AID IN COSTA RICA:

1982-1992

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CONTENTS

ABBREVIATIONS

CACM	Central American Common Market
CAI	Central American Initiative
DA	Development Assistance
ESF	Economic Support Funds
GDP	Gross Domestic Product
GOCR	Government of Costa Rica
IMF	International Monetary Fund
NBCCA	National Bipartisan Commission on Central America
NTE	Non-Tradiditional Export
PL 480	Public Law 480 (Food for Peace)
SAL	(World Bank) Structural Adjustment Loan

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Since 1982, the U.S. taxpayer has invested over a billion dollars in assisting Costa Rica, a tiny country with fewer than three million people. This paper will address as concisely as possible the key questions associated with that effort: Why so large a program? What was it supposed to achieve? What have the actual results been so far? Where should AID's program be headed over the medium-term future?

I. The Crisis of the Early 1980's

From its democratic revolution in 1948 until the end of the 1970's, Costa Rica appeared to be a model developing country. Real Gross Domestic Product (GDP) grew at better than 5% a year, reflecting strong prices for Costa Rica's traditional exports (coffee, bananas, and sugar) and the success of the Central American Common Market (CACM). The poor shared in this income growth. Based on income growth and massive GOCR social programs, quality-of-life indicators improved dramatically, to levels which are among the highest in Latin America. Life expectancy soared from about 55 years in 1950 to over 70 in 1979. Infant mortality dropped from 89 to 19 per thousand. Adult illiteracy was halved, dropping below 10%. Population growth rates during the same period dropped from 3.7% to 2.6%. Moreover, all these achievements took place within the context of a vibrant democracy.[1]

But this economic and social growth masked underlying structural problems. The expansion of CACM trade was based on a protectionist import-substitution model: local industries, shielded behind high external tariffs, never developed the efficiency which exposure to international competition would have required. Unrealistic interest and exchange rates encouraged investment that was too capital-intensive, and discouraged exports outside the CACM. By the mid-to-late 1970's, CACM growth slowed, as the limited import substitution possibilities were exhausted, and then reversed itself, as regional political and economic problems interfered with trade. The country began to resort to heavy external borrowing to maintain economic growth and social programs. A burgeoning state sector restricted the economy's flexibility in adjusting to a changing international environment.

A coincidental series of devastating external shocks, beginning around 1979, led to an economic crisis. The terms of trade turned against Costa Rica as coffee prices fell sharply from their 1977 high and the price of petroleum imports doubled. Political unrest and falling incomes elsewhere in Central America reduced investor confidence. Trying to stave off a painful adjustment, the GOCR resorted to heavier international borrowing, running up one of the highest per capita debts in the world; runaway international interest rates at the end of the 1970's further exacerbated the debt service burden.[2]

By 1981, foreign exchange reserves were exhausted, and the attempt to maintain real income collapsed with a *de facto* moratorium on servicing foreign debt. Per capita GDP declined by 16% from 1980 to 1983. Inflation exceeded

100% by mid-1982. Real wages plummeted in 1981 and 1982; even after some recovery in 1983, they were at only 79% of the 1980 level. By 1982, unemployment and underemployment rates had doubled to 9% and 14% respectively.

Based on Costa Rica's spectacular performance through the mid-1970's, AID had been considering the closure of its Mission in Costa Rica. Program levels in 1978-1981 were minimal. But as the dimensions of Costa Rica's economic crisis became apparent, AID assistance was increased to almost $50 million in 1982 and over $200 million in 1983, mainly in ESF balance-of-payments support. (See Annex I for 1978-1988 assistance levels.)

The motivation of the United States to help Costa Rica weather the storm was sharpened by geopolitical considerations. Especially as the situation in neighboring Nicaragua grew more troubled, it was feared that an unchecked economic collapse in Costa Rica might result in social and political destabilization. In this context, it made good sense to come to the aid of a country which has been a long-time friend of the U.S. and a beacon of democracy in the region.

II. The Kissinger Commission and the Central American Initiative

In July of 1983, President Reagan named a National Bipartisan Commission on Central America (NBCCA), chaired by Henry Kissinger, to recommend elements of a medium-term U.S. policy toward Central America. In its January 1984 report, the Commission proposed greatly expanded economic assistance to the democratic countries of the region. Four goals were paramount:

1. Arresting economic decline and promoting economic stabilization;
2. Laying the basis, through structural transformation, for sustained economic growth;
3. Increasing equity and spreading the benefits of growth; and
4. Strengthening democratic institutions and processes.

In February of 1984, the President sent to Congress proposed legislation -- known as the Central America Initiative or CAI -- which included most of the NBCCA's recommendations and requested $8.4 billion in U.S. assistance and guarantees for the region for the period FY 1984-89. The CAI was launched later in 1984, when Congress approved $370 million in supplemental funds, and its basic policy provisions were enacted through a 1985 amendment to the Foreign Assistance Act.[3]

For Costa Rica, implementation of the CAI has meant continuation of high AID levels from 1984 to the present, averaging $163 million per year, most of which has been in grant form for ESF balance-of-payments cash transfers (cf. Annex I). These cash transfers provide dollars which the Central Bank sells to local businesses, to pay for imports they need from the U.S. Each time the Central Bank receives a new infusion of ESF dollars, it deposits an equivalent amount of local currency (colones) in a Special Account. The colones in this account, owned by the GOCR, are allocated for development purposes by joint agreement of AID and the GOCR. (The AID mission in Costa Rica is unusual in that the majority of its project activities have been funded with ESF-generated local currency, rather than appropriated dollars -- cf. Annex III.)

