Agricultural Sector

Mr. de-la-Espriella held a preliminary meeting with key leaders of the agricultural sector to discuss the implications of recent policy changes. They told him the following:

Trade policy. *Prices.* Mr. José Rafael Brenes, chairman of the board of the Chamber of Agriculture, stated:

> Coming to an agreement with the experts is very difficult. But even if you accomplish this it doesn't matter because the president of the Republic makes the final decision. In other words, prices are determined politically. To this date, a viable technical method of doing this has not been found. This means that producer prices are not safe. You never know where you stand.

TABLE 16.7 Costa Rica: Average Real Costs of Production per Hectare, and Current Maximum Lending Allowance per Hectare, for Selected Agricultural Products, 1985 (current colones)

Product	Average cost per hectare	Maximum lending allowance per hectare
Rice	53,430	30,096
Beans	47,847	25,633
Corn	38,449	23,303
Sorghum	35,670	22,646
Mangoes	39,643	41,600
Melons	69,445	68,313
Pineapples	442,087	374,276
Peppers	599,200	618,849
Broccoli	111,243	100,000
Cauliflower	111,243	100,000
Onions	292,640	223,611
Potatoes	188,365	163,420
Carrots	103,740	87,898

SOURCE: Private Agricultural and Agroindustrial Council (CAAP) study.

Mr. Juan Rafael Lizano, former chairman of the board of the Chamber of Agriculture, remarked that the economy did not provide for a well-defined pricing policy. "If there were one," he added, "it would be an indexing method. This means that the most aggressive pressure group would obtain the best results." At this point, Mr. Alberto Amador, chairman of the board of the Cattle Ranchers Federation of Costa Rica, intervened:

> One clear example of what Juan Rafael is saying is the sugar industry. I hear that the sugar cane farmers are always at the president's house. This may explain the favorable prices they get, which, as we all know, are well above the international prices. In contrast with this, in the case of meat the local market price was one-half of the international price between 1970 and 1978; this is not logical, considering that both are agricultural products.

An independent economist said:

> There are basically two apparent alternatives that we must discuss at this meeting: total liberalization of prices, which means medium- and long-term efficiency; or continuation of a price-setting scheme that may be good or bad for the farmers. In this respect, I talked recently with Mr. Carlos Manuel Rojas [former Minister of Agriculture]. He told me price-setting in the past had been done on a cost-plus-benefit basis. Under this system, costs do not make any difference, and this is why we were completely detached from world reality. I believe it is necessary to make adjustments, and this can be accomplished by working from the top to the bottom. That is, identify the market price first and try to cope with it by reducing costs and using new technology if possible. The new plans of the government do not imply either a reaction against, for example, rice production, or the idea that rice prices were liberalized because it was felt that we were self-sufficient with respect to this product. Instead, it is clearly understood that its production must be maintained provided it is actually efficient.

Mr. Amador thought about these comments and responded in the following way:

> Each product needs different treatment. For example, meat has already been liberalized, and will always be competitive. Butchers earn a profit that is already provided for in the purchasing price, which means that the price is indexed. We, the beef producers, found liberalization to be favorable, since we obtained a local price that was equivalent to the international price. In the case of rice something intermediate and gradual would probably be best. This possibly would not be necessary in the case of sugar cane, or perhaps it would be politically impossible. In any case, there must be individual definitions for each product, but they must be the result of long-term and stable decisions.

Mr. de-la-Espriella said:

> The international market is not a good reference, in view of the fact that there are distortions, both abroad and in Costa Rica. The problem is not efficiency. We are efficient in many fields, including the rice industry. The problem is mainly distortions in the remaining sectors.

Mr. Brenes agreed with him, but argued that the basic reason why an opening had not been sought for rice in the international markets was that it was impossible to compete abroad on account of the high cost of fuel in Costa Rica.

Mr. de-la-Espriella felt the discussion would not be of much value unless a quantification was made of the costs and benefits of price-setting on the part of the state versus liberalization for the society (that is, for the consumers, the producers, and the state); such an analysis would include a comparison of local prices to "border" prices (international prices plus the cost of bringing the products to Costa Rican ports). The economist replied to Mr. de-la-Espriella that this information was contained in a book that had recently been published, that is, an analysis for staple grains, liquid milk, and other traditional exports, for 1983 and 1985. And then he added:

> The book's main conclusion is that liberalizing prices for staple grains would have left a net benefit for Costa Rican society of 70 to 230 million colones per annum for those years [see table 16.8]. It would also have represented an increase in the expenditure of foreign exchange of 271 to 870 million annually. In the case of milk, there would have been profits of 730 million colones in fresh foreign exchange, under the assumption that dairy production could have been adjusted in three years.

Marketing. Mr. Amador said that in the case of meat there was no problem, since there was a free market for it. Mr. José Rafael Brenes then commented on the marketing of basic grains.

TABLE 16.8 Costa Rica: Costs and Benefits of Eliminating Protection for Staple Grains and Milk, 1983–1985 (millions of colones)

Rice		Sorghum	
+Consumer	1,100	+Consumer	200
+Government	77	+Government	0
–Producer	1,100–1,200	–Producer	170–180
Benefit for society	55–155	Benefit for society	0–25
Loss in foreign exchange	190–530	Additional foreign exchange expenditures	0–70
Corn		Beans	
+Consumer	400	+Consumer	80
+Government	–100	+Government	–25
–Producer	270–283	–Producer	50
Benefit for society	14–47	Benefit for society	1 to 3
Additional foreign exchange expenditures	70–230	Additional foreign exchange expenditures	13–36
Milk			
Increase in foreign exchange	703 (after the adjustment)		

NOTE: "+" = benefit to, "–" = cost to.
SOURCE: COUNSEL, *Politicas de Precios en Costa Rica* [Price policies in Costa Rica] 1987.

> I feel it is important that the NPC assume the function it originally had, not the function it has decided to assume over the past few years. I remember its initial function was solely to regulate producer and consumer prices through the purchase of surpluses, or importation whenever necessary, and by setting prices at its outlets, respectively. This is necessary, since now, the same as before, producers are defenseless against the processors.

Mr. Rodolfo Brenes (a former member of Congress and a rice producer) felt that the NPC should let the Rice Bureau assume full responsibility, just as LAICA did in the case of sugar cane. However, he also felt that, in order to obtain results, the government should provide the bureau with more support and more authority. Mr. Edgar Quirós (former executive president of the NPC) did not share Mr. Brenes's feelings about the Rice Bureau. He explained he had always opposed the leadership of the bureau, which he felt was not a balanced representation of industrial entrepreneurs and producers. He further remarked that the rice industry lacked experience. When he was president of the NPC, he had had many problems with the industrial processors, who often failed to comply with the quality standards provided for under the export quotas. Mr. José Rafael Brenes believed that the slogan "Let's Return to the Earth" had been overplayed in promoting the dairy industry, and that it, together with the reduction in the family subsidies programs, had caused stocks of powdered milk to increase. As a consequence the Dos Pinos Cooperative had closed its doors to new producers. They were left with Lactaria S.A. as the only alternative.

Monetary policy. "I am afraid to go to the bank to apply for loans for agricultural operations. Less and less people apply for credit," said Mr. Lizano. He added:

> I have been a bank officer, and, as such, I concede that as long as the law can be applied against us personally for a bad decision, and in view of the

> fact that the maximum portfolio lending schedules have been eliminated, it is considerably safer, for instance, to authorize credit to a merchant. Repayment is more certain, than to authorize it for the cultivation of 100 hectares of rice. Furthermore, with the structural adjustment the farmers become delinquent after 30 days, while before it took several months.

Mr. Amador added the following:

> If all your operations are not completely up to date throughout the entire SBN you may not apply for further credit. This was possible in the past, and it is possible in many countries. It is normal, and is obviously not a sin, to apply for a new loan in a bank to pay for another loan in another bank. Furthermore, some of the requirements for credit seem illogical to me. For instance, to have to submit a certificate from the Costa Rican Social Security Institute [CCSS] to get a loan? The banks are not the collectors for the Social Security Institute!

Fiscal policy. The group felt the new fiscal policies were favorable to agriculture. Mr. José Rafael Brenes, however, mentioned that the indexed property tax would discriminate against small and medium farmers in marginal and semimarginal areas who would not be able to pay their taxes.

Export versus domestic production. When the economist indicated he would like to hear opinions on the current incentives, Mr. José Rafael Brenes replied: "At this time the only thing that matters is the export market. From its inception, the new agricultural policy was export-oriented. The idea is to abandon all production that is not profitable." "According to public officials," the economist interrupted, "the goal of the new agriculture is not just that, but, for instance, to produce irrigated rice. In other words, it could include the production of traditional commodities with new technologies." To this, Mr. Brenes retorted:

> That is ridiculous! . . . Because that was not the original idea. Furthermore, there are different opinions in this respect even within the government; Mr. Naranjo [the minister of the treasury], for example, said very clearly to me on one occasion that someone will have to suffer the consequences, meaning the producers of goods for local consumption.

The economist then asked, "Having such favorable conditions for exporting, are you not tempted to do so?" Mr. Lizano said he was not, since international trade was not very attractive for basic grains. "In addition," he added, "self-sufficiency was the goal. If there were surpluses it was because of inadequate long-term planning."

Conclusions

The participants summed up their views:

1. There are no well defined long-term policies for Costa Rican agriculture. The entire effort consists of putting out fires. It is necessary to define which pricing system, credit policies, and appropriate technologies the country is to have.

2. Macroeconomic policies are divorced from sectoral policies. Furthermore, there are inconsistencies in the government's plan. The Central Bank says one thing, and the Ministry of Finance says another. For example, there is price-setting for certain meat subproducts, but the remaining subproducts are liberalized.

3. If an adjustment is needed, it must be gradual in order not to neglect the time producers need to make changes. For instance, the change in rice policy was clear: they switched from a self-sufficiency model, with cultivation on dry land and the benefit of crop insurance, to a new model where they say no to crop insurance and no to cultivation on dry land—but without making available to the farmers an integral support program for the change. We have gone from self-sufficiency to surpluses and finally to importation. Finding an alternate use for the lands that have been dedicated to rice, for example, is not something that can be done in a few days. A timetable of the structural adjustment is therefore needed. Such a timetable could be accepted if the "rules of the game" were clear. There must be bipartisan support for the plan. It must be of such a nature that it provides for a strengthening of the sector's institutions, and for convincing the people that the project makes sense.

4. Support for nontraditional exports is a positive feature of the new policies. According to the participants, this type of support should continue.

Mr. de-la-Espriella was anxious to discuss the evolution of the sector over the past few years. He got ready to call the larger meeting to hear his colleagues' opinions.

Study Questions

1. What were the major characteristics of the Costa Rican agricultural sector up to 1984?

2. What problems did the sector face in 1988?

3. Describe the objectives of economic stabilization and structural adjustment in agriculture. Who might the winners and losers be?

4. How might Costa Rica achieve its agricultural transition at the lowest possible social cost?

16

Appendix

EXHIBIT 16.1 Costa Rica: The Agricultural Sector vis a vis the Structural Adjustment

The following is a summary of the letters to the International Monetary Fund (IMF), and of the structural adjustment loan agreement (SAL I).

I. SAL I (1985)

[In 1985, as part of World Bank support to the structural adjustment process, a structural adjustment loan (SAL) for US$80 million was negotiated with the World Bank. Its approval was contingent upon the following:

A. Entering into a new contingency agreement with the IMF

B. Legislative Assembly approval of the new Central American tariff schedules.

There were six main adjustment areas.]

1. *Export, trade, and marketing policies.* These policies constitute the main aspect of the proposal. In order to accomplish a substantial increase in nontraditional exports to third markets, a flexible exchange-rate policy has been adopted; taxes on nontraditional exports have been eliminated; and approval has been given to the new export incentives system, which provides for income and import tax exemptions. The most important change appears in the definition of the new regional tariff schedules, whose purpose is to rationalize effective [tariff] protection, and improve the allocation of resources. Among the most significant changes are the following: the modification of the tariff nomenclature; the representation of the tariffs in ad valorem terms; and the derogation of the provisions on fiscal incentives and the matching of import taxes. The reduction of effective protection was done through nominal rates for final goods, on the one hand, and an increase in the nominal rate for equipment and supplies, on the other. Thus, the current range of 50-1,600 percent effective protection will be revised to 50-150 percent (see table A16.1).

2. *Modifications to the national banking system.* It is intended to increase the efficiency of the banks as financial intermediaries, as well as to provide an incentive to internal savings, and to rationalize the use of credit. Proposed measures in this sense are: a real positive interest rate policy, for both holders and users of savings; liberalization of the credit program (global maximum lending schedules); and the urgent modification of the institutional framework of the banking system (General Law on the Banking and Financial Organizations of the Republic).

3. *Modification of agricultural policies.* With the purpose of increasing agricultural profitability, employment, and production in the realms of both traditional and new exports, [there will be] a revision of the incentive system (rate of exchange, prices, subsidies, tariff policy), and a change of the role played by the public institutions in the agricultural sector, particularly with respect to marketing, credit, extension, and research. It is at this level that the restructuring of the National Production Council (NPC) and the elimination of one part of the deficit play an important role.

4. *Economic democratization and income distribution.* Within the framework of structural adjustment it is

The summaries in this appendix were prepared on the basis of original data from the Consejeros Economicos y Financieros S.A.

TABLE A16.1 Costa Rica: Comparison between Main Characteristics of Current and Proposed Tariff Schedules, 1985

Characteristic	Current	Proposed
Nomenclature	NAUCA	Brussels
Basis for the assessment	Ad valorem and specific	Advalorem
Level of effective protection (%)	50–1,600	50–150
Tariffs (%) for:		
Final goods produced in the area	40–220	35–70[a]
Final goods produced outside the area	0–80	5–10
Intermediate goods	30–60[b]	10–30
Raw materials	2.5[b]	10
Capital goods	2.5[b]	20

NOTE: NAUCA stands for Nomenclatura Aransalaria Comun para Centroamerica (system governing terminology for Central American uniform tariffs).
a. Alcoholic beverages, tobacco, and automobiles or their components may be subject to higher taxes because of fiscal and balance-of-payments reasons.
b. The rates applied effectively are practically equal to zero, on account of the exemptions.

intended, on the one hand, to preserve the country's social peace and balance, which have been affected by the concentration of wealth in the economic crisis, by means of integral rural development plans, and by promoting worker-owned corporations. On the other hand, in order to influence demand in favor of goods with a smaller imported content, a redistribution of income is planned in favor of those who have lower incomes, since it is assumed they are less prone to demand goods with a high imported content; this will also contribute to an increase in production and employment.

5. *Improvement of public-sector administration.* In order to reduce the participation of the public sector and stimulate the participation of the private sector, rules have been adopted as follows:

a. To freeze for three years employment in the public sector
b. To strengthen the budgetary authority and to regulate the participation of the sector in credit
c. To develop a process for evaluating government programs and institutions in order to increase the effectiveness of expenditures, particularly in health, education, and energy
d. To redefine the performance of the public sector toward promotion, rather than execution, functions—for example, the restructuring of the Costa Rican State Development Corporation (CODESA) and its investments portfolio

6. *Improvement of public-sector planning.* The structural adjustment program provides for the strengthening of the Ministry of Planning, in order to improve the capacity for evaluating projects and carrying out macroeconomic analyses, with the purpose of scheduling public investment more adequately. In addition, it is deemed important to consolidate efforts to increase public savings (improvements in tax collection and in price and rate flexibility), and put in order the process for the negotiation, administration, and control of the external debt.

II. The IMF Proposal (1985–86)

The proposal contains a number of specific measures in different fields, measures intended as the defining elements of an economic policy to be followed until the end of 1988. The following is a summary of the objectives and specific measures.

A. Reduction of the nonfinancial public-sector deficit
   1. Tax package
   2. Reduction of acknowledged expenditures:
      a. Constant salaries in real terms
      b. Freezing of employment
      c. Adjustment of public service rates
      d. Reduction of subsidies
   3. Other:
      a. Transformation of CODESA into a private corporation
      b. Banking system credit limit
      c. Administrative fiscal reforms
      d. Transfer of municipal functions

B. Reduction of Central Bank losses
   1. Transfer of government resources

2. Payment of lower interest
3. Capital earnings by conversion of external debt
4. Open-market operations with fiscal bonds

C. Reduction of inflation
1. Central Bank credit limit
2. Private-sector credit restriction
3. Increase of the minimum legally allowed bank reserves to cover obligations

D. Promotion of internal savings
1. Flexible interest rates
2. Positive real rates
3. Charges on overdue interest
4. Control over nonbanking intermediaries

E. Other policies
1. Exchange:
a. Flexibility
b. Periodic minidevaluations
2. Commercial:
a. Reduction of effective protection
b. Improvement of administrative processes
3. External debt:
a. Renegotiation
b. Elimination of delays
c. Credit for development (long-term)

The following quantitative goals were envisaged for 1987 and 1988:

	1987	1988
Consolidated Deficit of the Public Sector/GDP	4.0%	3.0%
Deficit of the Nonfinancial Public Sector/GDP	.66%	equilibrium
Deficit of the Central Government/GDP	2.1%	1.7%
Losses of the Central Bank/GDP	3.4%	3.0%
Credit to the Private Sector (rate of growth)	13.0%	—
Inflation	10.0%	7.0%

EXHIBIT 16.2 Main Characteristics of the Application for a Structural Adjustment Loan (February 26, 1988)

I. Terms
A. Amount: US$100 million over three years
B. Similar cofinancing by the Government of Japan

II. Spheres of action
A. Foreign trade
B. Financial system
C. Public finance
D. Agricultural sector

II. Foreign trade
A. *Exchange policy*: Flexible and unified rates.
B. *Tariff policy*: (i) Reduction of the rate to a maximum of 40 percent for consumer goods, and to 5 to 20 percent for intermediate and capital goods; (ii) the reduction shall be gradual over three years (six similar reductions); (iii) in the case of clothing, shoes, and textiles, the reduction shall be in 10 biannual sections.
C. *Export policy*: (i) Reduction of advance deposits to a rate of 10 percent by December 1989; (ii) new incentive schemes to substitute for tax credit incentives (CATs), based on the reimbursement of taxes; (iii) creation of a one-window system.
D. *Other policies:* (i) Improvement of the transportation system; (ii) reduction to a minimum of quantitative restrictions on imports; (iii) modification of the sugar quota by a tariff of 40 percent; (iv) adjustment of the price of staple grains by comparing it to the international price.

IV. Changes in the financial system
A. *Interest rates:* (i) Passive rates higher than inflation and in line with devaluation; (ii) rates for government securities associated with the basic rate; (iii) limitation of subsidized credit to the November 1987 balance; (iv) rate liberalization policy is maintained; (v) no more Law to Promote Agricultural Production (FODEAS); (vi) budget-subsidized credit to small producers.
B. *Regulation*: (i) Creation of reserves on the basis of nonproductive assets; (ii) strengthening of the General Bank Audit; (iii) creation of the Securities and Exchange Commission; (iv) reduction of intermediary's margin of intervention through deferment reduction and elimination thereof by December 1990; (v) suppres-

sion of the recording of interest on loans delinquent for more than 180 days, and establishment of the obligation to pay delinquent charges.

V. Public finance
- A. *Objectives:* (i) Increase current savings of the nonfinancial public sector from 5.1 percent of GDP in 1987 to 6.5 percent of GDP in 1990; (ii) reduce the size of the semi-state-controlled sector.
- B. *Revenue policy*: (i) The tax package shall generate revenue equivalent to 1.3 percent of GDP in 1988, and to 1.7 percent of GDP in 1989-90; (ii) tax collection shall be improved; (iii) the rates for power, water, and transportation will be permanently increased in order to cover costs and make investment possible; (iv) fixed-destination revenue shall be reduced.
- C. *Expenditures policy*: (i) Elimination of subsidies to Costa Rican Railroad Institute (INCOFER), and those granted by the Costa Rica Oil Refinery (RECOPE); (ii) reduction of fixed-percentage expenditures; (iii) rationalization of public investment by limiting it to 6.8 percent of GDP, and aiming it at projects that may favor structural change.
- D. *Other policies*: Continue the dismantling of CODESA.

