Also by Wim Pelupessy

PERSPECTIVES ON THE AGRO-EXPORT ECONOMY IN CENTRAL AMERICA (*editor*)

Also by John Weeks

A CRITIQUE OF NEOCLASSICAL MACROECONOMICS

DEVELOPMENT STRATEGY AND THE ECONOMY OF SIERRA LEONE

Economic Maladjustment in Central America

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Preface

During the 1980s and into the 1990s, stabilisation and adjustment packages inspired by the multilateral organisations were implemented by all of the Central American countries (with Nicaragua coming latest to the game). The famous 'Washington consensus' judged these as adequate remedies for the external shocks and internal disequilibria suffered by the countries of the isthmus which arose in the context of serious social conflicts.

By the beginning of the 1980s, an assessment could be made of the impact of these programmes. While the so-called 'social costs' of adjustment have been widely recognised and the call for 'safety nets' for vulnerable groups widespread, there was much slower acceptance in the international financial and aid community of the theoretical and practical flaws of this approach to macroeconomic and trade policy. It is in this context that the contributors to the present volume draw attention to internal and external institutional limits to the implementation of mainstream macroeconomic policy-making. One hopes that our results prove useful in the design of alternative development strategies for the region, strategies that do not require 'safety nets' as an afterthought.

Versions of most of the essays in this book were presented at the Economic Restructuring Symposium of the Annual Conference of the Association for European Research on Central America and the Caribbean in September 1990. The foreword by Gert Rosenthal, Executive Secretary of the United Nations Economic Commission for Latin America and the Caribbean, as well as Chapters 1, 5 and 9, were included later to broaden coverage of countries and topics.

Numerous people contributed to the compiling of this set of essays, and special thanks, for her indispensable work of editing and compiling the index, goes to Elisabeth van Tilburg.

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1 Adjustment in Central America

Wim Pelupessy and John Weeks

1.1 CONTEXT OF ADJUSTMENT

With the exception of Costa Rica, despotic regimes ruled the Central American countries in the postwar period, in which the use of force played a key role both in the maintenance of civil order and in the day-to-day functioning of the economy. In these societies the allocation of resources and the division of labour derived as much from the police power of the states as from market forces, for these were economic systems based upon coerced labour.[1] In neoclassical analysis, under restrictive assumptions rarely made explicit in the conservative 1980s, markets give generally efficient outcomes as the result of the impersonal interaction of buyers and sellers. Among these assumptions are: access to market information, formal equality of economic agents, freedom of entry and exit from market contracts, and so on. Whatever the relevance of this analytical framework elsewhere, it was singularly inapplicable to Central America.

Particularly inappropriate was the concept of a labour market in which formally equal buyers and sellers met to determine employment and conditions of work, for this framework presumes on the part of the worker the freedom to decline the offers presented. In a sense all workers in market economies engage in the market under coercion, since the alternative to employment is unemployment and poverty. In Central America, coercion of labour went beyond this. Since colonial times and into the 1990s for El Salvador, Guatemala and Honduras, repression maintained the various forms of forced labour in the countryside, such that organising production represented a police activity as much as an economic one.[2]

In the 1980s the multilateral and bilateral lending agencies diagnosed the economic ills of Central America as derived from an excess of state intervention in markets. 'Statism' became the ideological catch-word to encapsulate the practice of government intervention in markets, to which all conceivable economic maladies could be traced.[3]

The cure for the disease of statism was 'deregulation' or 'liberalisation', involving elimination of a wide variety of instruments of economic policy. The 'deregulation' aimed at drastically reducing state influence over markets, for example through privatisation, and thus giving free reign to private economic interests.

In this context one can identify two types of market interventions. Taking the labour market as an example, a government might decide to institute a minimum wage to affect levels of pay, or decide not to do so. As a complement to that, it might implement a campaign to arrest or assassinate trade union leaders, or leave them free to organise. The second type of labour market intervention was endemic in Central America, by comparison with which the impact of the first type was insignificant, or dominated by the other. Thus, the World Bank and the IMF were quite right when they argued that most of the countries in the region required deregulation, but not of the type recommended in structural adjustment and stabilisation programmes.

The examples of market intervention given above require some definition of terms in order that our language be precise. The first type of interventions, minimum-wage laws for labour markets, tariffs for the foreign trade sector, etc., we shal call 'economic', or use of 'economic instruments'. The second, restriction of workers' rights and expelling of peasants from land, for example, might be called 'extra-economic instruments' of market intervention.[4] The distinction is important in that it highlights that reduction in use of economic instruments would not necessarily imply 'deregulation' of markets. On the contrary, reduction in use of economic instruments with no attention given to the extra-economic ones enhances the regulation of markets that serves the interest of the propertied classes in Central America.

The deregulation or liberalisation required in Central America would involve dismantling the oppressive mechanisms of the state, in particular the military in El Salvador, Guatemala and Honduras. To do so would need as a necessary, albeit not sufficient condition, major reforms in the control of property, in order to reduce the political and economic power of the oligarchies in whose interest the military carried out its repression. In other words, overcoming the 'statist' models of repression in Central America would imply a process of democratisation, radical in the sense that the principles of the French Revolution seemed radical at the end of the eighteenth century, but presumably should not have been so considered at the end of the twentieth (except in Central America).

It is the need for the liberalisation of political power in Central America that made the implications of the IMF–World Bank's narrow economic liberalisation so disturbing. Repression in economic life, taken to the point of decades of rule of terror in Guatemala, produced highly successful agro-export economies until the first oil-shock in the 1970s; or, to be more precise, succesful for the few. High degrees of openness to world trade and low incidence of state intervention in markets through use of strictly economic instruments characterised these economies by comparison to other parts of Latin America. Openness and an aversion to strictly economic intervention in markets facilitated the domination of the oligarchies over their countries. More of the same, as recommended by the adjustment programmes of multilaterial agencies and the US government, would further strengthen the political and economic power of oligarchies which by the 1990s were despotic anachronisms.[5] The liberalisation of product markets combined with factor markets under extra-economic coercion gave rise to extraordinary economic rents for the propertied classes.

1.2 THE IDEOLOGY OF ADJUSTMENT[6]

Fundamental to the liberalising and structural adjustment of the Central American economies, including Costa Rica, would be land reform, and two chapters in this book (Chapters 10 and 11) review the experience of agrarian reform in El Salvador and Nicaragua. The multilateral agencies, however, have taken a much narrower view of policy reform. 'Structural adjustment' serves as little more than a euphemism for reducing the use of economic instruments of state intervention in the economy, in favour of the use of market mechanisms and prices to shift resources to more productive sectors, in order to regain the growth after internal and external shocks.[7] The first two chapters of the domestic policy part of this volume (Chapters 2 and 3) deal with economic adjustment in a World Bank–IMF sense (on Nicaragua), while Chapter 4 treats the same terrain from a broader political economy perspective (on El Salvador).

As explained in the previous section, obsession with economic instruments and ignoring extra-economic instruments of intervention results in a regulation of markets in the interests of the propertied classes in Central America. USAID and the multilateral agencies tend to be unmoved by this political critique of their adjustment programmes, defending them on 'technical grounds'. It is alleged that

whatever the political implications of the programmes, they were technically sound, in that they represented in theory and practice effective solutions to the economic ills of the region. With respect to Guatemala, the World Bank commented favourably that 'the (Cerezo) government implemented a program of measures which have resulted in a broad improvement in major economic policy areas', and this improvement resulted from the efficiency effects of relying on market forces (World Bank, 1987a: 1).

To give this 'technical' defence of adjustment policies its due, presume a benign world in which we ignore repressive instruments of market intervention and negative redistributive effects which may make policies unsustainable.[8] In this context, economic deregulation is alleged to produce greater allocative efficiency and improved growth performance. It does so by neoclassical logic through markets providing price signals to economic agents which indicate the most profitable uses to which resources might be put. However, there is no consensus that improved allocation stimulates growth as Rodrik (1990: 938) has argued, 'theory is generally silent about the effect of liberalisation on the rate of growth of an economy'. Nevertheless, adjustment programmes were based on a faith that 'private' benefits and costs coincide with 'social' benefits and costs (no 'market failures' or 'externalities'), and that government intervention affecting prices resulted in sub-optimal, growth-depressing outcomes. Therefore, governments should restrict their activities to a minimum, and even in that minimalist role should strive for neutrality with respect to relative prices.[9]

The specific 'reforms' implied by this line of argument include reduction of tariffs and non-tariff constraints on trade, floating as opposed to fixed exchange rates, eliminating all forms of price controls in domestic markets, and privatisation of state activities where possible. Complementary to these market liberalisation steps was de-emphasis of fiscal policy as an instrument of macroeconomic stabilisation; indeed, reduction in state expenditure was a characteristic condition of multilateral lending in Central America.[10] However, in practice it proved difficult to implement the right fiscal measures, as shown by Edwards (1990: 2). More than 80 per cent of reversals of trade liberalisation measures in Latin America could be traced to inconsistent fiscal policies. Still, in place of an active fiscal policy multilateral adjustment programmes pressed for monetary policy as the primary instrument of macroeconomic management, invariably in the form of severe restraints on growth of the money supply.