III. Strategy and Results: 1982-1988

A. Stabilization and Economic Transformation

Imports, Exports, and Production (GDP). At the risk of some oversimplification, the recent Costa Rican crisis can be viewed fundamentally as a shortage of hard currency to pay for imports. Because Costa Rica is a small, open economy, its production tends to be heavily dependent on inputs imported from abroad. When there is not enough hard currency to pay for these imports, production falls. The disruption in production tends to restrict exports, leading to a vicious cycle of declining revenues available to pay for necessary imports. For a while, Costa Rica was able to cushion its foreign exchange shortfall by borrowing hard currency from foreign commercial banks. But after the *de facto* moratorium in 1981 on servicing this foreign debt, the banks refused to make further loans; there is no reason to expect this commercial window to open again any time soon.

AID's first step, in concert with the World Bank and IMF, was to help stabilize this downward spiral by sizable and immediate injections of hard currency. But it was recognized that such cash transfers were only a short-term palliative: large donor transfers should not -- indeed, could not -- continue indefinitely. Over the longer term, the alternatives were stark: either accept a drastic reduction in national income (with consequent risk of social and political disruption), or achieve a substantial increase in hard currency export revenues.

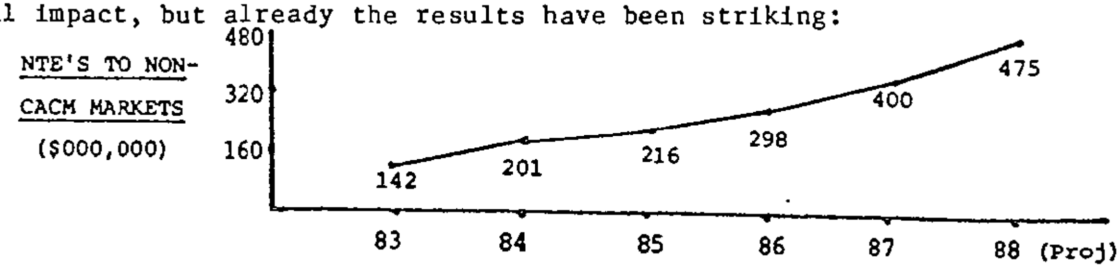
The country could not depend on sustained revenue increases from its traditional exports. Since Costa Rica was already a reasonably efficient producer of coffee, bananas, and sugar, it could not look to big productivity gains. In any event, the volumes of these exports are constrained by market conditions and international quota negotiations. These traditional products are international commodities, whose prices fluctuate widely; Costa Rica will continue to be at the mercy of disruptive price swings until it further diversifies its export base.

Nor is there any reason to count on a large near-term rebound in exports to the Central American Common Market; despite some improvement in 1988, the factors behind the CACM's collapse are not likely to be corrected quickly.

AID, other donors, and the GOCR have all agreed that the only viable solution is an increase in non-traditional exports (NTE's) to markets outside the CACM. This implies a long-term structural transformation of the local economy, away from its past import-substitution bias. AID has assisted Costa Rica with agressive NTE promotion projects, some of them unusually successful.[4] But it is conventional wisdom -- which happens to be true -- that such projects are of little lasting value except in the context of economic and trade policy reforms by the GOCR.

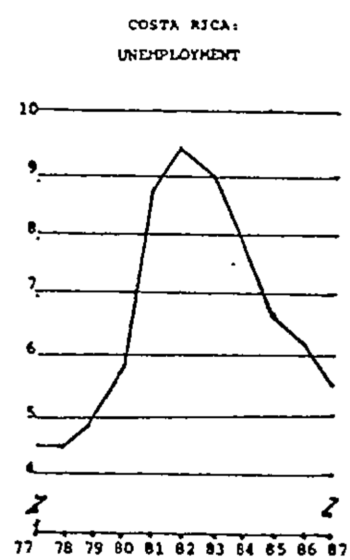
Thus, AID and the GOCR have pursued a strategy of coordinating temporary balance-of-payments support (cash transfers) with policy reforms and projects in support of a transformation of the economy toward export-led growth over the longer term.

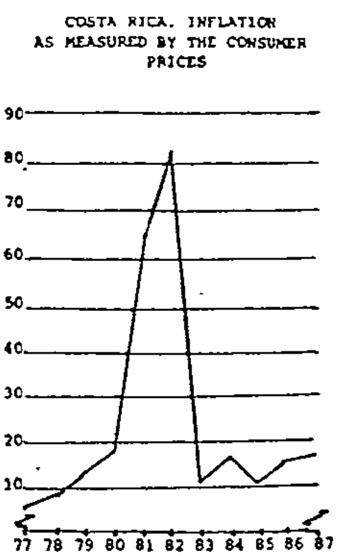
On balance, the results thus far have been encouraging. The biggest hindrance to new exports was a badly over-valued exchange rate. Although the political cost was very high, the GOCR promised and carried out a major devaluation of its currency in 1980-81, and has since maintained the rate at reasonably realistic levels through a system of mini-devaluations. A package of NTE incentives was enacted in an attempt to "level the playing field", including a much-improved regime for export processing zones. One should expect that a decade would be required for some of these reforms to have their full impact, but already the results have been striking:

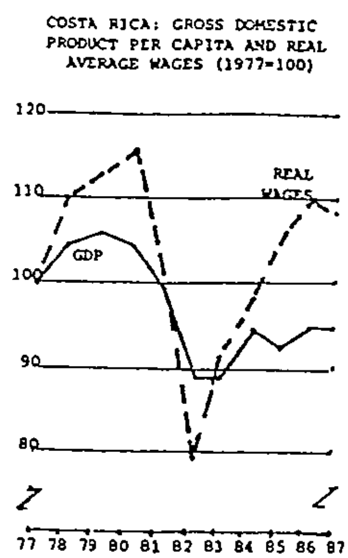


On the negative side, the World Bank has been less successful in its dialogue with the GOCR over reducing protection of industry producing for the local market and the CACM. Some tariff rationalization occurred in 1986, as part of the Bank's Structural Adjustment Loan (SAL I) program, but overall levels of effective protection were not reduced much. SAL II, which is now near signing, includes commitments for more substantial cuts, lowering rates of effective protection to around 75%, and nominal tariffs to 40%.