VI. Agricultural sector
- A. *Objectives*: (i) Increase employment and exports, especially of a nontraditional nature; (ii) increase efficiency in staple grain production; (iii) rationalize finances of CNP.
- B. *Policies*: (i) Eliminate quantitative restrictions on grain exports; (ii) give licenses to the private sector for the import of beans and corn; (iii) limit CNP activities to purchases from small producers; (iv) charge CNP intermediary action costs; (v) eliminate price differentials between producers and consumers; (vi) see that internal prices tend to become equivalent to international prices (1.4 times the five-year moving average).

EXHIBIT 16.3 Main Characteristics of the Letter of Intent Submitted to the IMF (May 14, 1988)

I. Terms
- A. Amount: SDR 40 million
- B. Period: Until March 1989

II. Diagnosis
- A. An economy with a high external deficit caused by an increase in imports as a consequence of coffee benefits , reduction of taxes and tariffs, and expansion of credit.
- B. Problems, caused by the financial crisis, in applying a restrictive monetary policy.
- C. Noncompliance with the terms agreed upon in October for net assets of the Central Bank, net reserves, and delays in external payments.

III. 1988 objectives
- A. Growth of GDP: 2.4 percent
- B. Lower inflation, to 10 percent
- C. Reduce external deficit by 4 percent of GDP (US$160 million)
- D. Improve the position of international monetary reserves of the Central Bank (US$60 million)
- E. Eliminate delays in external payments

IV. Exchange policy
- A. Exports have responded, but the depreciation of the colon has been insufficient to compensate for the reduction in taxes and tariffs.
- B. Minidevaluations shall continue to maintain the real rate in force as of the January minidevaluation.

V. Monetary and credit policy
- A. Restriction of monetary expansion (Ml to 12.9 percent, quasi money to 12.9 percent)
- B. General maximum lending schedules for each bank
- C. Reduction of 9.5 percent in Central Bank internal assets
- D. Restriction of credit to the private sector: increase of 5 percent with internal resources over the November 1987 level, and overall increase not greater than 10 percent

VI. Interest rate policy
- A. Flexible interest rates
- B. Reduction of the margin of intermediate action once the private-sector financial situation becomes normal

VII. Fiscal policy
- A. Surplus of the nonfinancial public sector equivalent to 0.75 percent of GDP (in 1987: deficit of 0.25 percent of GDP)
- B. Deficit of the Central Government equivalent to 2.0 percent of GDP (improvement of 0.25 percent)
- C. Increase of not more than 15 percent in acknowledged expenditures (may be expanded if there are resources)
- D. Surplus in remainder of the public sector by means of prices, rates, NPC loss reduction, and improvement of the Costa Rican Social Security Institute (CCSS)

VIII. External debt
- A. Reduction of delays
- B. Renegotiation with commercial banks and the Club of Paris
- C. Partial payments US$5 million/month

TABLE A16.2 Costa Rica: Agricultural Exports, by Product, Compared with Industrial, 1970–1987 (US$ million)

	Agricultural exports							
Year	Coffee	Bananas	Cattle	Sugar	Other	Total	Industrial exports	Total
'70	73.1	66.8	18.0	10.1	12.1	180.1	51.1	231.2
'71	59.3	64.0	20.3	12.9	13.7	170.2	54.7	224.9
'72	77.9	82.8	30.5	13.1	18.0	222.3	58.6	280.9
'73	94.0	90.7	33.3	21.5	25.6	265.1	79.4	344.5
'74	124.8	98.4	34.3	24.4	39.2	321.1	119.3	440.4
'75	96.9	144.1	38.2	48.2	47.7	375.1	118.3	493.4
'76	153.9	148.7	45.5	24.7	52.5	425.3	167.6	592.9
'77	319.2	150.3	51.3	15.6	75.8	612.2	216.0	828.2
'78	313.6	169.9	61.5	15.9	90.8	651.7	213.2	864.9
'79	315.4	190.5	82.5	17.5	76.0	681.9	252.5	934.4
'80	247.9	207.5	71.8	40.7	99.8	667.7	334.0	1,001.7
'81	240.1	224.8	76.5	42.0	79.5	662.9	345.2	1,008.1
'82	236.9	228.1	54.7	16.6	67.0	603.3	267.1	870.4
'83	230.1	240.3	31.9	23.9	69.5	595.7	276.9	872.6
'84	267.3	255.4	43.5	20.3	81.8	668.3	337.7	1,006.0
'85	315.9	202.1	53.6	11.0	78.8	661.4	301.6	963.0
'86	392.0	227.7	66.0	19.0	110.3	815.0	306.0	1,121.0
'87[a]	354.0	243.0	48.0	16.0	na	na	na	1,165.0

a. Preliminary figures.
SOURCE: Central Bank of Costa Rica.

TABLE A16.3 Costa Rica: Agricultural Gross Domestic Product, by Subsector, 1974–1987 (millions of colones)

Year	Farming	Cattle ranching	Forestry	Fishery	Other	Total
1974	1,062.6	381.8	52.5	21.9	20.2	1,539.0
1975	1,107.4	386.2	62.4	22.8	6.9	1,585.7
1976	1,096.5	394.1	75.0	25.8	2.2	1,593.6
1977	1,107.7	420.1	67.5	26.8	6.6	1,628.7
1978	1,184.3	448.4	60.7	34.3	8.5	1,736.2
1979	1,180.7	443.4	60.7	40.1	19.9	1,744.8
1980	1,197.6	417.7	64.3	30.9	25.6	1,736.1
1981	1,226.0	467.1	80.6	25.1	25.6	1,824.4
1982	1,224.9	413.1	64.2	21.9	14.7	1,738.8
1983	1,337.7	389.7	47.2	20.6	13.1	1,808.3
1984	1,438.8	453.7	55.9	27.2	14.7	1,990.3
1985	1,314.3	456.4	62.8	32.1	14.9	1,880.5
1986	1,358.5	451.4	87.8	35.7	26.5	1,959.9
1987	1,394.2	357.2	65.8	38.9	24.8	1,880.9

SOURCE: Central Bank of Costa Rica.

TABLE A16.4 Costa Rica: Agricultural Gross Domestic Product by Subsector and Selected Products (millions of colones)

Sector and product	1974	1980	1984	1987
Farming	1,062.6	1,197.6	1,438.5	1,394.2
Staple grains	116.3	175.3	216.2	142.8
Rice	57.3	130.5	149.5	75.6
Corn	29.5	24.3	34.4	32.2
Beans	22.6	9.3	17.7	27.4
Sorghum	6.9	11.2	14.6	7.6
For Export	821.1	889.8	1,056.6	1,038.7
Coffee	322.9	391.8	535.6	542.3
Bananas	376.7	401.1	408.2	393.0
Sugar cane	92.1	85.8	104.2	94.3
Cocoa	29.4	11.1	8.6	9.1
Cotton	1.7	1.8	3.0	1.0
Tubers and roots	22.6	24.2	23.6	36.1
Potatoes	20.9	22.3	20.8	33.2
Manioc	1.7	1.9	2.8	2.9
Stimulants	13.9	5.6	10.3	7.8
Tobacco	13.9	5.6	10.3	7.8
Plantains	22.6	35.3	39.7	40.8
Onions	1.7	3.8	3.6	4.7
Other	62.7	61.8	85.5	122.5
Livestock	381.0	417.7	453.7	357.2
Beef	178.4	139.2	207.9	95.5
Pork	21.1	32.4	32.1	23.3
Poultry	8.7	12.4	11.4	14.7
Milk	130.1	171.9	166.4	189.9
Eggs	43.5	61.8	35.8	33.9
Fishery	21.9	30.9	27.2	38.9
Forestry	52.5	64.3	55.9	65.8
Agricultural improvements	20.2	25.6	14.7	24.8
Total	1,539.0	1,736.1	1,990.3	1,880.9

SOURCE: National Planning Bureau (OFIPLAN), Costa Rica.

TABLE A16.5 Price of Powdered Milk in Costa Rica and Major Regions of the World 1976–1984 (U.S. dollars per kilogram)

Region	1976	1977	1978	1979	1980	1981	1982	1983	1984
Europe	0.97	0.86	0.81	1.07	1.38	1.48	1.40	1.12	1.02
Ireland	0.93	0.82	0.87	0.86	1.17	1.37	1.39	1.32	0.97
The Netherlands	1.14	1.20	1.38	1.01	1.53	0.97	1.64	1.50	1.34
France	0.97	0.77	1.12	1.31	1.60	1.61	1.54	1.34	1.35
Oceania	0.69	0.49	0.63	0.77	0.87	1.24	1.80	1.20	1.05
New Zealand	0.61	0.44	0.53	0.66	0.78	1.10	1.23	1.14	0.92
Australia	0.77	0.57	0.85	1.01	1.09	1.72	1.66	1.40	1.40
Central and North America	0.65	0.66	0.60	0.87	0.62	0.77	0.08	0.77	0.65
Costa Rica	1.75	1.80	1.80	1.85	2.21	NA	NA	2.67	NA
El Salvador	1.30	NA	NA	1.63	2.56	NA	1.97	2.05	NA
Guatemala	1.09	NA	NA	2.20	NA	NA	NA	NA	NA
Honduras	NA	NA	NA	1.35	1.41	NA	NA	NA	NA
Nicaragua	1.68	1.54	NA	1.87	NA	NA	2.53	NA	NA
Belize	NA	NA	NA	NA	NA	NA	2.75	2.62	2.67
USA	0.99	1.35	0.73	0.43	0.61	0.69	0.67	0.77	0.63
Canada	0.43	0.39	0.40	0.44	0.63	0.91	0.91	0.76	0.69
South America	0.65	1.03	1.12	1.80	1.83	1.57	1.30	1.18	1.30
Argentina	0.64	1.01	0.68	2.28	2.42	2.54	1.29	1.22	1.59
Asia	1.13	1.24	1.45	1.41	1.42	1.60	1.87	1.90	1.74
Africa	1.02	0.89	1.03	1.14	1.24	1.36	1.50	1.34	1.38
USSR	1.03	1.08	1.04	1.07	1.12	1.00	1.01	1.00	1.13
The world	0.89	0.77	0.89	0.99	1.24	1.38	1.31	1.09	0.99

NOTE: Refers to predominantly skimmed powdered milk.
SOURCE: Consultores Económicos y Legales (COUNSEL).

TABLE A16.6 Costa Rica: Economic Policy in the Agricultural Sector 1980–1987

Policies	1980–1984	1984–1987
Fiscal policy	• Increase in selective tax on consumption • Increase in export taxes • Increase in tax on the exchange differential	• Increase in selective tax on consumption • Decrease in export taxes • New external tariff schedules • Reduction of maximum tax bracket to corporations • Fiscal incentives to foreign investment • Increase in other taxes • FODEA law
Monetary policy	• Controlled interest rates • Inflation > interest rates • Priority to small agricultural producers and the exporting sector • Credit programs (maximum portfolio lending schedules)	• Liberalization of interest rates (positive) • Priority of the agricultural sector but with difficulties in access to credit (guarantees) • Amount of lending allowances as a % of cost • Elimination of credit programs • FODEA law, readjustment of overdue obligations
Trade policy	*Insurance* • Easy access to crop insurance *Prices* • Support prices for producers • Regulated consumer prices for staples (ASBANA, ICAFE, LAICA, NPC, MEC) • Increase in regulated prices • Increase in public services and fuel rates *Internal marketing* • NPC guarantees the purchase of the staple grain production *Foreign trade* • Control of imports: increase in advanced deposits and priorities • Import substitution for local consumer goods • State handling of staple grain exports and imports • Law for the promotion of nontraditional exports (CATs, export contracts, MINEX)	*Insurance* • More requirements (e.g., irrigation) *Prices* • In 1985, tendency to eliminate guarantee prices and staple grain (rice, sorghum) subsidies • Consumer price of staples under regulation (ASBANA, ICAFE, LAICA, NPC, MEC) • Increase in regulated prices • Incease in public services rates (price reflects cost) *Internal marketing* • Free marketing of staples (rice and sorghum) *Foreign trade* • Restrictions on imports, increases in advance deposits and temporary surtaxes • 1986: Decreases in advance deposits, surtaxes on consumer goods, tariffs • State handling of staple grain exports and imports • Decreases in taxes on imported machinery and capital goods • Promotion of nontraditional exports, Free Zones

Continued on next page

TABLE A16.6 *continued*

	Devaluation	*Minidevaluations*
Exchange rate policy	• Multiple and flexible rate of exchange controlled by Central Bank	• Dual and flexible rate of exchange
Wage policy	• Nominal salaries < real salaries	• 1986 salary adjustment mechanism relative to consumer price index

SOURCE: Esteban R. Brenes.

17 ROBERTO ARTAVIA

in collaboration with FRANCISCO DE PAULA GUTIERREZ

Rice Subsidies in Costa Rica

In May 1987 rice growers and cattle ranchers lodged serious protests against the Costa Rican government's price support policies. Their actions resulted in the resignation of the executive president of the Central Bank and later, after his reinstatement, the resignation of the minister of agriculture.

The Central Bank president opposed agricultural subsidies as an inefficient use of the country's resources. International donors such as the International Monetary Fund (IMF) and the World Bank took this position as well. The Ministry of Agriculture (MAG) defended the subsidies. The local producers themselves, accustomed to developing their operations within a relatively secure environment, supported the ministry. This debate occurred partially because of external pressure to control Costa Rica's increasing fiscal deficit.

Price support policies for rice were the principal reason why the National Production Council (NPC) had lost hundreds of millions of colones in previous years. However, the National Chamber of Basic Grains (NCBG) insisted not only that these policies be maintained but that subsidies actually be increased. On June 10, 1987, it demanded a support price increase of 160 colones per 73.6 kilo sack. The producers argued that the subsidies were necessary to assure an adequate rice supply for the population and to maintain employment in agriculture.

The Ministry of Economy (MEC) denied the producer's request. The MEC was in the process of proposing a more efficient system of establishing rice prices in line with real production expenses. Both the prices and the mechanisms establishing them would reflect, to a large extent, the government's attitude regarding future agricultural subsidies and would cause heated reactions.

Rice in Costa Rica

Rice is the principal source of calories for Costa Ricans. At the beginning of the 1980s, rice represented 7.5 percent of the total value of agricultural production. Policy makers hoped that, as the country developed economically, the population's food crops would become more diversified, (see table 17.1). However, between 1975 and 1985 the per capita consumption of rice was relatively stable. Total consumption increased to nearly 113,000 metric tons of rice without chaff in 1985. Annual per capita rice consumption in Costa Rica was approximately 50 kilograms. It was slightly higher in rural areas, where there was less diversification of food crops. Overall rice consumption (see table 17.2) directly affected the prices of alternative products like other grains, meat, and vegetables.

Rice production in Costa Rica was in the hands of 2,000 producers. Some had farms of less than one hectare and others of more than 1,000 hectares. The total cultivated area in 1985–1986 was 59,400 hectares with a high concentration in the largest farms. Ten percent of the farms cultivated more than 150 hectares and represented 54 percent of the total cultivated area (see table 17.3).

Roberto Artavia and Francisco De Paula Gutierrez are, respectively, an associate investigator and an associate professor at the Central American Institute of Business Administration (INCAE). They gratefully acknowledge the supervision of Marc Lindenberg.
This chapter was translated from the Spanish by Sandra Ely Bower.

TABLE 17.1 Costa Rica: Average Value of Farm Production, by Product, and of Cattle Raised, 1983–1985 (percentage)

Farming sector	Production
Coffee	26.6
Bananas	20.1
Sugar cane	5.3
Cocoa	0.4
Rice	7.2
Corn	1.7
Beans	0.9
Sorghum	0.6
Cotton	0.2
Potatoes	1.5
Plantains	2.4
Other	4.5
Total farming	71.4
Cattle-raising sector	24.1
Other areas	3.5
Total	100

NOTE: Total does not sum due to rounding errors.
SOURCE: Central Bank of Costa Rica.

TABLE 17.2 Costa Rica: National Rice Consumption and Actual Rice Consumption Needs, 1975–1985 (metric tons)

Year	National consumption	Actual consumption needs[a]
1975	92,612	89,721
1976	95,638	91,898
1977	98,468	94,132
1978	101,061	97,033
1979	103,648	99,725
1980	106,060	102,451
1981	108,434	104,886
1982	109,907	107,363
1983	112,480	109,876
1984	112,995	110,340
1985	113,000[b]	111,000[b]

a. i.e., actually needed to supply the general population with this basic source of nutrition.
b. Estimated.
SOURCE: Executive Secretary of Planning of the Agricultural Sector (SEPSA).

TABLE 17.3 Costa Rica: Area Cultivated for Rice, by Size and Number of Individual Farms

Size of farms (hectares)	Number of farms	Total area cultivated (hectares)
0 to 1.99	430	414.87
2 to 9.99	739	3,166.44
10 to 14.99	157	1,742.75
15 to 24.99	152	2,783.50
25 to 49.99	149	5,145.55
50 to 99.99	112	7,193.13
100 to 149.99	60	6,859.68
150 to 199.99	27	4,478.00
200 to 499.99	64	17,322.06
500 to 999.99	6	3,883.00
1,000 to 9,999.99	4	6,431.00

SOURCE: Central Bank of Costa Rica.

Total rice production in Costa Rica comprised barely 0.04 percent of world rice production in 1985–1986. Rice yields (metric tons per hectare) were low compared to the rest of the world. The yields in the early 1980s averaged 3.0 metric tons per hectare at the world level: 4.45 metric tons in North America and the Caribbean; and barely 2.3 metric tons in Costa Rica. In 1985–1986 some of the less efficient producers left the industry and Costa Rica reached 3.1 metric tons per hectare. Individual farm yields varied greatly. Much higher yields were obtained in areas with irrigation. (See table 17.4 for production and yield per hectare between 1975 and 1986.)

One of the most important characteristics of Costa Rican rice production was that all the country's agricultural zones, with the exception of the Central Valley, took part in it. However, farm size, total area cultivated, and agricultural yields were different in all zones (see table 17.5). The Southern Zone, for example, harvested 14,000 hectares with an average yield of 3.44 metric tons per hectare, and Guanacaste harvested 36,000 hectares with an average yield of barely 2.66 metric tons per hectare. As a result, policies that were good for the producers of one region were not necessarily good for producers of other regions.

Agricultural Subsidies

Between 1976 and 1985, the country's rice producers had been beneficiaries of subsidies whose objectives were to

TABLE 17.4 Costa Rica: Area Planted, Production, and Yield per Hectare of Rice, 1975–1986

Yield year	Area planted (hectares)	Production (metric tons)	Yield (metric tons per hectare)
1975–76	87,100	195,600	2.2
1976–77	80,200	149,700	1.9
1977–78	71,000	168,600	2.4
1978–79	73,700	195,900	2.6
1979–80	81,200	236,800	2.9
1980–81	84,600	243,600	2.9
1981–82	72,300	202,000	2.8
1982–83	77,000	148,400	1.9
1983–84	88,400	281,000	3.2
1984–85	72,200	226,000	3.1
1985–86	59,400	184,000	3.1

SOURCE: Executive Secretary of Planning of the Agricultural Sector (SEPSA).

1. Assure national self-sufficiency in selected products
2. Protect national producers from external competition, permitting imports only when faced with a lack of supply
3. Protect the nation's agriculture from contamination with the infestations and diseases existing in other countries.