The theoretical essence of this orthodox argument, that markets promote (static) efficiency and government interventions distort, has two important elements: economic agents are relative price-constrained and money is neutral. An economic agent is relative price-constrained if he/she acts on the presumption that he/she can sell (or buy) as much as desired at prevailing prices. In other words, there is no income constraint, for each agent's income results from a decision to allocate time between work and leisure, a decision itself derivative from prevailing prices. Relative price constrained economies are always at full employment unless 'distorted' to a less-than-full-employment' situation by government intervention. Monetary policy is preferred to fiscal policy in this model because it is assumed that relative prices are independent of the supply of money (money is 'neutral', affecting only the general level of prices); fiscal policy, on the other hand, is viewed as inevitably distorting relative prices.

Neoclassical economists themselves have demonstrated the extremely limited applicability of this analysis to theoretical models, much less to actual economies.[11] It is sufficient for the discussion of Central America to focus on the presumption implicit in structural adjustment programmes that the economies of the region do not suffer from a demand constraint. In a hypothetical demand-constrained economy at less than full employment, relative prices reflect the level of demand and have no efficiency implications. At the prevailing relative prices (or an infinite number of alternative sets of prices) more could be produced if the output could be sold. If resources are left unused due to lack of demand, relative prices are derivative from resource allocation, not the contrary.

A simple example demonstrates the role of prices in a demand-constrained model. In a situation of demand-constrained unemployment the prevailing interest rate, regulated by a ceiling set by the monetary authorities, may lie below the rate of inflation, thus negative in real terms. However, the negative real rate of interest may result from a depressed demand for investment, and raising it would reduce, rather than increase the level of output, by further restricting investment. Identifying the low rate of interest as the cause of low investment would represent a false application of partial equilibrium comparative statics (considering only one market, that for saving and investment) to a case requiring general equilibrium analysis (treating all markets simultaneously). An example of this invalid application of partial equilibrium appears in the World Bank report on Honduras, where it is asserted, 'interest rate policy (i.e. a higher rate) is a key

instrument in mobilising private sector savings' (World Bank, 1987b: p. iv). If the Honduran economy were demand-constrained, then the effect of a higher interest rate would be to depress investment, which via the Keynesian 'multiplier' would reduce the level of national income and result in a decline in the level of saving (see Chapter 5).

Extra-regional export demand historically provided the motor of growth of the Central American economies. During the 1980s this demand declined due to the world recession of the first part of the decade and increasing protectionism in the OECD countries, particularly on the part of the United States, Central America's principal market. The raw material nature of most of these exports gave additional disadvantages of worsening terms of trade and increasing substitution by alternative synthetic products. Evidence of this external demand constraint is shown in Table 1.1, which provides export indices in constant prices. As one would expect, export growth for war-torn El Salvador and Nicaragua shows negative, a decline over the decade of 40 and 23 per cent, respectively (and close to 40 per cent for Nicaragua if 1987 or 1988 is used). However, for Guatemala, where armed conflict had little direct impact on export production, performance proved hardly different from that of El Salvador and Nicaragua. In the case of Honduras, with little internal strife by regional comparison and beneficiary of large financial inflows from the United States, exports stagnated over 1980–85, and for the period as a whole grew at a minuscule rate of 1.8 per cent per annum. Only for Costa Rica was export growth respectable, at 5.8 per cent per year. Costa Rica represented the exception that proved the demand-constrained rule, for part of its relatively strong performance resulted from taking advantage of the export declines of its neighbours, particularly for the US market, including the limited opportunities offered by the Caribbean Basin Initiative. When four of the five countries of the region performed poorly in terms of export growth, and two of the cases were not explained by civil conflicts, it would take a true-believer in the magic of markets to argue that an external demand constraint was not operative.

A detailed study by Ray of Central American exports to the United States supports our argument that in the 1980s the Central American countries suffered from protectionist restrictions on access to the US market.[12] Even the World Bank in its 1989 country report on El Salvador conceded the tremendous terms of trade losses suffered by agricultural exporters in the 1980s.[13] However, the Bank failed to draw the obvious conclusion that these losses reflected declining world

Table 1.1 Exports of the Central American countries (constant prices)

Country	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*
Guatemala	100	86	78	70	68	71	61	65	68	81
El Salvador	100	82	70	84	81	77	67	76	69	60
Honduras	100	102	90	99	101	103	107	108	112	117
Nicaragua	100	116	106	114	90	80	66	64	56	77
Costa Rica	100	111	105	104	115	107	111	134	148	166

Base year for prices: Guatemala, 1970; El Salvador, 1962; Honduras, 1978; Nicaragua, 1980; and Costa Rica, 1966. Because of the different base years, it was not possible to provide a row for the region as a whole.
Source: SIECA, 1990a, pp. 123–6, 129; and SIECA, 1990b, pp. 9–11.

demand, implicitly attributing them to relative price changes within a general equilibrium, price-constrained world economy.

In addition to being constrained by export demand, the Central American countries suffered from an internal depression of demand as a result of their debt-service burdens. This relatively recent development worsened the effects of the regressive income distributions which always had constrained internal demand. Even partial payment of debt service required suppression of internal demand, in order to achieve the necessary unrequited real resource transfers. The necessity to do so, primarily through restriction of private consumption, was formally specified in a paper by Selowsky and Van der Tak of the World Bank (Selowsky and Van der Tak, 1986). Using their model, Chapter 5 of this book demonstrates that for Honduras to grow at five per cent per annum (implying consumption growth below the rate of population increase), it would take a net saving rate of 37 per cent of GDP to meet debt service, and ten years before the country would begin to reduce the absolute level of the debt.

Debt service represented but a part of the external capital loss financed by the Central American economies in the 1980s. Table 1.2 shows two estimates of capital flight from Central America, based on papers by Boyce (1990) and Cáceres (1990). The 'hot money' method of calculation yields an outflow of almost two thousand million dollars for 1980–87, though for the second four years of the period, 1984–87, the outflow was positive only for the two war-affected countries, El Salvador and Nicaragua. However, measuring capital flow categories alone is inadequate, since money might be expatriated by over-valuation of imports at the receiving end and under-valued exports

Table 1.2 Capital flight from Central America, 1980–87 (millions of US dollars)

Country	*1980–87*	*1984–87*
A. *'Hot money' method*		
Guatemala	519	−244
El Salvador	893	237
Honduras	−55	−57
Nicaragua	459	381
Costa Rica	142	−199
Central America	1958	118
B. *Adjusted for valuation of trade*		
Guatemala	2698	1132
El Salvador	65	−562
Honduras	282	−101
Nicaragua	1302	503
Costa Rica	2136	1565
Central America	6483	2537

Notes: Positive number indicates a net capital outflow, a negative one an inflow. For El Salvador, 1980–1986: 'hot money' method adds visible capital movements and 'errors and omissions' category of the balance of payments (see Cuddington, 1986). 'Adjusted for trade' adds in the difference obtained when one compares the national trade flow totals (both imports and exports) to those reported by the country's trading partners.
Source: Cáceres, 1990.

when they leave the country. The second half of the table includes the implicit capital outflow hidden in trade, based on comparing each country's imports and exports as reported by that country to the exports and imports reported by the trading partners.

By this calculation capital flight over the eight years exceeded six thousand millions of dollars. Quite striking is the discovery that by the latter calculation the countries suffering the greatest capital flight were Guatemala and Costa Rica (reflecting that these two countries had the largest trade flows for the period). Thus, it was not the countries experiencing acute political conflict (El Salvador and Nicaragua) that manifested the greatest capital flight on the more complete calculation, but the two more politically stable countries (though in the case of Guatemala it was a stability based on a reign of terror).

Consistent with their rather loose application of partial equilibrium comparative statics, the multilaterals were fond of attributing capital

flight to 'unrealistic' exchange rate policy and general economic mismanagement. The much more obvious explanation lay with the high real interest rates compared to long-run real rates of growth in Western Europe and the United States, and the aggressive policies of US banks in particular in soliciting deposits from Latin America. From 1979 to 1984 deposits of Central American citizens in the US financial system increased by 130 per cent (ECLAC, 1986: p. 28). Capital flight was also prompted by the high concentrations of ownership of property and excessive accrual of rents that led to an excess supply of capital in relation to profitable domestic investment opportunities. It also should be noted that low elasticities of supply of the main export commodities of Central America might be an indication of this concentrated nature of production in the region. Both theoretical (see the review by Bradford, 1990: p. 7) and empirical studies (see, for example, Faini and de Melo, 1990, as well as Lall, 1989) indicated the importance of the role of supply-side factors like human capital-formation, technical development and institution-building. Real depreciation of the exchange rate did not generally provoke a sufficient supply response under such constraints.