Turning from exports to the larger macroeconomic picture, a substantial recovery from the crisis is apparent, in terms of GDP, real wages, inflation, and unemployment.







How much of this recovery can be attributed to the AID-GOCR program of cash transfers and structural reform? Answering this question involves a "what-if" exercise which is inherently difficult. But a rough approximation is possible.

If GDP is to grow, increased imports must be paid for, as discussed above. Since the correction of the exchange rate, the ratio between GDP and imports has been fairly constant at about 3.8-to-1. Two factors can be isolated which contributed to the country's ability to pay for these imports: (1) balance-of payments transfers, mainly from AID's ESF funds; and (2) growth in NTE revenues, which can be assumed to stem principally from GOCR policy reforms. Applying the above GDP-to-import ratio, the following table can be derived, comparing actual GDP growth with what it might have been in the absence of the balance-of-payments assistance and increases in NTE's.[5]

	Actual GDP (1980 = 100) (%)	GDP without Assistance & Export Growth (%)	Importance of B/P Assistance (%)	Importance of Export Growth (%)
1980	100.00	100.00		
1981	97.74 (-2.3)	97.74 (-2.3)		
1982	90.62 (-7.3)	90.09 (-7.8)	100	--
1983	93.21 (2.9)	78.84 (-12.5)	93	7
1984	100.69 (8.0)	76.67 (-2.8)	71	29
1985	101.41 (0.7)	79.09 (3.2)	69	31
1986	106.95 (5.5)	80.34 (1.6)	54	46
1987	112.10 (4.8)	89.17 (11.0)	28	72
1988	115.54 (3.1)	88.30 (-1.0)	27	73

Two conclusion stand out from this analysis. Production and income in Costa Rica would have been much lower (i.e. by an estimated 24% in 1988) were it not for the ESF balance-of-payments assistance and NTE-oriented policy reforms. And the engine of NTE growth is pulling an increasing part of the load each succeeding year.

<u>Financial Reform.</u> Credit in Costa Rica was sucked dry by the 1979-82 crisis and ensuing capital flight; moreover, the Costa Rican financial market was hobbled by serious structural distortions. Thus, financial markets (especially the banking sector) were a key focus in AID's strategy. Here again, the strategy included a mix between quick credit infusions and longer-term structural reform.

From 1982 to the present, AID programs pumped about $200 million worth of credit into the local banks, two thirds of which was drawn, not from appropriated dollars, but from ESF-generated local currency. Many existing businesses and jobs were saved as a result. About 90 new or expanded NTE businesses, employing over four thousand Costa Ricans, were able to find adequate finance. (These credit infusions were a temporary expedient: banking system liquidity is now more or less satisfactory, and AID has planned no major new credit projects since 1986.)

In the meantime, AID and the GOCR have been addressing three major problems of financial structure. Up to 1983, interest rates had been regulated at unrealistically low levels (often negative in relation to inflation). The predictable result was a flight of local private capital to offshore accounts. After the GOCR complied with a commitment to allow rates to float up to real positive levels, cries of outrage were heard from those who had been lucky enough to have access to the former subsidized rates. But capital flight has been reversed, and financial liquidity restored to the banking system.[6]

Up to 1982, economically efficient distribution of credit had been impaired by centrally planned (and politically driven) credit allocations. In the ensuing years the GOCR has substantially dismantled this system, allowing credit flows to respond more freely to the needs of the market.

Costa Rica had nationalized its banks in 1948. Burdened with excessive regulations and political interference, the state banks became very inefficient. Their cost of intermediation (i.e. the spread they charge to pass money from depositors to borrowers) is high. Poor discipline in loan collection has led to seriously impaired loan portfolios. Processing delays are endemic. Although nationalization of banking has been a long and deeply-held commitment of the majority party, the GOCR agreed with AID on policy changes which allowed private banks to resume a substantial role. Private banks' share in total bank loan assets surged from 3% in 1982 to about 20% at present. Their superior efficiency is reflected in the fact that, with only 20% of loan assets, the private banks are handling the majority of industrial project finance and about 85% of NTE finance. This competition is now motivating a serious effort to improve state bank efficiency; a major banking reform law is about to be passed as part of the SAL II negotiations.

Fiscal Reforms. Before and during the crisis, governmental budget deficits had risen to unsustainable levels. These deficits contributed to runaway inflation, and constricted private sector production by swelling government's claim on available credit. As the United States knows only too well, deficit control is a difficult political pill to swallow. But the GOCR has honored covenants with AID and the IMF in reducing its non-financial public sector deficit from 14.3% in 1981 to 0.3% in 1987, with a small surplus projected for 1988 (see Annex II).

Public sector deficits were aggravated by disastrous investments and operating losses in dozens of state-owned enterprises. Between 1979 and 1984, CODESA (the GOCR's holding company) had used its free access to Central Bank credit to invest over $100 million per year in new state companies. Subsequent experience has shown that these investments were so ill-conceived that most of their value should have been written off the day they were made.

In 1984, the GOCR honored its covenant with AID to cut off new CODESA investment. Since then, substantial progress has been made in eliminating these burdens on national resources. The pace of divestiture has been frustratingly slow, but compares favorably with what other developing countries have been able to achieve. Of CODESA's 42 companies, most have been privatized or liquidated, with consequent savings to the public treasury and bank credit. A large aluminum plant, for instance, after running huge losses, has been passed to a private Costa Rican group which expects to achieve more exports in its first year of operation than CODESA did in eight years. A major sugar mill started making profits for the first time in its history, immediately after being transferred from CODESA.

