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CONTENTS

Crisis, adjustment policies and agriculture. <i>Luis López Cordovez.</i>	7
Agricultural development and macroeconomic balance in Latin America: An overview of some basic policy issues. <i>Richard L. Ground.</i>	29
The rural sector in the socio-economic context of Brazil. <i>Raúl Brignol Mendes.</i>	39
Agricultural planning in the countries of the Caribbean Community. <i>Eduardo Valenzuela.</i>	61
Agricultural sector policy and macro-economic planning. <i>Trevor Harker.</i>	69
Argentina: Crisis, adjustment policies and agricultural development, 1980-1985. <i>Luis R. Cuccia and Fernando H. Navajas.</i>	77
The external crisis, adjustment policies and agricultural development in Brazil. <i>Fernando Homem de Melo.</i>	83
Colombia: Effects of the adjustment policy on agricultural development. <i>Astrid Martínez.</i>	91
Costa Rica: Crisis, adjustment policies and rural development. <i>Juan M. Villasuso.</i>	107
Chile: Effects of the adjustment policies on the agriculture and forestry sector. <i>Andrés Sanfuentes.</i>	115
Ecuador: Crisis and adjustment policies. Their effect on agriculture. <i>Germánico Salgado P.</i>	129
Mexico: Study on the financial crisis, the adjustment policies and agricultural development. <i>Jaime Ros and Gonzalo Rodríguez.</i>	145
Peru: Agriculture, crisis and macroeconomic policy. <i>Javier Iguñiz.</i>	157
ILPES in its twenty-fifth year. <i>Alfredo Costa-Filbo.</i>	171
Recent ECLAC publications.	175

Costa Rica: crisis, adjustment policies and rural development

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At the end of the 1970s Costa Rica was hit by the worst crisis in its history. The coffee boom ended abruptly in 1978, causing a sizeable drop in export earnings. Furthermore, public spending increased sharply, generating a deficit which was financed largely by short-term foreign borrowing. In addition, the exchange-rate slippage, in conjunction with the deterioration in the terms of trade, brought about the exhaustion of monetary reserves, and this situation was exacerbated even further by the higher interest rates in the international market.

The gross domestic product fell 10% between 1980 and 1982, the fiscal deficit amounted to 42% of revenue and 22% of gross domestic product, the devaluation totalled 600%, and per capita income declined 25%. It is estimated that the country lost 24% of its income owing to the worsening of the terms of trade, the payment of interest on the debt, and remittance of profits abroad. When this situation became insupportable, the Government decided to defer payment of the debt. Meanwhile, unemployment and inflation, scourges virtually unknown in the past, climbed to unprecedented levels.

The new Government which came to office in 1982 set out to cut the fiscal deficit and dampen expectations of devaluation. To this end it took a number of steps which, together with international financial aid, helped to rebalance the fiscal and external accounts and thus facilitate the renegotiation of the debt and the agreement of a new adjustment programme with the International Monetary Fund.

Agriculture saw its contribution to the gross domestic product fall from 50% in 1977 to 37% in 1985, mainly owing to the behaviour of coffee prices in the international market. The steps taken to counter this trend and to stimulate exports growth and diversification do not seem to have been successful. The sharp devaluations apparently facilitated an increase in export earnings but not in export volumes, for the products in question were subject to export agreements or quotas.

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I

The situation up to de 1970s

Up to the end of the 1950s Costa Rica's agricultural sector absorbed about 55% of the economically active population, generated some 90% of export earnings, and contributed 40% of the country's gross domestic product. The relatively small public sector was concerned mainly with the provision of services and creation of infrastructure. The population and most of the activities were concentrated in the central region.

In the 1960s the Government began to encourage industrialization based on imports substitution. The country took an active part in the integration agreements which led to the establishment of the Central American Common Market, with a view to having access to a large and protected market. The hope was to obtain high growth rates by means of this industrial development and thus to increase employment, improve incomes and eliminate poverty. It was likewise hoped to reduce the country's vulnerability, for its foreign trade was entirely dependent on agriculture.

The steps taken to promote industrial activities, basically the set of instruments contained in the Industrial Protection Law promulgated in 1959 and the Central American Agreement on Fiscal Incentives, had almost immediate results.