Slack international demand and externally-induced capital flight placed strong downward pressure on exchange rates in Central America. These external pressures on exchange rates cast considerable doubt upon the repeated allegations of the World Bank that 'overvalued' exchange rates accounted for the poor export performance of the Central American countries. In the case of El Salvador, the Bank wrote that, along with falling world prices, 'El Salvador's real currency appreciation produced a 50% fall in real prices received by producers', and export products 'will all be benefited by freeing up prices and trade . . . and by improved macro-economic policy signals, crucially a real devaluation' (World Bank, 1989c: p. vi). In the same vein for Honduras, the Bank waxed lyrically: 'an appropriate exchange rate is the export incentive *par excellence*' (World Bank, 1987b: p. v). In this context, it is also worth noting that the country in the region whose exchange rate performed best in World Bank terms (i.e. depreciated the most), Guatemala, had a dismal export performance. The Guatemalan case, along with Costa Rica considered a neo-liberal success story in terms of non-traditional exports, is analysed carefully in Chapter 8.

This obsession with the exchange rate as an allocative price, as in the case of emphasis on the interest rate, falls victim to false application of partial equilibrium analysis. There is a definitional sense in which

exchange rates are always overvalued when a country suffers from balance of payments pressure, just as one can say that the price of apples is too high when there are apples unsold. Even were it the case that depreciation of the exchange rate would equilibrate the external sector, it does not follow that the resulting equilibrium exchange rate would represent an efficient price in terms of resource allocation. Consider the case in which a small economy is in general equilibrium, all markets cleared and resources optimally allocated between tradables and non-tradables. Assume that the country's major trading partner, a much larger country, embarks on a severely restrictive monetary policy that depresses its domestic demand and, therefore, the demand for the exports from the smaller country. The small economy will experience a trade deficit in consequence. With a floating exchange rate, a real depreciation will result, restoring the external sector to balance. The resulting exchange rate, even though it achieves external equilibrium, would be inefficient, distorted by the monetary policy of the large country, and misallocating resources toward exports.

The above hypothetical scenario was, of course, precisely what happened to the Central American countries in the 1980s and Chapter 5 demonstrates it for Honduras.[14] In neoclassical terms, mismanagement of the US economy resulted in excessive real interest rates, and the effect of multilateral pressure on the Central American governments for devaluation transferred the distortion to those small economies. Therefore, whatever its political advisability, it was not technically justified for the World Bank to write, for example, 'greater integration of Costa Rica into the world economy is the most promising growth strategy in the long run' (World Bank, 1988: p. ii). Such a judgement could not be made in technical terms without considering the effects on the Costa Rican economy of distorted world markets. Indeed, Chapters 6 and 7 in this volume on Costa Rica's trade indicate that the country's likely benefits from trade liberalisation were not at all straightforward.

Even were the theoretical and technical grounds for trade liberalisation in Central America not so shaky, the politics of doing so certainly cast doubt on the wisdom of this policy. Trade liberalisation in Central America implied in practice more reliance on the North American market. Following the invasion of Grenada, the Reagan administration in 1983 presented to the US Congress a preferential trade arrangement for Central America and the Caribbean allegedly designed to facilitate exports to the United States. On close inspection,

the Caribbean Basin Economic Recovery Act (CBERA), more commonly known as the Caribbean Basin Initiative (CBI), explicitly excluded from tariff relief several of the more important manufactured exports of Central America.[15] In addition, the CBI legislation required a US government agency to provide annual reports to Congress to verify that the trade concessions resulted in no harm to US manufacturers. If 'unfair' competition could be established (either by the agency or an affected company), 'countervailing' duties could be imposed upon the exporting country. This discretionary instrument of protectionism was used on several occasions against Costa Rican and Guatemalan non-traditional exports.[16] There seems no doubt that the CBI provided little improved access to the US market for Central American exports.[17]

Even from the viewpoint of the dominant classes in Central America, trade liberalisation and closer integration to the US economy offered slender hope for the rejuvenation of growth in the region. Given the size of the US trade deficit, the 1990s would likely bring less, not more, access to the US market. Thus, the pressure on Central American governments to abandon regional integration represented no strategy of growth. If the trade liberalisation of the structural adjustment programme meant more of the same in terms of the past economic policy of Central American governments, it also meant less of the same in the light of growing US protectionism.

1.3 DECLINE AND ADJUSTMENT

Strong growth performances characterised the Central American economies in the 1950s and 1960s. Except in Costa Rica, there was little 'trickle down' to peasants and the working class, and they became extremely dependent on the fluctuations of external markets. In the 1970s the increase in oil prices weakened growth performances, though in Costa Rica this was partly offset by the boom in the coffee market. The 1980s brought disaster.

The extent of the disaster is indicated in Table 1.3, which provides indices of per capita income for the countries of the region. From 1975 to 1980, per capita income rose in three of the five countries (see part A of the table). It would be reasonable to assume that had war not raged in El Salvador and Nicaragua, per capita incomes would have risen there, also. In the first half of the 1980s debt, world recession, and unstable international commodity markets proved much more

Table 1.3 Per capita income in Central America: 1975 and 1980s (constant prices)

Country	*1975*	*1980*	*1985*	*1989*
A. *Index, 1980 = 100*				
Guatemala	87	100	77	76
El Salvador	110	100	77	70
Honduras	84	100	87	86
Nicaragua	133	100	86	67
Costa Rica	90	100	88	93
Central America	98	100	81	78
B. *Index, Central America average = 100*				
Guatemala	101	114	108	110
El Salvador	94	83	79	74
Honduras	60	69	74	75
Nicaragua	91	66	70	56
Costa Rica	172	188	204	223
Central America	100	100	100	100
Std dev.	41.4	50.7	56.2	67.4
Coef. var.	0.400	0.488	0.525	0.626

Notes: 'Std dev.' is the standard deviation for the five countries, and 'coef. var.' is the coefficient of variation (standard deviation divided by the mean). The standard deviation is calculated unweighted for the population differences among the countries. Thus, the simple mean is used in the denominator of the coefficient of variation, and is in each case slightly larger than the weighted mean (= 100 by definition).
Source: SIECA, 1990a and 1990b.

powerful income-depressing forces than war, producing falls in per capita output in every country of the region. The impact of world commodity and financial markets, with no aid from civil strife, produced per capita income declines in Honduras and Costa Rica virtually equal to that for Nicaragua where a destructive war funded by the United States government gathered momentum.

By comparing 1985 to 1989 in Table 1.3A, one might reach the optimistic conclusion that the worst was over and growth lay ahead. If one attributed the El Salvadorean and Nicaraguan declines to armed conflict, then the conclusion could be reached that declines in per capita income were over; and having arrested decline, Guatemala, Honduras, and Costa Rica could anticipate growth. Indeed, per capita

income increased in Costa Rica by about 6 per cent in the second half of the decade.

If, as most experts on the region argue, the Central American economies were driven by extra-regional export demand, there existed little basis for the optimistic scenario described above (Pelupessy, 1989). When an economy ceases to contract, this may imply that it has reached a stable level of stagnation, not that the causes of the decline have been eliminated. The Central American economies declined in the first half of the 1980s because of unsustainable balance of payments pressure. Economic decline itself rendered the balance of payments positions sustainable through falling income reducing import demand, in particular that for inputs to production. Thus, a low-level equilibrium was reached in which the contractionary pressure eliminated itself (ignoring the two war-affected countries).

The performance of investment in the region during the 1980s gives additional support to this conclusion. Gross fixed investment declined considerably (measured in 1980 US dollars), and in 1989 was below the level of 1979 in all the five countries. As a percentage of GDP fixed investment fell, from 19.0 to 10.0 per cent in Guatemala, in El Salvador from 17.1 to 13.8, Honduras 21.6 to 15.4, Nicaragua 17.3 to 14.0, and in Costa Rica 26.5 to 20.8 per cent.[18] Table 1.4 provides the annual percentages for private investments, indicating the general decline in the region.[19] The implemented adjustment programmes did not even stimulate the private sector in the region. Only in Costa Rica (and for only one year, 1989) were structural adjustment policies associated with a recovery of private investment as a proportion of national product. Casting further doubt on the impact of adjustment is the experience of El Salvador, where investment appeared to do relatively better than in Guatemala and Honduras, despite civil war and the absence of significant influence by multilateral financial institutions on economic policy. In this case, financial assistance came primarily from USAID (Pelupessy, 1990a).

Faini *et al.* suggested that the lower rate of investment in GDP might be explained by higher capacity utilisation resulting from relaxation of foreign exchange constraints and increased efficiency in resource use. There was little direct evidence for this explanation. Costa Rica was the only country with some relaxation of the external constraint, but it also showed the highest, and in the second half of the decade increasing, proportions of investments in GDP. Further, it is difficult to see how increased efficiency might have been obtained in Central America in the 1980s. In any case, without new investments,

Table 1.4 Private fixed capital coefficient in Central America* (1975, 1979 and 1980s)

	Guatemala	*El Salvador*	*Honduras*	*Nicaragua*	*Costa Rica*	*CA*
1975	12.5	11.2	14.3	10.9	14.9	12.8
1979	13.3	10.2	14.5	3.2	18.1	11.4
1980	9.9	6.1	15.0	5.3	15.4	9.9
1981	8.8	5.6	10.4	3.3	11.8	8.2
1982	9.0	6.1	7.0	n.a.	9.2	n.a.
1983	7.1	6.6	8.1	n.a.	9.4	n.a.
1984	7.2	7.2	8.5	n.a.	12.1	n.a.
1985	7.5	8.6	9.1	n.a.	11.7	n.a.
1986	7.8	10.1	8.9	n.a.	13.5	n.a.
1987	8.5	10.6	9.2	n.a.	15.8	n.a.
1988	9.2	10.3	9.7	n.a.	14.4	n.a.
1989**	7.1	10.0	9.8	n.a.	16.1	n.a.