Rice subsidies, 1976–1985. Rice subsidies included

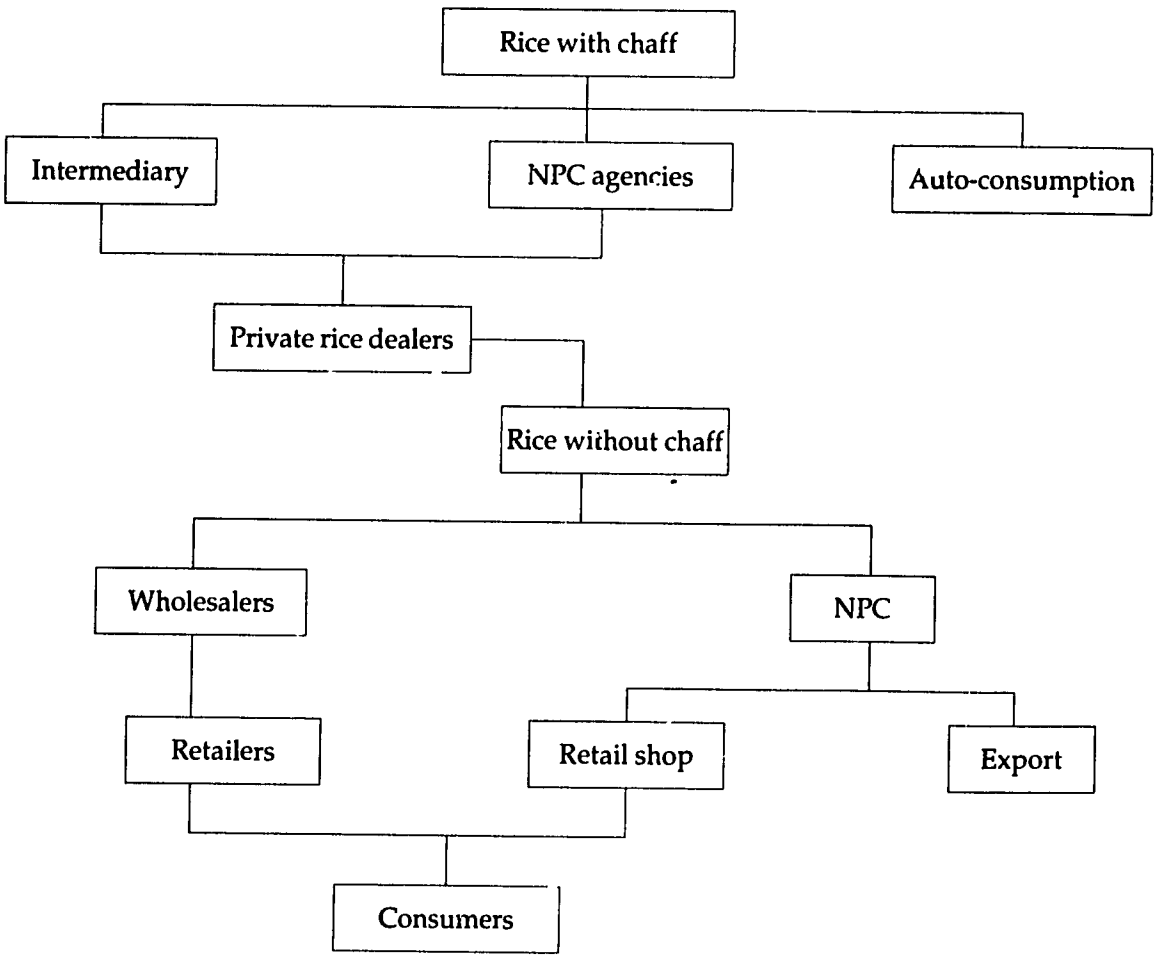
1. Assignment of an annual credit quota for rice production and processing. Even though rice producers had to compete among themselves for credit, they did not have to compete with other products for the allocation of funds.
2. A total ban on rice imports except when scarcities existed.
3. Setting by the National Production Council of a support price based on average local production expenses plus an acceptable margin for the producer; NPC agreement to buy all rice not purchased by private rice producers at this price; the purchase of all rice without chaff (that is after processing) that had not been placed on the national market (figure 17.1 presents an outline of the rice system in Costa Rica until 1985).

TABLE 17.5 Costa Rica: Distribution of Rice Production and Yield per Hectare, 1984–1985

Region	Area planted (hectares)	Yield (metric tons per hectare)
1. Central	14,992	3.41
Orotina	2,375	3.15
San Carlos	311	2.10
Pocosol	325	1.20
Aguirre	5,337	3.60
Parrita	6,644	3.54
2. Chorotega	36,073	2.66
Nicoya	5,705	2.71
Santa Cruz	7,780	2.80
Carrillo	3,716	3.12
Liberia	8,100	2.30
Cañas	6,242	2.29
La Cruz	500	2.30
Upala	1,900	4.14
Barranca	2,130	2.50
3. Brunca	14,135	3.44
Corredores	2,110	4.07
Osa	10,225	3.32
Pérez Zeledón	400	1.42
Puerto Jimenez	1,400	3.96
4. Huetar	6,775	3.78
Limon	6,775	3.78
Country total	72,335	3.08

SOURCE: National Production Council.

FIGURE 17.1 Costa Rica: The Rice System until 1985



NOTE: NPC stands for National Production Council.
SOURCE: Roberto Artavia.

4. Establishment of a crop insurance plan to reduce risks for rice producers.

5. Producer support prices that were high in comparison to those of the world market and assured rice producers of attractive profits.

The results of this subsidy plan had been important. The production area increased to levels that went far beyond the country's real needs and that in 1984 were more than double those needed for consumption. Security inventory maintenance stopped being a practical alternative because the inventory had been sufficient to cover many years of scarcity and so became impossible to justify financially. On the other hand, the subsidy plan discouraged productivity. Support prices were based on average production costs. Therefore the large producers with potential economies of scale were not encouraged to be more efficient since inefficient small producers increased the average production costs and hence their overall support price.

Another result of rice subsidies was that the NPC suffered large financial losses particularly when the purchase price in Costa Rica was substantially higher than the world price and the NPC had to sell surpluses in the world market. For example, in 1984 the price paid by the NPC per metric ton of rice was US$465 while the average international market price was around US$230. The NPC lost 1,300 million colones (US$27.5 million)—and this without taking transportation, storage, and shipment expenses into account. (The results of the plan

in terms of planted area and production can be observed in tables 17.1–17.5).

In 1985 as a consequence of Costa Rica's economic collapse and subsequent stabilization plan, the government sought to reduce its fiscal deficit. Rice support prices were an obvious target for cuts.

The Pressure Groups Mobilize

At the president's request government agencies took immediate steps to cut subsidies. For example, Jorge Torres, NPC executive president, stated that the government's objective was to lower NPC losses to the minimum possible, maintaining only those subsidies that were necessary to guarantee the subsistence of the poorest farmers. Furthermore, the government's objective of self-sufficiency in basic grains would continue to exist as long as possible. According to Torres, rice processors would lose their subsidies since they were not small producers. The processors, he added, were now both technologically and financially capable of confronting their own obligations. These actions were supported by the IMF and the World Bank. The United States Agency for International Development (AID) also made its payments to Costa Rica conditional on an adjustment program.

At the end of 1984, a Rice Commission was created to set norms for the production, processing, commercialization, national consumption, and export of rice. Output of rice above the level needed for national self-sufficiency would no longer be purchased by the NPC. The commission's specific duties were to recommend the area to be planted per region; to draw up procedures for exporting the excess rice; to fix the sales price and the amount of advance payments to producers; and to calculate the volume of rice required to guarantee rice self-sufficiency. The commission was made up of four government representatives, three producers, and one processor.

As the pressure mounted, key groups began to express their positions.

External sector. The principal foreign groups involved were the IMF and the AID.

The IMF's main objective was to stabilize the national economy. To do this it recommended reducing the fiscal deficit, restricting public- and private-sector credit, adjusting the exchange rate to the economic fluctuations, and controlling salary increases. According to the IMF, the result would be the reduction of internal demand and less inflation. In order to achieve these goals, the IMF's technical staff recommended that the government of Costa Rica ask the Central Bank to cut the financing the NPC needed for the subsidies.

The World Bank was more interested in structural adjustment. This required policies such as reduction of tariff levels, control of the fiscal deficit, credit, and liberalization. According to the World Bank this policy package would cause a redistribution of resources based on comparative advantage and an increase in exports. The World Bank position regarding rice prices was that they should reflect international prices. The bank also pressured the Central Bank to reduce the availability of funds to the NPC.

The Agency for International Development took basically the same position. AID made funds available to the Costa Rican government to help privatize the Costa Rican State Development Corporation (CODESA), a government investment organization whose objective was to create and administer productive industries that required major financing and then transfer them to the private sector.

The private sector. Private-sector organizations did not have a uniform position about the rice subsidy problem. The Chambers of Industries and Commerce opposed what they called exaggerated public expenses and a gigantic state. The president of the Chamber of Industries expressed his opposition to producer subsidies by the NPC. While he did not specifically call for totally eliminating them, he recommended a reorganization of agricultural production based on the country's real necessities.

The National Chamber of Agriculture as well as the rice farmers and cattle ranchers wanted subsidies increased. They believed that this was the only way to develop that sector and maintain national food security. Other farmer's organizations such as the Union of Small Farmers of the Atlantic (UPAGRA), the National Federation of Agricultural and Farming Cooperatives (FEDEAGRO), and the Farmers Union of Guatuso (UCADEGUA) supported the position of the rice farmers. They feared that reduction of rice subsidies would lead to subsidy cuts for other products such as beans and corn.

The National Chamber of Basic Grains. The NCBG opposed any reduction in rice subsidies. They argued that such reductions would cause an immediate, irreversible reduction in planted area and threaten national self-sufficiency. The reductions would cause immediate losses to many nonefficient producers concentrated in several regions. This

would leave entire populations in absolute poverty. They argued that the government would be obligated to invest more funds in alternate development activities with even less probability of success than the maintenance of rice subsidies. (Table 17.6 presents producer, wholesaler, and retailer rice prices for the years 1975 to 1985.)

The Chamber of Rice Processors. Rice processors favored maintaining rice subsidies for two reasons. First, the majority of the rice processing plants were partially or totally owned by rice producers, so that subsidies and price increments benefited them at two levels. Second, because their capacity was far in excess of national consumption needs, the elimination of subsidies and consequent fall in total production would damage their profitability.

Groups within the state. Within the government the Central Bank, the Ministry of Agriculture, the Ministry of Economy and Commerce, the National Production Council, and the Office of Presidency of the Republic all participated in the decision about rice subsidies.

The position of the presidency of the Republic was presented in the greatest detail by Dr. Eduardo Lizano, the Central Bank president. Lizano said that the country should use its limited resources for the production of goods that were more competitive internationally and import less expensive products like rice if it was necessary (see table 17.7 for a comparison between local rice prices and imported rice).

Furthermore, argued Lizano, because of the lower price of imported rice, the losses of foreign exchange to buy it would not be as great as producers claimed. In fact according to a recent study, 36 percent of current rice production costs required foreign exchange expenditures already. Lizano believed that if any subsidy existed, it should be directed toward the poorest farmers, specifically toward bean and rice producers.

The new minister of agriculture, after the previous minister had resigned, explained that the government as a whole had only one position, that expressed by the president and the Central Bank.

The Ministry of Economy and Commerce viewed its prime objective as protecting consumer interests. It believed in the importance of maintaining consumer price stability even if government deficits were not reduced in this area.

The government's general position was interpreted by NPC President Jorge Torres as a direct signal that rice subsidies should be cut immediately.

Liberalization Takes Effect

Rice subsidies in 1985. At the beginning of 1985, the National Production Council took the following actions. First, it informed the public that it would no longer take responsibility for the purchase of rice surpluses. Instead, each producer would be responsible for exporting any rice surplus directly and

TABLE 17.6 Costa Rica: Rice Prices to Industrialists, Wholesalers, and Retailers, 1975–1985 (current colones per metric ton)

Year	Price to industrialist[a]	Price to wholesaler[b]	Price to retailer[c]
1975	1,929.43	3,673.90	3,739.13
1976	1,698.44	3,152.18	3,782.60
1977	1,793.55	3,152.18	3,652.17
1978	1,868.28	3,391.30	3,500.00
1979	2,024.54	3,586.95	4,000.00
1980	2,676.65	4,239.00	4,326.10
1981	5,471.08	7,152.17	5,108.95
1982	10,905.33	16,260.85	21,652.17
1983	12,182.00	21,521.73	25,152.17
1984	11,877.00	22,413.04	26,086.00
1985	14,130.00	22,543.47	27,630.04[d]

a. Rice with chaff.
b. Rice without chaff.
c. Rice without chaff but with 20 percent broken grains.
d. Prices 1985–1989 have remained stable.
SOURCE: Ministry of National Economic Planning (MIDEPLAN), Costa Rica, 1986.

TABLE 17.7 Costa Rica: Local and Frontier Rice Price, 1975–1985

Year	Price paid by NPC (colones)	Exchange rate (col. per US$)	Price paid by NPC (US$)	World price (US$)
1975	3,673	8.57	428	360
1976	3,152	8.57	368	263
1977	3,152	8.57	368	239
1978	3,[illegible]1	8.57	395	315
1979	3,568	8.57	416	302
1980	4,239	9.24	458	361
1981	7,152	21.18	338	410
1982	16,260	39.77	409	298
1983	21,521	41.56	517	258
1984	22,413	44.40	504	230
1985	22,543	48.50	465	176

NOTE: NPC = National Production Council. Approximately US$7[illegible] per ton must be added to the import price for transport to San José. This price is compared to the rice price the wholesal[illegible]ays to the industrialist in Costa Rica and is the purchase price paid by the NPC.
SOURCE: Ministry of National Economic Planning (MIDEPLAN), Costa Rica.

would have to accept any financial loss that this implied. According to an NPC study, rice production cost US$250 per metric ton for rice with chaff (at an average exchange rate of 48.5 colones per dollar), assuming a yield of 3.1 metric tons per hectare (see table 17.8). The corresponding international figure in 1985 was approximately US$176 for cost, insurance, and freight.

A second step by the NPC was to freeze wholesale rice prices at 1,037 colones per 73.6-kilogram sack of rice with chaff with 20 percent broken grains. The producer support price was 14,130 colones or $291 per metric ton. The previous price paid had been US$435 per metric ton.

TABLE 17.8 Costa Rica: Rice Production Costs per Hectare, 1985–1987 (colones)

Item	Cost
Direct labor	1,036
Mechanized labor	13,181
Materials	15,761
Administrative expenses	4,280
Financing	3,332
Total	37,590

NOTE: Calculations assume a yield of 3.1 metric tons per hectare.
SOURCE: National Production Council.

Third, a Rice Office was created in December 1985. Its principal objective was to guarantee a rational and equitable participation of rice processors and producers in future decisions affecting the industry. The Rice Office assumed the obligations of the Rice Commission. Its specific obligations were the following: guaranteeing an adequate, high-quality rice supply at a reasonable price for the population; price-setting and resolution of the differences between producers and processors; decision making about commercialization, exporting, importing, and selection of varieties, production zones, and seeds.

Elimination of the subsidies, in addition to a drastic reduction in the area planted in 1986, resulted in roadblocks and demonstrations in front of the Presidential House on the part of rice growers.

The rice producers' situation in 1987. At the beginning of June 1987, the rice producers requested that the Rice Office increase producer subsidies. They argued that their production costs had increased because of national inflation and devaluation. Furthermore the producers wanted some additional expenses to be recognized by the Rice Office and MEC. The items that the MEC refused to take into account were crop insurance, land rental, transport of inputs, and employees' salaries. The support price had remained the same as in 1985.

Faced with this situation, the rice producers decided that less than 40,000 hectares would be planted. They predicted a food deficit in Costa Rica

for 1987. In 1986 they had planted 59,000 hectares under these same conditions. This had satisfied national needs and had produced a surplus of approximately 20 percent of the total yield. The Rice Office decided to purchase the whole crop. They established the 20 percent surplus as a safeguard for the country. The price was the same for all rice, so that producers avoided losing money through low-priced exports.

The MEC studied the alternatives to be presented to the government. While increases to keep pace with inflation could be granted, MEC analysts worried that this would not help narrow the difference between prices for national producers and those of the international market. At the same time failure to raise producer prices might increase the probability that rice growers would not plant enough for national needs.

Decision makers thought that policies should be established to encourage more efficient rice production in irrigation districts. These might take the form of tariff mechanisms that maintained a constant relationship between national and international prices and that promoted reorganization of the production, distribution, and processing of rice in the country.

The decision about whether to raise subsidized prices for rice producers had caused frictions within the government. At the end of 1986, Eduardo Lizano had made a firm declaration to the press referring to the inefficiency of farmers and cattle ranchers. He opposed two laws proposed by Minister of Agriculture Alberto Esquivel. The objective of these laws was to restructure outstanding producer debts so that producers could increase their future borrowing. Lizano's declarations caused Esquivel to call Lizano a hopelessly "academic economist" who was out of touch with national realities Lizano resigned as Central Bank president but Esquivel continued his attacks. Later, Esquivel resigned after the president requested that Eduardo Lizano return to his post.

The new decision on subsidies would establish whether the government would continue its policy of liberalizing the agricultural sector. Rice producers warned that failure to raise the support price would result in demonstrations. Roadblocks and farmer demonstrations were not part of the image that the Costa Rican government wished to project. However, a reversal of the liberalization policy might jeopardize the whole structural adjustment effort and antagonize the international donors who supported this effort. Policy makers began their meeting to make the decision.

Study Questions

1. Describe government policies for rice between 1976 and 1985? What were their strengths and weaknesses?

2. What new policies were proposed for 1986–1988? What economic and political impact do you suppose these new policies might have? Make a political map which may help identify supporters and opponents of these policies.

3. If the government wanted to help ease the social costs of adjustment for small rice farmers between 1986 and 1988, what would you recommend?

The Banana Industry in Costa Rica in 1985

At the end of 1984, La Compañía Bananera, a wholly owned subsidiary of United Brands Company, decided to close down its banana operations in the Pacífico Sur (Southern Pacific Zone) of Costa Rica near the port of Golfito. The decision was taken at the close of a long and difficult labor strike, the longest in the history of the banana industry in the country. For Costa Rica, the decision would have serious economic consequences: bananas grown in Pacífico Sur represented 15 percent of all bananas exported from the country and US$32.8 million in foreign exchange earnings, of which US$5.6 million was tax revenue for the government. Over 2,500 direct employees of the banana company would be affected and perhaps an equal number of persons whose incomes were indirectly tied to banana production, packing, and exporting in this region. According to company officials, the decision of La Compañía Bananera to close operations was based on a careful evaluation of the long-term economic prospects of exporting bananas from the Pacific coast of Costa Rica. At the same time, government officials viewed the company's move as a major economic dislocation for the country. The immediate questions for policy makers were how should the government react, and what was the best set of policies and objectives given the changing competitive dynamics of the world banana trade in the 1980s.

Banana Production in Costa Rica

History. The banana industry in the Americas had its beginnings in Costa Rica in the late 1800s. The New York-born investor and entrepreneur, Minor C. Keith, went to Costa Rica in 1871 with his three brothers and attempted to construct a railroad from Puerto Limón to San José.

The effort took 19 years, and resulted in a track running about 160 kilometers. Seeing that he would need paying freight in large quantities to make the investment profitable, Keith started growing bananas on land adjacent to the railroad, and by 1890 was shipping small cargoes of bananas to ports in the United States via steamers. At the turn of the century, Keith's banana company, along with several other export enterprises, was merged with an association of fruit distributors in Boston, Massachusetts, to form the United Fruit Company.

