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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

24 June 1988

Summary

The Central American democracies have achieved a degree of economic stability since the region emerged from a steep recession in 1983, but persistent budget and trade problems, political turmoil, and low private investment still stand in the way of sustainable longterm growth. With the exception of Costa Rica, living standards in the region remain below 1980 levels. Weak government revenues are making it difficult for regional governments to rebuild decaying infrastructure, provide credit for private businesses, or control inflation. A dependence on traditional agricultural exports continues to subject the region to the vagaries of world commodity prices, limiting the stable supply of foreign exchange needed to fund growth. Regional political instability has made it difficult for the democracies to enact needed economic reforms and attract the domestic or foreign private investment needed to stimulate growth. [redacted] 25X1

Backed by substantial amounts of US economic assistance, the countries have begun to implement corrective reforms, particularly to diversify exports; progress, however, will be slow and uneven. If the Central American democracies are to sustain even current levels of economic performance in the next several years, they need substantial economic assistance from the United States and other bilateral and multilateral lenders.

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This typescript was prepared by [redacted] 25X1
Middle America-Caribbean Division, Office of African and Latin American Analysis. Comments and queries are welcome and may be directed to the Chief, Middle American-Caribbean Division, ALA, 25X1
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El Salvador: Difficult Tradeoffs

During the last five years, modest economic growth in El Salvador has been insufficient to halt a nine year decline in living standards. Buoyed by a boom in construction activity as the country began to rebuild from a destructive earthquake that struck San Salvador in late 1986, real economic growth may have reached 2 percent in 1987--its highest in a decade--according to preliminary US Embassy estimates. Agricultural production, which accounts for 25 percent of GDP and 40 percent of total employment, withstood a punishing drought and stagnant investment to increase by 2.5 percent. Manufacturing output grew about 3 percent on the strength of substantial increases in production of cigarettes, alcoholic beverages, and foodstuffs. [redacted] 25X1

Despite this success, San Salvador has been unable to make significant progress in reversing the impact of a deep recession that ended in 1983. Living standards remain depressed--per capita income has fallen roughly 30 percent since 1979--and as much as half the country's working population may lack fulltime employment, according to the US Embassy. Although the government successfully cut inflation to 25 percent last year, the real wages of most Salvadorans has declined by 30 to 50 percent since 1982. Moreover, capital flight probably still exceeds $100 million annually, reflecting concern about the country's political stability and economic prospects. Finally, President Duarte's Christian Democratic government largely has failed to build upon a comprehensive economic stabilization program enacted in 1986. Such inaction, when coupled with the effects of a crippling insurgency, is holding back longterm, sustainable economic growth. [redacted] 25X1

Scarce Funding

One of San Salvador's most pressing economic problems is its chronic inability to fund government operations. In 1987, nearly 70 percent of total current revenues came from consumption and trade taxes, leaving the regime vulnerable to fluctuating world trade trends, according to Embassy [redacted] reporting. For example, depressed world prices for coffee--the country's major agricultural export--contributed to a 10 percent decline in total tax revenues in 1987. Revenue shortfalls have been exacerbated by the conservative business community's opposition to government efforts to shift the tax burden from the lower classes to wealthy individuals and businesses. The government's ability to improve its finances also has been constrained by social and political pressures to subsidize essential public services and basic needs of low income groups. [redacted] 25X1

Limited revenues have forced San Salvador to make tough choices between sustaining its counterinsurgency effort and funding other public sector operations. The US Embassy reports that spending on defense and public security, which has doubled in real terms since 1980, now accounts for roughly 40 percent of the government's total budget. At the same time, spending on a

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wide range of social programs--including education, health, and agriculture--has been halved in real terms since 1980, and now accounts for only about one-quarter of the total budget. The impact of these tradeoffs has been somewhat lessened by the infusion of US economic and military assistance--over $3 billion since 1980--which has enabled the government to meet its most immediate financial and material needs. 25X1

Trade problems caused by poor export performance also have severely undercut El Salvador's economy. The country's merchandise trade deficit has averaged $250 million annually over the last five years; in 1987 it was nearly $400 million, according to Embassy reporting. Foreign exchange earnings from traditional export products have been decimated by low world commodity prices and by a depressed regional market for manufactured goods:

- -- Sharply lower world prices for coffee slashed foreign exchange earnings by nearly $200 million in 1987, according to Embassy reporting. Depressed prices and mismanagement by the state-run coffee export monopoly have fueled a 30 percent decline in coffee production since 1980.

- -- Income from sugar exports has declined because of steep reductions in the US sugar quota, while the insurgency has contributed to an 80 percent drop in cotton production since 1980, making El Salvador a net importer of cotton, according to US Embassy reporting.