* Private Gross Fixed Investment as a percentage of GDP
** Preliminary
n.a. not available
Source: FLACSO, 1990, p. 16.

private or public, the structural adjustment programmes could not be sustained and economic recovery would remain beyond reach in the region.

Escape from stagnation would require an increase in exports, to sustain the rise in imports provoked by renewed growth. Except for Costa Rica, the 1980s offered no evidence that the Central American countries could anticipate increased export demand or a domestic supply of tradables that would sustain growth of per capita income. In the early 1990s it was not clear whether Costa Rica's export success represented what the other countries could reasonably hope for, or whether these were gains made at the expense of the other countries in the region as the US and European markets became more protectionist.

A quite disturbing aspect of the disastrous 1980s was precisely increased regional inequality. In 1975 three of the countries had per capita incomes within 10 per cent of the regional average; in 1989 none were this close. Considerably less than twice the regional average in 1975, Costa Rica's per capita income rose to over 220 per cent of that average in 1989 (see Table 1.3B). While the greatest relative changes were by the war-affected countries, the possibility could not be

discarded that abandoning regional integration in favour of an extra-regional export strategy unleashed a process of uneven development in the region. Exactly this possibility is demonstrated in the growth simulations in Chapter 9. In part this uneven development might have resulted from the conscious selection by the lending agencies of Costa Rica for special consideration. For example, after much publicity and propaganda in mid-1989, debt relief under the Brady Plan was extended to only one country in the region, Costa Rica. Perhaps because of its success, the Costa Rican experience cannot be repeated in the region: the markets and concessionary financial support for the other countries would not be forthcoming.

1.4 ANALYSING CENTRAL AMERICA

In the preceding sections of this chapter we analysed the theoretical as well as practical pitfalls of mainstream structural adjustment programmes in the region. The results were disappointing even in terms of the macroeconomic and growth objectives established by the architects of such programmes. The ten chapters that follow treat in more detail major issues of social and economic policy for the Central American countries. In our summary of these essays we distinguish three broad categories of policies: those concerning the domestic economy, international trade and the agrarian sector.

Domestic economic policymaking was basically directed at stabilisation and reactivation of economies that suffered from external as well as internal shocks in the first half of the decade. Macroeconomic relationships are treated for Nicaragua and El Salvador, two of the most disrupted and war-torn countries in the region, and Honduras. Both studies on Nicaragua examine the appropriateness of monetary, fiscal and other traditional IMF–World Bank recommended instruments to combat hyperinflation, to increase exports and recover economic growth (see Chapters 2 and 3).

Chapter 2 questions the correctness of the application of a demand contraction strategy by the Sandinistas in the last years they held government. The redistribution without growth policy they implemented previously was a direct consequence of the North American military and economic interventions. The fundamental causes of hyperinflation and recession which the country suffered in the second half of the decade could be explained by these factors, and not only attributed to excessive rates of devaluation, money expansion, and

fiscal deficits. Supply-side constraints and the absence of cooperation of the private sector were obstacles to success of the outward-orientation policy proposed to the Sandinistas, while the tight money policy did nothing more than to suppress the consequences and not eliminate the roots of hyperinflation. Further,the outward-orientated strategy presupposed the fall of the Sandinista government for successful implementation (see Chapter 2).

The monetary and internal price policy of the next Nicaraguan government anticipated a more favourable external context, and is analysed in Chapter 3. Equilibria on macro-economic balances and increased export production became key objectives of economic policy. Policies resulted in a rapid change in internal relative prices and the elimination of a great part of the subsidies established by the Sandinista government. This was accompanied by a restrictive monetary policy linked to the sequencing of the agricultural production cycle.[20] Chapter 3, like the previous one, stresses the importance of the socio-political context and the social polarisation that affected the viability of the strategy. To prevent a continuing flight out of the *córdoba oro* to the dollar, the Chamorro government should consider, according to the author, a planned and negotiated (partial) privatisation of state enterprises inherited from the Sandinistas.

Income and power distribution are also at the heart of the analysis of El Salvador in Chapter 4, which emphasises that counterinsurgency and economic surplus appropriation from the traditional oligarchs were the main objectives of economic policy of the Christian Democratic government. This was supported by a massive inflow of military and economic aid from the United States, which intervened to save the government from military defeat. On the effects of economic reforms in agriculture, banking and exports, as well as on fiscal, wage and price policies, the conclusion is reached that these had a regressive character, with priority placed on executing the war and debt service expenditures. While private investment grew somewhat after 1984 and, in comparison to Nicaragua, inflation was low, real wages fell and unemployment and underemployment remained high. Due to strong opposition from the private sector, the government found it impossible to make fiscal policy more progressive. These developments, ongoing civil war and rising social unrest, undermined the Salvadorean variant of adjustment with structural reforms. Chapter 4 concludes that the electoral defeat of the Christian Democrats and the accession to power of the ultra-rightist ARENA party, brought a return of the oligarchy to its dominant position of the past.

Honduras had been less dramatically affected by social unrest. Prospects for recovery according to the design of international financial institutions is scrutinised carefully in Chapter 5, which shows empirically how domestic policymaking was restricted by external imbalances, especially the foreign debt and adjustment policies within developed economies. It finds that the level of the accumulated debt at the end of the 1980s implied saving rates of prohibitive levels to be necessary to finance debt service through economic growth. Using the same logic, it is shown that economic measures by developed countries, that resulted in rising international interest rates, contributed significantly to the high accumulated debts of the developing world. The conclusion is reached that in the case of Honduras nearly half of the foreign debt should be 'forgiven'. All the chapters in this section make it clear that domestic policymaking in Central America suffered from external disruptions, primarily by the United States. These were either of a strictly economic nature (e.g. international interest rates) or of a coercive, extra-economic type (e.g. military intervention).

The four chapters on trade policy analyse economic external relations between Central America and world markets. Trade policy in the 1980s was directed at reducing the negative impact of world market fluctuations, lowering protection levels, and of increasing competitiveness and efficiency of production. The specific case studies treat countries with governments prone to accept IMF–World Bank advice, while Chapter 9 compares this policy approach to alternatives. The two chapters on Costa Rica examine the rationale behind the institutional changes which accompanied the country's outward-orientated strategy during the 1980s (see Chapters 6 and 7). Costa Rica implemented the most consistent policy in this direction, through agreements with both international institutions and individual countries (e.g. the United States). Agreements included cross-conditionality with the IMF and the World Bank (see Fuerst 1989).

Chapter 6 on Costa Rica considers the relation between this country's regional peace initiatives and its structural adjustment process in terms of non-traditional exports promotion. Because of the restricted and unequal benefits produced by the Central American Common Market in the 1970s, Costa Rica opted for a straightforward export orientation to recover from its economic crisis. This extra-regional export strategy required political stability in the region in order to reach bilateral and multilateral economic agreements without severe political restrictions. At the same time, the Costa Rican government pursued regional cooperation on specific issues, for

example on international coffee agreement and development aid negotiations.

The entry of Costa Rica into the international trade organisation GATT seemed another logical step in the move to liberalise the economy. However, as Chapter 7 shows, considerable costs were involved, which would precede expected but uncertain benefits. Among the possible benefits were new export opportunities outside the region. Among the costs are included disruption ('reallocation') of resource use, reduction of real wages and social expenditure, as well as modification of institutions reducing national sovereignty. It is argued convincingly that these costs were insufficiently evaluated in the discussions about the GATT membership. A meaningful national debate by all parties involved had not taken place when the entry was approved by the National Assembly in 1990.

Using econometric techniques, Chapter 8 investigates the effectiveness of economic policy instruments in stimulating non-traditional exports in Guatemala. As mentioned earlier in this chapter, Guatemala received praise from the World Bank for successfully applying market forces to revive the economy. Chapter 8 calculates the effects of policies on the principal non-traditional product categories. In spite of data problems and ambiguities of regression specification, there are some interesting conclusions. The real interest rate, export taxes and agricultural wages had in many cases no significant effects on export behaviour. In some cases there were 'perverse' results, like a positive effect of export taxes and real agricultural wages, though the latter might be reconciled as a source of finance for small producers. Chapter 8 suggests that the insensitivity of export changes to real interest rates might be explained by the structure of the financial system in Guatemala, in which these rates did not reflect the real costs of capital. The statistical evidence indicates that the most relevant instrument for specific products seemed to be the real exchange rate.