B. Spreading the Benefits of Growth

The macroeconomic results have been good. However, AID's clientele is not economies, but people. More precisely, "the principal purpose of United States bilateral development assistance is to help the poor majority of people in developing countries to participate in a process of equitable growth...." (Foreign Assistance Act). Decades of research and experience have made it clear beyond argument that one cannot automatically assume that macroeconomic growth will better the lot of the poor in all countries.[7] Recognizing this reality, the Kissinger Commission and the Central American Initiative included "spreading the benefits of growth" as a key strategic element.

Thus, in crafting a program for Costa Rica, AID could not, and did not, rely on any preconceived general assumption that a rising tide would necessarily lift all boats. Rather, the economy and society of Costa Rica had to be analyzed in country-specific terms.

In fact, Costa Rica is demonstrably superior to most developing countries in passing the benefits of growth to the poor majority. During the boom between 1961 and 1971, for instance, overall cash income grew by 58%, while income of the lowest half of the population grew by 80%, and income of the richest tenth grew by only 19%. During the same period, absolute poverty, measured by cash income, dropped from 51% to 20%.[8]

The pattern becomes even more striking when non-cash benefits from GOCR social programs (e.g. education and health care) are added to the picture. Every year, Costa Rica -- which has no army -- devotes 60-70% of its budget to social programs, a level unmatched by any other developing country in the world. Naturally, the benefits of this social spending are skewed toward the poor. In 1982, for example, GOCR social spending directed to the lowest 20% of the population was equivalent to 87% over and above the cash income of that group. (Social programs in Costa Rica, as anywhere else in the world, have their inefficiencies; yet it is hard to argue with their impressive results, reflected in the quality of life indicators cited on page 1 above.)

But social programs must be paid for. Especially after the collapse of Costa Rica's international credit, the only viable source for these funds is taxation of local private production and income. The tax burden (as a percentage of Costa Rican GDP) has grown during the eighties, and is relatively high for a developing country (see Annex II). And the proportional allocation of taxes to social programs is probably at its practical limit. Thus, social spending is tied to maintenance and growth of GDP. The analysis on p. 5 above suggests that, absent the package of ESF assistance and structural reform, social programs would have had to be reduced by as much as 24% below actual levels in 1988.

AID's conclusion is that, in this particular country, the most important issue for the poor majority is the recovery and growth of the private economy, which does a relatively good job of providing jobs and income to the lower half, and which is the sole source for maintaining the social programs which do so much for the quality of life of the poor. It is this analysis, and not some "trickle-down" ideology, which has led AID/Costa Rica to concentrate its resources so heavily on macro-economic, export, and private-sector issues.

Turning to the level of projects, AID's private sector NTE promotion activities have had substantial direct impact on the poor majority. Each year, Costa Rica must create about 28,000 new jobs to keep pace with labor force growth. During the last three years, more than a quarter of that annual requirement has been contributed by new direct[9] jobs created in companies attracted to Costa Rica by the AID-funded foreign investment promotion program or financed by AID NTE credit lines, and new jobs associated with AID shelter and agriculture programs. Most of these jobs go to persons from the lower half of the economy.

Despite the focus on private sector projects and growth, AID has also devoted substantial resources to more traditional activities which deal directly with lower-income groups, in order to cushion the impact of the crisis on these groups. Over 40% of AID's current project portfolio is devoted to health, housing, family planning, education, and integrated rural development in the impoverished and isolated Northern Zone -- see Annex III. Space does not permit much discussion of these activities, but the reader is urged to review Annex IV, which presents in abbreviated form a sample of the direct impacts of AID social projects on lower-income groups.

In social areas, just as in macroeconomic areas, AID recognizes that structural and institutional reform is more crucial than resource transfers in the long run. In the field of housing, for example, AID's most lasting contribution has been support for a second-tier mortgage bank, which should significantly improve the housing finance market.

C. Strengthening Democratic Institutions

Costa Rica is one of the most vibrant democracies in the developing world. As a result, AID has assumed a very limited role in assisting "democracy" initiatives. Our shared democratic traditions have been promoted by training potential leaders through the Central American Peace Scholarship program; an administration of justice project; support to institutions which provide regional models (e.g. a human rights institute); supporting a legislative information service; publishing books on democracy and civics; and promoting community organizations in concert with the Peace Corps and PVO's.

IV. Directions for the Future: 1989-1992

AID/Costa Rica's most recent Strategy Paper, approved in March of 1988, continues the directions described above, with certain adjustments of emphasis.

Export Promotion. Assuming the eventual success of the World Bank's SAL II program in reducing levels of protection for CACM-oriented industry, it would appear that Costa Rica has effected most of the necessary basic reforms in trade and export policy, with a consequent strong improvement in NTE's. But "trees do not grow to the sky": one can assume the first waves of new exports to be the easiest, and continuation of the present rate of growth will demand increased attention to a "second generation" of export-related issues.

Exports (and production generally) may be stifled unless Costa Rica quickly increases its electric generation capacity: AID expects to offer policy and project assistance in this area. Possible labor shortages in the country's central valley, as well as considerations of equity, will dictate increased efforts at bringing the disadvantaged outlying regions more fully into the process of export-led growth.

Public Sector Efficiency. Maximizing export growth will require improvements in certain sectors of government operations. A high priority for AID will be institutional reform of Costa Rica's fragmented, and sometimes ineffective, export promotion agencies. Customs and port operations need serious attention. The GOCR's recent success in reducing deficits was accomplished partly by deferring capital investments: thus, a pent-up demand for infrastructure investments is becoming a pressing concern.

Public sector efficiency has social as well as economic implications, since welfare indicators of the general population are so dependent on government social programs. Some of the social agencies have too much of their budget tied up in salaries; it should be possible to reduce public employment levels without hurting the quality of programs, even though such steps will be politically sensitive.

Natural Resources. Rapid depletion of forest resources not only raises environmental concerns, but also poses a clear and present danger to Costa Rica's balance of payments; so AID is cooperating with the GOCR on a major new initiative in natural resource management.