United Fruit's subsidiary in Costa Rica expanded rapidly, and bananas quickly became one of the country's principal exports. Trade dwindled in the 1930s and 1940s due to economic depression and the disruptions caused by World War II as well as disease problems in the banana plantations of the Zona Atlántica (Atlantic Zone). Due to disease and other problems, United Fruit began a gradual abandonment of its properties in the Zona Atlántica in the 1930s, moving the company's operations to

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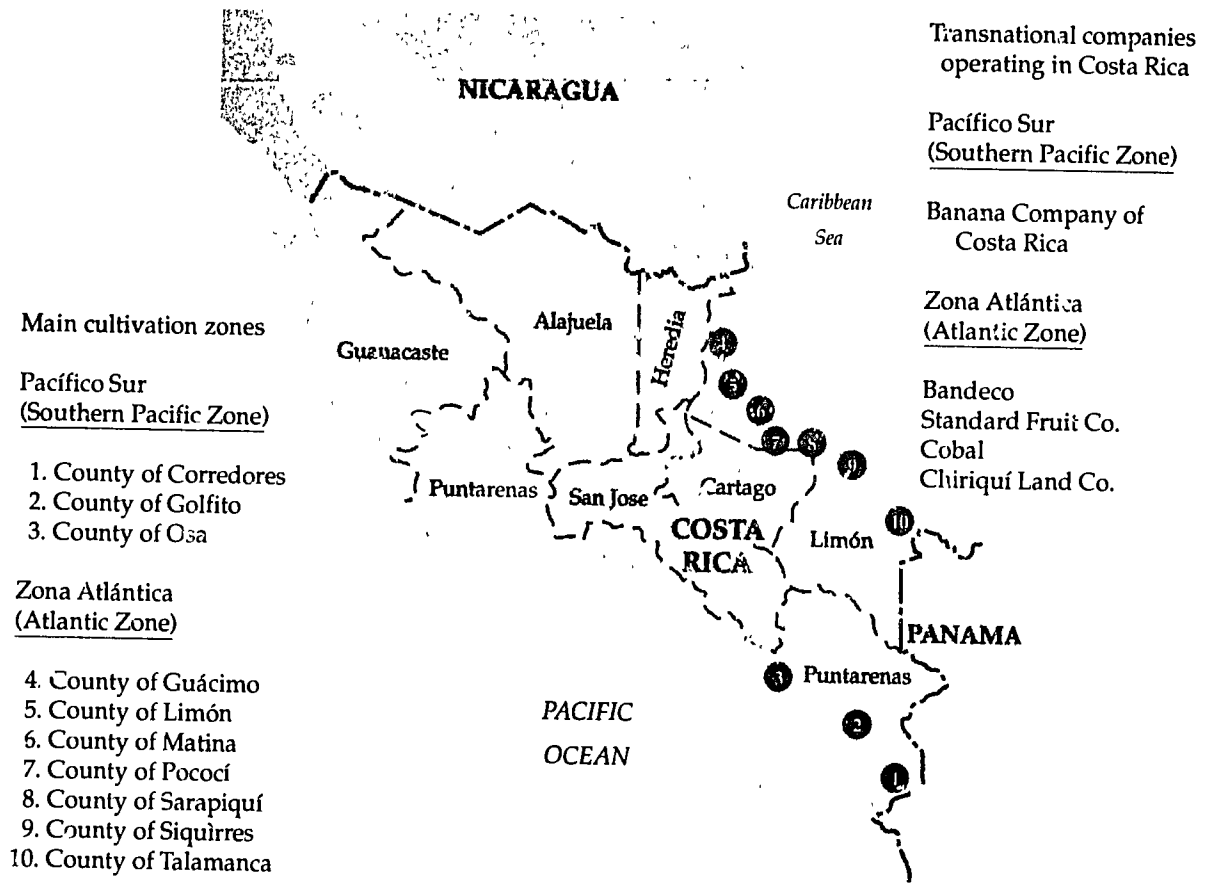
FIGURE 18.1 Costa Rica: Main Areas of Banana Cultivation, 1985



SOURCE: ASBANA.

bases on the Pacific Coast (Coto, Palmares, and Quepos) and developing the port of Golfito for export shipments via the Pacific.

Banana production did not return to the Zona Atlántica until 1956 when the Standard Fruit Company with major holdings in Honduras both established its own plantations and began to buy bananas from private independent producers for export from the Atlantic Coast port of Limón. The third major producer-exporter to enter the market was Del Monte, which acquired a small tropical fruit exporting company in the 1960s. Del Monte's subsidiary in Costa Rica, BANDECO, began producing and exporting from Zona Atlántica sites in 1968.

In the 1950s, Costa Rica's share of the world banana trade averaged about 9 percent. Beginning in late 1968 and for the following decade, the banana industry went through a strong expansion stage in which plantings were more than doubled from 12,000 to over 27,000 hectares. By 1979 Costa Rica had become the second largest exporter of bananas in the world, following Ecuador, which had 19 percent of world trade.

Current production in Costa Rica. The two export banana growing regions in Costa Rica are the Zona Atlántica stretching along the eastern part of the country and the Pacífico Sur in the southwest (see figure 18.1). All banana production for export was by independent growers or by companies that had their own plantations as well as export operations. There were six such companies, five of which were subsidiaries of one of the three large banana exporting companies, United Brands, Castle and Cooke, and Del Monte (owned by R. J. Reynolds).

The six companies that had production and export operations in Costa Rica were

1. La Compañía Bananera, a subsidiary of United Brands Company (formed by a

TABLE 18.1 Costa Rica: Area Cultivated with Bananas for Export, by Type of Ownership, 1976–1983 (hectares)

Year	Owned by exporter	Owned by associated producers	Total
1976	16,359	10,964	27,323
1977	14,054	11,142	25,196
1978	14,683	10,529	25,212
1979	14,714	10,577	25,291
1980	14,362	11,460	25,822
1981	14,442	12,285	26,727
1982	14,241	14,157	27,398
1983	12,904	13,590	26,494

SOURCE: National Banana Association (ASBANA).

merger of United Fruit and AMK Corporation in 1970), with headquarters in New York. Until its decision to pull out of banana production in 1984, La Compañía Bananera had 4,000 hectares in the Palmares area of Pacífico Sur. The company also bought a small portion of its needs from independent growers farming about 400 hectares in the Zona Atlántica.

2. Standard Fruit Company, a subsidiary of Castle and Cooke Corp. with headquarters in San Francisco, California. The company had 4,100 hectares of plantings in the Zona Atlántica and bought from independent producers farming about the same number of hectares.

3. BANDECO, owned by Del Monte which was bought by the diversified tobacco company R. J. Reynolds in 1978. BANDECO cultivated almost 4,000 hectares in the Zona Atlántica and bought from independent growers having a total of 4,700 hectares.

4. and 5. COBAL and Chiriquí Land Company together owned or bought the production from 3,800 hectares. Both companies were wholly owned subsidiaries of United Brands.

6. Pandol Brothers, a small company that had begun exporting in 1983.

A summary of financial results and key operating statistics for the parent companies of United Brands, Castle and Cooke, and R. J. Reynolds is presented in the statistical appendix at the end of this chapter (tables A18.1–A18.3).

In addition to the export companies, there were 70 independent producers who cultivated bananas on smaller plantations ranging from 50 to 800 hectares in size. These growers sold to one of the larger exporters, generally on fixed-price contracts, and had maintained long-standing relationships with the buying companies.

Over the past decade, the Zona Atlántica had accounted for about 80 percent of banana plantings and the Pacífico Sur the remaining 20 percent. The cultivated area had remained fairly stable since 1976, fluctuating between 25,000 and 27,000 hectares. In recent years there had been a tendency for the large exporters to shift from land ownership to a contracting system in which independent farmers supplied produce, while the firm retained responsibility for technical assistance and marketing. This trend can be seen in table 18.1, which shows that there had been an increase in the percentage of exports coming from independent as opposed to company-owned farms.

Yields of exportable bananas had averaged about 1,900 40-pound boxes per hectare since the mid-1970s. Yields were higher in the Zona Atlántica, averaging over 2,000–2,400 boxes per hectare and reaching 3,000 boxes per hectare on well-managed farms compared to 1,800–2,100 boxes per hectare in the Pacífico Sur.

Since 1976 total production had ranged between a low of 48.9 million to a high of 53 million 40-pound boxes (see table 18.2). The major factors affecting the volume of production from year to year were weather or labor strikes rather than changes in area. The three exporters grew or purchased 99 percent of

TABLE 18.2 Costa Rica: Area, Yield, and Production of Bananas for Export, 1976–1983

Year	Area (hectares)	Yield per hectare (40-lb. boxes)	Production (1,000 40-lb. boxes)
1976	27,323	1,959	53,534
1977	25,196	2,095	52,794
1978	25,212	2,088	52,655
1979	25,291	2,104	53,215
1980	25,822	1,895	48,925
1981	26,727	1,921	51,343
1982	27,398	1,849	50,663
1983	26,494	1,970	52,199

SOURCE: National Banana Assosciation (ASBANA).

TABLE 18.3 Costa Rica: Comparative Value of Exports, by Product, 1978–1983 (millions of 1978 U.S. dollars)

Product	1978	1979	1980	1981	1982	1983
Coffee	307.4	315.4	247.8	240.0	236.9	228.4
Bananas	116.9	194.5	215.0	224.8	239.0	237.3
Unrefined sugar	15.7	17.5	40.7	42.0	13.2	23.9
Fresh meats	60.4	81.7	70.8	74.2	53.6	31.5
Granulated cocoa	15.1	9.7	4.2	2.7	2.4	0.9
Other products	296.4	315.5	423.2	424.4	326.5	340.4
Total	811.9	934.3	1001.7	1008.1	871.6	862.4

SOURCE. Central American Economic Integration Secretariat (SIECA), 1984.

the fruit exported and in 1983 had roughly equal shares of the total volume. Table A18.4 in the appendix shows a breakdown of banana exports by company and according to whether production was from company-owned plantations or purchased from independent growers.

In Costa Rica's external trade, exports of bananas ranked second in value only to coffee. In some years, foreign exchange earnings from bananas had even exceeded those of coffee, and because of the year-round production of the fruit, the flow of foreign exchange to the country was quite stable. Table 18.3 shows the value of Costa Rica's principal exports since 1978 and the position of bananas relative to other exports.

The banana industry also figured importantly in the country's employment, with over 17,000 direct employees in 1983. This did not include employment in related industries, such as the manufacture of packing materials, port workers, or the small businesses that develop to bring services and goods to workers and their families located in the banana-

TABLE 18.4 Costa Rica: Direct Labor Utilized by the Banana Industry Compared with Total Labor Force, 1978–1983

Year	Banana industry (no. of workers)	Total labor force
1978	17,282	729,199
1979	17,373	755,672
1980	17,737	770,272
1981	18,442	795,841
1982	17,961	838,456
1983	17,370	843,813

SOURCE: National Banana Association (ASBANA) and Ministry of Labor.

TABLE 18.5 UPEB: Volume of Banana Exports, by UPEB Member Country plus Ecuador, 1974–1983 (thousands of 40-lb. boxes)

Country	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Colombia	15,788	21,000	23,677	24,059	33,086	34,910	40,813	45,278	41,778	44,346
Costa Rica	53,175	54,414	53,664	52,794	52,655	53,215	48,925	51,343	50,663	52,199
Guatemala	14,077	11,235	13,924	13,465	13,731	11,827	19,346	19,697	21,002	14,704
Honduras	35,347	19,989	33,069	38,968	39,525	49,288	47,772	42,810	45,338	35,019
Nicaragua	6,272	6,802	6,045	6,098	6,012	5,637	5,694	4,938	2,276	4,288
Panama	23,124	27,321	28,990	30,275	34,657	31,105	27,865	31,603	31,041	36,172
Dominican Republic	1,404	1,213	1,487	862	606	256	500	928	413	133
Total UPEB	149,187	141,974	160,856	166,521	180,272	186,238	190,915	196,597	192,511	186,861
Ecuador	69,582	69,847	61,125	64,421	69,531	69,916	66,523	63,269	62,430	39,735
Total	218,769	211,821	221,981	230,942	249,803	256,154	257,438	259,866	254,941	226,596

SOURCE: Union of Banana Exporting Countries (UPEB).

producing regions. Table 18.4 shows the estimated number of workers in the banana industry compared with the total workforce since 1975.

World Trade in Bananas

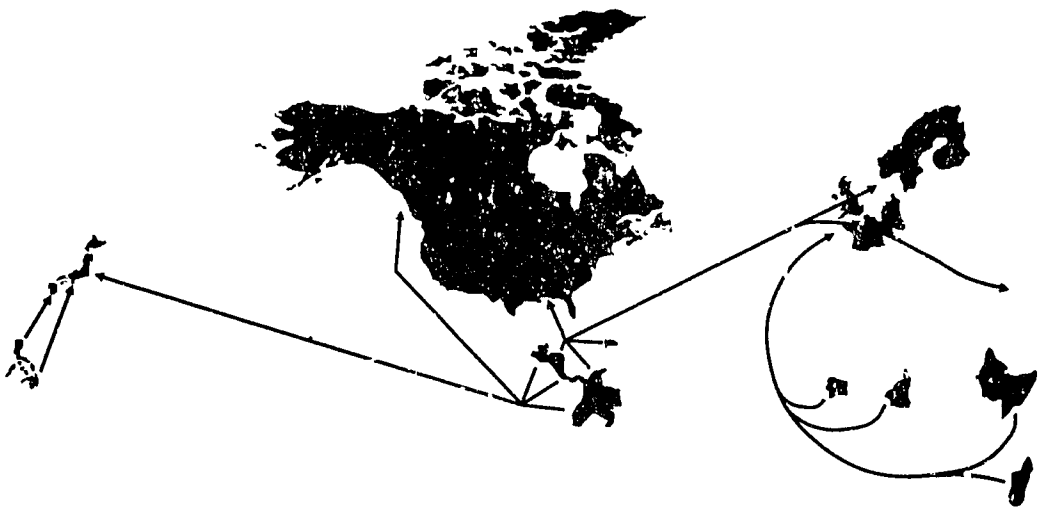
Bananas were produced in over 100 countries and were a major staple in many diets. Of the estimated 41 million metric tons that were produced annually, between 6.5 and 7.0 million metric tons, or a little less than one-fifth of production, entered world trade. Eleven countries accounted for over 85 percent of exports, and slightly more than half of all bananas exported came from Central America and the Caribbean. Figure 18.2 shows the principal trade flows in the international banana trade. Table 18.5 and table A18.5 in the appendix contain information on the volume of banana exports by country from 1973 to 1983.

The banana was one of the few tropical fruits to have gained wide acceptance in consumer markets throughout the world. The major share of banana exports went to northern hemisphere countries. Trade with the United States, Canada, and Europe grew rapidly from 1950 to 1970, from 2.4 to over 6.2 million metric tons, increasing at a rate of almost 5 percent annually due to strong consumer demand following the end of the war, particularly in Europe. By the early 1970s, trade had slowed, growing by about 2 to 3 percent annually. A peak in world trade was reached in 1979 at 7.1 million metric tons, but a recession combined with weak consumer demand reduced trade in the following three years. In 1983 exports dropped to 6.2 million metric tons, their lowest point in ten years due to poor weather and reduced supply in Ecuador, Honduras, and Guatemala.

Traditionally there have been two types of markets. "Free markets" were those in which there were no restrictions in relation to the quantity or origin of fruit that could enter. Countries in this group included the United States, Canada, Japan, and many European countries. "Protected markets" were ones that gave preferential treatment to certain exporting countries based on historical ties, they included France, Italy, and the United Kingdom. In total, protected markets accounted for about 15 percent of trade.

The banana industry was characterized by a high degree of concentration as well as integration between production and exporting. The three largest international banana companies that operated in Latin America—United Brands, Castle and Cooke, and Del Monte—were estimated to have a combined share of world trade somewhere between 55 percent and 60 percent. In Central America and Panama,

FIGURE 18.2 World Banana Trade Routes, 1985



Traditional markets

Main producing-exporting countries

SOURCE: UPEB.

about half the bananas exported by the three majors were grown on their own plantations.

The large exporters also were integrated forward into transport and shipping, using their own ships as well as charters. In the United States, these exporters sold green bananas to "ripeners" who had facilities for ripening fruit. As a consequence of antitrust rulings that sought to reduce the market power of exporters, they were prohibited from integrating forward into the marketing and distribution system. In Europe these restrictions did not exist, and some exporters had operated long-standing wholesale-distribution businesses that sold bananas to retail outlets.

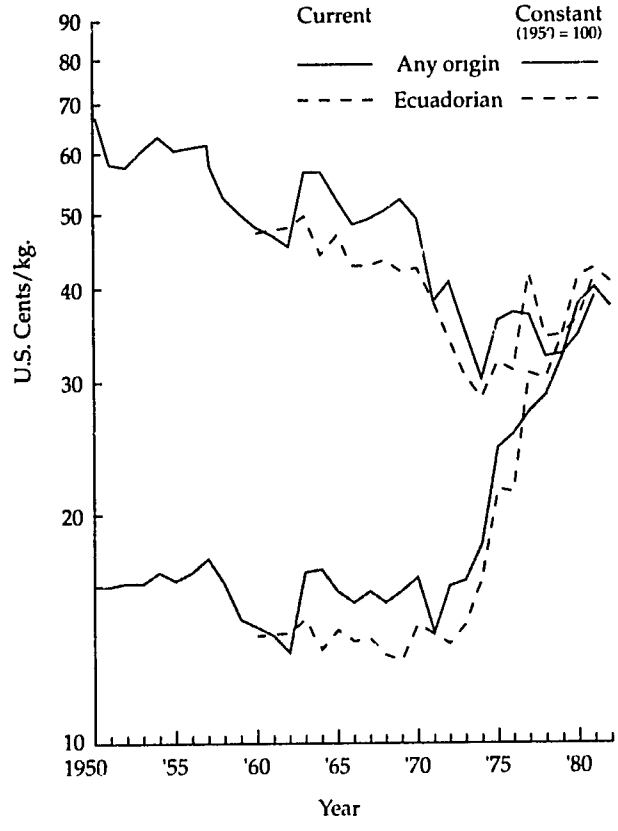
In the United States about 55 percent of bananas were ripened by almost 1,000 independent wholesalers or "jobbers." The remaining volume was handled by warehouse and ripening facilities of the large chain stores, which bought for their own retail outlets. As was the case with the distribution of other perishable fruits and vegetables, in recent years the trend had been toward more ripening and distributing by chain stores compared with independent wholesalers and jobbers, due to the economies gained in centralized purchasing and distribution.

Compared with other fruits and vegetables sold in U.S. supermarkets, bananas were the number one seller in terms of dollar volume, with estimated sales of US$1 billion at the retail level in 1983. The outlook for growth in consumption in the United States and in Europe was a resumption of the 2–3 percent annual growth that occurred prior to the beginning of the 1980s. Some industry observers believed that growth would be due mostly to increases in population and that per capita consumption would remain fairly stable. Others saw a potential for somewhat higher growth, particularly in U.S. markets following a strong consumer trend towards more purchases of "health" and "natural" foods.

Trends in prices. Between 1950 and 1973, real prices for bananas traded in the world market declined steadily (see figure 18.3). This was a consequence of several factors. First, real costs for producers had been declining due to productivity improvements in production and shipping. Producers had switched from the Gros Michel to the Cavendish variety for export bananas which resulted in substantial improvements in yields. In addition, the shift to packing in boxes and containerization in shipping meant less shrinkage during transport to consumer markets.

A second factor that influenced the decline of real prices was the emergence of Ecuador as a major

FIGURE 18.3 World Prices for Ecuadorian and All Countries' Bananas, 1950–1982 (cents per kilogram)



NOTE: Prices are annual averages.
SOURCE: *Commodity Trade and Price Trends*, World Bank, 1983.

producer of bananas. Unlike the initial development of the industry in Central American countries, production in Ecuador was mostly by independent, medium-size producers rather than large exporter-owned plantations. Due to the excellent growing conditions, government support and financing, and the relative efficiency of medium-size growers, Ecuador rapidly achieved the status of low-cost producer of bananas and became the world's largest exporter. Thus, both the growing worldwide supply and the competitiveness of Ecuador in the international market had exerted a downward pressure on world prices through the beginning of the 1970s, as can be seen from figure 18.3.

The banana industry had suffered from periods of oversupply throughout its history. As a perennial plant, the banana shared many characteristics with tree crops. Once a root system was established it could continue to produce for 15 years, and the incremental costs of harvesting were low in comparison to the costs of establishment. As in the case of coffee, production in the short term would be relatively unresponsive to low prices. This was especially true when the fixed capital costs of the investment were high, as was the case with the large exporters, and resources were not easily transferable to other uses.

Real prices had recovered since their historical lows of 1973–1974, when an international "banana war" was stimulated by conditions of oversupply. Table 18.6 shows average prices to ripeners by month for the period from 1977 through 1984 in North America.

TABLE 18.6 Monthly Prices for Costa Rican Bananas in North America, 1977–1984, FOB, (US$ per 40-lb. box)

Month	1977	1978	1979	1980	1981	1982	1983	1984
Jan.	4.49	4.80	4.84	6.63	6.82	7.19	6.15	6.28
Feb.	5.56	5.78	5.43	6.75	7.31	6.80	6.85	7.15
March	5.84	6.45	5.98	7.46	7.95	7.64	7.89	7.30
April	5.62	6.63	6.38	6.94	7.70	8.15	8.84	7.01
May	5.64	5.67	6.49	7.44	7.73	7.92	10.22	7.14
June	4.62	4.81	6.46	5.88	6.62	7.24	10.16	7.88
July	4.44	4.24	5.48	5.85	5.87	5.58	8.75	6.34
Aug.	4.04	3.89	6.05	6.28	6.12	5.38	7.60	5.83
Sept.	4.55	4.66	5.44	6.40	7.45	5.99	7.84	NA
Oct.	4.83	4.35	5.39	5.18	6.85	5.88	6.08	NA
Nov.	4.70	5.03	5.88	6.82	6.94	6.17	5.16	NA
Dec.	4.29	5.33	6.17	6.02	7.13	5.86	5.62	NA
Annual avg.	4.88	5.14	5.83	6.52	7.03	6.65	7.58	NA

NOTE: Data reflect prices to ripeners in North America. NA= not available. FOB = free on board.
SOURCE: UPEB.