Industry grew 9.4% a year on average between 1965 and 1973 and increased its contribution to the gross domestic product from 16% to 20%. Industrial jobs also increased, to 12% of the total in 1963 and to 15% in 1978, a proportion which has remained constant.

Agriculture, however, saw its share of employment fall from 50% in 1963 to 30% in 1983 and, what is more, it shed manpower. The workers who left agriculture and those entering the labour market for the first time were largely absorbed by the growing industrial sector and by the public sector, which underwent a large expansion. The public sector provided barely 6% of jobs in 1950 but by 1983 it had increased its share to 19%.

The new development model enabled the country to modernize the economy and establish an extensive network of communications, transport infrastructure and manpower training systems, as well as a wide range of commercial and financial services.

II

The structural problems

This development model soon began to exhibit a number of undesirable features. On the one hand, these included consumption patterns which had a high imported component and a low savings coefficient, equivalent to about 6% to 7% of the national income; this caused the country to resort to foreign borrowing to finance the accumulation of capital. On the other hand, neither the highly protected industrial sector, nor the primary sector were capable of placing very much of their production outside the Central American market. Furthermore, some of the specific policies adopted encouraged a techno-

logical pattern heavily dependent on imported goods.

When the need subsequently emerged for adjustment of the development model, a number of measures were introduced, including in particular the creation of the Exports and Investments Promotion Centre, the granting of tax exemptions on non-traditional exports to markets outside Central America, exports incentives, and the establishment of the Development Corporation of Costa Rica which, with its subsidiary bodies, was intended to diversify the production structure and promote the use of domestic raw materials.

III

The crisis

At the end of the 1970s a combination of phenomena —structural and contingent, external and internal— produced the worst crisis ever experienced by the country in all its history. One of the main factors in the crisis was the oil price rise and its impact on domestic prices. The first increase in 1973 did not have serious consequences because the country had an adequate supply of external financing and coffee, the main export product, was trading at high prices in the international market.

Costa Rica's terms of trade underwent a sustained decline in 1970-1976. In 1974 the ratio was only 78.6% against the 100% of 1970, for although export prices increased almost every year, import prices rose at a faster rate.

The Government took a much more active role between 1970 and 1978, especially with respect to investment, which was financed by foreign borrowing on generally advantageous terms. The aim was to alter the production structure in order to increase exports of manufactured goods with a high domestic component. Investments were made in production plants for

cement, aluminium and derivatives, and anhydrous alcohol, amongst others.

A number of incentives were introduced in the rural sector for enterprises which set up in the countryside and constructed transport and communications infrastructure works. The Government also intervened in the installation of processing plants for commodities such as cotton.

These and other measures cushioned the effect of the deterioration in the terms of trade. The inflow of capital to finance public investment was sufficient to obviate recourse to devaluation to cover the increasing external imbalance. Stimulated by the investments, production grew at a rate of 6% and unemployment accordingly remained low, at a rate of under 5%.

The foreign exchange earnings helped to counter inflationary pressures by enabling imports to grow in step with the expanding demand.

The dramatic recovery of the economy as a result of the rise in export prices in 1977 was reflected in a considerable improvement in the

country's external accounts, which made adjustment of the exchange rate seem unnecessary. Against this background, with good coffee prices, the Government contracted more foreign loans to finance new public investments.

After the change of Government in 1978, economic policy goals gave emphasis to private initiative in the allocation of resources and assigned a marginal role to the Government.

That year coffee prices fell 6.7%, putting an end to the boom, and the situation worsened sharply. Despite the declared objectives, public spending rose 52% between 1978 and 1979, while revenue rose only 28%. As a result, investment fell and the deficit had to be financed by short-term foreign borrowing.

The maintenance of the exchange rate was another objective given preference even at the expense of other variables. As a result of the level of debt and the use of international reserves, the colón was maintained at 8.60 to the dollar.

The terms of trade continued to worsen, monetary reserves were depleted and became negative in 1980, and the foreign debt became a burden difficult to bear. The outbreak of the international financial crisis meant a smaller supply of resources for lending and higher interest rates.

In view of this critical situation, the currency was devalued. In 1981 the gross domestic product recorded a negative rate for the first time (-4.6%). However, public spending continued to grow in that year, at a rate of 10%. The fiscal deficit rose to 41.8% of revenue and 21.8% of gross domestic product. The fall in the gross domestic product continued in 1982, at a rate of -8.9%.

