

The Costa Rican Solution

An Innovative Approach to Export Promotion

By John C. Edmunds and William Renforth

After years of debate and halfway measures, the Costa Rican government passed a law on 2 March 1984 which is a major departure from its previous trade policy. This law dramatically lowers the taxes on companies engaged in exporting, and includes a strong fiscal incentive to launch export ventures. Such a law may seem commonplace, but given its magnitude and the current business environment in Costa Rica, it may be the catalyst for a new export-oriented economic policy. A major shift toward export emphasis and open trade has been in the air for some time, and now it appears that the country has taken a major step on a new path.

Many Caribbean countries have tried to encourage export activity as an engine of domestic economic growth, with varying degrees of success. What makes the Costa Rican case interesting is that its leaders are as concerned with preserving the distribution of income as they are with reviving the economy. Costa Rica's distribution of income is worth preserving; it is notably egalitarian, an aberration in the region. This fact deterred until now an aggressive move toward export promotion because leaders worried that while producing growth, export substitution would also polarize the income distribution. To their distress, this polarization was occurring regardless of the country's export policy, in a context of economic decline during 1980-83. It appears now that they have adopted export promotion, knowing that it may not arrest polarization, but needing to revive the economy by whatever means available.

John C. Edmunds teaches at the Instituto Centroamericano de Administración de Empresas (INCAE) in San José, Costa Rica. William Renforth teaches in the College of Business Administration at Florida International University.



President Luis Alberto Monge of Costa Rica (right) with Miami Mayor Maurice Ferre, 1983.

Instability

From 1960 to 1979, the Costa Rican economy grew rapidly through a policy of import substitution, implemented in conjunction with its membership in the Central American Common Market (CACM). Rather abruptly, this policy ceased working in 1980, as political and monetary instability rocked the region. Costa Rican shipments to CACM trading partners fell 55.7 percent between 1980 and 1982, and evidence from market participants shows a continuation of this alarming downtrend. Worse still, this decline in exports to the CACM came at the same time as a severe downturn in traditional primary product export revenues. In world markets, coffee, sugar, and beef prices all performed poorly.

As this decline in export revenues was going on, the country was reeling under a foreign debt of \$4,500 million, equivalent to approximately six times its annual export revenues or twice its GNP. The country's access to international credit was frozen from mid-1980 onward, and government negotiators have been busy since then trying to achieve repayment terms consistent with the economy's debt capacity. There has been some success in this endeavor,

but a return to the growth rates previously achieved clearly will require a recovery in export revenues or long-term autonomous capital inflows.

At the end of 1980, facing a balance-of-payments crisis, the government floated the currency, hoping that the *colón* would find a new equilibrium after a devaluation on the order of 30-50 percent. Floating or outright devaluation is the orthodox neoclassical economic policy for a country with balance-of-payments difficulties. When Costa Rica tried this policy, it backfired in spectacular fashion. The exchange rate, steady at 8.52/\$1 for the preceding 10 years, reached 65/\$1 in 19 months. Several factors contributed to this astonishing

escalation. Among them was fear that the political turbulence in the region would spill over into Costa Rica and lead to radical change. Another was fear that the Costa Rican government, in its efforts to promote economic recovery, would resort to inflationary policies. A third factor was that devaluation itself spurred inflation. The import content of GNP was between 40 and 50 percent in the late seventies, so when import prices rose, domestic prices followed soon afterwards. This created an inflationary spiral, and fear gave the spiral added impetus: when the currency floated, people who earlier had been unable to buy dollars decided to buy before the price of dollars went any higher. And as the exchange rate got worse, domestic prices started to rise sharply, confirming people's fears that inflation would race out of control. This incentive to convert assets into dollars exerted further pressure on the exchange rate.

The power of expectation was demonstrated. Consumer prices increased 35 percent in 1981, the first year after the float was initiated, and then rose 85 percent in 1982. During this time the number of *colones* required to buy a dollar increased approx-

imately 600 percent. The effective devaluation for exporters of manufactured goods was on the order of 100 percent; that is, by the beginning of 1982 exporters could charge half as much in dollars and earn the same profit margins in local currency as they would have in 1980. This maxi-devaluation, which was expected to spur a wave of nontraditional exports, in fact spurred very few. In 1981 there was a slight improvement in nontraditional exports to markets outside Central America, but this improvement evaporated in 1982, a year in which exports in all categories continued to fall.

No improvement in exports materialized for several reasons. First, investors within the country were more concerned with trying to get their money out than with trying to take advantage of the opportunities presented. Exporting a wide variety of products was profitable, according to studies done by Arthur D. Little, Inc., but very few people cared. Investors outside the country were wary, and few put money into export projects. They were in no hurry because many observers both inside and outside the country thought that things would keep getting worse.