As with other perishable commodities, intraseasonal price fluctuations tended to be greater than the variation between average yearly prices. Prices also tended to be higher during the months of March, April, and May, when less competing fruits were available to the consumer in the grocery store.

More than any other factor, prices were influenced by conditions of supply and demand. Normally, the fruit was not sold on forward contracts with buyers. Instead, the exporter/importer began to quote prices and accept bids one to two days before a shipment arrived at a port. Shipments usually arrived with some percentage of the cargo unsold, and the auctioning of fruit continued until final sale. The behavior of prices during 1983 demonstrates the impact of supply on prices. Heavy rains in Ecuador from January through April reduced exportable production for that year from 62 to 40 million boxes. In addition, production in Guatemala and Honduras fell a total of 18 million boxes due to poor weather. Thus, total production of Latin America was down 40 million boxes, representing some 11 percent of world trade and 27 percent of U.S. imports. Due to restricted supply, prices to ripeners during April-July 1983 were very high, between US$8.50 and US$10.22 per 40-pound box. By the end of 1983, production had recovered in most areas and prices sank to the US$5–6 range.

Given the variability of prices at the wholesale level, it was difficult to quote a "fixed" cost and price structure between the exporter/importer, the wholesaler, and the retailer since margins could vary considerably. A "typical" price structure for a top-grade banana would be as follows:

Per 40-pound box

Price to ripener	US$ 7.50
Costs and margin of ripener	2.75
Price to retailer	10.25
Costs and margin of retailer	5.75
Price to final consumer	US$16.00

Most of the bananas sold at the retail level were branded and carried the label of the exporter. The "Chiquita" brand was United Brands' top-quality fruit and had been able to command a premium in the marketplace over other brands for many years. Brand labeling was far more extensive in bananas than in most perishable products and required a much higher level of advertising and support directed primarily at consumers. Other than price and brand name, product quality was an important dimension on which exporters competed. The Costa Rican fruit was considered by most in the trade to be excellent in quality.

Costs of banana production in Costa Rica. One of the causes of great concern in the banana industry in Costa Rica in 1984 was the sharply elevated costs of production and increased competition with other exporting countries in the face of sagging prices. The presence of black sigatoka, an airborne fungal disease that first appeared in Honduras in 1969 and had since moved to plantations in Costa Rica, had elevated production costs in recent years. Control could be achieved through spraying with fungicides, but treatment was costly, ranging from US$500 up to US$1,000 per hectare.

Costs of production varied depending upon the region and the type of cultivation. Costs tended to be higher in the Pacífico Sur since irrigation was required during the dry season from January to April. Exporters were required to pay a minimum price to independent growers for fruit that was packed, delivered to the port, and put on board ship. In 1984 this price was set at US$3.40 per box.

Costa Rica also had a per box export tax, currently of US$0.70. The history of this tax dated back to 1975 when the Union of Banana Exporting Countries (UPEB) was formed. One of UPEB's objectives was to increase the market power of exporting countries in the face of a highly concentrated industry and companies with a history of difficult relations with host governments. In order to capture more of the value of banana exports and increase the industry's contribution to the rapidly growing fiscal needs of governments in the region, the initial members of UPEB (Colombia, Costa Rica, the Dominican Republic, Guatemala, Honduras, Nicaragua, and Panama) agreed to place an export tax on each box shipped. However, only Costa Rica, Honduras, Guatemala, and Panama actually followed through with the tax. Costa Rica initially imposed a tax of US$0.45 per box, which was increased to US$0.95 per box in 1980. This tax was reduced to US$.70 per box in 1983.

Thus, total costs for shipping a box to New York from the Atlantic Coast were estimated as follows:

Per 40-pound box

Cost of packed fruit, FOB	US$ 3.40
Sigatoka control	.40
Export tax	.70
Freight and insurance	1.50
Handling charge at port of destination	.20
Total Cost	US$ 6.20

According to exporters in Costa Rica, a price to ripeners of US$7.50 per box was required to cover their costs including administration and overhead.

TABLE 18.7 FOB Value of 40-lb. Box of Bananas in UPEB Member Countries, December 1984 (US$)

Country	Value of packed product	Taxes	Total
Colombia	3.90	0.19	4.09
Costa Rica	3.93	0.74	4.67
Guatemala	3.75	0.13	3.88
Honduras	3.78	0.44	4.22
Nicaragua	3.11	NA	3.11
Panama	3.89	0.40	4.29
Dominican Republic	2.65	NA	2.65

NOTE: NA = not available.
SOURCE: UPEB.

With prices averaging US$6.50 to US$7.00 per box in the U.S. market in the first three quarters of 1984, exporters' margins were coming under pressure. Exporters were trying to find ways to improve their cost position and were considering limiting production to the most productive land. The companies also had lobbied strongly for reductions in export taxes. Table 18.7 shows the average FOB export value of bananas including tax charges from each of the member countries of UPEB for the latter part of 1984. Table A18.6 in the appendix compares port charges for five UPEB countries, including Costa Rica.

Changes in the market for Pacific Coast exports. La Compañía Bananera had been evaluating the changes that were taking place in the market for bananas shipped from Costa Rica's Pacific coast since the mid-1970s. Several events had occurred that changed the competitive position of production in this region. First, a natural market for Pacífico Sur production for many years had been Japan as well as the West Coast of the United States. Japan's imports averaged 45 million boxes in the early 1970s and over 70 percent was shipped from countries in Latin America. Ecuador satisfied a major part of Japan's requirements. In subsequent years, banana production in the Philippines increased dramatically, and it became more economical for Japan to import from that country. By 1980 the Philippines accounted for over 90 percent of Japan's imports and bananas shipped from Latin American countries dwindled to less than 1 percent.

At the same time, competition over West Coast markets in the United States increased markedly following the loss of trade with Japan. Fruit formerly destined for Asian markets now had only West Coast U.S. markets as an outlet, and the increase in supply resulted in stronger competition and less favorable prices. In addition, in the past few years the private exporters had complained that Nicaraguan fruit was being "dumped" at prices below cost in West Coast markets following the nationalization of the banana industry in that country.

One alternative for La Compañía Bananera was to ship fruit to East Coast and European markets via the Panama Canal, but this elevated freight costs and put the company at a disadvantage compared with Atlantic Coast shippers, particularly Colombia. (Neither Colombia nor Ecuador imposed a per box export tax). In addition, bananas grown in the Pacífico Sur tended to have lower yields and required irrigation during the dry season from January to April, two factors that elevated La Compañía Bananera's costs of production in comparison with growers on the Atlantic coast.

On July 10, 1984, approximately 2,500 workers of La Compañía Bananera in Palmares and members of the Union of Workers in Golfito went on strike demanding that the company enter negotiations for salary increases. While the company was in the process of making salary adjustments following the government's announcement of semiannual increases in minimum wages, management maintained that their contract with the union did not require them to enter into negotiation with the union over salaries until the contract expiration date of August 1985. By the end of July the strike was declared illegal by the national labor court, but it was not until late September that most of the employees returned to work. In the meantime, production had been virtually halted. When work was resumed, it became evident that the plantations would require extensive rehabilitation if they were to be brought back to an economic level of production for export. The company estimated that rehabilitation costs for 3,000 hectares would amount to US$8.4 million, an investment they felt was not justified by the poor economic prospects for future exports from the region.

TABLE 18.8 Costa Rica: Export Taxes Collected on Banana Export ($US million)

Year	Taxes
1974	8.1
1975	22.5
1976	24.2
1977	23.9
1978	24.7
1979	23.9
1980	27.5
1981	50.6
1982	48.1
1983	47.0[a]

a. Estimated.
SOURCE: UPEB.

Alternatives for the Government of Costa Rica

The importance of the Pacífico Sur investment to both the regional and national economy was unquestionable, and the loss of banana production in the area demanded a response at the highest levels of Costa Rican government. At the end of 1984, public officials as well as private-sector participants were examining a range of alternatives for coping with the current situation. The following proposals had been informally put forth:

1. One option was for the government to provide financing for another group to rehabilitate the plantations in Palmares and continue export production from the region. The best candidate, from the government's perspective, would be the National Banana Association (ASBANA), a mixed private/public sector organization providing technical assistance to banana producers. ASBANA had been created in the early 1970s to revitalize failing banana operations of independent producers who had been financed by the national banking system. The organization had developed a good reputation in terms of technical ability. In a revitalization scheme, ownership of the land could eventually be transferred to private, independent producers since it was unlikely that any of the major export companies would be interested in producing bananas in Pacífico Sur.

2. A second option was to stimulate production in the Zona Atlántica to make up for the volume lost from the Pacific. This could occur either through expansion by current producers or through providing financing and technical assistance to new growers. The costs of establishing new banana plantings were estimated to be between US$7,000 and US$8,000 per hectare. ASBANA could serve as the lead organization in such a scheme. It was unlikely that the other export companies would expand their associate producers' programs to absorb a much higher volume

TABLE 18.9 Costa Rica: Revenues and Expenses of the Central Government, 1981–1983 ($US million)

Item	1981	1982	1983
Current revenues	361.4	323.7	508.3
Tax	336.3	307.0	479.6
Nontax	75.4	75.4	117.3
Capital income	19.4	0	0
Total revenues	380.8	323.7	508.3
Current expenses	370.6	306.0	473.5
Capital expenses	95.7	79.7	148.3
Total expenses	466.3	385.7	621.8
Operating results[a]	(85.5)	(62.0)	(113.5)

a. Parentheses show deficit.
SOURCE: Central American Economic Integration Secretariat (SIECA).

or handle the marketing of this group of producers on a commission basis.

3. A third option—and one that had not been well articulated at this point—was to try to do something to improve the cost position of banana producers in Costa Rica. This could range from changing the export tax, investing in improvements in productivity, or examining other ways in which costs could be reduced. Table 18.8 shows revenue from the per box banana tax since it was imposed in 1976. Table 18.9 summarizes revenue and expenses of the Costa Rican government from 1981 to 1983.

4. Some argued that the real problem in the banana industry was low prices in consumer markets. Since its inception in 1976, UPEB had been trying to negotiate some sort of supply control agreement, such as the one which existed with the International Coffee Organization, in order to avoid problems of oversupply and strengthen export prices. Such efforts had so far failed. The question at this point was, Why had an agreement not been reached and was it worth putting time and resources into renewing this effort?

5. Still others maintained that independent of low prices, the costs and margin between the banana producer and final consumer were substantial, and that a disproportionately high percentage of the value added to the final product occurred at the exporter, ripener/wholesaler, and retailer level. What was needed was a way for producers to export directly in order to capture that value and improve their returns. Several such marketing efforts had already been attempted. In 1978 UPEB formed La Comercializadora Multinacional de Banano, S.A. (COMUNBANA) to create an alternative for producers who sold their production through the large banana exporting companies. By 1982 the company had been dissolved, after several consecutive years of losses and difficulty in purchasing an adequate supply of fruit. Other marketing efforts, including several in Colombia and Ecuador, had succeeded. If such an attempt was made in Costa Rica, it would be worth examining why entry into this segment of the industry was so difficult and what was required in order to succeed.

6. A final recommendation was not to stimulate new banana production at all but to encourage the production of alternative agricultural crops in the Pacífico Sur. One such crop being considered was cacao, which employed one person for every 2.5 hectares cultivated compared with bananas which employed one person per 1.5 hectares. Preliminary tests of the agronomic feasibility of producing cacao in this area were promising, but very little investigation had been done on the marketing side.

The events in Pacífico Sur had seemed sudden, but the changes that had occurred in the international market had really been going on for some time, at least over the past decade. For government officials, there was the immediate question of how to respond to the vacuum left by the closed operations of La Compañía Bananera. At the same time, it seemed like an opportune moment to evaluate what the country's position was in that market and to try to devise a coherent strategy for the future.

Study Questions

1. Review the history of the banana industry in Costa Rica. What were the different stages in the development of the industry, and what problems took place at each stage?

2. What are the current problems of the industry, and which of the above options would you recommend for solving them?

3. Which groups might support the option you propose and which might oppose it? How would you manage the opposition?

18

Appendix

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TABLE A18.1 United Brands Company: Summary of Financial Results, 1982–1984 (US$ million)

Item	Year ending 3/31/84	Nine months ending 3/31/83[a]	Year ending 6/30/82
Net sales			
Bananas and others	1,232	826	1,294
Meat	1,735	1,304	2,322
Other food products	191	147	194
Diversified operations	203	129	163
Total	3,361	2,406	3,973
Operating profits (losses)			
Bananas and others	91	(50)	1
Meat	24	1	12
Other food products	6	4	16
Diversified operations	18	18	24
Corporate expenses	(16)	(12)	(15)
Consolidated operating profits (losses)	123	(39)	38
Interest expense	(34)	(30)	(48)
Profit for debt/equity exchange	—	—	10
Other income	6	9	14
Profit (loss) before restructuring	95	(60)	14
Provision for restructuring	—	(120)	(19)
Profit (loss) before taxes	95	(180)	(5)
Taxes (credit)	49	(13)	(8)
Net profit (loss)	46	(167)	3
Net profit (loss) per share ($)	3.43	(13.82)	0.06
Total average assets	1,058	1,178	1,287
Average equity	262	396	564
Net profits/sales	0.014	(0.069)	0.001
Sales/assets	3.18	(9 months)	3.09
Assets/equity	4.04	2.97	2.28
Net profit/equity	0.176	(0.422)	0.006
Dividends per share ($)	—	0.05	0.40
Number of common shares in circulation	12,587	11,463	11,050
Market value of common stock share ($)	9 ½–27 ⅛	6 ½–10 ⅝	7 ⅜–13 ⅜
Average book value per share ($)	20.81	34.54	51.04

a. Fiscal year changed from July–June to April–March in 1983.
SOURCE: United Brands Company, annual reports.

TABLE A18.2 Castle & Cooke Inc.: Summary of Financial Results, 1982–1984 (US$ million)

Item	Year ending 6/16/84	Year ending 6/18/83	Year ending 6/16/82
Net sales	1,520	1,361	1,413
Gross profit	195	155	159
Sales, marketing, and administrative	166	128	113
Interest expense	31	30	38
Other expenses (income)	(9)	(5)	(22)
Special charges	24	58	—
Profit (loss) before tax	(17)	(56)	30
Tax (credit)	(9)	(22)	11
Net profit (loss) in main activities	(8)	(34)	19
Real estate business	9	2	4
Net profit (loss) from current operations	1	(32)	23
Discontinued operations	(78)	(18)	(13)
Extraordinary gains	—	—	3
Net profit (loss)	(77)	(50)	(13)
Net profit (loss) per share ($)	(3.13)	(1.95)	(0.28)
Total average assets ($ million)	1,037	1,080	1,155
Average equity ($ million)	282	325	360
Net profits/sales	(0.051)	(0.037)	0.009
Sales/assets	1.46	1.26	1.22
Assets/equity	3.68	3.32	3.21
Net profit/equity	(0.273)	(0.154)	0.036
Dividends per share	—	—	0.57
Number of shares in circulation (thousands)	25,617	28,007	27,311
Market value of common stock ($)	11 ¾–19 ⅝	6 ⅞–16 ¼	NR
Average book value of common stock ($)	11.00	11.60	13.18

NOTE: NR = no response.
SOURCE: Castle & Cooke Inc., *Annual Report*, 1984.

TABLE A18.3 R. J. Reynolds Industries: Summary of Financial Results, 1981–1983 (US$ million)

	Year ending 12/31/83	Year ending 12/31/82	Year ending 12/31/81
Net sales	13,533	11,492	10,069
Profits from current operations	1,587	1,437	1,401
Interest expense	170	172	135
Other income	50	37	100
Extraordinary gain	6	172	9
Profit from current operations, before taxes	1,473	1,474	1,375
Taxes	638	683	624
Net profit from current operations	835	791	751
Net profit from discontinued operations	46	79	17
Net profit	881	870	768
Net profit per share ($)	7.25	7.82	7.03
Total average assets ($ million)	9,838	8,688	7,230
Average equity ($ million)	4,995	4,326	3,686
Net profits/sales	0.065	0.076	0.076
Sales/assets	1.38	1.32	1.39
Assets/equity	1.97	2.00	1.96
Net profits/equity	0.176	0.200	0.208
Dividends per share ($)	3.05	2.85	2.50
Number of common shares in circulation	113,399	112,779	104,583
Market value of common shares ($)	45 ¼–63 ⅝	40–57 ¼	40 ⅞–53
Book value of share ($)	46.11	42.33	37.63

SOURCE: R. J. Reynolds Industries, *Annual Report*, 1983.

TABLE A18.4 Costa Rica: Annual Exports of Bananas, 1976–1983, by Exporting Company's Own Production and Purchases from Associate Producers (40-lb. boxes)

Company	1976	1977	1978	1979	1980	1981	1982	1983
La Compañia Bananera	15,182,002	15,081,378	14,525,393	13,589,264	11,881,213	10,279,307	10,905,399	8,313,981
Own	14,444,323	14,313,674	13,721,320	12,951,452	11,350,595	9,732,212	10,194,287	7,711,347
Associate	737,679	767,704	804,073	637,812	530,618	547,095	711,112	602,634
Standard Fruit Co.	21,301,338	19,111,526	20,018,623	19,535,193	17,430,633	20,068,021	16,234,368	17,708,249
Own	11,705,500	10,905,676	11,126,573	10,509,819	8,843,402	10,413,625	8,940,486	9,798,583
Associate	9,595,838	8,205,850	8,892,050	9,025,374	8,587,231	9,654,396	7,293,882	7,909,666
Bandeco	13,734,567	15,075,590	14,550,141	15,536,897	14,622,922	15,521,049	15,697,209	17,122,205
Own	6,048,703	6,642,693	8,091,514	8,905,659	8,227,297	8,100,087	7,208,326	8,466,667
Associate	7,685,864	8,432,897	6,458,627	6,631,238	6,395,625	7,420,962	8,488,883	8,655,538
COBAL	3,315,920	3,525,142	3,510,518	4,498,195	4,019,204	4,331,173	5,818,713	5,931,382
Own	175,691	—	—	—	—	—	—	—
Associate	3,140,229	3,525,142	3,510,518	4,498,195	4,019,204	4,331,173	5,818,713	5,931,382
Chiriquí Land Co.	—	—	50,152	55,803	970,729	1,143,736	2,005,785	2,762,645
Own	—	—	—	—	—	—	—	—
Associate	—	—	50,152	55,803	970,729	1,143,739	2,005,785	2,762,645
Pandol Brothers	—	—	—	—	—	—	—	353,424
Own	—	—	—	—	—	—	—	—
Associate	—	—	—	—	—	—	—	353,424
Others	—	—	—	—	—	—	1,350	6,824
Own	—	—	—	—	—	—	—	—
Associate	—	—	—	—	—	—	1,350	6,824
Total	53,533,827	52,793,636	52,654,827	53,215,352	48,924,701	51,343,285	50,662,824	52,198,770
Own	32,374,217	31,862,043	32,939,407	32,366,930	23,421,294	28,245,924	26,343,099	25,976,597
Associate	21,159,610	20,931,593	19,715,420	20,848,422	20,503,407	23,097,362	24,319,725	26,222,113

SOURCE: Central American Institute of Business Administration (INCAE).