Financial Deepening. AID will continue its support for an expanded role for the more efficient private banks. But the success of this effort so far has created a political backlash. As a practical matter, the state-owned banks will continue to play a major role into the indefinite future. Thus, the World Bank is focussing on ways to help the public banking system improve its efficiency. The need for better financial services is particularly acute in rural areas. Over the coming years, AID expects to assist public and private rural financial institutions, not only in terms of providing more agile credit, but -- just as importantly -- in terms of improved deposit mobilization.

Funding Levels. Projections of Costa Rica's balance-of-payments position through 1992 are presented in Annex V. Gazing into this crystal ball is an inherently uncertain exercise: so for the sake of context, AID's estimates are matched against those of the IMF and the World Bank as well.

All the projections allow for levels of import growth which would be required for a 4-5% annual growth in GDP. Even after taking increased exports into account, the projections all conclude that there will remain a basic balance of payments gap, which must be financed by some combination of donor balance of payments support and debt relief (or payment arrears).

Progress on negotiating debt rescheduling and relief has been disappointingly slow. The Arias administration has taken an aggressive position in these negotiations, and has been unable in recent years to reach an agreement with the commercial creditors and the Paris Club (official bilateral creditors). It is difficult to predict the eventual outcome of these negotiations, other than to observe that it will have to involve some combination of (1) partial de facto forgiveness of the actual value of these obligations, and (2) a reasonable level of payment from Costa Rica (possibly higher than what it is presently paying), commensurate with its economic condition.

Even after debt relief, donor balance of payments assistance will be required for a few more years if the economy is to grow at the projected rate. AID presently plans declining levels of ESF balance of payments support, together with maintenance of present DA and PL 480 levels. (The 1989 ESF level shown below represents a Congressional earmark which was $20 million higher than AID's request.)

AID/Costa Rica Planning Levels ($000,000)

	1988	1989	1990	1991	1992
ESF	85	90	57	36	15
DA	12	12	12	12	12
PL 480	--	15	15	15	15
Total	97	117	84	53	42

The planned decline in AID balance of payments support reflects several factors. The success so far of stabilization and NTE growth reduces the need for balance of payments transfers. Reduced levels will provide a discipline which reinforces the motivation of the GOCR to continue with needed adjustments. And an increasing role should be played by other (non-AID) donors, notably the World Bank, the IMF, and perhaps Japan. The GOCR would probably prefer a more diversified base of support, and the policy reforms effected to date make Costa Rica an attractive candidate for some of these other donors.

The stabilization which has been achieved to date is still fragile. The delicate balance of payments position projected in Annex V is subject to several unpredictable factors, including terms of trade (e.g. coffee and oil prices), the economic health of Costa Rica's trading partners, debt renegotiation, and interest rates. Future developments may require revision of planned AID resource levels.

V. Conclusions

Three broad conclusions stand out from this review of AID's efforts in Costa Rica from 1982 to the present. (1) The package of balance of payments support combined with policy reforms and export programs has been successful in stabilizing the economy and putting it on the road to export-led growth. (2) The basic human needs of the poor majority have been protected and supported in this process. (3) Continued AID support, though at gradually declining levels, will be required to finish the job.

NOTES

1. Space limitations make it impossible to cite more than a few of the sources relied on in preparing this paper. The reader who is interested in more detailed documentation should contact the Costa Rica desk (LAC/CEN) in AID/Washington, or the USAID Mission in Costa Rica.

2. Costa Rica's public sector foreign debt for selected years:

	Debt ($ billion)	Ratio: Debt/GDP	Ratio: Debt Service/Exports
1978	1.1	29.9 %	29.0 %
1981	2.4	65.1 %	51.7 %
1987 (est.)	3.9	102.0 %	54.0 %

It should be noted (a) that the Debt Service/Export ratios for all years exceed the 25% rule-of-thumb maximum for creditworthiness, and (b) the above figures do not include the effects of rescheduling, relief, or growth of arrears.

3. In a March, 1987 "Full Funding Report", the administration proposed to extend the execution of the CAI for three years through 1992, and to add $0.5 billion to the total of appropriated funds for the effort.

4. An AID-financed program for attracting foreign NTE investment to Costa Rica has had excellent results. (Most of the investments reported below resulted from "cold calls" by this program's overseas offices.)

	NTE Investments Committed In			
	1986	1987	1988 (-9/30)	Total
Total Investment ($000,000)	18	29	71	118
Currently Projected Direct Jobs at Full Production	3,925	4,768	8,116	16,809
Actual Direct Jobs to Date	3,100	3,194	3,037	9,331
Projected Annual Exports at Full Production ($000,000)	21	22	58	101

Promotional costs -- below $500 per job created so far -- have been a small fraction of the costs typical in similar programs in other countries.

5. Details of the model and calculations summarized in this table are included in an October 5, 1988 paper by USAID/CR/EAO entitled "The Benefits of ESF Assistance", which is available from the Costa Rica desk in AID/W (LAC/CEN) or from USAID/Costa Rica.

6. The "Private Capital plus Errors and Omissions" account showed an outflow of $181 million in 1980, which has been reversed to an inflow of $102 million (est.) in 1987.

7. E.g. Gary Fields, Poverty, Inequality, and Development, Cambridge U. Press: 1980.

8. Cespedes and Jimenez, Evolución de la Pobreza en Costa Rica, Centroamerica: 1987, passim; and Fields, op. cit., pp. 181-239. During crisis, poverty increased, and income distribution may have deteriorated. But public policy and social programs succeeded in cushioning the impact of the downturn on general welfare indicators of the population. Fields, Employment and Economic Growth in Costa Rica, USAID/CR: 1985; Thery et al., Costa Rica: Social Equity and Crisis, AID: 1988.

9. Indirect job creation is more difficult to measure than direct job creation, but experience in the Mexican border zones suggests that each new direct export job leads to two new indirect jobs.