The Monge Policy

The sharply worsening trade performance

affected all economic sectors. GNP fell a staggering 9.1 percent in real terms in 1982. What was worse, all economic strata did not suffer equal income losses. The middle class, and the lower middle class in particular, lost most heavily. Costa Rica's noted political stability and admirably egalitarian income distribution were jeopardized. Clearly something major and fundamental had to be done. The economic model that had worked so well in the sixties and seventies had run its course. The economy would have to be restructured, and a new model would have to be put in place.

Surprisingly, although most Costa Rican decisionmakers recognized what had to be done, change proceeded very slowly. The transition from one economic paradigm to another is never smooth, but in Costa Rica's case change was especially slow, and fraught with agonizing but fruitless debate.

The Monge government, which took office in May 1982, immediately pursued a policy of monetary restriction. The principal policy objective was to restore confidence in the economy and to arrest the currency's decline. Costa Rica in 1982 was a warehouse's paradise: merchants could buy goods on credit, paying 31 percent interest, while the general price level was rising at an annual rate of 85 percent. This chaotic set of conditions obviously could

not be allowed to persist; incentives were so distorted that most productive activity was unprofitable. A few merchants were doing extraordinarily well, but most of the country was in a profound slump.

To break the inflationary psychology and the mania for buying dollars, the Monge administration pursued a policy that had worked once in the past to restore monetary stability after the 1948 revolution. The government intentionally revalued the *colón*. The legally recognized parallel market exchange rate was 65/\$1 in private moneychangers' shops at the beginning of August 1982. At the same time the interbank exchange rate was 38/\$1. For certain transactions the central bank gave dollars at the official rate 20/\$1. This multiple exchange rate had been in effect since the currency was floated, but under the terms of an agreement with the IMF, the parallel and interbank rates were to be unified.

The Monge regime's strategy for unifying the two exchange rates was unexpected. Most observers thought that the government would supply dollars to the parallel market to keep that rate steady, and then gradually raise the interbank rate until the two were equal. This would have led to a single exchange rate in the vicinity of 65/\$1, and with the rate at that level exporting would have been very profitable. With

Who speaks for the Caribbean?

Caribbean Review does!



Please send a subscription for the period indicated.

Mail to: Caribbean Review
Florida International University
Miami, Florida 33199



My check for \$_____ is enclosed.

Please charge to my
MasterCard Visa

Name _____

Address _____

City _____

Country _____ Zip _____

Account No. _____

Expiration Date _____

Signature _____

	1 Year	2 Years	3 Years
For subscribers in the U.S., P.R., & U.S.V.I.	<input type="checkbox"/> \$12.00	<input type="checkbox"/> \$20.00	<input type="checkbox"/> \$25.00
For subscribers in the Caribbean, L.A., & Canada	<input type="checkbox"/> \$18.00	<input type="checkbox"/> \$32.00	<input type="checkbox"/> \$43.00
For subscribers in other destinations	<input type="checkbox"/> \$24.00	<input type="checkbox"/> \$44.00	<input type="checkbox"/> \$61.00

Subscriptions to the Caribbean, Latin America, Canada, and other foreign destinations will automatically be shipped by AO-Air Mail.

the currency once again pegged, and with investment moving into export industries, the country would perhaps have experienced an export-led recovery.

The alternative of uniting the two exchange rates at the 65/\$1 level, however, had a number of drawbacks. First, it ignored threats to political stability. Clearly it would have further enriched the merchants who gambled on hyperinflation and currency decline. Also, it would have generated more inflationary pressure because the weighted average exchange rate would have continued its upward movement. Worse, it would have produced further shifts in the distribution of income among social strata. The last point was an especially important consideration for Monge's party, *Liberación*, which represents middle-income groups and organized labor. The party viewed exchange rate policy first as a means of altering or preserving the distribution of income. An export-led recovery was an appealing prospect to the country's commercial groups and creditors; but the argument that exports would rise lacked credibility. Exports had not risen in the first year-and-a-half following the maxi-devaluation. It was hard to convince Monge's advisers that intentionally undervaluing the exchange rate for a few more months would suddenly lead to an export boom. There was skepticism that such a plan would work, and at the same time they knew that its initial impact would be to hurt their constituency further.

Consequently the Monge regime unified the two exchange rates by pushing the parallel rate down toward the interbank rate. To accomplish this, the monetary authorities first outlawed private money changing. To gain more direct control over the parallel rate, all parallel transactions had to be carried out through commercial banks from the second half of August 1982 on. The Central Bank then began supplying dollars to the parallel market. By October 1982 the parallel rate was below 60/\$1, and by the end of 1982 it was below 50/\$1. By the third quarter of 1983 the government had unified the two exchange rates at 43/\$1 and pegged them both at that rate. This was a remarkable accomplishment because many observers felt in mid-1982 that the parallel rate would reach 100/\$1 by the end of the year. Such a currency collapse would have been consistent with what was happening elsewhere, in Mexico for example.

Surprisingly Monge's policy worked, although no economist with firmly-held neo-classical convictions would have thought so. The administration placed its bets well. The middle class continued to suffer, but at a less severe pace. Inflation slowed to an annual rate of 22 percent. Exports stagnated, but they could hardly have been expected to rise in a year of worldwide recession. Foreign bankers waited for better

times, the only thing they could do.