- -- Salvadoran exports to the floundering Central American Common Market--the traditional outlet for the region's manufactured goods--has fallen by over 60 percent since 1980, despite a modest rebound in 1987. 25X1

Foreign exchange shortages and concerns about the security situation continue to constrain business activity and investment, although balance of payments pressures have been alleviated by US economic assistance and by foreign remittances--roughly $300 million annually from some 600,000 Salvadorans working abroad. New foreign investment in El Salvador has totaled less than $3 million in the last 3 years. Although the US Caribbean Basin Initiative has stimulated some significant investment by Salvadoran firms, it has been largely unsuccessful in attracting foreign investment, according to Embassy reporting. 25X1

Prospects

Political maneuvering leading up to presidential elections in 1989 is likely to postpone significant progress towards resolving El Salvador's fundamental economic problems in the next year. In our judgment, neither the Christian Democrats nor the

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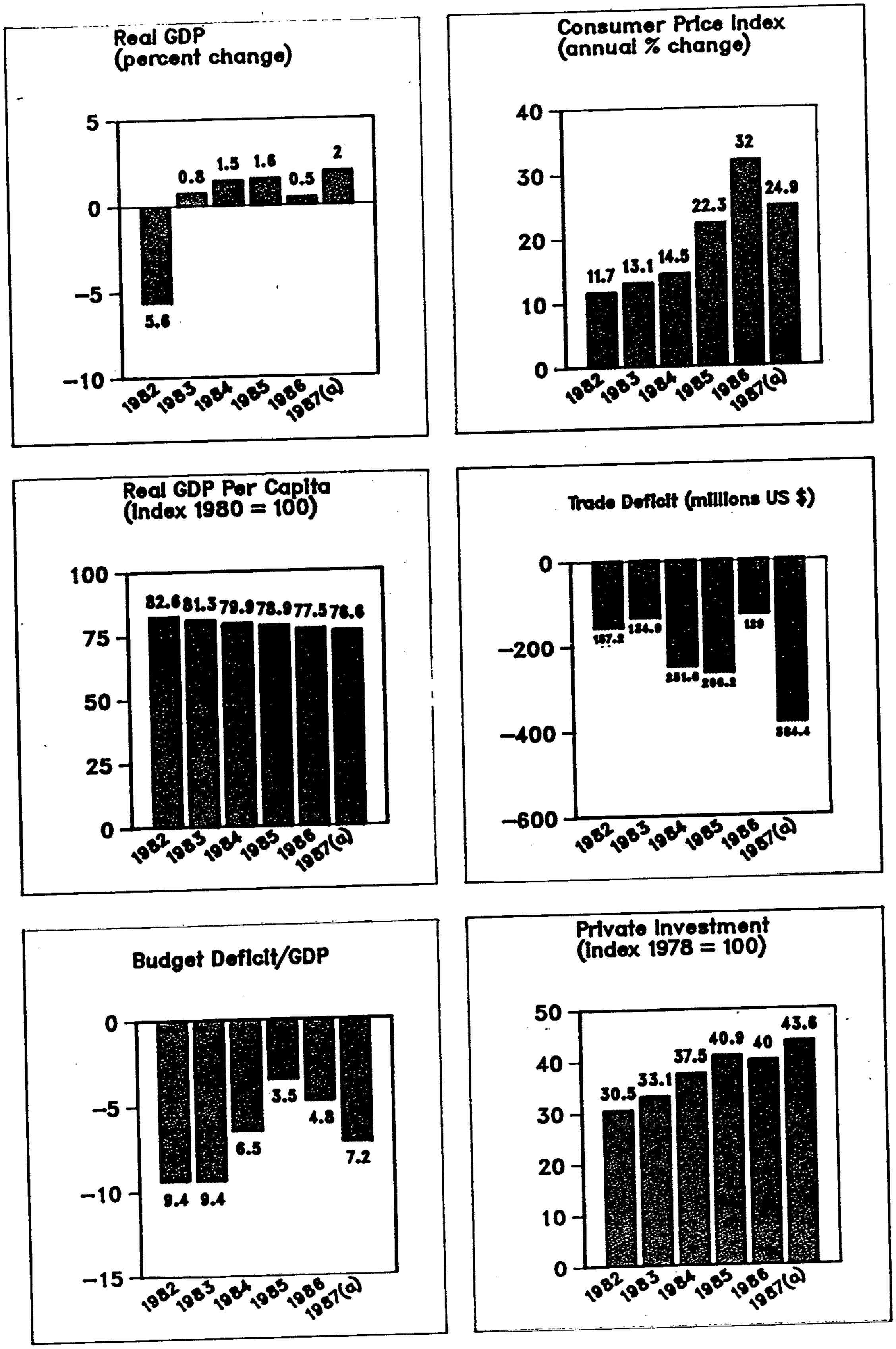
rightist Nationalist Republican Alliance are likely to push for fundamental but potentially unpopular measures--such as devaluation or tax reform--that would address El Salvador's resource constraints. [redacted] 25X1