ANNEX II

COSTA RICA: SELECTED ECONOMIC INDICATORS, 1977-1987

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
1. GDP in Constant Prices 1977=100	100	106	112	112	110	102	105	113	114	120	126
2. GDP Per Capita in Constant Prices 1977=100	100	104	106	104	99	89	89	94	92	94	96
3. Consumption in Constant Prices 1977=100	100	108	111	110	101	92	96	103	106	113	119
4. Consumption Per Capita in Constant Prices 1977=100	100	105	105	101	91	81	82	85	86	88	89
5. Real Average Wages (1977=100)	100	110	113	116	101	79	92	97	106	110	108
Public Sector	100	111	112	118	98	73	85	87	97	99	98
Private Sector	100	109	113	111	102	84	97	105	113	118	117
6. Prices (Percent Charge)											
Consumer Prices (Dec. to Dec.)	5.2	8.1	13.2	17.8	65.1	81.8	10.7	17.3	10.9	15.4	16.4
Wholesale Prices (Dec. to Dec.)	7.4	8.9	23.9	19.3	117.2	79.1	5.9	12.2	7.6	11.9	10.9
7. Unemployment (Percent)	4.6	4.6	4.9	5.9	8.7	9.4	9.0	7.8	6.8	6.2	5.6
8. NTE to Non-CACM Markets (Millions of US $)	100.7	110.0	138.0	154.8	173.4	159.2	141.6	201.3	216.4	298.0	390.0
9. Public Sector Deficit (As percent of GDP)(1)	6.6	8.8	13.5	11.2	14.3	14.6	8.1	6.6	7.2	5.5	3.3
Non Financial Public Sector	6.6	8.8	13.5	11.2	14.3	9.0	3.1	1.9	1.9	1.7	0.3
10. Tax burden (As percent of GDP)	20.5	21.2	20.7	20.4	22.1	23.0	25.1	25.2	26.1	24.9	26.1
11. Exchange rate (Colons per US $)	8.60	8.60	8.60	14.23	36.07	40.50	43.65	48.00	53.95	59.25	69.75

(1) From 1978 to 1981 represents the deficit of the non-financial Sector. From 1982 on includes the deficit of the non-financial Sector and the Central Bank's net operating losses.

Annex III

AID/Costa Rica: Current Project Portfolio,
By Action Plan Objective
($000,000)

Objective	DA & HG	ESF	PL 480	TOTAL
1. Strengthen Agriculture	--	5.1 (1.8%)	12.7 (20.6%)	17.9 (3.2%)
2. Strengthen Private Sector	11.8 (6.0%)	32.4 (11.0%)	4.0 (6.5%)	48.1 (8.7%)
3. Stabilize Financ. Structures	1.2 (0.6%)	3.2 (1.1%)	--	4.4 (0.8%)
4. Increase GDP	--	0.6 (0.2%)	--	0.6 (0.1%)
5. Promote Exports	67.7 (34.6%)	78.4 (26.7%)	2.4 (4.0%)	148.5 (27.0%)
6. Natural Resources	--	0.2 (0.1%)	0.7 (1.1%)	0.8 (0.1%)
7. Infrastructure	--	12,2 (4.2%)	25.7 (41.7%)	37.9 (6.9%)
8. Family Planning	8.5 (4.4%)	0.3 (0.1%)	--	8.8 (1.6%)
9. Health	12.6 (6.4%)	0.2 (0.1%)	0.1 (0.2%)	12.9 (2.3%)
11. Housing	0.9 (0.5%)	47.4 (16.1%)	2.0 (3.2%)	50.2 (9.1%)
Housing Guarantee Program	31.4 (16.1%)	--	--	31.4 (5.7%)
12. Education	0.2 (0.1%)	100.0 (34.0%)	2.0 (3.2%)	102.2 (18.6%)
14. Democracy	41.4 (21.2%)	4.7 (1.6%)	0.9 (1.4%)	47.0 (8.5%)
15A. Regional Development (Northern Zone)	19.9 (10.2%)	--	8.9 (14.4%)	28.7 (5.2%)
16. Other: Prog. Support/O.E.	--	9.1 (3.1%)	2.4 (3.8%)	11.5 (2.1%)
TOTAL	195.6 (100%)	293.8 (100%)	61.6 (100%)	550.9 (100%)

Notes:
-- DA (Development Assistance) and HG (Housing Guarantee) amounts are in dollars.
-- ESF (Economic Support Funds) and PL 480 (Food For Peace) amounts are in dollar equivalents.
-- This table does <u>not</u> include (1) completed projects, (2) ESF dollar ba[illegible]s transfers, and (3) local currency demonitization transfers.

ANNEX IV: IMPACT OF SELECTED PROJECTS ON LOW-INCOME GROUPS (1984-1988)

Title	Amount (Millions)	Description	Outputs
Housing	106.1	Low and moderate cost housing construction, frame and infrastructure.	Housing for 45,500 families.
Parrita Coop. Development	$ 6.0	Loan and technical assistance to a 1600 ha. finance cooperative farm.	110 families have land tenure and increased income.
Federation of Coffee Coops.	21.0	Credit for coffee renovation and diversification into other crops.	7,000 families with increased incomes.
Northern Zone Infrastructure	21.5	Integrated Rural Development.	12,000 families directly benefitted.
Campesino Union Strengthening	1.75	Marketing services	3,000 families have higher incomes.
CAAP and NETS	3.5	Promotion of non-traditional products	2,000 new jobs.
Ag. Settlement & Productivity	14.0	Land tenure and agricultural extension	4,800 families with land titles and TA.
Formal Credit through Coops.	6.1	Loan and TA to Bancoop, TA to Fedecredito.	30,000 persons use this bank and network of credit unions.
IDB & other Ag. Productivity	5.3	Agricultural Extension Services.	125,000 families.
Irrigation Projects	5.5	Wells and canals in Guanacaste and San Carlos.	3,050 farm families.
IDB Municipal Infrastructure	1.5	Small town public buildings.	15000 families use the project buildings.
South Zone Roads and Drainage	13.21	Access roads in the Southern Pacific cantons.	8,000 families have better access roads.
CAPS Scholarship Program	16.96	Scholarship program for study in the U.S.	1,214 trainees.
Elementary Textbooks	2.0	Textbooks for primary school students.	1,800,000 textbooks and 135,000 teachers's guide printed
PVO-ACOROE	8.0	Support to PVO's for projects to small and Micro-enterprise.	6,500 microenterprise loans.
Contraceptive Social Marketing	1.2	Subsidized sales of condoms.	17,000 couples served.
School Refurbishment	0.4	Renovation of rural classrooms.	620 classrooms renovated.
Special Development Fund	1.2	Financing of rural community improvements.	359 projects completed.
PIE	8.5	Foreign investment promotion.	16,000 direct jobs(32,000 indirect jobs?)