TABLE A18.5 World Exports of Bananas by Country, 1973–1983 (thousand tons)

Country	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Developed countries	401.6	389.6	340.1	340.8	347.6	398.0	383.2	433.7	440.3	427.0	437.1
Portugal (Madeira)	20.0	20.0	18.1	19.0	21.7	22.0	19.1	28.3	26.9	27.6	32.5
Spain (Canary Islands)	380.9	368.0	320.0	320.0	325.0	375.0	364.1	405.4	410.5	396.4	401.6
Israel	0.7	1.6	2.0	1.8	0.9	1.0	0.0	0.0	2.9	3.0	3.0
Developing countries	6,375.9	6,196.2	6,087.7	6,065.4	6,441.1	6,749.8	6,759.5	6,419.3	6,513.5	6,545.0	5,757.8
UPEB countries	3,186.0	2,825.5	2,747.0	2,963.1	3,133.1	3,270.1	3,426.1	3,426.1	3,539.6	3,499.5	3,459.4
Colombia	214.4	336.3	390.0	457.4	560.6	592.2	635.0	691.6	802.9	758.0	805.0
Costa Rica	1,178.5	1,037.6	1,105.1	970.3	961.3	955.2	965.3	887.7	931.5	919.2	948.0
Dominican Rep.	22.2	27.6	23.8	29.1	16.9	11.9	7.8	9.6	18.6	9.0	4.0
Guatemala	275.2	230.4	240.2	275.0	261.3	249.1	236.3	352.0	357.3	381.8	249.0
Honduras	850.0	640.0	370.0	612.0	695.0	712.1	895.0	866.5	788.0	823.6	718.2
Nicaragua	105.0	131.0	134.0	113.0	113.0	123.0	110.0	110.0	94.1	43.4	76.0
Panama	537.7	419.6	481.3	523.8	524.0	624.4	572.0	504.2	544.2	561.5	656.2
Venezuela	3.0	3.0	2.6	0.5	1.0	2.2	4.7	5.4	3.0	3.0	3.0
Other Latin America	1,541.2	1,549.7	1,553.1	1,348.2	1,426.1	1,557.0	1,574.5	1,451.8	1,369.6	1,367.6	959.0
Belize	0.0	0.0	0.0	7.1	10.9	15.0	15.7	15.0	10.4	9.5	10.0
Brazil	138.5	156.0	147.4	92.1	111.7	132.5	128.5	67.3	66.7	59.2	79.1
Ecuador	1,369.9	1,357.1	1,362.4	1,201.0	1,260.5	1,362.8	1,386.0	1,318.2	1,246.8	1,254.4	800.1
Mexico	3.0	2.0	5.0	11.0	15.7	17.7	17.0	17.3	9.2	7.0	37.6
Surinam	29.8	34.6	38.3	37.0	27.3	29.0	27.3	34.0	36.5	37.5	32.2
Caribbean	469.5	484.2	440.1	500.7	519.2	580.2	395.7	230.8	396.2	401.8	400.3
Jamaica	109.4	72.5	71.3	78.0	80.1	77.9	68.8	33.1	18.8	21.9	23.5
Former Windward Islands	95.7	106.9	91.8	103.5	108.0	126.0	96.0	67.8	107.4	101.0	114.0
Dominica	28.4	31.4	27.4	29.6	29.6	32.1	15.9	7.6	27.2	25.6	—
Grenada	11.2	8.9	13.7	13.6	13.5	14.9	14.0	11.8	11.2	8.6	—
St. Lucia	35.7	44.8	32.1	34.6	39.8	50.5	44.0	33.4	48.0	42.1	—
St. Vincent	20.4	21.8	18.6	25.7	25.1	28.5	22.1	15.0	21.0	24.7	—
Guadeloupe[a]	114.2	118.2	111.4	108.1	105.6	132.9	90.9	56.9	117.0	122.2	102.7
Martinique[a]	150.2	186.6	165.6	211.1	225.5	243.4	140.0	73.0	153.0	156.7	160.1

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TABLE A18.5 *continued*

Country	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Asia	507.7	714.5	872.9	816.1	886.6	890.0	921.5	970.9	922.1	980.9	662.9
India	5.0	7.0	0.9	1.0	0.1	0.1	0.2	0.0	0.0	0.0	0.0
Lebanon	4.3	2.4	1.5	2.2	2.0	1.0	2.0	0.0	0.0	0.0	0.0
Malaysia	20.0	23.0	23.6	24.0	25.0	27.1	23.9	23.1	27.9	25.9	25.0
Pakistan	0.6	2.5	3.7	1.5	2.0	8.5	17.6	12.4	9.4	10.0	10.0
Philippines	465.8	663.0	822.7	764.4	840.9	834.1	858.6	922.7	868.6	926.7	615.9
Thailand	12.0	16.6	19.5	23.0	16.6	19.2	19.2	12.7	16.2	18.4	12.0
Africa	411.6	451.3	346.1	315.2	312.6	344.6	308.7	223.9	191.5	187.7	157.1
Angola	77.1	65.7	35.0	45.0	50.0	50.0	50.0	0.0	0.0	0.0	0.0
Cameroon	64.5	74.0	74.3	81.3	82.5	83.0	78.3	59.5	54.6	49.1	45.2
Cape Verde	1.5	0.7	0.0	0.7	0.9	0.7	0.4	0.9	1.7	1.0	1.1
Ethiopia	9.6	16.6	10.7	11.9	6.9	7.0	5.0	5.0	2.0	2.0	2.0
Ivory Coast	131.7	174.7	135.5	96.5	112.8	139.8	118.0	121.0	105.1	85.0	73.2
Madagascar	7.0	6.0	4.5	6.3	4.7	6.0	5.0	3.5	1.1	0.3	0.6
Mozambique	5.0	6.6	4.3	1.0	1.0	1.0	2.0	2.0	2.0	2.0	0.0
Somalia	115.2	107.0	81.8	72.5	53.8	57.1	50.0	32.0	25.0	48.3	35.0
Oceania	4.9	6.1	4.1	4.7	5.0	4.9	5.0	4.9	8.5	6.1	5.1
Cook Islands	1.4	2.0	0.7	0.6	0.2	1.0	1.1	2.1	2.5	2.1	2.5
Samoa	1.0	1.3	0.5	1.3	1.5	1.5	0.9	1.8	3.3	3.4	1.6
Tonga	2.5	2.8	2.9	2.8	3.2	1.4	2.0	1.0	2.7	0.6	1.0
Asian CPEs[b]	255.0	164.9	124.4	117.4	158.5	103.0	128.0	110.0	86.0	102.0	114.0
China	250.0	160.0	120.0	110.0	150.0	95.0	120.0	102.0	78.0	94.0	106.0
Vietnam	5.0	4.9	4.4	7.4	8.5	8.0	8.0	8.0	8.0	8.0	8.0
All others	0.0	0.0	3.6	5.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
World total	6,777.5	6,585.8	6,431.4	6,411.7	6,788.7	7,147.8	7,142.7	6,853.0	6,953.8	6,972.6	6,194.9

a. French Overseas Departments whose shipments to France are included here as exports.
b. Asian centrally planned economies.
SOURCE: UPEB.

TABLE A18.6 Typical Port Costs for Banana Shipments in Selected Latin American Countries (US$ per shipment)

Item	Costa Rica	Colombia	Guatemala		Honduras
	Limón	Santa Marta	Puerto Barrios	Santo Tomás	La Ceiba
Services to ships	1,875	636	315	208	545
Wharfage	4,514	2,035	—	410	—
Zoning charges	2,775	—	1,463	95	—
Stevedore company fees	4,606	—	—	—	—
Basic cargo services	5,665	796	—	7,828	—
Conveyor charges	8,881	6,101	—	—	332
Demurrage[a]	502	—	—	—	—
Stevedore services	12,924	20,533	13,000	—	13,181
Total	41,742	30,101	14,778	8,540	14,058
Per box	0.2940	0.2007	0.1478	0.060	0.0990

a. Late fees.

SOURCE: Commission of Representatives of JAPDEVA, FECOSA, Camara Nacional de Bananeros, ASBANA, Compania de Estiba, S. A., Compania de Estibadores Bananeros, S. A., Standard Fruit Company, COBAL, *Study of Port Costs of Limón*, 1983.

The Agricultural Sector of San Marcos

Early in 1977, the recently named minister of agriculture in the Latin American republic of San Marcos evaluated the public sector's capacity to implement a series of new policies for the agricultural sector. In the installation ceremony for the minister, the president of the Republic had announced:

> The government will initiate a new policy to help the small farmer. The policy's objective will be to improve the levels of living of the rural population. There will be efforts to modernize the rural sector so that it can make a larger contribution to the economic development of the country. The government will attempt to give broader coverage and higher quality in the services that it provides. It will attempt to develop the organizational skills of both farmers and public-sector employees. The government's services will be oriented toward agricultural production. Finally, there will be an organization established to guide the rural sector that will direct, plan, coordinate, and allocate resources and that will ensure compliance from the public sector. The new minister of agriculture will have my unqualified support in order to accomplish a restructuring of organizations concerned with the rural sector and will have from me all of the means necessary for accomplishing his objectives.

During 1977 the government provided 500 million pesos for development efforts (one San Marcan peso is equivalent to one U.S. dollar). Of this, 103.5 million was given to rural public-sector institutions (see table 19.1). Projections for 1978 revealed that the government would provide 8.5 million pesos in additional external resources if and when the projects and programs presented for financing were approved by the international organizations.

The Rural-Sector Economy of San Marcos

An examination of a topographical map of San Marcos revealed that 40 percent of the territory, especially in the Atlantic region, which occupied 60 percent of the country, had extremely densely forested areas that were practically uninhabitable. These areas were extremely rainy during most of the year and had little chance of supporting agricultural activity.

The central region of the country, which occupied approximately one-third of the total land area, included highlands separated by small floodplains and valleys. Finally, in the Pacific region, the climate was primarily tropical but with prolonged dry seasons. This was the part of the Republic in which 57 percent of the population lived although it occupied only 15 percent of the total land area.

As in the majority of Latin American countries, agriculture was the primary productive activity. It was the Central Zone of San Marcos that produced

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This case is about a real country situation; however, it has been disguised at the request of those interviewed. This chapter was translated from the Spanish by Marc Lindenberg.

TABLE 19.1 San Marcos: Expenditure and Investment Budget for Rural-Sector Institutions, 1977 (thousand pesos)

Institutions	Total	Expenditures	Investments
Ministry of Agriculture	3,509.9	3,200.6	309.3
Development Bank	61,027.4	7,251.5	53,775.9
Institute for Basic Grains	24,875.8	2,418.1	22,457.7
Agrarian Institute	2,454.5	1,936.8	517.7
Coffee Institute	413.8	413.8	—
National Cotton Institute	830.6	789.5	41.1
Development Institute	9,310.1	1,640.7	7,669.4
Irrigation Institute	796.1	457.0	339.1
National Rural Committee	315.7	315.7	—
Total	103,533.9	18,423.7	85,110.2

TABLE 19.2 San Marcos: Value of Agricultural Production by Principal Product, 1976 (million pesos)

Product	Value
Cotton	143.3
Coffee	63.1
Sugar cane	16.0
Rice	24.1
Corn	47.4
Beans	19.1
Sorghum	9.0
Total	322.0

about 60 percent of all its agricultural outputs. Cotton, coffee, corn, sugar cane, and beans were the principal agricultural products. In 1976 the value of production of the principal items cultivated was 322 million pesos (see table 19.2). The agricultural production of the 11 principal crops took place in an area equivalent to 7 percent of the national territory and produced around 13 percent of the 2,500-million-peso gross national product in 1975. Table 19.3 shows the principal products in 1975 by area.

As can be observed in table 19.4, the majority of the agricultural cultivation could be found in the Pacific and Central regions. Cultivated areas of less than ten manzanas represented 44 percent of all land cultivated and those larger than one thousand manzanas represented 1 percent (a manzana is slightly less than one hectare).

There was a variety of landholding patterns. Some 55 percent of all land in cultivation was farmed by producers with land titles. Another 20 percent of the land in cultivation was farmed by people without titles (see table 19.5). Other forms of landholding for cultivation were renting and leasing.

Almost half of agricultural production was for export and those exports accounted for about 75 percent of the total of all exports. Coffee and cotton alone represented 50 percent of all exports in San Marcos.

Agricultural export production took place primarily along the Pacific Coast. Production for internal consumption, especially of basic grains, was carried out by farmers on small plots situated in the center of the country and in a few of the Pacific Coast areas as well.

The population of San Marcos in 1977 was approximately 3.15 million inhabitants of which 55 percent lived in rural areas. The distribution of the urban and rural populations can be observed in table 19.6.

The Farmer in San Marcos

The majority of the rural-sector workers were basically subsistence farmers who produced largely for their own consumption. Low levels of education and poor housing constituted two of the principal problems for the population of San Marcos. In fact two-thirds of the rural population could not read or write. At the same time, of the 500,000 housing units that existed in San Marcos, more than half did not have indoor plumbing, and most of these were found in the rural areas.

Usually the small farmers constructed their own homes, which consisted of two rooms with dirt floors. One of the rooms was used as a bedroom and the other as a living room. In addition, they gener-

TABLE 19.3 San Marcos: Principal Agricultural Products by Principal Geographic Region of Production, 1976 (manzanas under production)

		Products for						
		Internal consumption				Export		
Region	Total	Rice	Corn	Beans	Sorghum	Cotton	Sugar cane	Coffee
Atlantic	1.6	1.4	—	0.2	—	—	—	—
Central	665.5	25.8	316.5	108.6	37.6	4.3	7.8	164.9
South Pacific	389.4	4.8	111.7	3.2	29.6	188.0	49.0	3.1
Central Pacific	264.9	26.9	60.4	14.5	25.2	29.3	14.8	83.8
North Pacific	35.4	7.6	11.7	5.3	0.7	10.0	7.0	3.1
Total	1,356.8	66.5	500.3	131.8	93.1	231.6	78.6	254.9

TABLE 19.4 San Marcos: Number of Farms by Size and Region, 1976

			Pacific			
Manzanas	Atlantic	Central	South	Central	North	Total
0 – 10	1,527	29,042	11,713	18,919	4,114	65,315
10.1 – 50	281	31,238	7,602	5,889	1,421	46,431
50.1 – 100	75	14,708	1,736	1,168	388	18,075
100.1 – 500	97	11,485	1,695	1,425	413	15,115
500.1 – 1,000	26	1,008	258	262	104	1,658
More than 1,000	7	549	235	245	114	1,200
Total	2,063	88,030	23,239	27,908	6,554	147,794

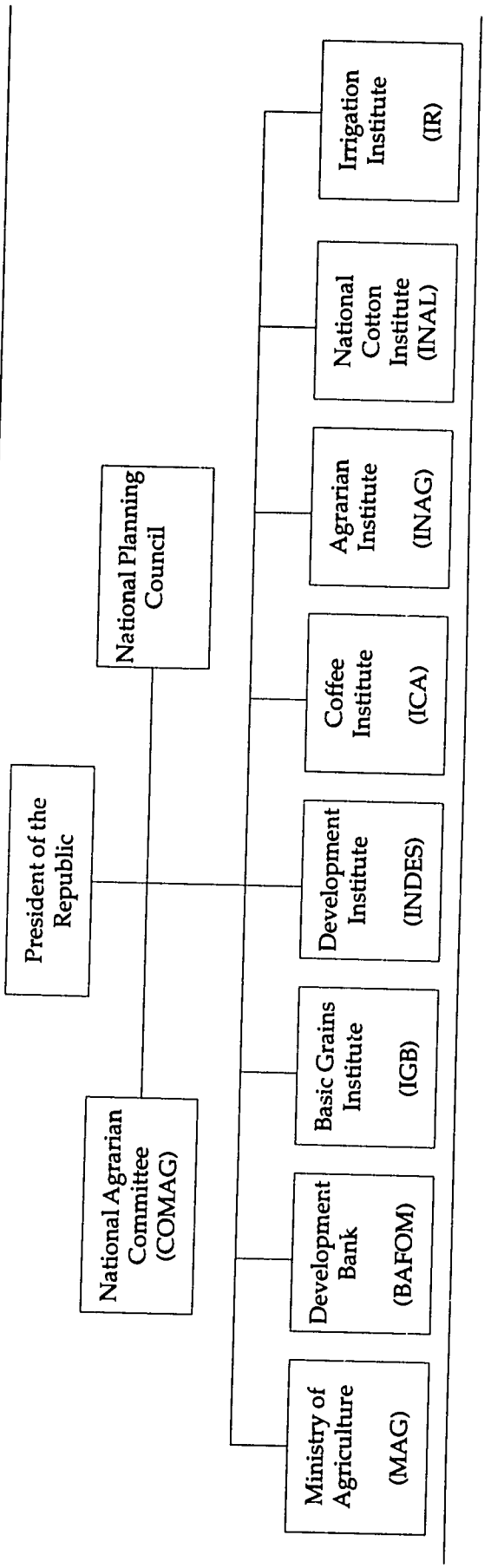
TABLE 19.5 San Marcos: Number of Farms by Region and Form of Ownership, 1976

Region	Total	With title	Without title	Leased	Other forms
Atlantic	2,011	158	1,756	39	58
Central	87,876	43,557	22,579	13,629	8,111
South Pacific	23,241	12,216	3,482	5,962	1,581
Central Pacific	27,907	20,743	1,552	4,835	777
North Pacific	6,553	4,095	748	1,494	216
Total	147,588	80,769	30,117	25,959	10,743

TABLE 19.6 San Marcos: Rural and Urban Population Distribution by Region, 1976

		Population (thousands)			
Region	Size (km.^{2})	Rural	Urban	Total	Density (per km.^{2})
Atlantic	97,750	281	79	360	3.7
Pacific	68,425	751	232	983	14.4
Central	29,325	693	1,107	1,800	61.4
Total	195,500	1,725	1,418	3,143	16.1

FIGURE 19.1 San Marcos: Organization of the Rural Public Sector, January 1977



ally had a small kitchen attached to the outside of the building, usually covered with a grass roof.

One of the other characteristics of the rural population of San Marcos was its low nutritional state. Corn was the basic item consumed by the rural population and was usually prepared either as tortillas or tamales or as an alcoholic beverage. Regardless of the way it was consumed, corn produced a diet that was poor in calories, proteins, and vitamins. In effect, half the population could be classified as suffering from malnutrition.

The most frequent causes of death were infections and gastrointestinal diseases. Practically half of all deaths were due to these causes. Simultaneously, about 90 percent of the population had intestinal parasites.

Modern agricultural practices were practically unknown to the small farmer, who largely used methods learned from his ancestors. The transformation of agricultural practices was one of the most difficult objectives to achieve because the population was dispersed and the farmers were very individualistic, so that their resistance to change was quite high.

For some of these same reasons, rural small farmers' organizations did not exist in San Marcos. Only the large agricultural producers had organizations and associations.

Public-Sector Services for Agriculture

The organizations that comprised the rural public sector in 1977 are described in figure 19.1. The government coordinating committee or "Junta" was considered to be the most important organization for the direction of rural-sector policy.

This organization made the decisions and executive resolutions for the rural sector. One of the staff organizations for the Junta was COMAC, the National Agricultural Committee. Members of COMAC included the president of the Central Bank; the ministers of credit and finance; the minister of economy, industry, and commerce; and representatives from the government and the Office of the President; it was presided over by the president of the Republic. The principal function of this committee was to structure and prepare investment projects in the rural sector and also to give periodic diagnoses of problems in the sector.

Table 19.7 presents the distribution of services and functions of the institutions that make up the rural sector. The services of agricultural extension and investigation, socioeconomic studies, rural

TABLE 19.7 San Marcos: Rural Public-Sector Agency Services, 1976

Services provided	MAG	BAFOM	IGB	INDES	ICA	INAG	INAL	IR	Others
Research and experimentation	✪	✪	☆	✪	✪	☆	✪	✪	
Socioeconomic studies	✪	✪	☆	✪	☆	✪	✪	✪	☆✪✪
Information and statistics	✪	☆	☆	✪	☆	☆	★		
Training	✪	☆	✪	✪	☆	✪			☆✪
Extension and tech. asst.	✪	✪	✪	✪	☆	✪	★	✪	
Provision of inputs	★	★	✪	✪		✪	★		
Finance and credit		✪	☆	✪	☆	☆		✪	
Marketing and pricing	★	★	✪	☆	✪	☆	✪		✪
Agribusiness	☆	☆	✪	☆		☆	☆		
Animal health	✪			☆	✪		✪		
Colonization and land titles						✪			
Agrarian reform						☆			
Irrigation and infrastructure		★		✪		✪		✪	★★
Natural resources	✪			✪	☆	☆			✪✪✪✪
Farmer's associations	★	✪	★	☆	✪	✪			✪☆
Control and regulation	✪			✪	✪		✪	☆	✪
Weather and climate							★		★★

NOTES: ☆ = Authorized services. ★ = Unauthorized services. ✪ = Authorized services actually taking place.

TABLE 19.8 San Marcos: Geographic Location of Personnel from Rural-Sector Institutions, 1976

Institutions	Region			
	Atlantic	Central	Pacific	Total
Ministry of Agriculture	51	116	723	890
National Bank	37	270	916	1,223
Basic Grain Institute	0	87	258	345
Development Institute	31	15	206	252
Coffee Institute	0	3	31	34
Agricultural Institute	19	12	230	261
National Cotton Institute	0	0	129	129
Irrigation Institute	0	0	87	87
National Agrarian Committee	0	0	44	44
Total	138	503	2,624	3,265

training, extension and technical assistance, the provision of agricultural inputs, marketing and price controls, irrigation and infrastructure, natural resources, rural-sector associations, and others were presided over by more than three institutions. Other services, like health, education, housing, environmental hygiene, nutrition, social organization, potable water, social security, and employment, were the responsibility of institutions that were not considered to be part of the rural sector alone.