While living standards will almost surely continue to decline in the next year, we believe pre-election maneuvering is unlikely to cause significant further deterioration of El Salvador's economy. In particular, economic activity is likely to be bolstered by scheduled infusions of US economic aid and continued inflows of foreign credits and donations for earthquake reconstruction activity. We estimate that real economic growth in 1988 will approach last year's figure--averaging between 1.5 to 2.5 percent--but is unlikely to keep pace with El Salvador's 3 percent population growth rate. As a result, El Salvador probably will experience its tenth consecutive year of falling per capita income. [redacted] 25X1

Over the longer term, pressing resource constraints and the continuing insurgency will make it difficult for the next administration to engineer a sustainable longterm economic recovery that will reverse declining living standards. As a result, we believe El Salvador's ability to maintain a minimum level of political and economic stability and consolidate nascent democratic institutions will remain largely dependent on the level of US economic assistance. [redacted] 25X1

EL SALVADOR: SELECTED ECONOMIC INDICATORS 1982 – 1987



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Guatemala: Looming Economic Problems

Guatemalan President Cerezo's government has successfully arrested a steep economic slide since taking office two and a half years ago. US Embassy estimates put real GDP growth at 2.5 percent last year, a sharp improvement over 1986 when the economy was stagnant. Tight control over credit and money supply growth has kept inflation under control; it now stands at roughly 10 percent, well below the nearly 40 percent rate that Cerezo inherited. Nevertheless, unemployment remains high, with perhaps 40 percent of the working population lacking a fulltime job. Moreover, budgetary constraints--government revenues amount to only 8 percent of GDP, one of the lowest rates in Latin America--have prevented Cerezo from tackling pressing social needs or restoring an eroding infrastructure. [redacted] 25X1

After a promising start, the Cerezo government's progress on needed budget and trade reforms has been slowed by domestic opposition and bureaucratic inertia. Efforts to put forward a major tax reform package last fall were sidetracked by strong opposition from Guatemala's powerful business community. Internal debate, meanwhile, has delayed the phasing out of a complicated three-tiered exchange rate that has contributed to costly government subsidies. [redacted] 25X1

Resource Constraints

Like the other countries in the region, Guatemala's dependence on traditional agricultural exports--coffee, cotton, and sugar--has undermined its trade account. Guatemala's trade deficit widened to more than $450 million in 1987, as imports surged due to higher economic activity and speculation over tax and exchange rate changes. Despite a higher volume of coffee exports, lower world prices slashed earnings from coffee--the country's most important export product--by $150 million last year. The dismal performance of traditional commodities was somewhat offset by a nearly 40 percent increase in nontraditional exports, particularly fresh fruits and vegetables. These products, however, still contribute only a small percentage of total export earnings, and even if their strong performance continues, the short term outlook for Guatemala's trade balance is unfavorable. [redacted] 25X1

Poor export performance and uncertainty over economic reforms has sparked a growing foreign exchange shortage in the first half of 1988 that could force the government to ration hard currency by imposing import controls. Guatemala reportedly lost $70 million in foreign exchange reserves in the first four months of 1988, according to the US Embassy, compared to a gain of $75 million for the same period last year. Capital flight, after a lull in 1986, reportedly has accelerated in the last 12 months, reflecting concerns about an uncertain economic climate. At the same time, the government's failure to move forward with reform has delayed new agreements with the IMF and World Bank, which

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could net Guatemala over $100 million in new funding. Hard currency shortfalls in the next few months--when seasonal factors limit export earnings even further--could sharply constrain business activity and bring economic growth to an abrupt halt. [redacted] 25X1

Guatemala faces a difficult challenge in servicing its external debt. Although the country's total foreign debt of $2.5 billion is low by Latin standards, we estimate that scheduled obligations--60 percent of total debt service falls due before 1990--will eat up 50 percent of export earnings in each of the next two years. The government and creditors are particularly concerned about $450 million in dollar-denominated stabilization bonds, of which about $200 million fall due in July. Although the government hopes to retire as much as $85 million before then by using a menu of options for bondholders, it lacks the foreign exchange reserves to redeem the remainder. [redacted] 25X1

Government-Private Sector Tensions

Conflict over economic reforms and business perceptions that Cerezo is intent on pursuing populist economic policies has soured relations between the government and the private sector:

-- Businessmen argue that government policies, including export taxes and cumbersome bureaucratic requirements, have reduced production and export incentives at a time when they are being asked to provide critically needed spending.