Summary Balance of Payments: Costa Rica, 1984-1988 and Projections for 1988-1992
(millions of U.S. dollars)

Year	1984	1985	1986	1987	1988	Annual Average 1989-1992		
						AID	IMF	IBRD
Commodity Exports, FOB	997.5	939.0	1,085.8	1,113.6	1,177.0	1,425.9	1,412.1	n.p.
—Traditional	597.3	591.0	689.6	641.8	636.1	748.6	n.p.	n.p.
—Nontraditional	400.2	348.0	396.2	471.8	540.9	677.3	n.p.	n.p.
——Exports to CACM	191.0	143.5	98.9	98.0	101.0	114.4	n.p.	n.p.
——Exports to Panama	36.3	28.9	41.7	37.0	39.9	40.0	n.p.	n.p.
——Exports to R. of W.	170.0	175.6	255.6	336.8	400.0	522.8	n.p.	n.p.
Commodity Imports, CIF	-1,102.2	-1,110.9	-1,163.2	-1,385.0	-1,310.0	-1,510.4	-1,556.7	n.p.
Balance of Trade	-104.7	-172.0	-77.4	-271.4	-133.0	-84.6	-144.6	n.p.
Interest & Profit Remit.	-313.6	-282.2	-280.7	-285.3	-281.8	-313.6	-312.3*	-324.7
Nonfactor Services	122.5	105.5	136.6	133.6	144.1	161.1	163.1	n.p.
Transfers	45.9	58.8	69.4	67.7	73.0	70.0	70.0*	n.p.
Bal. on Current Account	-249.9	-289.9	-152.1	-355.4	-197.0	-167.0	-232.5	-247.5
Private Capital, E.& O.	11.9	98.7	49.3	102.3	133.7	149.5	118.8	71.8
Project loans	165.8	185.3	135.7	79.6	117.5	127.5	136.7	129.0*
Official Amortization	-339.0	-357.6	-379.6	-439.9	-449.0	-463.3	-333.8	-397.9
Basic Balance	-411.2	-363.5	-346.7	-613.4	-394.8	-353.1	-310.8	-444.6
Change in Payment Arrears (a)	175.3	-169.5	135.7	373.8	-554.0	0	0	0
Official Debt Relief	153.7	357.8	145.9	42.9	785.5	253.0	225.7	187.0
Financial Gap (-sign)	-82.2	-175.2	-65.1	-196.7	-163.3	-98.5	-85.1	-256.7
(B/P Support Flows)	(145.9)	(305.0)	(84.1)	(57.8)	(210.0)	(88.4)	(108.4)	(195.0)
—ESF Loan & Grant	130.0	160.0	80.6	120.0	125.0	55.0	63.0	115.0
—Revolver Credit Facility	49.9	75.0	—	—	—	—	—	—
—IMF Net Inflow	-34.0	30.0	-36.0	-62.2	-15.0	8.4	-22.1	n.p.
—IBRD SALs	—	40.0	39.5	—	100.0	25.0	67.5	80.0*
Over-all balance (b)	63.7	129.8	19.0	-138.9	46.7	-10.1	23.3	-61.7

Note: (a) A change in payment arrears with a positive sign is an accumulation of arrears and with a negative sign it is a net disaccumulation (repayment). (b) The over-all balance with a positive sign is an increase in the official net international reserve position, and with a negative sign it is a decrease. (*) Indicates an attributed allocation but with total conforming to the source of the projection.

File with Transition Paper

MEMORANDUM

RECEIVED
- 6 OCT. 1988
PRD

October 5, 1988

TO: OPS: RRosenberg and MEDL

FROM: EAO:RAdler

SUBJECT: The Benefits of ESF Assistance

1. A few days ago I promised you that I would attempt to quantify the impact of the ESF assistance of recent years on the Costa Rican economy. One of the major handicaps in such a quantification of benefits is that AID does not undertake a project-type analysis as the justification for ESF assistance. The PAAD document includes only an indication that there is some kind of balance of payments gap that can be filled with external assistance which is nonprojectized and usually fast disbursing. The presentational story is that there is a situation in country _x_ typified by accelerating inflation, a too-large fiscal deficit, a multiple exchange rate system, non-market interest rates, and that the government of country _x_ needs balance of payments assistance so that imports can come in at a reasonable, if somewhat reduced quantity, and that the economic team of country _x_ will undertake to improve economic policies. The analysis is usually very short-term typically with projected economic aggregates for the ensuing year and mostly illustrative. With the newer terminology of structural adjustment the economists dig deeper to find the root causes of the problem, and policy adjustment work is extended beyond the usual one to two years to four or five years. Another way for economists to conceptualize balance of payments assistance is to do it the same way that we conceptualize project assistance. That is, there is a stream of costs, namely, the balance of payments assistance monies, and a stream of benefits, namely, the increase in export earnings, and along with that some other benefits, such as, a higher Gross Domestic Product, a higher level of government services, higher employment, and higher wages. Importantly, the balance of payments assistance monies can flow throughout a series of years and the benefits are derived not only from the direct impact of a higher level of imports facilitated by such assistance, but also from the indirect impact of a higher level of imports facilitated by the impacts of policy changes undertaken in the country. In a small-open economy changes in imports and exports usually have strong impacts upon GDP and employment.

