ECONOMIC DEVELOPMENT IN CENTRAL AMERICA

MACROECONOMIC ISSUES

I. INTRODUCTION

The following papers provide A.I.D.'s analysis of the principal economic issues facing Central America in the two major economic sectors -- agriculture and industry -- that are likely to play a major role in the region's progress during the next few years. Background papers on urbanization and energy are also included. In each case, the paper provides our best judgements concerning the most feasible approaches to deal with these issues on a regional basis. This paper provides a macroeconomic context and overlay for those sectoral analyses.

Central America is facing its worst economic and social crisis since the 1930's. Added to the obvious political conflicts are structural problems that can be traced to the history and economic traditions of the region. They have been intensified by a financial and economic crisis due to events in the world economy. Almost inevitably, per capita Gross National Product (GNP) -- the most basic indicator of economic well-being -- will continue falling in 1983 and 1984. This would extend a steady decline that has been underway since 1979, and bring the per capita GNP level, measured in 1981 dollars, from $1,070 in 1979 to $920 in 1984. Even the assumption that steady growth can be achieved after 1984 is likely to mean that the average person in Central America will be worse off in 1990 than he was in 1979.

This period of economic decline and stagnation becomes even less tolerable when one considers two additional factors. First, much of the population of these countries is poor, uneducated and subject to severe health hazards. These needs cannot be addressed without economic expansion that would provide additional public and private resources. Thus, the inability of the countries to provide enough of a "social dividend" over the medium term to mitigate unrest among economically and socially disadvantaged groups is likely to remain a potential threat to political systems in the region.

Second, employment is an equally explosive issue, given the limited economic prospects for the 1980's. The rapid growth in population over the past two decades has meant that young people will be entering the labor force at historically unprecedented rates in most of the countries of the region. Currently, more than 250,000 additional jobs must be created each year to prevent the unemployment situation from deteriorating. This number will increase rapidly into the future, reaching about 500,000 additional jobs needed per year in the year 2000. Creating jobs at such a rapid rate would be a serious challenge to any economy; given Central America's current and projected difficulties, it threatens to be insurmountable.

The Balance of Payments Problem

With the rise in oil prices and the decline in commodity prices over the past several years, Central America faces a severe adjustment problem. The region can no longer pay for the level of imports it previously could afford, and must adjust by reducing imports and increasing exports. The oil price increase cost the region on the order of $700 million per year in order to pay for the same quantity of oil it had been importing previously. The decline in coffee prices between 1980 and 1983 cost the region an additional $400 million in reduced export revenues, while the declines in price of sugar, bananas and cotton may have cost an equal amount. Since the price prospects for at least the two largest exports -- coffee and sugar -- are not bright, the loss in export earnings from the price declines must be treated as permanent.

Thus, the region's balance of payments deteriorated by about $1.5 billion due to the unfavorable changes in prices of oil and other commodities. This loss is in addition to the unfavorable impact of the world recession on the demand for the region's products, which reduced the quantity of exports that the region could sell to the rest of the world as well. The $1.5 billion shift in terms of trade means that the region would have to increase its exports by about one-quarter in order to be able to buy the same quantity of imports. In the short term, new export opportunities simply do not exist, so reductions in the region's imports have had to take place. Since much of the regional industry is heavily dependent on imports of raw materials and intermediate goods, this had a direct negative impact on employment.

It was to avoid such declines in employment that some countries of the region, most notably Costa Rica, borrowed heavily during the last several years. This only postponed the problem temporarily, and the rise in world interest rates in the early 1980s created additional problems. The accumulation of debt proved to be a false solution. Guatemala, the country that accumulated the smallest amount of foreign debt, now seems best prepared to resume economic growth when the world recession ends and violence subsides. The countries that accumulated the largest debt burden -- Costa Rica and Nicaragua -- now face the most serious challenges. In both cases, the external debt is more than 80% of the country's GNP, and the debt service burden cannot be sustained at present.

Savings and Investment

While economic policies are essential to creating proper incentives, the actual growth of the region will depend upon the levels of investment. In turn, investment levels depend upon domestic savings and the extent to which foreign resources can be attracted. Historically, the region had been making considerable progress in generating internal savings until 1980. The share of GNP in the region that was saved rose from about 11 percent in 1960 to 18 percent in 1978, before taking a sharp downturn during the past several years. The rate was 14 percent in 1981, representing $3.3 billion. Some of the decline in savings is due to capital flight, either for political reasons or because government policy has made domestic savings unattractive compared to foreign rates of return.

Savings that have moved abroad are unlikely to return without an increase in confidence in political institutions and succesful completion of stabilization programs. Thus, a vicious circle has been created, where stabilization and confidence-building are difficult to achieve due to lack of domestic investment, and investment is precluded by the poor economic climate.

If this vicious circle can be broken by some action that would alter the political and economic climate, an increase in investment resources will be needed to produce rapid growth. Given an export-oriented growth strategy combined with improved economic policies, the region might be able eventually to achieve a satisfactory rate of economic growth (annual GNP growth of 7-8%) through investment expenditures on the order of

25% of GNP. Since the region's current GNP is about $24 billion, this would represent about $6 billion per year at present. In the recent past, an increase on the order of $750 million - $1 billion in additional investment would have allowed the 25% investment level to be reached. Given the magnitude of the uncertainties about what is possible or likely concerning domestic savings, however, the amount of external finance that would be required to reach this level is conjectural.