-- They believe that the government needs to slash unnecessary spending to free limited financial resources for capital spending.

-- Large landowners are concerned that the government plans a sweeping land reform program, despite repeated assurances from Cerezo that private property rights will be respected. [redacted] 25X1

Growing distrust between Cerezo and the business community is threatening further economic expansion and, at the extreme, the future of democratic government in Guatemala. In the absence of increased business confidence and a strong expansion in private investment and employment, Guatemala is unlikely to move beyond the 3 percent growth rate needed to restore per capita income growth. Radical rightwing businessmen, meanwhile, have taken their distrust of Cerezo even further by encouraging coup plotting among discontented military officers, which led to an abortive attempt in May. Although radical businessmen by themselves are unlikely to succeed in removing Cerezo, their disaffection will make it increasingly difficult for his government to encourage growth or deal with its growing economic problems. [redacted] 25X1

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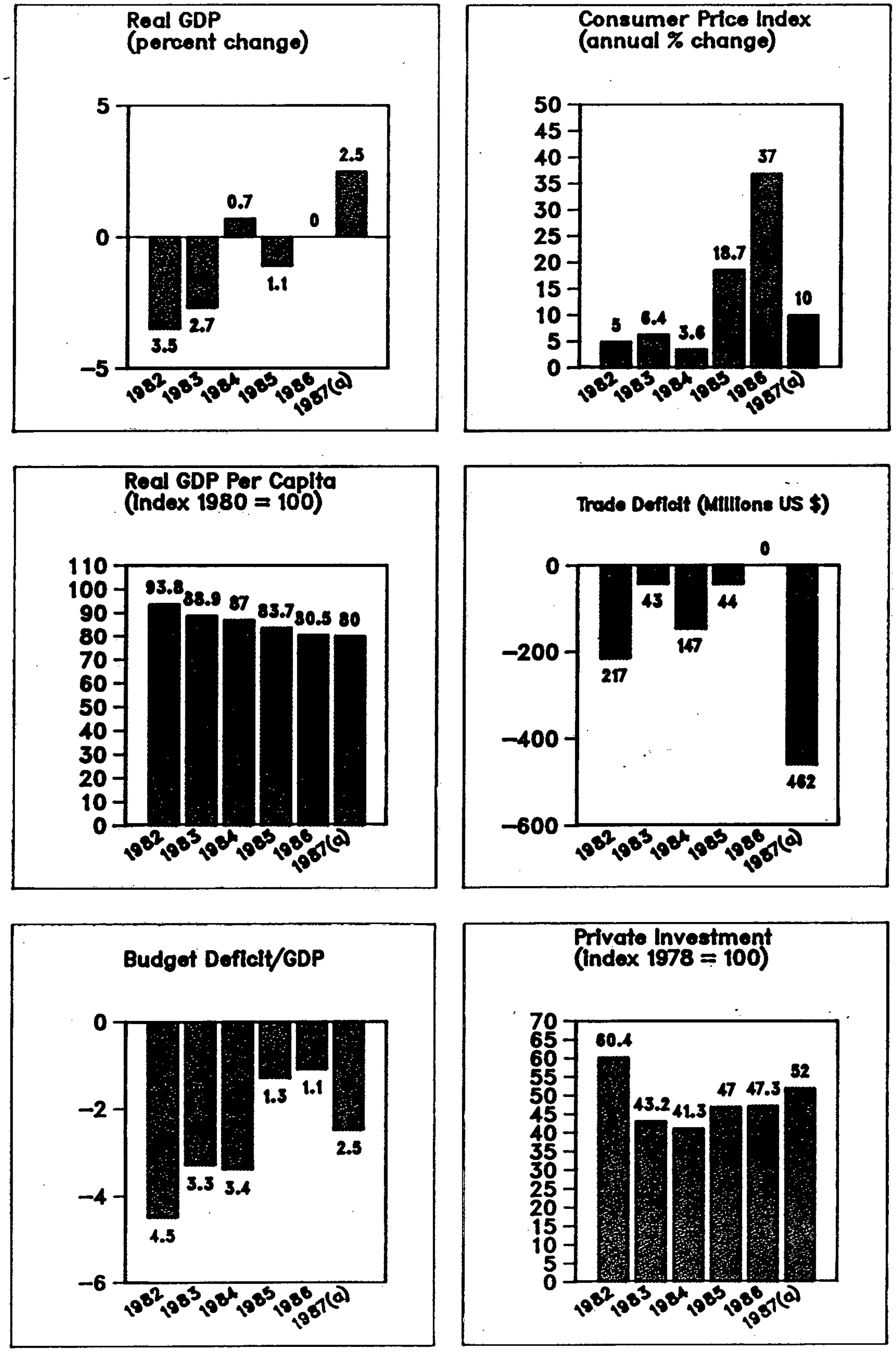
GUATEMALA: SELECTED ECONOMIC INDICATORS 1982 – 1987