The geographic distribution of the 3,264 rural-sector employees in 1976 is presented in table 19.8. When the new Minister of Agriculture assumed his position in 1977, he decided to study the functions and programs of the institutions that made up the rural public sector in San Marcos.

The Ministry of Agriculture. The most important work to be developed by the Ministry of Agriculture was the provision of extension services and technical assistance to 13,600 agricultural producers. Furthermore, the ministry assigned its resources to activities such as extension, experimentation, rural health, and feasibility studies. The ministry was also in charge of providing certain agricultural inputs and of improving the marketing of various products, although, legally, it lacked responsibility to carry out these activities.

Of all of the employees who worked within the ministry, 81 percent could be found within the Pacific Zone and 13 percent within the Central Zone. Of the 889 employees of the ministry, 206 were assigned to the programs of extension and technical assistance, 132 worked in agricultural investigation, 92 in animal health, and 88 in regulation. The other functionaries were distributed among ten additional programs.

In general, technical assistance functionaries preferred to work with medium- and large-sized farmers since they were more inclined to receive, assimilate, and use the technical assistance that could be given. Since ministry officials provided a great deal of individual attention to the medium and large farmers, they often were able to see the positive results of the technical assistance. Easy access to these producers generally resulted in extended contact with them and, at the same time, resulted in many opportunities from ministry officials to leave the public sector and work directly for medium- and large-scale farmers.

Opportunities to work with the small farmers were not very frequent due to the poor quality of roads and the great distances between small farmers' lands. As a consequence of these difficulties, and for reasons of their own, ministry agricultural extension agents often said that the small farmers were not particularly interested in listening to their recommendations or in making changes.

The Development Bank. The Development Bank was the organization in charge of financing and credit for the rural sector, although at the same time it provided technical assistance and agricultural input, helped the farmers' organizations, and performed occasional work on rural infrastructure.

The bank had about 10,200 clients in the rural sector. Of all the authorized loans, the Pacific region received about 90 percent. This was the region that produced the largest quantities of cotton and coffee cultivated for export, and also that received the largest amount of banking system resources. Of the 53.7 million pesos in its portfolio, 47.8 million were distributed to about 45 percent of the bank's clients.

TABLE 19.9 San Marcos: Distribution of the Development Bank (BAFOM) Portfolio among the Principal Geographic Regions, by Principal Crop, 1976

Region	Cotton	Coffee	Sugar cane	Rice	Corn	Beans	Sorghum	Total
Atlantic								
Amount[a]				17	5	9		31
Area[b]				328	434	318		1,080
Central								
Amount[a]	432	4,474	24	291	439	189	180	6,029
Area[b]	2,513	32,050	315	3,640	15,310	4,831	2,411	61,070
North Pacific								
Amount[a]	28,856	7	111	461	304	2	26	29,767
Area[b]	149,522	230	1,362	2,511	3,223	46	357	157,251
South and Central Pacific								
Amount[a]	9,598	1,520	1,698	3,970	558	92	484	17,920
Area[b]	49,668	13,977	13,729	23,503	8,730	1,532	6,465	117,604
Total								
Amount[a]	38,886	6,001	1,833	4,739	1,306	292	690	53,747
Area[b]	201,703	46,257	15,406	29,982	27,697	6,727	9,233	337,005
Clients (no.)	2,910	1,583	143	76	2,939	1,676	255	9,582

a. In thousands of pesos.
b. In manzanas.

These clients were largely export producers. Table 19.9 presents a distribution of the bank's portfolio by agricultural products and by region in 1976.

The Institute for Basic Grain Production. The central responsibility for the Institute for Basic Grain Production (IGB) was to improve basic grain cultivation, to regulate prices of basic grains for both the producer and the consumer, and also to fumigate, clean, and dry grains from the central agricultural region. Some of the institute's other functions were to inspect the insecticides and seeds the producers would use.

Table 19.10 reveals that the institute purchased about 16.6 million pesos' worth of grain produced, and sold about 9.6 million pesos' worth. With the exception of sorghum, the sale prices to the consumer were always lower than the international prices for basic grains, and in all cases the price to consumers was lower than the price the institute paid the producer.

However, the institute bought only 13.5 percent of the value of production and sold only about 57 percent of this amount. Nor did the institute carry out some of the functions it was legally authorized to perform; for instance, it did not engage in rural study and experimentation, financing and credit, or socioeconomic study. Nonetheless, it performed the major function for which it had been given legal

TABLE 19.10 San Marcos: Status of Basic Grain Production, 1976 (millions of U.S. dollars)

Basic grains	Production	Purchases	Median purchase price	Sales by IGB[a]	Median sales price	Median international price
Corn	40.6	3.7	43.9	4.3	53.2	57.2
Beans	33.8	5.4	135.8	1.0	141.9	183.2
Rice	36.7	2.2	55.2	1.9	129.0	148.8
Sorghum	12.4	5.3	38.4	2.4	53.6	49.4
Total	123.5	16.6		9.6		

a. IGB = Institute for Basic Grain Production.

TABLE 19.11 San Marcos: Agrarian Reform Program 1966–1976

Change in land tenancy	Families benefited and area affected					
	From June 1966 until December 1970		From January 1971 until December 1974		1975[a]	
	Families	Manzanas	Families	Manzanas	Families	Manzanas
Title confirmation[b]	9,860	662,861	17,952	1,842,412	—	—
Land redistribution	2,839	--	—	—	—	
Returned to the state and redistributed	1,496	966	—	—	—	—
Purchased from private sources and redistributed	1,258	30,248	—	—	—	—
Redistributed by private individuals on their own initiative	85	748	184	291	NA	651
Designated collective plots	5,644	142,402	969[c]	144,116	1,243	20,398

NOTE: NA= not available.
a. There were no agrarian reform activities during 1976.
b. Or other guaranteed form of possession.
c. The 1971 data for families are unknown.

responsibility. In order to carry out its activities, the institute received a budget of 24.8 million pesos and employed a staff of about 340.

The Agrarian Institute. The Agrarian Institute was in charge of the programs of colonization, rural reform, and land title receipt. Activities in the land title program included locating the land, describing its boundaries, classifying its soil, classifying its occupants, and registering the title. Between 1966 and 1975, the Agricultural Institute granted titles to 30,000 families in an area of approximately 2.5 million hectares. A description of the detailed activities of the Rural Institute can be found in table 19.11.

In order to carry out its activities, the Rural Institute received a budget of 2.4 million pesos and had 260 employees. It was possible to find only 13,600 of the titles issued because a fire had destroyed the institute's offices.

The president of the Republic had recently made the following statement about the Rural Institute: "I will be happy when the Rural Institute of San Marcos has provided titles to all of those who have national land. Furthermore, I will be pleased when they are able to give land and titles to those families who want land."

Other institutions. The other institutions that comprised the rural public sector were the following:

- The Development Institute of San Marcos, in charge of programs for rural credit and oriented toward specific areas and specific products especially for agri-industries
- The Coffee Institute, in charge of improving the commercialization of coffee production
- The Irrigation Institute, in charge of the construction and administration of projects to improve irrigation

In addition to the rural-sector organizations, San Marcos included other organizations whose work was especially important to rural development:

- The Ministry of Finance and Public Credit, responsible for investigating and assessing the value of property and land, participating in a mapping program, and also for the national budget
- The Ministry of Public Works, in charge of construction and maintenance of secondary access roads

- The Ministry of Public Health, responsible for operating education programs in health, nutrition, and care of livestock
- The Ministry of Education, in charge of schools in rural areas at the secondary level and also at the primary level
- The Ministry of Economics, responsible for the protection and development of natural resources
- The Ministry of Labor, responsible for enforcing the labor code, minimum salary laws, and reviewing conditions of employment in rural areas
- The Central Bank, responsible for formulation of monetary and fiscal policy, the preparation of national statistics, and various research and experimentation programs for certain crops

The Alternatives

Before the new minister of agriculture made any effort to reorganize the rural sector, he wanted to consider his alternatives. One of them consisted in redistributing the resources of the existing agencies in line with the new criteria as to which target groups should be receiving services from the public sector. He might consider reassigning people within the organizations in order to concentrate attention on the small farmer.

At the same time, the minister was not all that sure about which employees could actually and effectively assist in strengthening institutional performance. Slightly less than half the personnel employed in the rural sector were less than 30 years old, 85 percent of them had not completed secondary school, and half of them had an income of less than 150 pesos a month. This situation, the minister suspected, might call for training efforts in order to provide an education for those who were less competent or skilled. The minister, however, was not sure whether new financial resources could be used for such a training program, nor whether it would give satisfactory results within such a short time.

An alternative to reorganizing the ministry had been discussed intensively by a group of outside consultants. Their alternative was to create a new organization for integral rural development. The new institution would be put in the same category as the banking and credit institution, and would be in charge of giving financing and technical assistance; facilitating the marketing of agricultural products; and providing agricultural inputs, tools, and the other elements a small farmer would require and that were presently not being provided by other institutions. This organization might also be in charge of infrastructural development and the organization of cooperatives for the small farmer.

Another alternative the minister wanted to explore was that of reorienting credit programs for the small farmer through the existing institutions. The existing situation might make it easy to establish this focus. In effect, of all the functionaries of the sector, about 28 percent provided credit. Furthermore, of all the investment resources of the rural sector, the National Bank of San Marcos contributed 63 percent. In order to reorient credit to small farmers, it would be necessary to change the composition of the rural-sector portfolio. Presently 64.8 million pesos were distributed to 19,200 operations. Rural credit represented 79 percent of all operations but occupied a volume of only 12 percent of all available credit funds. Furthermore, credit was concentrated on export products.

A group of economists suggested a different perspective to the minister. They recommended establishing a mechanism to improve the prices paid to the producers of basic grain, with the double objective of stimulating production and improving producers' incomes. The minister was concerned with the effect of such an activity on the balance of payments, and he was also inclined to weigh the political feasibility of such an idea. At the same time, he thought about exercising stricter control over the minimum prices needed by a renewed emphasis on the activities of the Institute of Basic Grains, whose efficiency up to this point had not been convincingly demonstrated.

Finally, a group of sociologists studying the rural situation in San Marcos had suggested that the minister concentrate his activities on the area of rural-sector reform.

> The government ought to orient itself in an effort to resolve social inequalities. The lack of small farmer access to land results in an income gap between the large and small producers. This gap increases each year. Although our statistics show that rural sector production improves year by year, the difference in the quality of life of the farmers without land and those of the large farmers increases every day. The landless farmers live in adverse conditions and without social services.

In considering the means to restructure the rural sector, the sociologists indicated that

> the government should find a middle ground between two often suggested alternatives. One alternative was the expropriation of large tracts of land which were presently not being farmed, with the objective of improving income distribution and social justice. The land could be distributed to small farmers who were able to pay the government a small amount of annual interest on a long-term loan. The proprietors of the land which was expropriated could be paid in long-term government bonds.
>
> The other consideration would be to begin a process of colonization, which would involve the movement of families from the Central and Pacific zones to uninhabited regions on the Atlantic Coast. These programs had been demonstrated to have certain difficulties: infrastructural costs were great because there were not any secondary roads, services, health, or education services. Furthermore, it was not considered easy for families to adapt themselves to new living conditions or to drastic changes in agricultural production required by different quality of soil, rainfall, and other factors.

In an effort to consider all these alternatives carefully, the minister reviewed the documents that he had available to him (see tables 19.1–19.11 and figure 19.1).

Study Questions

1. Describe the rural sector and the distribution of production by crop and by type of public-sector services.
2. What is the new mandate for the rural sector, and how is it different from the old one?
3. What might be the most effective way to reorganize public-sector organizations to make the new mandate work?
4. What problems might you expect and how would you manage them?

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INDEX

Adams, F. Gerard, 155n1
Adjustment policies, 39–42
  costs and benefits in agriculture, 253–54
  government management of, 37–49, 50–56
  lags in response to, 93–96
  resistance to, 42–45
  See also Special interest groups; Stabilization programs; Structural adjustment programs
ADN. *See* National Democratic Action party (ADN)
Agency for International Development (AID), 107, 281
The Agrarian Institute (San Marcos), 312–13
Agricultural Industrial Sugar Cane League (LAICA), 259, 260
Agricultural sector
  in Costa Rica, 253–55, 257–60, 277–84
  in Indonesia, 125
  medium-term economic policy for, 248–53
  in San Marcos, 305–14
  short-term economic policy for, 243–48
  support and opposition potential for policy of, 254–55
  in Taiwan, 112, 116
Agricultural subsidies. *See* Subsidies
AID. *See* Agency for International Development (AID)
Alessandri, Jorge, 89
Allende, Salvador, 89–90
Alliance party (Singapore), 167
Amador, Alberto, 263
Araya, Carlos, 74, 187–88
Ardito-Barletta, Nicolás, 34n23, 36, 43, 48, 51, 52, 56n6, 156n6
Argentina
  capital account transactions in, 154
  effect of inconsistent government policy in, 140
  stabilization and liberalization policies in, 32, 153–55
Argüello, Xavier, 56n7, 58nn60, 61, 64–66
Arias Sánchez, Oscar, 54–55, 71
Arrighi, G., 157n43
ASBANA. *See* National Banana Association (ASBANA)

Baer, W., 157nn38, 43
Balance of payments, 18, 20–21
Balassa, Bela, 156nn11, 28, 157nn47, 48, 49
Banana industry
  effect of international competition on, 289–94
  history of, 285
  production, 286–89
Barison Socialist party (Singapore), 9, 162
Beck, Richard, 187
Behrman, John, 156nn32–33
Bell, Harry H., 156n17
Bellows, Thomas, 167, 171nn15–16, 18
Bernal, R., 16n17
Blanco, Jorge, 51
Blazic-Metzner, Boris, 15nn5–6
Blejer, Mario, 156n6
Bolivia, 32
  control of hyperinflation in, 61–62
  grace period in, 51
  liberalization and stabilization policies in, 31, 153, 154
Bonavia, David, 168, 171nn26–28
Boston Consulting Group, 147, 156n34
Botswana
  adjustment policy in, 40, 53–54
  economic and political strategy in, 50, 55
Brazil
  adjustment policy in, 40
  economic and political strategy in, 50
  industrial policy for, 154
Brenes, José Rafael, 262–63, 264, 265
Brill, Howard, 16n17
Buchanan, Ian, 171, 171n30
Bulgarelli, Oscar Aguilar, 189

CAAP. *See* Private Agricultural and Agroindustrial Council (CAAP)
CACIF. *See* Consolidated Chambers of Private Enterprise (CACIF)
Cagan, Phillip, 34n13
Cahfee, Frederik, 121nn7–10
Callaghy, Thomas, 16n18, 57nn32, 49
Calvo, Guillermo, 156n9
Capital transactions
  liberalization of, 39, 154
Carazo Odio, Rodrigo, 51
Carbajal, Celestino, 156n9
Cardoso, Iliana, 34n6

Carvajal, Mario, 76, 77, 187, 188, 193–94
Castillo, Carlos Manuel, 73, 74
Castle and Cooke, 286, 289, 299
CATs. *See* Tax savings certificates (CATs)
CCP. *See* Chinese Communist party (CCP)
CENPRO. *See* Export and Investment Promotion Center (CENPRO)
Central American Agreement on Fiscal Incentives to Industrial Development (1962), 193, 194
Central American Agreement on Import Tax Equalization (1959), 193
Central American Chambers and Industrial Associations, 194
Central American Common Market (CACM), 187, 193
Central American Economic Integration Secretariat (SIECA), 71
Central Bank
  role in Costa Rica of, 195, 257, 260, 277, 282
  role in Taiwan of, 112
Central Provident Fund (CPF), 165
Cerezo, Venicio, 35–36, 48
Céspedes, Victor Hugo, 56n7
Chan Heng C., 171nn6, 14, 19–20
Chenery, Hollis, 34n8, 139–40, 147, 149, 156nn4, 10–11, 15, 18, 35, 157n37
Chiang Ching-kuo, 203–4
Chiang Kai-shek, 107, 110, 203
Chile
  adjustment program management in, 53
  capital account transactions in, 154
  economic growth of, 95–96
  economic policies of, 89–90
  effect of inconsistent government policy in, 140
  exchange rate policy of, 93–94, 95
  financial services industry in, 94–95
  fiscal and monetary policy under liberalization in, 90–91
  land reform in, 90
  liberalization and stabilization programs in, 90–93, 95, 153–55
  nationalization and privatization in, 90, 96
  trade policy of, 91–92, 94–96, 153
Chinese Communist party (CCP), 204
Choe, Alan, 171n7
Choksi, Armeane, 16n15, 34n21
Clark, W., 255n6
Cline, William, 16n14, 34nn9, 14, 56n24
Closed economies, 18
Coalitions, 9, 41, 48–55
CODESA. *See* Costa Rican State Development Corporation (CODESA)
Coffee Institute (ICAFE), 259, 260
Cohen, Stephen S., 156n28
Communist party of Bolivia (PCB), 61
Communist party of Indonesia (PKI), 124–25
Compensatory Finance Facility, 95
Condon, T., 94n1, 96n1
Consolidated Chambers of Private Enterprise (CACIF), 36
Corbo, V., 34nn10, 19, 96nn1, 3
Cornia, Giovanni Andrea, 16n15, 56n25, 57nn26–27, 29, 32
Costa Rica
  agreement with IMF of, 73, 79–81
  agricultural policy in, 253–55, 257–66, 277–84
  banana industry in, 73, 285–90, 292–93
  economic and political strategy in, 36, 45, 48, 50, 71
  Economic Emergency Law of, 73
  economic stabilization program for, 36, 72–73, 76–77, 154, 281
  external debt negotiations of, 54–55
  fiscal policy of, 75, 245–46
  grace period in, 51
  Industrial Contract system in, 193
  industrial policy in, 74, 147, 149–50
  industrial structure of, 190, 192–93
  inflation in, 73
  recession in, 71–72, 253
  rice industry in, 277–81
  special interest groups in, 41–42, 43, 45, 48
  structural adjustment program with World Bank, 71, 82, 253
  tax savings certificates in, 194, 195
  trade policy of, 73–76, 187, 193
  wage policy for, 145, 147
Costa Rican State Development Corporation (CODESA), 73, 281
Country performance analysis, 3–15
CPF. *See* Central Provident Fund (CPF)
Crosby, Benjamin, 16nn10, 16
Current account
  deficit in Indonesia, 131
  deficit in Costa Rica, 72
  liberalization of transactions for, 154

Dagnino Pastore, José María, 156n9
Dauharje, Andres, Jr., 56n8
Davies, Rob, 58n56
Debt, external
  of Costa Rica, 72
  of Indonesia, 128
Deficit
  current account, 72, 131
  fiscal, 73
De Franco, Silvio, 157n62
Del Monte, 286, 289
Democratic and Popular Unity Coalition (UDP), 61
Democratic Revolutionary party (PRD), 36
Dengo, Jorge Manuel, 189
Devaluation in stabilization programs, 39, 43, 45
Devarajan, Shantayanan, 157n73
Development Bank in San Marcos, 313–14
Development strategy, 3–5, 5–6
DeWitt, Francis, 156n28
Dhal, Henrik, 157n73
Díaz-Alejandro, Carlos, 157n41
Diebold, William, Jr., 156n26
Di-Mare, Alberto, 74
Dominican Republic
  economic and political strategy in, 36, 50
  industrial policy of, 154
  use of grace period in, 51
Donors. *See* Foreign resources; Multilateral organizations
Dornbusch, Rudiger, 33n4, 34n6
Duarte, José Napoleón, 51

Economic Commission for Latin America (ECLA), 34n9, 189
Economic Development Board (EDB), 164
Economic growth
  short-term goals for, 24
  stimulation policy for, 29
Economic problems, short-term, 18–23
Economic Research Institute (IICE), 74
Economic stabilization programs. *See* Stabilization programs
Economic strategy
  framework to analyze, 17
  importance of, 3–5
  in Indonesia under Suharto, 126
  medium-term, 10–11, 29–31, 32
  outward- compared with inward-oriented, 31
  political risks in implementing, 11, 14
  short-term, 10–11, 24–29, 31, 32
  See also Adjustment policies; Stabilization programs; Structural adjustment programs
Ecuador, 290–91, 293