Weak Recovery

The Costa Rican economy continued to decline in the first half of 1983, but not so steeply as in 1982. Then in the second half of 1983 it staged a modest rise, with GNP increasing 0.8 percent in real terms. Consumer prices rose at an annual rate of only 6.25 percent from July 1983 to March 1984. This is one of the most remarkable inflation turnarounds in the region's history.

The economy has been in recovery during 1984, with forecasts suggesting a 2 percent growth in real GNP for the year. The actual figure may be somewhat higher, because private capital is now flowing in. Some investors have apparently come to believe that the Monge administration's exchange policy is sustainable and so have stopped hoping for further speculative gains. In addition, high real rates of interest can be earned on *colón* deposits. *Colón*-denominated CDs are now paying 21 percent, and with consumer prices rising only 6.25 percent, this gives a real interest rate high enough to attract flight capital back to the country.

For the future, the limiting factors are foreign exchange and economic structure. The country is now in the "easy" phase of its recovery. Recovery can proceed for a time without coming up against any capacity constraints. Many activities can recover to their 1979 levels. The problem is external limitation. There is no prospect of having enough foreign exchange to sustain economic growth with the current economic structure. The economy as it is currently constituted consumes more foreign exchange than it generates. From 1960 to 1979 this fact did not restrict growth, because the country was able to attract foreign investment or foreign loans sufficient to finance current account deficits. In the future, however, Costa Rica will have to generate more foreign exchange than it consumes. The country will have to make some payments on its foreign debt regardless of how successful it is in renegotiating and refinancing it. This fact, which was obvious in 1980 if not earlier, is what makes a major economic restructuring necessary.

Restructuring the Economy

Shortly after moving to restore confidence in the currency, economic policymakers began to address the issue of structural change. They knew that exports had to increase, and they had already seen that something more than devaluation would be required to accomplish this. This first prerequisite, a worldwide economic recovery, began with the strong US upturn commencing in January 1983. This upturn, however, had no impact on Costa Rica that year. Exports were below the depressed

Continued on page 45



NUEVA SOCIEDAD

MARZO/ABRIL 1985

Nº 76

Director: Alberto Koschuetzke

Jefe de Redacción: Daniel González V.

ANÁLISIS DE COYUNTURA: Nueva Voz: Guatemala: ¿Volverán los Militares a sus Cuarteles?; D.F. Maza Zavala: La Difícil Austeridad.

ENTREVISTA: Diálogo con Leopoldo Zea. La Juventud Latinoamericana: Crear lo que Nunca Han Tenido.

TEMA CENTRAL: JUVENTUD LATINOAMERICANA: ¿UNA FICCIÓN? Juan Carlos Tedesco: 5.380.000 Preguntas al Futuro. La Educación Superior en América Latina: Felipe Carrera Damas: Jóvenes y Sexo; Mario Marcel: La Generación Pendiente; Miguel Bonasso: De los "Desaparecidos" a los "Chicos de la Guerra"; Gloria Ardaya: Mujer Joven: Discriminación y Participación; Edgar Montiel: Conformismo y Rebelión; Ana María Foxley: Marginados entre Marginados. Los Jóvenes Artistas: Ricardo Solari: Entre la Ilusión y la Desconfianza; Claudio Ferrín: Lugares Comunes y Ópticas Erradas. Políticas Estatales para la Juventud; Friedrich Welsch - Germán Campos: ¿Juventud = Problema? Una Definición de Juventud a Partir de Ella Misma; Mario Toer: ¿En Búsqueda de un Nuevo Perfil? Los Movimientos Estudiantiles en el Cono Sur.

POSICIONES: Nuestra Conducta Partidaria y la Gestión del Gobierno de la UDP. Una Evaluación Crítica y Auto-crítica del MIR Boliviano.

POLÍTICA — ECONOMÍA — CULTURA: Andrés Serbin: El Caribe Oriental; Las Secuelas de Granada; Roberto Díaz Castillo: Rabinal Achi, Macho Ratón, Mambo. . . El Hecho Folklórico Danzario; Alcides Hernández: La Reaganomics para Honduras; Roberto López: Exportaciones Tradicionales y Crisis Centroamericana; Nils Castro - Oyden Ortega: Nuevas Causas de Conflicto. El Canal de Panamá a Cinco Años del Tratado.

NOTICIAS — INFORMES — RECENSIONES

SUSCRIPCIONES (Incluido flete aéreo)	ANUAL (6 núms.)	BIENAL (12 núms.)
América Latina	US\$ 20	US\$ 35
Resto del Mundo	US\$ 30	US\$ 50
Venezuela	Bs. 150	Bs. 250

PAGOS: Cheque en dólares a nombre de NUEVA SOCIEDAD.
Dirección: Apartado 61.712-Chacao, Caracas 1060-A, Venezuela.
Rogamos no efectuar transferencias bancarias para cancelar suscripciones.