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Honduras: Dependent on Foreign Aid

Honduras in 1987 enjoyed its highest rate of economic growth in five years, but overall performance was uneven and constrained by longstanding structural budget and trade problems. Fueled by government deficit spending and substantial inflows of US and multilateral economic aid, real GDP grew more than 4 percent. Strict control of money supply and credit growth, coupled with relatively small wage hikes and stagnant demand in the private sector, kept inflation below 3 percent. Nevertheless, real per capita income remained below its 1980 level. 25X1

A growing shortage of foreign exchange over the last year--international reserves have fallen an estimated 35 percent--has underlined both structural and policy weaknesses in the Honduran economy. The country's trade balance deteriorated last year as world prices for coffee--the country's major export--fell substantially. Demand for scarce hard currency has been fueled by a chronically overvalued exchange rate, a weakness that Tegucigalpa has steadfastly refused to address. Dwindling reserves have forced a curtailment of imports and caused Tegucigalpa to fall into arrears on its international debt obligations. 25X1

Budget and Debt Uncertainties

Honduras has had a chronically large budget deficit, even by Central American standards, but so far has been able to avoid significant spending cuts or tax increases because of large injections of external funds. In 1987 US economic assistance reached $196.4 million and $159 million has been requested for 1988. Tegucigalpa's creditors are insisting that Honduras reduce its budget deficit--which has hovered above 6 percent of GDP for the last two years--to 4 to 5 percent in 1988. The government, however, faces a number of obstacles. The operating surplus of government agencies has fallen steadily for the past three years, according to Embassy reporting. Despite some revenue enhancements due to better tax administration, the government reduced export taxes on coffee, cutting revenues by $15 million per year. Meanwhile, foreign aid and loans are dwindling, and debt principal payments are coming due this year. 25X1

By the end of 1987, Honduras had amassed an external debt of $3.9 billion, equivalent to 66 percent of the country's annual GDP. The government's effort to reschedule debt obligations and attract additional financing has been complicated by persistent payment arrears. According to Embassy reporting, Tegucigalpa is nearing final agreement with the World Bank on a macroeconomic package that would provide up to $100 million in the next two years. The program is contingent upon Honduras remaining current on loan repayment and implementation of a series of fiscal, monetary, and structural reforms. Although the IMF approves of the World Bank program, it will not negotiate a standby arrangement with Tegucigalpa until some $18 million in arrears are paid. The Embassy reports that Tegucigalpa is considering an agreement rescheduling commercial debt that capitalizes overdue

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interest and refinances approximately $235 owed in principal arrears. Honduras faces large payments this month, and the US Embassy reports the government is likely to request bridge financing from either the United States or commercial banks. [redacted] 25X1

Fate of Reforms

President Azcona does not have the political clout to carry out economic reforms which would wean Honduras from its reliance on foreign assistance by addressing the country's structural problems such as dependence on agricultural exports. Although many national leaders recognize the fiscal deficit needs to be reduced, they disagree sharply over which fiscal and monetary measures should be taken. Meanwhile, efforts to diversify the country's export economy have been slowed by bureaucratic red tape and legislative foot-dragging on a variety of initiatives. With national elections looming in 1989, it is unlikely that the legislature will move to pass unpopular economic measures that would put the economy on a more sound footing. As a result, we expect Tegucigalpa's entrenched reliance on US assistance is likely to continue, at least for the foreseeable future. [redacted] 25X1