EDB. *See* Economic Development Board (EDB)
Edwards, Sebastian, 56nn12, 21, 58nn50, 53, 156nn6–7, 157nn63, 71
Effective protection, 144
El Salvador, 51
Employment
in Costa Rica, 192, 288–89
policy in Malaysia, 225–26
de-la-Espriella, Eduardo, 257, 261, 262, 263, 266
Esquivel, Alberto, 284
Ethnic group conflict, 6, 225–26
Exchange rate policy
in Argentina, 153
in Chile, 91–96, 153
in Costa Rica, 75–76, 189
in Indonesia, 130–31
management in industrial policy, 143
and medium-term agricultural strategy, 252
in open and closed economies, 18
in short-term economic policy, 27
and short-term strategy, 27, 245–46, 248
in stabilization program, 27
Export and Investment Promotion Center (CENPRO), 75–76
Export promotion, 30–31, 76, 91, 152–53
External sector, 6, 20–21

Falcon, Wallace, 255n1
Farmers Union of Guatuso (UCADEGUA), 281
FEDEAGRO. *See* National Federation of Agricultural and Farming Cooperatives (FEDEAGRO)
Fei, John, 30, 34n17, 58n52, 121nn12–13, 154, 156n28, 256n20
Fernández, E., 34n6
Financial disintermediation, 30
Financial markets
in Chile, 94–95, 140
in open economies, 18
in Taiwan, 216–18
Finger, J. Michael, 255n2
Fiscal policy
in Chile, 90–91
in Costa Rica, 75, 245–46
as diagnostic tool, 18, 20
in Indonesia, 131–33
and industrial strategy, 145
and medium-term agricultural strategy, 251
and short-term strategy, 26, 244–45, 246–47
Fisher, S., 34nn11, 15
Foreign exchange. *See* Exchange rate policy
Foreign resources
to Costa Rica, 70
policy for, 29, 33–34n5
short-term effect of inflow of, 26, 54
Foreign sector. *See* External sector
France, 147
Frei, Eduardo, 89, 90
Frenkel, Jacob, 33n4, 34n6, 56n21, 156n13
Furuya, Keiji, 121n2

Galenson, Walter, 121n16
Gambia, 32
liberalization and stabilization policies in, 153–54
García, Alan, 32
GDP. *See* Gross domestic product (GDP)
Geiger, Francis, 171nn1–2, 13
Geiger, Theodore, 171nn1–2, 13
George, T. J. S., 171nn17, 21
Germany, West, 147
Ghana
adjustment policy in, 40
economic and political strategy in, 36, 50, 54
grace period in, 51
Goh Keng Swee, 162, 164, 1171nn5, 8, 22
González-Vega, Claudio, 73, 255n9
Government role
in industrial policy, 140–41, 147
in management of adjustment policy, 48, 50–56
Greece
industrial transition of, 153
Gross domestic product (GDP)
as diagnostic tool, 18, 19–20
Guatemala
banana industry in, 292
coalitions in opposition in, 48
economic and political strategy in, 35–36, 45, 48, 50
industrial policy role of government, 147
special interest protest in, 41–42, 43
use of grace period in, 51
Guislinger, Steven, 140

Hager, Wolfgang, 156n27
Hanson, James, 58n50, 156n6
Harberger, Arnold C., 17, 34n8, 56n12, 58n50, 156n6, 157n72
Hayami, Y., 255n7
Heller, Peter, 57n28
Herin, Alejandro, 58n58
Hirschman, Albert, 157n38
Honduras
banana industry in, 292
special interest protest in, 43
Hong Kong, 30
Hsu, C., 156n28
Hughes, Helen, 15nn5–6, 139
Hunter, Guy, 255n1
Hyperinflation in Bolivia, 61–62

Ibáñez, Carlos, 89
ICAFE. *See* Coffee Institute (ICAFE)
IICE. *See* Economic Research Institute (IICE)
Ilchman, Warren, 16nn10–12
IMF. *See* International Monetary Fund (IMF)
Imported inflation. *See* Inflation
Import substitution policy
in Chile, 91–92
in Costa Rica, 71, 74, 150, 152–53
effect of medium-term, 30
in Singapore, 6
in Taiwan, 112–13
types of, 150, 152
Indonesia
effect of oil price on economy of, 126–27, 130, 133–34
external debt of, 128
fiscal policy of, 127–28, 131–33
Pertamina crisis in, 128, 130–34
rural and industrial development in, 124–25
structure of economy of, 123
technocrats in government of, 126, 128, 130
trade policy of, 125–27, 130–33
See also Pertamina debt crisis
Industrial Contract (Costa Rica), 193
Industrial policy
in Costa Rica, 74
in León, 173–79
outward and inward orientation for, 141–45, 147, 150, 153, 154
in Taiwan, 116, 118–19
See also Import substitution policy; Liberalization program; Stabilization programs
Industrial Protection and Development Act of 1959, 193
Inflation
in Chile, 90, 92, 93, 95

in Costa Rica, 72–73, 189
effect of policy to correct, 26, 28–29
imported, 22–23
in open and closed economies, 18
Institute for Basic Grain Production
in San Marcos, 311–12
Internal coalitions. *See* Coalitions
International Monetary Fund (IMF), 33n4
economic stabilization (or adjustment) programs of, 25–26, 37–55
stabilization plan for Costa Rica, 281
stabilization program in Chile, 95–96
stand-by arrangement with Costa Rica, 73
structural adjustment loan agreement with Costa Rica of, 267–71
See also Multilateral organizations; Stabilization programs
Inward-oriented policies
and agricultural strategy, 248–50
Israel, Arturo, 57n28

Jacoby, Neil H., 121n3
Jalan, B., 15n2, 33n2
Jamaica, 51, 55
James, William, 248, 256nn19, 22–23
Jansen, D. J., 256n28
Japan
export promotion policy of, 30
industrial policy role of government, 147
Johnson, Booth, 255n1
Johnson, Harry G., 33n4, 34n6
Johnston, B. F., 243, 255n6
Jolly, Richard, 56n25, 57nn26–27, 29, 32

Kampuchea (Cambodia), 24
Katzenstein, Peter, 15nn5–6
Keesing, D. B., 157nn47–49
Keith, Minor C., 285–86
Kerstenetsky, I., 157n38
Keynes, John Maynard, 18, 33n3
Keynesian theory, 18
Kgosidintsi, B. N., 58n55
Kirby, Peter, 255n1
Kirkpatrick, C. H., 155n1, 156nn10–11, 157nn39–40, 42
Klein, Lawrence, 155n1
Klitgaard, Robert, 57n28
Korea, Republic of
adjustment policy in, 40, 53
economic and political strategy in, 50
export promotion policy of, 30
industrial policy for, 154
Krueger, Anne O., 32, 34n24, 39, 58nn20, 23, 154, 156nn12, 14, 157nn68, 70–71
Kuo, Shirley, 15n4, 58n52, 121nn5, 11, 14, 15, 17, 18, 156n28, 256n20
Kuznets, Simon, 33n2

Labor policy
in Costa Rica, 187, 195–96
in industrial strategy, 145, 147
and medium-term agricultural strategy, 252
in short-term economic policy, 26–27
and short-term strategy, 26–27, 245, 247–48
See also Wage policy
LAICA. *See* Agricultural Industrial Sugar Cane League (LAICA)
Landau, Luis, 156n6
Landholding in San Marcos, 306
Land reform in Taiwan, 112–13, 116
Lau, Lawrence, 15n4, 58n51, 154, 156n28
Lee Quan Yew, 159, 162, 167, 171nn23–25
Lee Soo Ann, 171nn9–12
Leff, N. H., 157n41
Lending, foreign. *See* Foreign resources
León, 173–79
Levy, Brian, 58n70
Li, K. T., 119–20, 121nn20–25
Liberalization program
in Chile, 90–93
effect of, 153–55
sequence of, 39
sequence of implementation in agriculture for, 255
See also Stabilization programs; Structural adjustment programs
Liberman, Luis, 75, 76
Lindenberg, Marc, 15n2, 16n10, 57n30, 156n27, 157n53
Little, I., 256nn19, 22
Liviatan, Nissan, 34n11
Lizano, Eduardo, 73, 257, 263, 264, 265, 282, 284
Lodge, George, 15n7
Loebl, Herbert, 156n30

Macroeconomic policy, 23
Magaziner, Ira, 156n26
Malaysia
economic strategy in, 24
employment policy in, 225–26
industrial policy program of, 147
special interest groups in, 37
Malaysia (government of), 156n29
Malaysian Federation, 167
Malaysian National Operations Council (NOC), 225
MEC. *See* Ministry of Economy (MEC)
Meier, Gerald, 248, 256n19
Mejía Víctores, Oscar, 48
de Melo, J., 94n1
Méndez, J. C., 96n2
Merhav, M., 157n46
Mexico, 154
Michaely, Michael, 56n21, 57–58n49, 58n53, 154, 156nn14, 16, 157n56, 59–60, 63, 71
Michalopoulos, Constantine, 16n14, 56nn15–17, 19, 22, 58n53
MIDEPLAN. *See* Ministry of National Economic Planning (MIDEPLAN)
Miller, Robert, 140
Ministry of Agriculture (San Marcos), 310
Ministry of Economic Affairs (Taiwan), 107, 108
Ministry of Economy (MEC), 259, 277, 282–84
Ministry of National Economic Planning (MIDEPLAN), 73
MIR. *See* Movement of the Revolutionary Left (MIR)
MNRI. *See* National Revolutionary Movement of the Left (MNRI)
Monetary approach to balance of payments, 18, 33n4
Monetary policy
as diagnostic tool, 18, 20
different effects in open and closed economics for, 18
and industrial strategy, 145
and medium-term agricultural strategy, 251
in short-term economic policy, 26
and short-term strategy, 26, 245, 247
Monge, Luis Alberto, 187
administration of, 36, 41, 48, 51, 52, 189, 193, 253
stabilization policy of, 72–74
Mosher, Arthur, 255n1
Movement of the Revolutionary Left (MIR), 61, 62
MRN. *See* National Revolutionary Movement (MRN)
Multilateral organizations as lenders or donors, 55, 277
Multilateral Treaty on Free Trade and Economic Integration (1959), 193
Mundell, Robert, 33n4
Mussa, Michael, 56n21, 157n63

Nasution, Anwar, 134, 135n2
National Banana Association (ASBANA), 259, 260
National Banking System (SBN), 261

National Chamber of Basic Grains (NCBG), 277, 281–82
National Democratic Action party (ADN), 61, 62
National Federation of Agricultural and Farming Cooperatives (FEDEAGRO), 281
National Insurance Institute (INS), 260
Nationalism, 110, 112, 203
Nationalist party (Taiwan), 110
Nationalization in Chile, 90
National Liberation party (NLP), 71, 73, 188
National Planning Bureau (OFIPLAN), 75
National Production Council (NPC), 259, 260, 264, 267, 270, 271, 277, 279–81
National Revolutionary Movement (MRN), 61, 62
National Revolutionary Movement of the Left (MNRI), 61, 62
National strategy. *See* Adjustment policies; Development strategy; Economic strategy
Naya, Seiji, 248, 256n19
NCBG. *See* National Chamber of Basic Grains (NCBG)
Nelson, Joan, 15n5, 16nn16, 18, 52, 53, 56nn7–8, 25, 57nn33–34, 41, 47, 48, 156nn24, 27, 157n65
Netto, A. D., 157n41
Newbery, David, 156n19, 256nn24–25
Nicaragua
economic changes in, 21–22
effect of economic policies:1976–78, 21–22
effect of inflow of foreign resources, 54
Nixon, F. I., 155n1, 156nn10–11, 157nn39–40, 42
NLP. *See* National Liberation party (NLP)
NOC. *See* Malaysian National Operations Council (NOC)
Nominal rate of protection, 144
Noriega, Manuel, 36, 48
Nuqui, Wilfredo, 58n58

OECD. *See* Organization for Economic Cooperation and Development (OECD)
OFIPLAN. *See* National Planning Bureau (OFIPLAN)
Olechowiski, Andrzej, 255n2
Open economies, 18, 33n2
Opposition groups.
resistance to government economic policies by, 37, 41–55
See also Coalitions; Special interest groups
Organization for Economic Cooperation and Development (OECD), 156n27
Orroch, Louise, 15n5, 157nn44–45, 50–52, 256n20
Outward-oriented policies
and agricultural strategy, 250–53

PA. *See* People's Association (PA)
Panama
coalitions in opposition in, 48
economic and political strategy in, 36, 45, 48, 50
opposition to economic stabilization programs in, 48
resistance to devaluation in, 45
special interest protest in, 42, 43, 45
PAP. *See* People's Action party (PAP)
Papageorgiou, Demetris, 16n15, 34n21
Papanek, Gustav, 157n38
Paz Estenssoro, Víctor, 52, 61–62
PCB. *See* Communist party of Bolivia (PCB)
Peacock, A., 156n27
Pearson, Robert, 255n1
People's Action party (PAP), 159, 162, 164–68
People's Association (PA), 166–67
People's Republic of China, 110, 112, 113, 204
Pertamina debt crisis, 127, 128, 130
Peru, 32
Petras, James, 16n17
Philippines
adjustment policy in, 40
banana industry in, 293
stabilization program in, 54
Pinder, John, 155n1
Pinochet, Augusto, 32, 89, 90
PKI. *See* Communist party of Indonesia (PKI)
Political management. *See* Adjustment policies; Coalitions; Government role; Special interest groups
Political mapping, 6, 9, 11
Political parties, 6
Political risks, 11, 14
Porter, Michael, 14, 15n7, 16n19
Portugal
industrial policy of, 153
PRD. *See* Democratic Revolutionary party (PRD)
Pressure groups, 6. *See* Special interest groups
Private Agricultural and Agroindustrial Council (CAAP), 257
Privatization
in Chile, 96
in Costa Rica, 281
Protectionism
in Costa Rica, 74
and economic strategy choice, 29–30
See also Effective protection; Import substitution; Nominal rate of protection
PUSC. *See* Social Christian Unity party (PUSC)

Quant, María Larraz de, 57n30, 156n22

Ramírez, Noel, 16n13, 33n1, 57n46, 156nn26–27, 256n26
Ramos, Joseph, 16n16
Ranis, Gustav, 15n5, 29–30, 34nn16, 17, 58n52, 121n19, 154, 156nn11, 28, 157nn44–45, 50–53, 250, 256n20
Recession
in Chile, 95
in Costa Rica, 71–72, 75
Reich, Robert, 15n7, 156n26
Republic of China. *See* Taiwan
Reserves, international, 20–21
Rice Commission, 281, 283
Rice Office, 283–84
Rice subsidies, 116, 278–83
Robinson, Sherman, 156n4
Rodríguez, Carlos, 156n9
Rottenberg, Simon, 56n12
Ruiz, Hernando, 58n62
Ruttan, V., 255n7

Saballos, Iván, 27, 31, 156nn22
Sachs, Jeffrey, 34n12, 57n45, 250, 256n21
Samuelson, P., 34n18
Sanders, David, 58n56
San Marcos
alternatives to current agricultural situation, 313–14
rural economy of, 305–8
rural public-sector services in, 308–13
SBN. *See* National Banking System (SBN)
Schultz, Theodore W., 24, 255nn1, 6
Scitovsky, Tibor, 256n19
Scott, Bruce, 5, 15n7, 15–16n9
Scott, M., 256n19
Seaga, Edward, 51
Secularism, 110, 112
Shadow agreements, 54
Sih, Paul K. T., 121n6
Siles Suazo, Hernán, 61–62
Singapore
economic development of, 6
export promotion policy of, 30
geopolitics of, 159, 161–62
industrial policy for, 154
monetary policy of, 165–66
political map of, 9–10
relations with Malaysia of, 168–70
trade union activity in, 166–67
wage policy for, 145

Singapore Investment Trust (SIT), 162
Sjaastad, Larry, 156n9
Social Christian Unity party (PUSC), 189
Soviet Union
industrial policy of, 147
Spain
industrial transition of, 153
Special interest groups, 6, 9
in Costa Rica, 281–82
response to adjustment policy by, 41–48
See also Coalitions
Sri Lanka, 24, 55
Stabilization programs
citizen resistance to, 43, 45
effect of, 153–54
in Ghana, 54
in Philippines, 54
political management of, 37–39
purpose and effect of, 24–28, 32, 37–39
as short-term strategy, 24–26, 37
and structural adjustment, 31–32
use of, 24–25
Zimbabwe, 54
See also Structural adjustment programs
Standard Fruit Company, 286
Stern, Nicholas, 156n19, 256nn24–25
Stewart, Frances, 56n25, 57nn26–27, 29, 32
Stoffaes, C., 156n28
Stolper, W., 34n18
Stolper/Samuelson theorem, 30, 34n18
Structural adjustment loan (SAL)
implementation in Costa Rica of, 55, 71
Structural adjustment programs
citizen resistance to, 43, 45
as medium-term strategy, 37
policy sequence question for, 31–32
political management of, 39
purpose and effect of, 39
Subsidies, agricultural, 278–82
Suharto government, 123, 124–26, 128, 133
Sukarno administration, 126
Sun Yat-sen, 109–10, 112, 203, 211, 219
Syrquin, Moshe, 156n4

Tait, Alan, 57n28
Taiwan
adjustment policy in, 53
agricultural policy in, 112, 116
economic and political strategy of, 55, 112
economic planning in, 107–8
export promotion policy of, 30
financial markets in, 216–18
fiscal policy in, 218–19
geopolitics of, 108–9, 205–8
history of, 208–10
industrial policy of, 147, 153, 154, 211–13
political foundations of, 109–10
trade policy of, 213–16
Tax savings certificates (CATs), 194, 195
Tidalgo, Linda, 58n58
Timmer, Peter, 241–42, 255n1, 3–5
Torres, Jorge, 281, 282
Trade policy
in Chile, 91–93, 94–96
in Costa Rica, 71–75
in Indonesia, 126, 127
in industrial strategy, 143–45
inward oriented, 4–5, 144–45
and medium-term agricultural strategy, 251–52
outward oriented, 4–5
and short-term strategy, 26, 245, 247
in stabilization program, 27
See also Effective protection; Exchange rate policy; Export promotion; Import substitution policy; Nominal rate of protection; Protectionism
Trade unions
in Singapore, 166–67

UCADEGUA. *See* Farmers Union of Guatuso (UCADEGUA)
UDP. *See* Democratic and Popular Unity Coalition (UDP)
UNICEF, 39–40, 58nn57, 69
Union of Banana Exporting Countries (UPEB), 292
Union of Small Farmers of the Atlantic (UPAGRA), 281
United Brands Company, 286, 289, 298
United Fruit Company, 285
United Kingdom, 147
United Nations Industrial Development Organization, 156n3
United States
assistance to Taiwan by, 107–8, 112, 121
industrial policy role of government, 147
University of Chicago, 18, 33n4
UPAGRA. *See* Union of Small Farmers of the Atlantic (UPAGRA)
UPEB. *See* Union of Banana Exporting Countries (UPEB)
Uphoff, Norman, 16nn10, 11, 12
Uruguay
capital account transactions in, 154
liberalization policy in, 32, 155
USAID. *See* Agency for International Development (AID)

Vargas, Federico, 75, 76
van Vijnbergen, Sweder, 56n12, 157n73
Villasuso, Juan Manuel, 76–77

Wagenhals, Gerhard, 156n27
Wage policy, 27, 145, 147
Weintraub, Cline, and Associates, 34nn7, 12
Weintraub, Stanley, 16n14, 34nn9, 14, 56n24
Wescott, Robert, 156n26
Whee Rhee, Yung, 154, 156nn12–13, 19–20, 157n62
Woo, Wing Thye, 135n2
World Bank, 15nn1, 8, 34nn20, 22, 38, 56nn10–11, 18, 57–58n49, 58n63, 96n1, 147, 149, 154, 155n2, 156nn5, 8, 10–11, 15, 18, 21, 157nn36–37, 54–58, 61, 67, 69, 71, 74, 255nn2, 10–14, 16
economic stabilization programs of, 25, 37–55
structural adjustment arrangement with Costa Rica of, 71, 82
See also Multilateral organizations; Structural adjustment programs

Yankelewitz, Samuel, 194
Yohirara, Kunio, 171nn3–4

Zambia, 36
adjustment program in, 52–53
Zimbabwe
adjustment strategy in, 40
economic and political strategy in, 50, 54, 55
Zimmermann, Ekhart, 56nn13–14

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