The gloomy prospect prompted the authorities to take two important steps: they imposed taxes on export activities and resorted to internal borrowing. The taxes on foreign trade eventually amounted to 66% of new tax revenue, and the public sector took up 44.7% of the loans of the national banking system.

In March 1980 agreement was reached with the International Monetary Fund on a two-year stabilization programme designed to reduce the fiscal deficit and the current account deficit of the balance of payments. Of the SDR 60.5 million approved, only 15.4 million were disbursed,

owing to failure to comply with the agreement.

In June 1981 an expanded service arrangement with the Fund replaced the earlier agreement, making SDR 276.8 million available to the country for a period of three years. Of this amount, only 22.5 million was actually disbursed, again owing to failure to meet the agreed targets.

In August that year the debt service became insupportable and the country decided to defer payment. The currency was devalued by 600% between 1981 and 1982 and, because of the urgent need to finance essential imports, the debt was concentrated in short-term obligations. The gross domestic product fell at a rate of about 10% between 1980 and 1982, and output reverted to its 1977 level, while per capita income fell 25%. It is estimated that interest payments on the debt, the deterioration of the terms of trade, and the remittance of profits abroad by foreign companies together took 24% of the country's revenue.

Inflation, a process virtually unknown in the country up till then, broke out in 1982, forcing the consumer price index above 100%. The result was a profound change in the costs structure in the production of goods and a decline in workers' real incomes of about 45% between 1979 and 1982.

Open unemployment increased rapidly in this situation, affecting in particular wage earners in the modern sector and rural dwellers, especially the youngest. Unemployment among young people aged 15 to 19 reached 18% in 1982.

This deterioration in the situation can be clearly appreciated when it is remembered that the cost of the basic shopping basket took about 60% of the average wage in 1980 but 86% in 1982.

1. *The manifestations of the crisis*

The most important manifestations of the crisis included the fall in output, the external imbalances and the fiscal deficit.

The growth rate of the gross domestic product began to slow down in 1977, reaching a rate of 0.8% in 1980; in 1981 it fell in absolute terms for the first time, recording a rate of -4.6%. The rate was -8.9% in 1982; this trend was reversed in 1983 but without a return to the earlier rates.

This development was due to the following causes, amongst others:

- The restriction of lending to the private sector. Domestic credit was cut back by the sharp increase in resources for the public sector, while external credit declined owing to the difficulties connected with the tightening of the international financial markets;
- The higher production costs caused by inflation, devaluation of the currency and increased interest rates;
- The contraction of aggregate demand as a result of the drop in real wages and the stagnation of external demand;
- The climate of uncertainty in the business world, which led to a fall in private investment and an outflow of capital from the country;
- The development of speculative financial activities whose profitability made them more attractive than the production of goods.

Although the problems of the external sector are many and complex, for the purposes of this article they can be reduced to two: the trade balance deficit and the large foreign debt.

The trade balance deficit dates back to the mid-1950s and is due to the stronger growth in the value of imports in comparison with exports. Exports accounted for 23% of the gross domestic product in 1970 and 30% in 1980, while the contribution of imports was 25% and 40% respectively. In these circumstances the trade deficit, which was equivalent to 40% of exports in 1970, rose to 60% in 1980.

This situation was brought about, among other factors, by the heavy dependency on imported raw materials and capital goods, a consumption pattern with a large imported content, the sustained decline in the terms of trade, and the weak performance of exports, especially non-traditional ones, as a result of the powerful protection —both internal and in the Central American Common Market— and the very conservative behaviour of businessmen.

The methods used to cover the trade balance deficit were foreign borrowing and foreign

investment, with the first being the more important. The public foreign debt rose from US\$900 million in 1978 to over US\$3 000 million in 1982. The structure of the debt worsened in this period, with concentration of payments in the short term. The debt service, moreover, amounted to 60% of the value of exports.

2. Income distribution and poverty

In 1977 25% of all Costa Rican families were unable to meet their basic needs to some extent and 13% lived in extreme poverty. The rural areas contained 34% of poor families and 19% of extremely poor families. No great change occurred in this situation until the outbreak of the crisis and the introduction of the adjustment policies. A comparison of 1970 with 1983 shows that the share of the poor sections of the population in income declined in favour of the higher-income groups; this was mainly an urban phenomenon. Furthermore, according to a MIDEPLAN study, 41.7% of wage earners were poor in 1980, and this proportion rose to 56.4% in 1981 and 70.7% in 1982, indicating the impoverishment of wage earners as a result of the crisis and the adjustment. The causes must be sought in the drop in real wages and employment, the higher public tariffs, and the cutback in government assistance programmes.