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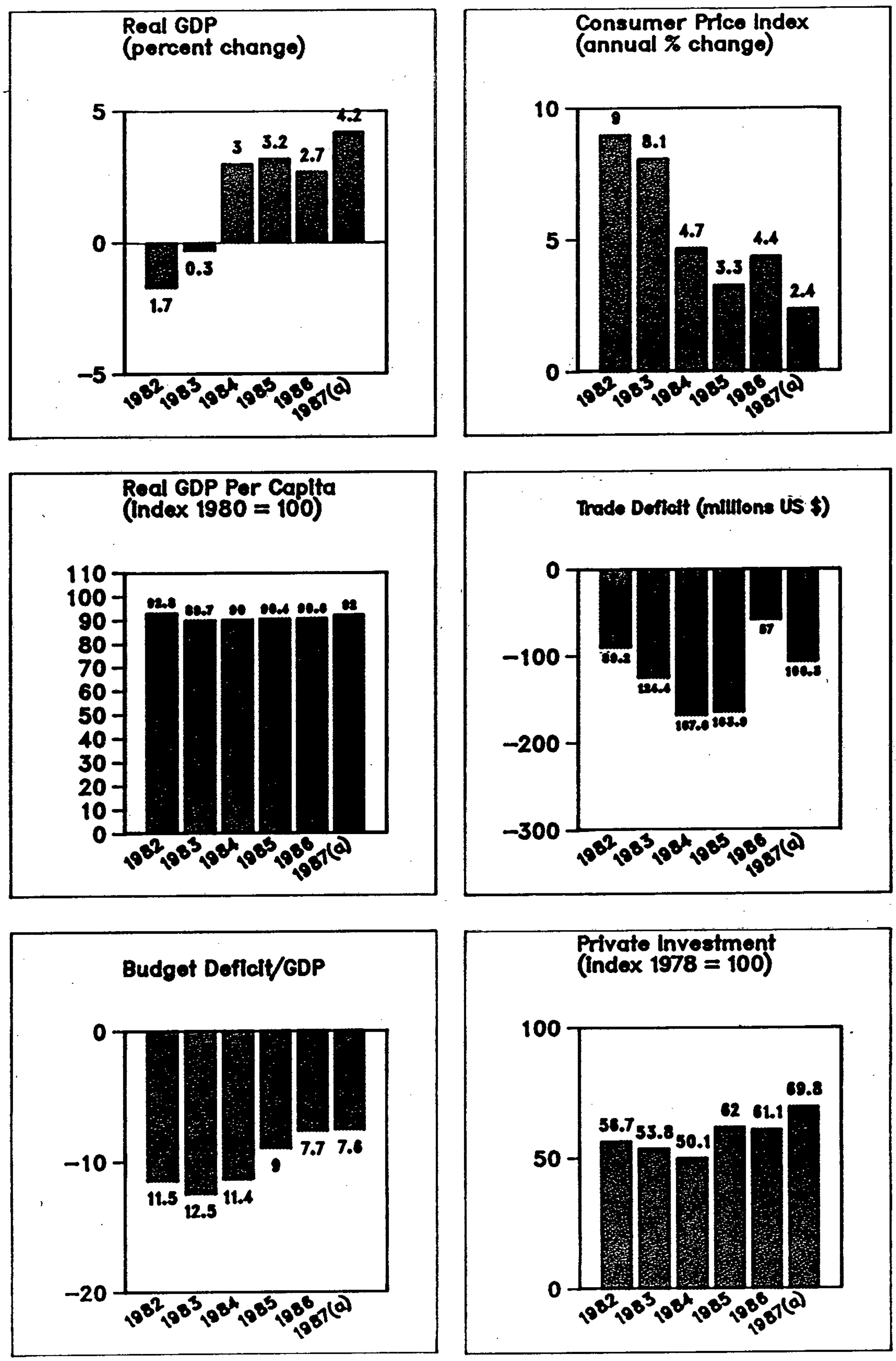
HONDURAS: SELECTED ECONOMIC INDICATORS 1982 – 1987



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Costa Rica: Heavy Debt Burden but Modest Growth

Costa Rica's economy grew modestly in 1987, continuing a five year record of slow economic recovery. Real economic growth exceeded 3 percent, dropping slightly from a rate of 4.6 percent in 1986, primarily because of the relatively poor performance of Costa Rica's major export crops and a sharp decline in world coffee prices. The gradual economic expansion, led by increases in banana production, manufacturing, and construction, has kept the unemployment rate below 7 percent, but inflation has accelerated to over 15 percent. rate estimated to be as high as 16 percent. Meanwhile, San Jose's longterm policy of economic diversification and gradual payment of its massive external debt has reduced its debt as a percentage of real GDP steadily over the last five years. Attempts to reduce public spending have been largely ineffective, however, leaving the government dependent on revenue-generating measures and foreign assistance to close a persistent budget deficit. [redacted] 25X1

Debt Burdens and Negotiations

Costa Rica's economy is heavily burdened by an extensive foreign debt incurred in the late 1970s, when San Jose's terms of trade deteriorated sharply and international interest rates increased. Although San Jose's debt is small by Latin American standards--over $4.5 billion--it is roughly the same size as the annual GDP. The cost of servicing scheduled debt payments was more than half of the value of Costa Rica's exports of goods and services in 1987. Although efforts to reschedule its debt in 1987 repeatedly fell through, Costa Rica continues to insist that the composition of its debt be reformulated to ensure servicing obligations are not made at the expense of economic development. [redacted] 25X1