Chapter 9 concludes this section on trade policy in Central America by calculating the impact of alternative strategies on the recuperation of the region, using the 1980 level of real per capita consumption as criterion. Using a simplification of a Keynesian two-gap econometric open economy model, scenarios for each of the five countries in the region are calculated. Even when qualifications are made for the data, assumptions and limitation of the model, the results are striking. If the 1984–87 growth trends in CACM and non-traditional exports were continued, only Costa Rica by 1995 would achieve its per capita consumption level of 1980. If, as recommended by the international agencies, all countries shifted to non-traditional exports to extra-regional markets, none of them would reach the target in 1995. This was also the case for a continued regional import substitution strategy. A combination of both strategies performed considerably better than the target for Guatemala, El Salvador and Costa Rica, but still less than this for Honduras and Nicaragua. However, all countries should be better-off in this scenario than in the case of continuing 1984–87 trends. Obviously, these results questioned the effectiveness of the market-orientated free trade strategy that became so generally accepted in international economic policymaking of the 1980s.

The final two chapters of this book treat agrarian policies aimed at economic recovery through the application of reforms designed to change the structure of ownership and power in the rural economy. It was no coincidence that Nicaragua and El Salvador were the two countries where agrarian reforms were introduced in the 1980s. These reforms played an important role in the attempts to restructure the economies and bring an end to social turmoil. The US government played an important role in both reforms, although of a totally different nature. The Nicaraguan reform proved considerably more redistributive than the Salvadorean. At the beginning of the 1990s both reform processes stagnated and were placed in danger as a result of electoral victories by more conservative forces. Future developments would depend on the changes that the reforms had generated in rural class structure, productive efficiency, and commitment of the peasantry to the reforms. Also crucial would be the role of the pro-reform opposition to the new governments and the availaibility of external aid in support of the reforms.

Chapter 10, on the future of the Nicaraguan reform in the post-Sandinista period argues that in order to reactivate the peasant economy, technical improvements and risk-reduction measures must be introduced. After analysing the nature of the Sandinista agrarian reform, the different phases of land distribution, and the adjustment policy of the Chamorro government, it is concluded that there remained ample space for the cooperatives of various types. Since inefficient state monopolies hampered the development of the Sandinista cooperatives, privatisation of enterprises might open the possibility of rural development along cooperative lines. However, the danger remained that state monopolies would be replaced by private ones.

The development of agrarian cooperatives proved more problematic in the Salvadorean case (see Chapter 11). Under the Christian

Democratic government in the 1980s there were serious constraints on cooperatives for both production and marketing. These led to individualisation of land use and ownership, which threatened to disintegrate the cooperatives. Conflicting economic and political objectives made the position of the smallholder worse, which contrasted strongly with the relatively favourable position of the same group in Nicaragua. Ironically it was the ARENA, rather than the reformist Christian Democratic regime, which took a strong stance in favour of expanding the allocation of land to individual families. This policy further undermined preferential treatment for the cooperatives and laid the ground for a reversal of the Salvadorean agrarian reform.

To prevent agricultural stagnation in Central America it might be necessary to reduce regulations and controls on product and factor markets, but this would not be sufficient. Institutional changes and state intervention would still be necessary to fulfil redistributive as well as efficiency objectives. Nearly all studies pointed to the need for redistributive strategies to achieve growth and social sustainability goals. Because of the persistence of capital flight, and the *rentier* behaviour of the rich, greater income equality need not decrease saving rates (Bradford, 1990). State intervention could play an important role in eliminating supply-side constraints, as it did in the past when directed toward integrating the Central American economies into international commodity markets. This could stimulate dynamic export growth more than simple static allocative efficiency gains from relative price changes.

Notes

1. In the literature on labour systems in Central America the terms 'unfree' and 'forced' labour are used to refer to non-capitalist forms of labour relations such as debt peonage, the *colono* system, *mandamiento*, *enganche*, and contract labour combined with vagrancy laws (the latter implemented through use of passbooks carried by the worker). Our term 'coerced' labour includes these, but also strictly capitalist employment relations within a repressive context that denies the rights normally granted to workers in capitalist society: the right to organise effectively, to strike, and to protest against the political system.
2. The relationship between forced labour and political despotism in Central America is treated in John Weeks, 1986.
3. The argument for 'deregulation' is found, country by country, in the following World Bank reports: World Bank 1987a and 1989b (Guatemala); World Bank 1987b (Honduras), World Bank, 1988 (Costa Rica); and World Bank, 1989c (El Salvador). The case for the region as a whole is presented in World Bank, 1989a.

4. A review of how extra-economic instruments managed by both entrepreneurs and the state affected labour relations on coffee *fincas* in El Salvador in the late 1980s is given in Pelupessy, 1990b.
5. For a USAID view of structural adjustment in Central America, see Buttari, 1990. Carlos Vilas has written of the political impact of multilateral adjustment policies that they would enhance the power of 'the new right' in Central America and in general the traditional dominant groups (Vilas, 1990: p. 4).
6. A related but different reasoning emphasising the role of adjustment in agricultural modernisation and the way it favours accumulation, can be found in Bernstein, 1990.
7. See for this traditional definition Balassa, 1982.
8. On the importance of sustainability for structural adjustment programmes, see Rodrik, 1990.
9. This position was stated explicitly in a World Bank report on Panama (World Bank, 1989, p. 3).
10. For example, 'The Honduran economy faces fundamental structural problems. These include . . . a large and inefficient public sector . . .' (World Bank, 1987b: p. ii). .
11. The critiques of this approach are explained in Weeks, 1989a: Chapters 8–10.
12. At a more general level, Ray writes, 'The recession of 1982 (of the US economy) dealt a stunning blow to developing countries in two significant respects. First, their export sales dropped dramatically . . .' (Ray, 1989: p. 113).
13. 'The average world price of agricultural commodities fell by over 40% between 1978 and 1987 . . .' (World Bank, 1989c: p. vi).
14. Rivera (1987) argued that devaluation was not an effective instrument for Central America, with reasoning similar to ours.
15. Among the items exluded were: textiles and clothing (these being subject to separate protectionist legislation), footwear, handbags, luggage, flat goods, certain types of leather goods, most products derived from petroleum, and watches.
16. The protectionist measures are reported in the annual reports of the International Trade Commission (ITC) to the US Congress. In its 1985 report, the ITC observed that the use of protectionist duties appeared to have discouraged US investment in Central America. For further discussion, see Weeks, 1989b.
17. Using quite cautious language, Ray concludes that the CBERA further institutionalised protection against those products for which Central American producers might have enjoyed a competitive advantage in the US market. 'The evidence . . . suggests that . . . the CBERA provide(s) duty-free access to US markets for exports from Caribbean countries that would not face substantial protection in the absence of (this) program . . . . The CBERA explicitly excludes many of the leading export sectors for the Caribbean region from access to the duty-free provisions of the bill. To the extent that inducement effects are embodied in the

legislation, they are not compatible with the likely competitive opportunities facing the region in international trade' (Ray, 1989: p. 207).

18. These percentages are from the regional data base of FLACSO (1990). The earlier figure for Nicaragua refers to 1975.
19. The decline in investment after the application of structural adjustment policies is treated in an international context in Rodrik (1990); Faini *et al.* (1989); and Faini and de Melo (1990).
20. See Edwards, 1990, for the general importance of sequencing for adjustment policy.

Part I

Domestic Economy Policy

2 The Nicaraguan Stabilisation Programme of 1989 and Prospects for Recovery

John Weeks

2.1 INTRODUCTION

Through the 1980s, the Nicaraguan economy showed increasing signs of crisis. By 1984 the economy was in decline (see Table 2.1), in 1985 inflation reached triple digits, and 1988 took the monetary economy into chaos with hyperinflation. Beginning in 1985, the government responded to the accumulating difficulties by introducing demand-depressing measures, though these proved ineffective, perhaps even disfunctional (INIES, nd; chapter III). In early 1988 the Sandinista government introduced a draconian package of fiscal and monetary reforms, accompanied by the issuance of a new currency unit in February, in which 1000 old córdobas exchanged for one new. Still the crisis of the monetary economy worsened, indicated by a rate of inflation that year of over 30 000 per cent, accompanied by a devaluing of the official exchange rate from 80 new córdobas to the dollar to 7000 in the space of a year (February 1988 to February 1989)[1]

With the monetary economy out of control, the government accepted a mission of foreign economic experts funded by the Swedish International Development Agency to assess the situation and produce a programme for short-run stabilisation and medium-term recovery. The mission spent January and March of 1989 in Nicaragua and apparently delivered its report to the government in late April. The *New York Times* released the text of the report in June 1989, and President Daniel Ortega publicly disowned the document. Under political pressure not to abandon what remained of the redistributive policies of Sandinista populism (IHS, 1988), he denied that the mission had been officially invited, and challenged the figures it used and its analysis. Nevertheless, in the report could be found repeated assertions

Table 2.1 Nicaragua: basic macroeconomic data, 1976–1989 (constant prices, except for inflation rate)

	Gross Domestic Product Growth rate	Index Total	Index Per capita	Private consumption per capita	Inflation rate
1976	–	100	100	100	–
1978	-7.9	95.8	91.5	92.7	5.0
1979	-26.5	70.5	65.2	65.4	38.4
1980	4.6	73.7	66.1	74.7	37.0
1981	5.4	77.7	67.4	62.1	11.7
1982	-0.8	77.0	64.8	52.5	16.7
1983	4.6	80.6	65.7	48.0	11.0
1984	-1.6	79.3	62.7	44.1	39.0
1985	-4.1	76.1	58.2	39.3	167.2
1986	-1.0	75.3	55.9	35.0	282.9
1987	-0.7	74.8	53.8	32.8	521.9
1988	-8.9	68.8	47.9	28.8	11 500.8
1989	-12.0	60.8	41.0	n.a.	35 000.0

Source: SIDA, 1989.

that government economic policy during the first four months of 1989 was formulated with close consultation with the SIDA mission.[2] Further, this report became the centre-piece of the debate over economic policy in Nicaragua until the Chamorro government took office in March 1990.