The Central Role of Policy

The Central America region does not have the absolute shortage of human resources, infrastructure and technology that characterize some African countries. On the other hand, it lacks the well-functioning economic institutions and broadly skilled population of the more developed countries. At this stage in its development, efficiency and incentive structures become increasingly important in moving the region further down the development path. Government policies become increasingly important, and government investment programs become less so. This is because the private sector, where the bulk of economic activity takes place, responds to policy signals. Where exchange rates are overvalued, private individuals and business firms will respond by exporting less and importing more, including the use of more imported machinery and less domestic labor. If interest rates are subsidized, again there is an incentive to use more machinery and less labor.

In such cases, additional financial resources cannot themselves produce development -- in specific cases, they can actually be a hinderance. The case of Mexico is instructive. Its oil bonanza produced dramatically higher foreign exchange earnings: foreign exchange earnings from oil alone in 1981 were 2-1/2 times the earnings from all exports in 1976. Even so, Mexico found itself unable to sustain its economic growth, and was forced in 1982 into steps that produced economic decline and lower standards of living, because the public sector became overextended with current expenditures, and an overvalued exchange rate created incentives for imports at the expense of domestic production and encouraged capital outflows by the private sector.

In the Central American region, the principal policy changes needed are to make exports more attractive by eliminating the variety of economic and administrative obstacles that discriminate against exports to world markets. The most important steps include assuring that exchange rates provide sufficient incentive for exporting, eliminating excessive protection that creates artificially large incentives for production for the domestic or regional market, even at high costs, and reducing the myriad of bureaucratic obstacles to new investment and exporting.

II. AGENDA FOR ACTION

The trends indicated above demonstrate that restoring a pattern of satisfactory economic progress in the Central American region will be extremely difficult at best. The immediate priority is to achieve economic stabilization that will allow the individual governments to restore financial solvency to their international payments systems. The current situation, where long delays are required in payments for imports and where foreign exchange is rationed by governments, is itself reducing the potential for economic recovery and growth, besides creating ample incentive and opportunity for corruption and fraud.

A rapid recovery of the world economy and a continued willingness to maintain financially-sound programs would gradually bring financial stability. It is questionable, however, whether current inflows of resources are sufficient to allow the governments to cope with these problems without potentially destabilizing strains. Additional balance-of-payments assistance in the near term would reduce the disorganization and speed the restoration of the kind of investment climate that would make longer term growth possible. Such aid would allow the stabilization phase -- i.e., an end to the steady decline -- to be completed within about two to three years for most of the countries of the region. Costa Rica is an exception, because the depth of the Costa Rican financial overcommitment will probably require a longer stabilization period there.

When the stabilization process is well along, the question of how to develop a long-term dynamic growth process will again reappear as central. The major challenge is to speed the creation of productive employment in the region, so that the labor force can be absorbed at a much more rapid rate than in the recent past. Given that the major opportunities for internally-generated growth have already been exploited through the CACM, and that no significant opportunities for growth based on exploitation of some rich natural resource appear to exist, the region has little choice but to seek faster growth and employment creation through participation in the world economy. This is the approach taken by the most successful of the developing countries, notably South Korea and Taiwan, over the past few years.

In essence, the countries of the region will need to generate large amounts of labor-intensive exports for the world markets if they hope to provide any signficant increase in living standards over the next few years. Obviously, the industrial sector is one source of such opportunities.

Domestic firms in the region have the potential to respond to this challenge in an important way. There is a considerable entrepreneurial base in the region, and the experience of industrialization within the CACM demonstrates that they can respond rapidly to opportunity. Nevertheless, foreign investment will also need to play an important role, particularly during the early stages. Multinational firms have the experience in international marketing, access to technology and the ability to mobilize financial resources quickly.

Even with considerable foreign involvement, industrialization alone cannot solve the employment problem in the medium term. On a net basis, there are now more than 250,000 persons entering the labor force annually, a number that increases by nearly 10,000 each year. At best, industrial employment can be expected to grow at 5% annually in the near future; this would provide 70,000 new jobs per year -- only one-fourth of requirements. The service sector can absorb increases as well -- perhaps of roughly the same magnitude. Assistance to the informal urban sector might accelerate this somewhat.

Despite the urban possibilities, it is clear that the agricultural sector must continue to provide a growing employment base if unemployment is to be kept under control. As in other sectors, the role of government policy in influencing the structure of production is important here. Agricultural diversification and commercially-oriented small farms are the keys to increased employment creation in the rural areas. They can provide the increased employment of both family and hired labor to ameliorate the rural underemployment problem through production and export of higher-value crops if incentives are appropriate and if adequate supporting infrastructure is available. Increased access to land can play a limited but important role. Rural roads, port facilities, and improved communications are important, although the nature and magnitude of such problems varies considerably from country to country. Over the longer term, improvements in the human resource base and agricultural research and extension infrastructure will be needed in order to improve productivity. Industrial policy can also stimulate increased processing and agro-industrial activity, leading to further rural employment generation.

Industrial and agricultural exports can be stimulated through government programs such as export financing, support for skills training, and technical assistance in export promotion and marketing. Much more important, however, particularly in the longer term, is the elimination of structural disincentives for exports. These include overvalued exchange rates, tariff structures that support inefficient industries and saddle potential exporters with high-cost raw materials, and labor legislation that raises the cost of urban labor above productivity levels. In addition, government regulations and documentation requirements in all of the countries of the region create substantial impediments to efficiency and to new activities, except by those with preferred access to the government administrative apparatus. As a result, bureaucratic procedural requirements tend to favor existing vested interests, limiting upward mobility and reinforcing the highly unequal income distribution.

While a direct effort to generate productive employment through export-oriented production may be the major element of an appropriate development strategy, direct action to deal with the problems of extreme poverty in the region also appears essential, both to improve the quality of the human resource base, and to maintain social peace by spreading the benefits of growth more broadly. Spread of availability of adequate basic education to the poorest sectors of society is probably the single most important element in providing greater equality of opportunity over the long run.