San Jose plans to use official and multilateral lenders, instead of commercial banks, to secure new loans on concessional terms. According to the US Embassy, San Jose obtained a $48 million IMF standby arrangement late last year and has renegotiated its $120 million debt with Mexico. Negotiations with the World Bank for a second structural adjustment loan entered its final stage in late March and awaits approval by the Costa Rican legislative assembly, according to Embassy reporting. [redacted] 25X1

According to press reports, the government is reluctant to increase commercial indebtedness and sees private debt rescheduling as a means of keeping new loans to a minimum. Under a revised plan, creditor banks would purchase 20-year, zero-coupon, US government bonds that would guarantee the outstanding principal; a separate fund under World Bank supervision would guarantee interest payments. Government officials are reluctant to predict when an agreement will be reached, however, but have delayed a review meeting with Paris Club creditors until the end

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of July to allow time for negotiations with private creditors. Due to political constraints, the Central Bank has warned that San Jose will have to reschedule its commercial debt after the 1990 national elections if an agreement is not signed soon. [redacted] 25X1

Exports Vulnerable

Despite recent efforts to diversify the economy, Costa Rica remains dependent on a few agricultural exports that are vulnerable to fluctuating commodity prices. Coffee and bananas, Costa Rica's major foreign exchange earners, still account for roughly 60 percent of San Jose's exports. The performance of non-traditional exports such as ornamental plants and flowers has been uneven during the 1980s, although such exports increased by an average annual rate of 16 percent in the last two years. Recently, the government has expanded fiscal incentives to make non-traditional exports more competitive, including devaluing the colon. The government's expansion of export subsidies in 1987 was offset by better tax collection, the introduction of new tax measures late in the year, and utility rate increases in order to remain within 1987 targets set by international creditors. [redacted] 25X1

Political Constraints

Attempts to reduce spending in other areas such as agricultural subsidies and wages have been undermined by President Arias's willingness to backtrack when faced with domestic protests. Growing public antipathy to austerity measures has prompted public officials to promise not to impose additional measures this year, although demands on government finances remain high. For example, rapid inflation is expected to spur demands for wage increases, according to Embassy reporting. Moreover, the government is legally required to adjust wages when anticipated annual inflation exceeds 7 percent. [redacted] 25X1

Upcoming elections in 1990 and the ruling party's slim majority in the National Assembly are likely to further hamper Arias' ability to control the economy and stimulate growth. Although public pressure probably will prevent the President from making needed economic reforms, we expect Costa Rica's economy to grow modestly--about 2.5 percent--in 1988. Soft terms offered by official and multilateral creditors most likely will encourage San Jose to remain dependent on foreign assistance, although the IMF predicts that the debt service ratio will continue to decline. The US Embassy reports that opposition legislators are increasingly are concerned about Costa Rica's heavy debt load and they may stall passage of new loan agreements. Meanwhile, costly government initiatives to promote new industries probably will strain public finances. Costa Rica will continue to make use of the Caribbean Basin Initiative to expand non-traditional exports to the United States. [redacted] 25X1

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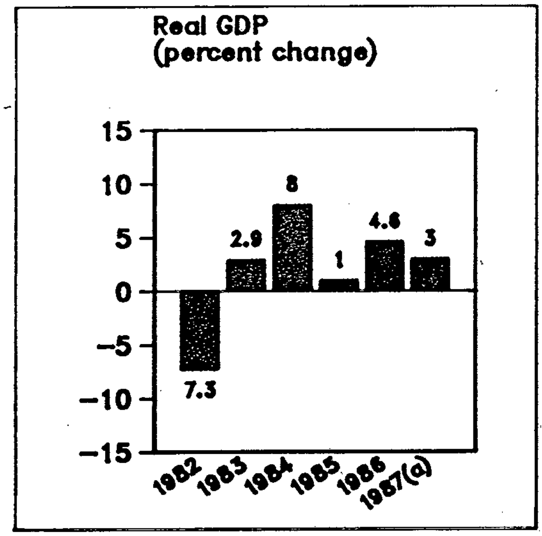