This chapter uses the SIDA report as a vehicle to analyse the past problems, current state, and future prospects of the Nicaraguan economy. The first step is to describe the economic circumstances which prompted the government to take quite dramatic policy steps. Second, it is argued that the SIDA report recommended policies quite similar to those associated with IMF/WB stabilisation and structural adjustment programmes. This argument is made prior to considering the report as such in order to present theoretical objections to this approach to macroeconomic management. Third, a critical analysis is made of the stabilisation programme of the SIDA report, to demonstrate that the mission tended to treat the crisis in terms inappropriately narrow. From stabilisation the discussion moves to the programme for recovery found in the report. Here it is argued that the policy recommendations for medium-term recovery were of limited relevance to the Nicaraguan economy in 1989. The analysis of the chapter leads to an extremely pessimistic perspective on future prospects for the economy.

2.2 CRISIS OF THE NICARAGUAN ECONOMY

The war to overthrow Somoza proved extremely expensive in economic terms. The Sandinista seizure of power was achieved at great cost to the country, comparable to other major revolutionary struggles – for example, in Russia, China, Algeria, Mexico. In addition to the terrible lost of life, during 1978 and 1979 real output fell by over 30 per cent, accompanied by extensive destruction of productive capacity both in agriculture and manufacturing. In July 1979 the Sandinistas inherited an economy in ruins.[3] To a great extent, the cost of the war was increased by the policy of the US government to avoid at all costs a government controlled by the FSLN.

With major inflows of foreign finance, the economy expanded on the basis of unutilised capacity in 1980 and 1981 (see Table 2.1). Still disbursing this finance, the government achieved a positive growth rate in 1983 despite a slight contraction the previous year. However, in 1983 per capita income was virtually the same as it had been in 1979 (column 3 in the table), and per capita private consumption was considerably lower (column 4). The recovery proved minimal; perhaps not to be described as a recovery at all. In 1984 decline set in, coincident with a return to war and a shift of resources to military uses. For the eleven years, 1978–1988, only three could be described as 'peacetime', 1980–82 (and perhaps only 1980–81). With war came inflation, rapid in 1985 and 1986, rampant in 1987, hyper for 1988–90.

By 1989 per capita income had fallen to half its 1976 level, and per capita private consumption was less than a third.[4] The distribution of losses was not even across the income classes. While there are no data on income distribution as such, reasonably reliable figures on food supplies exist. According to the FAO, the per capita consumption of calories in Nicaragua for 1974–86 was 2431 a day, and the per capita consumption of protein 69g. For 1984–86, when per capita income was 35–40 per cent lower than ten years before, calorie consumption per head was 2473 (up 2 per cent) and protein consumption down 10 per cent to 62. These figures are consistent with a substantial redistribution toward lower income groups, primarily through subsidised sales of grains, part of it imported through concessional arrangements.[5]

With regard to gainers and losers during the period of economic decline, one can summarise the situation as follows. Capitalists and landlords of the large-scale sector suffered a substantial erosion of their incomes due to declining exports and a contraction of the manufacturing sector. The latter occurred because of the collapse of

the Central American Common Market (CACM), the decline of domestic consumer demand, and a shortage of foreign exchange for inputs. In relative terms the urban working class suffered much more. Taking 1981 as 100, real wages fell to 60 in 1985, 14 in 1987 and 7 in 1988 (SIDA, 1989). Further, employment contracted sharply, perhaps by as much as 30 per cent over the period, though the military absorbed some of the labour surplus. Probable gainers were petty traders, referred to often as the 'informal sector'. Despite government policies that generally discouraged this class, the pervasive spread of parallel and black markets shifted income towards petty commerce. The urban artisanal class might have not have gained, however, because it too suffered from the shortage of foreign exchange, at least indirectly. Within the so-called informal sector as for the economy as a whole, activities involved in circulation benefited while production declined.

The peasantry certainly improved its relative position in the functional distribution of income, though through a process that alienated a considerable proportion of small- and medium-holders from the Sandinista government. The distribution of land reduced the degree of landlessness, both officially (through formal land distribution) and unofficially (most land invasions that were not reversed). It is a general rule for predominantly agrarian societies that in times of severe economic crisis, those in the lower classes with access to agricultural land can protect themselves better than those without such access. This safety net, having the means to produce basic foodstuffs, proved particularly insecure in Nicaragua since peasant families did fear loss of land through indebtedness and forced sale. Indeed, in the late 1980s, the Sandinistas forgave much of the agrarian debt.[6] While agricultural families received tangible benefits, a number of policies of the Sandinista government embittered the peasantry. Particularly unpopular was the role of the state purchasing agency ENABAS, to whom peasants were required by law to sell their surplus production of all the major crops. While evasion of ENABAS was widespread, this did not reduce the unpopularity of the government's agricultural policy.[7]

In summary, the process of decline made almost everyone worse-off, and the country's relatively small working class suffered most. Further, those that gained, relatively or absolutely, probably saw themselves as doing so despite, not because of, government policy. Within this process of decline, Sandinista policies brought a social revolution to Nicaragua. The dominant classes of the Somoza period were profoundly weakened, and a peasantry captured within relations of forced labour was transformed into a class of independent smallholders (Dore and Weeks, forthcoming).

2.3 THEORETICAL OBJECTIONS TO IMF-STYLE PROGRAMMES

The crisis of the Nicaraguan economy manifested itself in most virulent form through a relatively enormous trade deficit, a massive fiscal deficit, and hyperinflation. The proposed adjustment programme of 1989 addressed itself to these symptoms. Implicit in the analysis could be found the view that a substantial reduction in inflation would improve the current account of the balance of payments. This argument was made even though the trade deficit pre-dated hyperinflation by seven years.[8] The report assigned the cause of the hyperinflation to excessive increases in the money supply (referred to as 'monetary emission'), which themselves were the result of an enormous fiscal deficit.[9]

While it included heterodox elements, the analysis fitted comfortably into the mainstream view that inflation is a monetary phenomenon arising from a more or less strict relationship between the general price level and the amount of the means of circulation outstanding in the economy. This approach might be called 'the theory of autonomous money'. In this analysis, the word 'money' implies that the quantity of the means of circulation is at any moment a determinate quantity (at least in principle), and this quantity behaves autonomously with respect to the level of real output. It bases itself on two important theoretical abstractions: 1) as already mentioned, the means of circulation can be treated as autonomous with respect to the level of output and prices; and 2) that the primary determinant of the rate of expansion or contraction of the means of circulation is government policy. Elsewhere I have criticised in detail both of these theoretical abstractions (Weeks, 1989a: Chapter 4). In an economy in which the narrowly-defined means of circulation consists largely of bank-created instruments (demand deposits rather than 'cash'), the autonomy of the means of circulation with respect to output depends upon the behaviour of credit-creating institutions. Not even the most monetarist of neoclassicals would believe that governments control the money supply. The theoretical generalisation maintains that certain actions of

the 'monetary authorities' will have a determinate outcome on the means of circulation when economic agents behave according to formal criteria of 'rationality'. There exists a considerable literature calling this approach into question.

It could be argued that this line of criticism of the theory of autonomous money was not relevant to the Nicaraguan situation in the 1980s. First, as inflation proceeded, currency accounted for an increasing proportion of the means of circulation, and all would agree that this component of the means of circulation falls within the control of government authorities, be their policies systematic or random. Second, the credit-creating institutions of the economy (banks) were part of the state sector, so the authorities could directly set borrowing limits. And finally, the expansion of the means of circulation increasingly took the form of central government deficit spending financed by printing money or the government borrowing from itself ('monetising the deficit'). In this context, monetising the deficit resulted in an excess supply of the means of circulation, which increased the notional monetary demand for commodities. With the supply of commodities restricted by an import constraint and other structural bottlenecks associated with the war of aggression, upward pressure on prices resulted.

This brief inflation story differs from that of the International Monetary Fund. First, it stresses the structural and political causes of the fiscal deficit. Second, it denies that the economy would tend toward full employment equilibrium in the absence of 'distortions', chief among which would be the fiscal deficit itself in the IMF view. However, in common with the IMF is the conclusion that inflation's proximate cause is 'expansion of the money supply'. Thus, both approaches prescribe the same remedy: reduce the fiscal deficit and the inflation rate would fall. Both approaches emphasise, almost exclusively in the case of the IMF, the means of circulation as the major function of money, and a putative stability in the demand for money. If money serves primarily to facilitate exchange; if the demand for money as means of circulation is stable; and if the government determines the supply of the means of circulation; then it follows that inflation is a monetary phenomenon within the control of government, though exerting that control might have high costs in terms of lost output and distributional shifts.