The same study offers more dramatic figures for the rural sector. Poor rural families made up 57.7% of the total in 1980, and this proportion rose to 72.1% in 1981 and 82.3% in 1982. The rate of child undernutrition among poor rural families was double the national average.

No specific research on the food supply has been carried out since 1971. However, analysis of the development of the apparent supply shows no major falls in aggregate terms in the main foods in the basic shopping basket. In other words, a "normal" supply of rice, beans, maize, meat, milk and eggs was still guaranteed despite the reduced supply of foreign exchange. It is not possible to draw any definitive conclusions from this information, for it refers to aggregates and does not indicate the effects of changes in income distribution.

IV

Description of the main adjustment policies

With the change of Government in 1982, a series of measures was adopted with the aim, on the one hand, of reducing the fiscal deficit—considered to be the main generator of inflation—and, on the other hand, of reorganizing the exchange market in order to reduce the high level of expenditure and discourage expectations of devaluation. These measures included:

- *Modification of the exchange-rate régime.* Purchase and sale of foreign currency was restricted to the Central Bank and its authorized agents in the banking system. This checked speculation and expectation of a devaluation.
- *Measures to adjust the fiscal deficit.* In view of the rigidities in expenditure, it was decided to make adjustments on the income side by means of increases in public tariffs, fuel prices and income tax, and the introduction of new export taxes based on the exchange-rate differential, together with import taxes and reduction of certain subsidies. In addition, enterprises of the Development Corporation of Costa Rica (CODESA) were put up for sale, and the rates of contribution to the social security system were increased.

The large increase in fiscal revenue achieved by the introduction of these measures reduced the non-financial fiscal deficit from 8.6% in 1982 to 3.7% in 1983, despite an increase in public expenditure of 44.5% in nominal terms. The adjustment achieved by these methods enabled the country to resume its negotiations with the International Monetary Fund and reschedule its foreign debt, thus gaining access to the international financing which it needed.

In December 1982 a new standby arrangement was agreed with the International Monetary Fund for SDR 92.25 million for a period of three years. Disbursements remained subject to attainment of the goals, which consisted basically of reduction of the fiscal deficit to 4.5% of

the gross domestic product, reorganization of the foreign-exchange market, and containment of inflation. This time the programme was carried out and the payments were made as planned, for most of the proposed targets were attained and even better results were achieved. With respect to the foreign debt, an agreement was reached with foreign banks on rescheduling of the payments; a similar agreement was reached with the Club of Paris on the external public debt.

In order to offset the social costs of the adjustment, the Government introduced a number of specific measures such as the plan to rescue businesses hit by the crisis and the Social Compensation Plan, which included the provision of food for extremely poor families, half-yearly adjustment of wages in step with changes in the prices of the items in the basic shopping basket, control of these prices, a programme to create jobs by means of subsidies, a social housing programme, and a land provision programme.

Attention must necessarily be drawn to the role played by foreign aid in overcoming the crisis. In 1983 and 1984 the United States, through the International Development Agency, provided more than 25% of the external resources received by Costa Rica. If the contributions of bodies in which the United States Government has a decisive influence are included, the total comes to 83% of the external resources in 1983 and 65% in 1984. In the first three years of the Government of President Monge, United States assistance through the IDA amounted to US\$634 million. Clearly the success of the stabilization programme owes much to these amounts of aid, which reduced the independence of the national authorities.

Accordingly, the IMF and IDA have imposed their views on economic management. In 1984, for example, the IDA made a loan conditional on modification of the organic law of the Central Bank in order to give private banks access to that institution's resources.

V

The impact of the adjustment policies on agriculture

Since 1975 Costa Rica's farming economy has followed a pattern of irregular growth with periods of definite stagnation. More or less every three years the sector experienced large drops in its output (negative growth of the gross domestic product), alternating with years of great expansion, 1983 and 1984, for example, when it recorded growth rates of 9.2% and 8% respectively. This phenomenon is explained partly by the performance of two items, coffee and bananas, which have a great impact on the sectoral economy. After a period of recovery, coffee output fell sharply in 1985 and the same happened to bananas, which were already showing some weakness. It is therefore important to stress the influence of coffee production on the whole of agriculture: coffee's relative weight in the gross domestic farm product was almost 50% in 1977 and it fell to 37% in 1985. The rest of the crops did not record any great changes, except those due to the weather and plant disease.