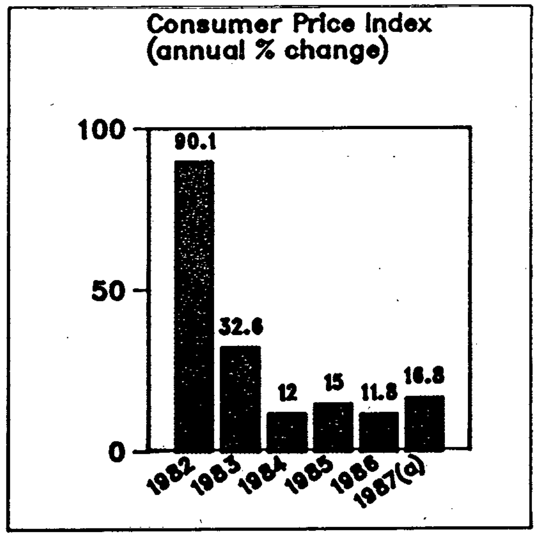

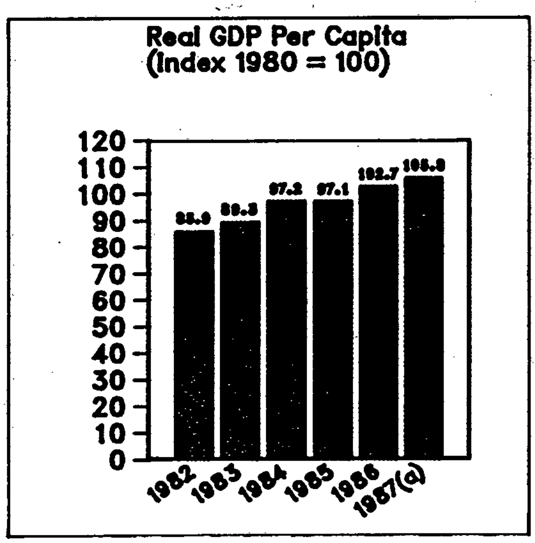

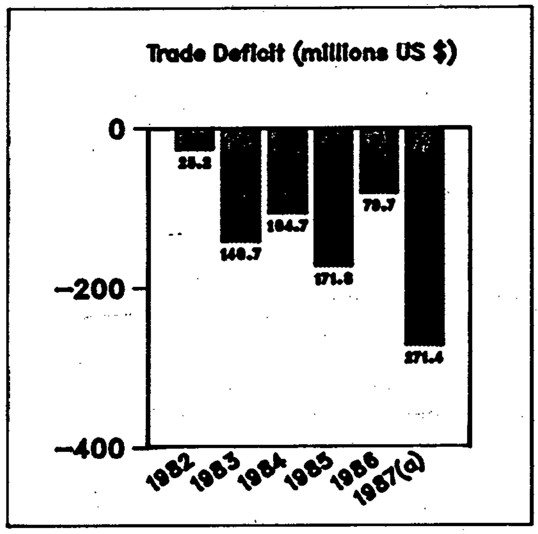

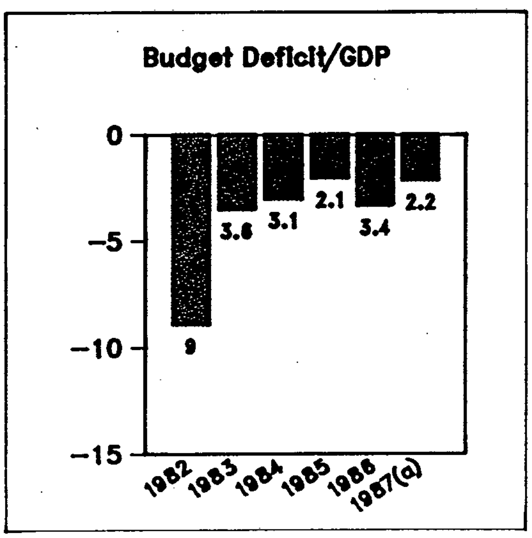

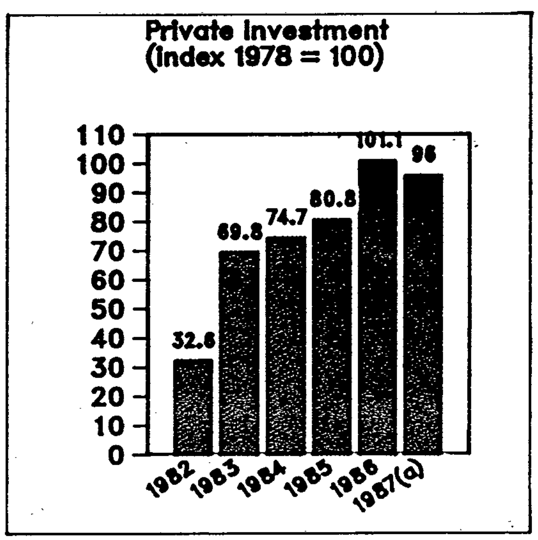

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24 June 1988

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