However, money does not exclusively serve as a facilitator of exchange. Particularly in times of high inflation, two other functions of money assert themselves: money as a store of wealth and as means of payment.[10] Store of wealth is obvious: in a commodity-producing society the generalisation of exchange creates the need to hold wealth in the form of a general equivalent; otherwise it represents potential rather than actual claim upon commodities and labour. Money as means of payment involves a subtler point, which can be illustrated by a mundane example: a credit card serves as means of circulation, but cannot itself be used to cancel the debts it creates. When the credit-card bill comes in the mail and is paid, money serves not as means of purchase (this occurred long before), but a means of cancelling debt (means of payment). This example demonstrates a general point: the same instrument is not in general satisfactory to serve all the necessary functions of money.[11]

As the grip of US economic and political sanctions tightened around Nicaraguan society and counter-revolutionary activity intensified, the córdoba increasingly failed to function as either a means for storing wealth or a means of payment. Massive capital flight represented the major vehicle undermining the normal function of the córdoba. As córdobas flowed into the hands of capitalists and landlords, these were used to purchase dollars, continuously devaluing the national currency. At the same time the propertied classes increasingly required that debts among themselves be cancelled in dollars, as part of the same process of capital flight. In the absence of an expansion of the means of circulation ('growth of the money supply'), this process would have created a decline in the real money supply, through the black market devaluation of the córdoba. By the second half of the 1980s the black market exchange rate rose to over one hundred times the official rate, with the economy suffering from both acute córdoba inflation and a compression of the real demand for commodities. The córdoba inflation derived from the speculation-driven devaluations, and the contraction of demand from the decline in the real value of the available means of circulation.

In this context restriction of growth of the means of circulation would have a purely output-restricting effect. Inflation, and later hyperinflation, represented in Nicaragua a symptom rather than cause of the maladies of the economy. The fundamental cause was the war into which the country plunged, a war prompted by the obsession of the Reagan–Bush administration to overthrow the Sandinista regime. Córdoba speculation played a key role in this war, undermining the stability of the monetary economy. Hyperinflation emerged after the Nicaraguan government exhausted its foreign exchange reserves, leaving it with no control over the exchange rate.

Once inflation reached astronomical rates in Nicaragua, the economy could be stabilised, but only at a very low level; put another way, the economy could be stabilised but not revived. The Chamorro government would discover this unpleasant reality in 1990 and 1991. Hyperinflation in the late 1980s was not, strictly speaking, a problem to be solved. Rather, it was a manifestation of the breakdown of the process of economic reproduction. Hyperinflation signalled that the economy required basic restructuring; that the economy and the society could not continue in the same way. In this sense 'stabilisation' was not the appropriate word for the policies required, for the tension surfacing in the form of hyperinflation could only be *repressed* through use of normal monetary and fiscal instruments, not resolved. At best, anti-inflation policy in Nicaragua would convert chaos and collapse with hyperinflation into chaos and collapse without hyperinflation. From a narrow economic perspective one might conclude that improvement occurred by this conversion, but only the monetary manifestation of the collapse would have been affected.

When pursued as a single-minded priority (for example, Bolivia in 1985–86), eliminating hyperinflation intensifies the problems that caused it in the first place. In the case of Nicaragua, the attempt to contract monetary demand resulted in weakening those groups in the society who supported a progressive solution and strengthening those supporting a return to the old order. Hyperinflation signalled that the Sandinista attempt to bring about a fundamental change in wealth and power, though it had not failed, had reached its limit; demand contraction policies reflected an abandonment of their project altogether. The market-orientated, demand-suppresion policies of the Sandinista government during 1988 and 1989 intensified the problems that initially caused the hyperinflation: namely, the contradictions of the mixed economy strategy.

2.4 DIAGNOSIS OF THE SIDA REPORT

The SIDA report was organised in a way that was familiar to those involved in multilateral or bilateral economic missions to underdeveloped countries, incorporating what might be called 'policy optimism'. In this approach bad policies brought the economy into a mess and good policies would reverse decline, with the effect of the former made worse by US aggression, but seen as major determining factors in their own right. The report flowed as follows:

1. statement of the problem, with emphasis focusing upon policy mistakes;
2. suggestion of alternative policies, presented with the optimism that they will result in a significant correction of the problems; and
3. the suggestion that the policies would not only correct the situation but bring dramatic improvement, with this hope fortified by hypothetical scenarios involving counterfactual developments that produce benign outcomes.

This approach tended to focus upon factors over which the government could control (reasonable enough for a policy report), then to downplay those over which the government did not have control, or posit *ex machina* improvement in these non-policy factors.

The crisis of the economy was seen as threefold: hyperinflation, balance of payments (imports in 1988 were almost four times exports), and the need for external assistance. It is not clear why the mission believed that inflation went from rapid to hyper. Taking hyperinflation as given, the report told the following story: once the inflation rate rose to hyper levels (say, 1000 per cent annually), the government was forced into major devaluations which increased the demand for credit both for the private and public sectors. Then, government budgeting went completely out of control, so it was necessary to rapidly expand extra-budgetary allocations to cover imports bills. At the same time, the lag between expenditure and tax revenues produced an increasing deficit. With inflation over 100 per cent a month towards the end of 1988, the real value of assessed taxes fell precipitously by the time payments came due. The solution offered for hyperinflation was monetary and fiscal austerity, involving expenditure cuts and monetary restraint. The two were closely related since there was no private market for government debt. At no point did the report put a number to the expenditure reduction; rather, emphasis was given to monetary restraint as such.

In critique of this approach, it can be noted that while fiscal and monetary restraint might have reduced the rate of inflation, given the concrete circumstances of Nicaragua in the late 1980s, evidence provided in the report gave reason to doubt that monetary expansion was the proximate cause of the rapid price increases. Regression estimates presented in the report showed that the coefficients on the narrowly-defined money supply (M1) were not significant for quarterly data. The most significant variables proved to be the nominal black market exchange rate and the inflation rate lagged one-quarter. One

reason that the money supply showed non-significance may have been that the monthly and quarterly inflation rates manifested great variability. Further, far from adhering to the hypothesis of neutrality, tremendous changes in relative prices characterised the inflationary process.[12] The relative price changes could not be explained by selective price controls, for most of these were abandoned officially or *de facto* prior to the emergence of hyperinflation. Further, the regressions indicated that in the absence of nominal changes in the exchange rate and growth of the money supply, the inflation rate would stabilise at 7 per cent per month (an annual rate of 125 per cent), which the mission called 'improbably high'. This high level of unexplained inflation suggests the omission of important explanatory variables. To treat this residual as reflecting inflationary expectations would have been merely to give a label to an unexplained quantity.

Any inflation can be reduced if monetary demand is suppressed enough. But given that the quarterly price increases were volatile in magnitude, non-neutral, and apparently not closely related to money growth, one could adopt an alternative hypothesis that demand suppression would not address root causes, but rather result in their manifestation in alternative form. The basic problem in the inflation analysis was highlighted in the following quotation from the report: 'The . . . maxi-devaluations and the inability of the authorities to control the fiscal deficit and money growth are the fundamental causes of the hyperinflation' (SIDA, 1989: p. 27).

Use of the word 'fundamental', along with placing devaluations and money expansion at the same level of analysis suggests a rather narrow perspective that did not adequately take into account the basic conflicts and contradictions in Nicaraguan society following the fall of Somoza. The demand suppressing medicine worked, albeit briefly. With the exception of June 1989, when the new córdoba was devalued from 7900 to the dollar to 21.000, the inflation rate dropped spectacularly for several months. But by early 1990 inflation returned to its previous levels of hyperexpansion and continued unabated into 1991. The root causes of the inflation had not been eliminated, but only momentarily repressed.

2.5 THE SIDA REPORT'S GROWTH STRATEGY

The report sought not only to provide a programme for stability, but also a strategy for recovery and growth, in which 'the major impetus will have to come from increased exports' (SIDA, 1989: p. 12). In a sense this conclusion was incontestable: in the absence of compensating capital flows, no country can grow if imports are four times the level of exports. However, if the emphasis upon exports implied an export-led growth strategy in which the productive structure of the economy would become more open to the international economy, the recommendation becomes somewhat dubious. Any prudent judgement in early 1989 had to conclude that the US government would continue its policy of isolating Nicaragua politically and economically. Further, changes in Eastern Europe and the Soviet Union indicated that assistance from those countries and access to their markets would decline. Therefore, increased openness to the world market would increase Nicaraguan vulnerability to US economic sanctions.