2. Turning to the specific case of Costa Rica in the 1980s, the country received balance of payments assistance in the form of ESF disbursements, net inflows from the IMF, and disbursement of the World Banks SAL I. There was also assistance in the form of debt relief and rescheduling, so that foreign exchange outflows to creditors were lower than originally scheduled. Inasmuch as this assistance raises the question concerning the validity of the intially planned debt service, I judge that such relief was not assistance, but merely a convenience in maintaining the value of the obligation. By 1983 Costa Rica was also experiencing an increase in its nontraditional exports to markets outside of Central

America, and a portion of these new foreign exchange earnings were also available to pay for imports. These flows are as follows (in millions of U.S. dollars):

Year	ESF	IMF	IBRD	Total	NTExport over 1983	Drawback	Total (Adjusted)
1982	20	-10	--	10	n.a.	n.a.	--
1983	156	99	--	255	0	10	10
1984	130	-34	--	96	76.2	26.1	71.8
1985	160	30	40	230	80.9	35.0	74.6
1986	80.6	-36	39.5	84.1	160.9	37.3	133.8
1987	120	-62	--	58	242.1	40.0	185.3
1988	125	-15		110	305.3	47.5	230.7

The data on new export earnings includes in the total column only 60 percent of the value of the increase in nontraditional exports from 1983 (and the 1983 value was $ 94.7 million) and the full amount of the local value-added of the drawback exports (because that is the amount remitted to Costa Rica to pay local costs).

3. If the balance of payments assistance had not been made available and if Costa Rican policymakers had not made policy changes favorable to exporting to new markets, then we expect that GDP would have declined more and been lower for all years following the economic crisis of 1980-1982. Insofar as exports are concerned, one could construct a multiplier based upon historical experience to judge the impact of new net export earnings upon GDP, and such a multiplier have a value between 2.5 and 3.0. However, one may also judge that such new net export earnings would also increase GDP because they pay for increased imports. Balance of payments assistance also has a direct benefit on imports because if other B/P transactions remain the same, the impact of such assistance is to increase imports. In the case of Costa Rica data on imports of goods and GDP (in 1986 constant prices) indicates that the ratio of imports to GDP amounted to 49.4 % in 1980, but it dropped to 36.6 % in 1981 and during the period 1982-1988 this ratio ranged from 26.0 % to 29.2 % with an average of 26.5 %. This behavior accords with exchange rate overvaluation in 1980 and to the subsequent depreciation of the Colon. It appears reasonable to assume that imports were an important constraint to GDP and that each $ 1.00 of additional imports permitted an additional $ 3.78 of GDP. Applying this assumption to the actual behavior of Costa Rica's Gross Domestic Product in the 1980s implies that GDP would have been lower in the absence of balance of payments assistance and the growth of nontraditional exports. The following indicate the performance of actual GDP, GDP without the combined impact of B/P assistance/export growth, and changes in the relative importance of B/P assistance and export growth.

	Actual GDP: 1980 equals 100	%	GDP without assistance & export growth	%	Importance of (a) B/P Assistance	(b) Export Growth	Total
1980	100.00		100.00		--	--	--
1981	97.74	(-2.3)	97.74	(-2.3)	--	--	--
1982	90.62	(-7.3)	90.09	(-7.8)	100		100
1983	93.21	(2.9)	78.84	(-12.5)	93	7	100
1984	100.69	(8.0)	76.67	(-2.8)	71	29	100
1985	101.41	(0.7)	79.09	(3.2)	69	31	100
1986	106.95	(5.5)	80.34	(1.6)	54	46	100
1987	112.10	(4.8)	89.17	(11.0)	28	72	100
1988	115.54	(3.1)	88.30	(-1.0)	27	73	100

4. In regard to conclusions, this model indicates that GDP would have fallen over a longer period of time and that recovery would not have been as robust and as continuous as what did, in fact, take place. In 1988, GDP would have been 23.6 percent lower than the actual. This suggests that the public sector finances would have been a major problem area, and it is improbable that social services could have been maintained. Even with the economic growth that did take place, general government tax revenues increased from 20 % of GDP in 1976 to 26 % of GDP in 1987. The sum of general government current and capital expenditures, which is a good test of expenditures in the domestic economy (excluding amortization of debt) amounted to 28.5 % of GDP in 1980-1981 and 26.9 % of GDP in 1986-1987, and due to the increase in GDP general government expenditures increased by about 2.0 percent from 1980 to 1987. Even with this increase the deficit of the general government declined from 7.3 % of GDP in 1980-1981 to 1.5 % of GDP in 1986-1987.

5. Turning to economic theory, it should be noted that the usual relationship between GDP and imports is specified as a demand function. That is, imports grow because GDP grows, and this function is usually specified as a income elasticity of demand for imports. In the case of Costa Rica, economists usually use hypothetical specifications at 0.9, 1.0, and 1.1 in order to see what impact growth will have on imports. Our specification is similar to a 1.0 income elasticity of demand, but the emphasis is upon imports as part of the aggregate production function for the economy. That is, for a given exchange rate, given price relationships for final goods and factor imputs, an economywide input-output table will give a unique relationship for imports as a function of each unit of final demand. Obviously, if the supply of foreign exchange and external assistance are inadequate to finance the required level of imports, then the exchange rate and other price relationships will have to change. The shortfall will be covered by real devaluation and a decline in the real remuneration of labor and capital and a decline in real aggregate demand. A consultant import supply multiplier indicates that the decline in GDP will be proportional to the decline in imports.