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Lessons from Costa Rica

Eduardo Lizano

INTERNATIONAL CENTER FOR ECONOMIC GROWTH

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PREFACE

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

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

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

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

Panama City, Panama
January 1991

ABOUT THE AUTHOR

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

EDUARDO LIZANO

Economic Policy Making

Lessons from Costa Rica

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

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

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

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

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

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

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

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

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

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

The Assumptions

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

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

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

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

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

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

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

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

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

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

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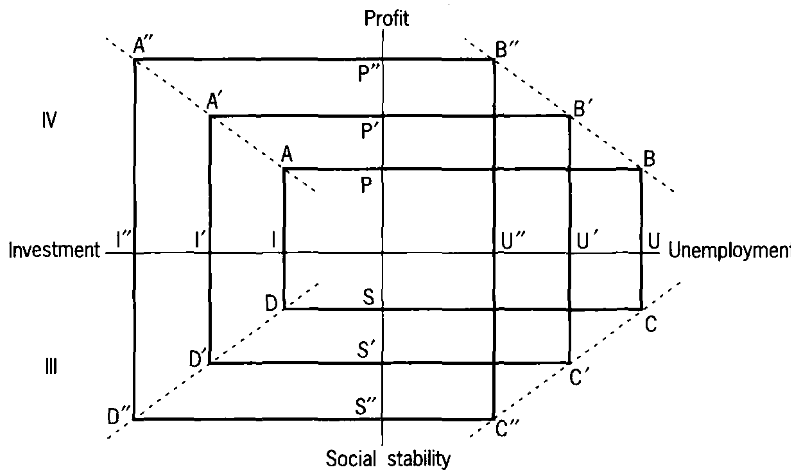
1. This point was clearly recognized by Alfred Marshall (1887, 216–17): "In the ordinary course of things the first benefit of an improvement in the demand for their wares goes to the employers; but they are likely to want to increase their output while prices are high, and make high profits while they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

Figure 1 Real Wages and Profits



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

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

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

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

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

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

The Objectives

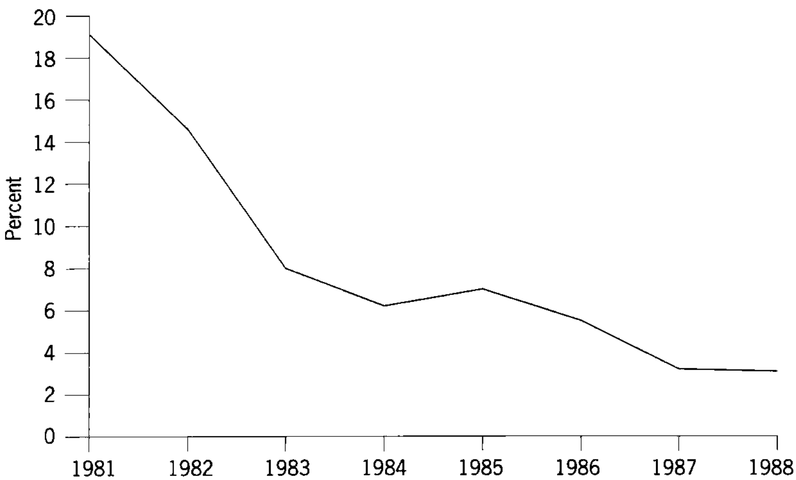
Given the problems described above and our three assumptions, we undertook to set concrete goals and specific objectives for economic policy. We decided to set four essential objectives and attempted to keep them as clear and simple as possible. One targeted public finances and attempted to reduce the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

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

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

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

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

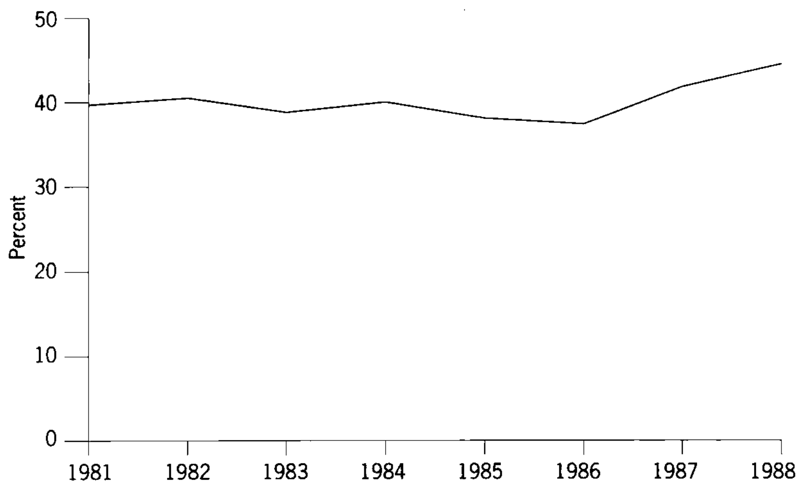


NOTE: Deficit includes the non-financial public sector plus the Central Bank of Costa Rica, in accordance with IMF standards.
SOURCE: Central Bank of Costa Rica, *Annual Report*, various years.

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

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

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



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

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

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

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