The soundness of the strategy of the SIDA report was further brought into question by the concrete policy measures by which exports would be increased: 'Real devaluation will be the foundation for an export push. However, recent experience in developing countries shows that getting key prices "right" is only a necessary and far from a sufficient condition to improve trade' (SIDA, 1989: p. 12)

Despite the strong qualification in the second sentence, the proposal that 'real devaluation' would provide the 'foundation' for a substantial increase in exports would seem rather misplaced. In 1988 the value of exports stood at less than 50 per cent of the 1981 level, and barely 35 per cent seem a blunt instrument indeed to achieve the needed recuperation in exports. But Nicaragua was a country at war, in which many of the major export producers, whose response to the devaluation would be crucial to its successful impact, had thrown their lot with the armed opposition. Setting aside the theoretical doubts about the impact of devaluation on exports presuming a strong supply response from large-scale private producers was hardly appropriate in the Nicaraguan conditions.

As indicated by the last quotation, the report considered that policies in addition to devaluation would be necessary to stimulate exports: 'Directed, supply-side policies must be devised to raise performance in important export sectors. These include coffee, fish and shellfish, and oilseeds apart from cotton (soya and sesame have good prospects)' (SIDA, 1989: p. 12)

This rather vague recommendation represented an example of 'policy optimism', with its implication that there existed in the economy sectors or products heretofore unexploited which could be expanded at relatively little cost to yield significant increases in export

earnings. For such proposals to have credibility they would need to incorporate an explanation of why these opportunities had not previously been exploited. In the absence of such an explanation the implicit hypothesis would appear to be that the opportunities went unrealised because of the distorting effects of incorrect policies. This hypothesis assumed what it must establish: that incorrect policies represented the basic constraint to export expansion. Even if one accepted that such opportunities existed in Nicaragua in 1989, success in 'supply-side policies' (a phrase unfortunately tainted with the ideology of the political right) would require cooperation from the same private sector that threw in its lot with the counter-revolutionaries. The SIDA explicitly recognised this prerequisite for export expansion: 'Export growth will not be possible without a genuine social accord with the productive sector. [] Stable rules of the game are essential to motivate productive firms to invest . . . . Specifically, the mission suggested that limits be defined for the process of agrarian reform (a step taken in January), that equal treatment be given by relevant government functionaries to enterprises in the private and public sectors, and that in general an environment be created to support a healthy private/public mix of economic activity' (SIDA, 1989: p. 12).[13]

This same recommendation, establishing 'stable rules of the game', represented a key element in the World Bank report on Nicaragua of 1980 (World Bank, 1980). Earlier attempts to achieve a 'social accord' fell victim to US aggression and the *contra* war, and prospects had not substantially improved by 1989.[14] The capitalists and large landowners participated in the conflict as partisans of the counter-revolution, and as long as the Sandinistas remained in power the US government was committed to their overthrow. With the US government maintaining this hostile policy, no social accord with the private sector was possible. Thus, the recommendation of a strategy dependent upon a peaceful settlement beyond the control of the Nicaraguan government could not be considered very practical.

Also impractical was the suggestion that exports might be increased to the Central American region if Nicaragua's arrears to its CACM neighbours were paid.[15] Notwithstanding this optimism, the CACM did not offer a significant market for an increase in Nicaraguan exports in 1989. The CACM fell into decline after 1980, and by the end of the decade intra-regional trade dropped to a third of its peak level. Within this general decline, Nicaragua's regional trade fell more than for any other country, reflecting the political exclusion of the Sandinista government from regional cooperation. With the international agencies opposed to regional integration (e.g. World Bank, 1989), the economies of the area in depression (except for Costa Rica's), and Nicaragua a pariah, prospects for Nicaraguan exports within the region were considerably bleaker than suggested by the SIDA report.

A further, quite important aspect of the strategy, stressed in the report, was that its success would require substantial inflows of hard currency. No figure was offered; one would assume that the report had in mind at least US$ 200 million annually over several years and probably considerably more. If anything could be treated as certain in Nicaragua in the late 1980s, it was that the government could expect no significant inflows of hard-currency assistance. Under economic pressure from the US government, neither the multilaterals nor the Western European governments would provide such aid. Under the best of circumstances the Soviet Union and its erstwhile allies provided closely-tied aid, and by 1989 even that was in decline.

On reflection, the SIDA growth strategy can be judged as one that would only be successful if the Sandinistas fell from power: their fall would prompt the US government to end its aggression, thus paving the way for the 'genuine social accord' mentioned in the report, as well as access to multilateral lending. Therefore, it is not surprising that President Daniel Ortega in June 1989 publicly disowned the report: it was not relevant for his government; indeed, the fall of his government would be the prerequisite for implementation of the programme.

2.6 PROSPECTS FOR THE 1990s

The failure of the SIDA report to produce a feasible stabilisation programme and recovery strategy derived from circumstances beyond the control of the authors of the document: in the late 1980s there existed no realistic scenario for reactivation of the Nicaraguan economy. The fundamental economic problem was the enormous deficit in the current account. One could imagine no source of external capital flows to cover this deficit, and an expansion of exports to do so would be impossible in the medium or short run. To be completely fair to the SIDA mission, it should not have been criticised for not producing an effective programme of recovery, since none existed, but rather for not acknowledging that none existed.

Foreign missions that promote optimism when none is warranted only bring governments into disrepute, making continued decline appear as policy failure. The World Bank and the International Monetary Fund developed this role of external advisers to an art form in their structural adjustment programmes of the 1980s, producing largely irrelevant and frequently inappropriate policy packages, then leaving governments to bear the culpability for the subsequent continuation of economic decline.[16] The Chamorro government in 1990 would discover the intractable nature of the Nicaraguan crisis. Central to stabilisation was maintaining a fixed or moderately-depreciating exchange rate. The new government based its hopes for exchange rate stability on substantial US assistance and reversal of the capital flight that drained the economy of foreign exchange in the 1980s. Neither of these sources of balance of payments support proved remotely sufficient to the task. With the Soviet Union no longer a rival in the western hemisphere, the US government lost interest in funding success stories of transition from socialism to capitalism. Nicaragua demonstrated, as did Panama, that clientage no longer represented a sufficient condition for US largesse. With regard to the return of flight capital, the electoral defeat of the Sandinistas certainly delighted wealthy Nicaraguans abroad and at home. However, 'business confidence' and capital inflow would follow, not lead, the stabilisation of the economy.

By the end of 1990, the chaos of the Nicaraguan economy in some ways surpassed that of the Sandinista years. For several months, Nicaragua held the dubious distinction of being a country with three currencies in general use: the córdoba of 1988, the córdoba oro and the US dollar. The much-heralded córdoba oro plan for exchange rate stabilisation (see Chapter 3) proved in practice a fiasco. In the absence of substantial inflow of foreign exchange, further economic decline represented the only mechanism of adjustment for the balance of payments. One could presume that there existed some per capita product so low that imports would contract to the depressed level of exports. As the 1990s began, the Nicaraguan economy continued its descent in search of that level, with policy intervention at a loss to arrest it.

Notes

1. Just before February 1988, the official exchange rate had been 10 old córdobas to the dollar. Therefore, in February 1989, in the absence of the currency reform there would have been seven million old córdobas to the dollar. This represented but the first burst of hyperdevaluation. In January 1991, the new córdoba rate went to 4 million to the dollar (thus, four thousand million old córdobas). At roughly this rate the Chamorro government introduced another new córdoba (the córdoba oro), on par with the dollar. In May 1991, the córdoba oro traded at five to the dollar, implying an original córdoba exchange rate of forty thousand million). See Chapter 3 for a discussion of the córdoba oro. The hyperdevaluation of the córdoba can be followed in *Vistazo Económico*, a newsletter on economic affairs begun in 1989.
2. Official endorsement was also suggested by the creation within the government of a unit to monitor the economy's response to the adjustment measures recommended in the report (Nicaragua, República de, 1989a and 1989b).
3. For details, see World Bank (1980). Implications of devastation left by war for economic policy are treated in Dore (1986) and Weeks (1985: Chapter 8).
4. A review of the economic situation at the end of 1988 can be found in CEPAL, 1989.
5. For the years 1980–86, 11 per cent of total maize consumption was food aid and 14 per cent of rice. However, per capita food aid in cereals to Nicaragua (17.6 kg per year) was less than for Costa Rica (34.1 kg), El Salvador (42.2), and Honduras (22.0). Only Guatemala had a lower per capita amount (6.1). See Weeks (forthcoming: p. 81).
6. Agricultural policy during the Sandinista years is reviewed in Weeks and Hopkins (1991).
7. Sandinista agricultural policy, and especially food policy, were plagued with difficulties. See Dore (1989), which is based on the comprehensive study directed by Dore of the food system (Ministerio de Comercio Interior, 1983).
8. In 1980, the year after the triumph, the trade deficit was US$352 million and the current account deficit 379 million. In no other year in the 1980s was the current account deficit less, and it was over 800 million in 1985. Only in 1982 was the trade deficit lower than in 1980, and it was consistently above US$500 million during the second half of the decade (SIECA, 1990).
9. A comparative study by Cornia and Stewart (1990) gave the overall government deficit in Nicaragua in 1987 as 16.3 per cent of GDP, higher than for any other Latin American country except Bolivia (28.3 per cent). The study includes 42 underdeveloped countries, and of these only the deficit for Bolivia was larger than Nicaragua's.
10. The different roles of money and the function of these roles was stressed by Marx. For a presentation of Marx's theory of money, see Weeks (1981: Chapters 4 and 5).