It can thus be seen that macroeconomic stabilization policies apparently did not have a very great effect on this performance. Moreover, in conjunction with the introduction of these policies, the State adopted a number of compensatory measures, on top of the great external aid received. Thanks to these two factors, there was no need to resort in agriculture to the drastic measures of a shock policy.

The farming sector was especially favoured by this compensatory action on the part of the State, for it was designed primarily to correct the drop in the demand for foodstuffs and subsidize basic inputs of external origin in order to keep food production stable. This goal was attained by the introduction of a price stabilization policy in 1982, the purpose of which was to maintain the balance between the strength of output and the level of consumer prices. The external assistance was translated into a number of initiatives such as, for example, the Farm Productivity Incentives Programme (IDB), which in conjunction with the tax policy increased the domestic demand by incorporation of technology without forcing production costs up by very much.

The implementation of this set of measures was facilitated by the high domestic component in farm production, which is largely immune to external restrictions and increases in import prices.

However, the crisis did have a greater effect on the farm exports sector, which also had a number of internal problems such as the considerable adverse effects of the withdrawal of the banana companies. Thus, despite the establishment of a number of programmes to stimulate the output of exportable farm goods, especially bananas and sugar cane, exports remained virtually unchanged.

Nor did the devaluations influence export volumes. Coffee, bananas and sugar cane, which accounted for more than 54% of total foreign sales, were subject to export quotas. The devaluations did not have any great impact on other farm products either, for their domestic prices remained far above international prices; prices for the 1984/1985 harvest were 90% higher in the case of rice, 102% for maize and 50% for beans. It must therefore be assumed that the increased income resulting from implementation of this measure went mainly to export consortiums and did not serve to stimulate producers.

The results of various pieces of research confirm that one of the social costs of the adjustment policies has been the drop in income from work; it is nevertheless admitted that the adverse effects were greater in urban areas and the impact on the countryside was less. Here again the domestic component helped to cushion the recessive effects.

With respect to specific policies for agriculture, the "*Volvamos a la tierra*" plan (Let Us Return to the Land) of the Government of President Monge sought to make agriculture and agro-industry the axis of the development process. Five main action areas were defined for this purpose: agricultural production, agro-industrial integration, the agrarian issue, the support system, and natural resources.

The public agricultural sector was then restructured, the planning system was strengthened, a specialized irrigation and drainage service was established which brought together the resources dispersed among several bodies, and the Ministry of Agriculture was reorganized to increase and improve its regional presence and avoid duplication of functions.

The following measures were implemented in 1982-1986:

- Prices policy to stimulate and then stabilize production, thus favouring both producers and consumers. The period 1982-1983 had seen price increases of over 100% for producers of rice, beans and sorghum, and somewhat smaller increases for producers of maize and eggs. The rises were moderate in 1984 and 1985 as a result of the fall in inflation and the stability of input prices.
- Policy for support of banana production by means of an incentives plan which envisaged price compensation, assistance with disease control, and production incentives. The aim was to restore the competitiveness of banana production, which had been impaired by the high incidence of disease, the drop in prices, and other factors.
- Quest for new alternatives for cane production. Alcohol production was tried for this purpose, both for the home market and for export. This activity has been affected by the low international prices, but the area and the yields were nevertheless increased, and output showed sustained growth.
- Policy of support for cocoa production. As a result of increased State support —through the Cocoa Promotion Programme— the sown area was expanded and the downward trend reversed.
- Policy of farm credit and insurance for the most important food crops. Finally, as a result of the introduction of these measures and the influence of imponderable external factors, banana output rose in 1983 and 1984 before falling back in 1985 owing to the drop in prices and incidence of disease; cane production increased but ran up against problems of overproduction and low international prices; livestock production grew between 6% and 10% from 1982, the year in which it had experienced a sharp fall; and the output of rice, maize and beans recorded increases which made it possible to meet the national requirements —except in the case of hard maize— and even to make some exports, although at subsidized prices, the cost of which had to be borne by the official marketing body.