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Central American Core Four: Struggle for Economic Recovery

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An Intelligence Assessment

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January 1986

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Central American Core Four: Struggle for Economic Recovery [redacted]

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An Intelligence Assessment

This paper was prepared by [redacted] the Office of African and Latin American Analysis. Comments and queries are welcome and may be directed to the Chief, Middle American–Caribbean Division, ALA [redacted] 25X1

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Central American Core Four: Struggle for Economic Recovery [redacted] 25X1

Key Judgments

Information available as of 30 November 1985 was used in this report.

Economic performance in the Core Four [1] has been lackluster over the past five years, and the region has not yet rebounded from its worst recession on record. Declining standards of living are generating social unrest and fueling political instability for hard-pressed governments in the region. Trade, investment, and production have all been choked because of the disruptions caused by the revolution in Nicaragua, guerrilla activity in El Salvador and Guatemala, and depressed markets for the area's agricultural exports. As the economies of the Core Four countries have stagnated, much of their labor force and industrial capacity has been idled. Living standards have steadily eroded, and regional per capita GDP is one-fifth below the 1979 level.

Against this regional backdrop, the Core Four countries have been unable to date to build on increased US economic support to restart their economies. While more US aid catalyzed a small amount of GDP growth in 1984 and 1985, local economies have shown virtually no sign of internally generated economic growth. According to Embassy reporting [redacted] foreign commercial lending is almost nonexistent, 25X1 capital flight is still draining domestic investment funds, public investment programs are being trimmed because of persistent budget deficits, and regional turmoil continues to dampen business confidence.

External constraints and an array of internal problems will probably continue to undercut any sustained economic recovery for some time to come. Competition in international commodity markets are keeping export prices depressed and limiting prospects for steady economic growth based on exports of traditional crops—coffee, bananas, cotton, and sugar. Prospects for diversifying the export base to new crops and manufactured goods are clouded by the poor investment climate. Large debt service obligations, incurred when officials borrowed heavily at the onset of the region's economic decline, further restrict growth prospects.

[1] The Central American Core Four includes Costa Rica, El Salvador, Guatemala, and Honduras. Nicaragua's expanded state role in the economy and its drastically altered trade and aid patterns eliminate many of the similarities with its neighbors that previously enhanced regional economic analysis. We therefore exclude it from detailed consideration and examine only its interaction with the other Central American economies. [redacted] 25X1

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From a domestic standpoint, Core Four leaders are finding it increasingly difficult to adopt and maintain measures needed to rebuild strong economies. Reform programs are being implemented only on the margin, because governments fear political backlash. Guatemala, Honduras, and Costa Rica for example, have all shown signs of policy compromise to avoid public discontent in the face of local elections. Failure to adopt responsible exchange rate, monetary, and fiscal policies has not only weakened the local investment climate but also has resulted in the loss of badly needed foreign financial funding that would be available with comprehensive stabilization programs.

In our judgment, both internal and external constraints to economic recovery are unlikely to ease significantly any time soon. For at least the next year we see only marginal improvement in the area's security situation, persistent trade and debt problems, and a continuing domestic economic policy drift. In these circumstances, we judge that Core Four economic growth will stay below 2 percent through 1986.

In our view, continuing economic troubles are likely to undercut social and political progress in the region. Widespread frustration may revive political instability, making the Core Four more vulnerable to political radicals or armed insurgents. Such pressures are likely to lead to strains in US relations with Core Four governments as they demand ever higher levels of US financial and economic aid.

Even under favorable circumstances, our analysis indicates that it will take more than a decade to restore living standards to pre-1980 levels. In this situation, even with preferential trade and aid from the United States, we expect growing local criticism of close economic and political ties to the US from the press, opposition politicians, and labor unions. On the plus side, we expect that even worse economic problems in Nicaragua will provide little incentive for radical political movements within the Core Four countries to point to Sandinista-style economic structures and institutions as a role model.

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Central American Core Four: Struggle for Economic Recovery [redacted]

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Introduction

During the past five years, Central America's economies have been buffeted by adverse circumstances. Since 1979, regional trade has declined, international credits and foreign investment lost, and private-sector business confidence has eroded. Local political and security problems, as well as external economic conditions, continue to complicate efforts by regional governments to end five consecutive years of falling per capita incomes. [redacted]

This paper describes the economic conditions and prospects of the Core Four countries of Central America: Costa Rica, El Salvador, Honduras, and Guatemala. It examines how the region's economies are faring, and explores alternative growth scenarios through the 1990s. It also assesses the impact of those projections for area governments and for political stability in the region. [redacted]

The Dismal Economic Record, 1979-84

Since 1979 the Core Four countries have departed dramatically from the favorable economic growth of the 1960s and 1970s that provided consistent improvement in average living standards. The economies of the region have been hard hit by the mutually reinforcing effects of a dramatic deterioration in the international terms of trade, inadequate domestic economic policies, and political turmoil. As a result, the region is experiencing its worst economic performance on record, although sharply higher US aid to the region since 1982 has eased economic problems somewhat. [redacted]

On the international front, IMF and other financial data show that the fall in the region's terms of trade was touched off by the sharp fall in coffee prices in 1978 and a doubling of imported oil prices during 1979-80. Balance-of-payments positions eroded, because coffee provides one-third of the Core Four's export earnings and petroleum purchases are 20 percent of imports. El Salvador was particularly hard hit because coffee provided more than half of the country's export earnings. Regional balance-of-payments problems were compounded by dramatic capital flight, which IMF estimates place at $2 billion for Guatemala and El Salvador combined from 1979 to 1982. Capital inflows from foreign sources dried up as commercial banks cut back on supplier credits, and direct foreign investment fell sharply. Large numbers of foreign investors left the area during these years because of political violence. In El Salvador, for example, most of the large Japanese business community left in 1979, following the kidnaping and slaying of several prominent Japanese businessmen. Similar trends were seen in Guatemala and Honduras. US Department of Commerce data show that US businesses pulled out $100 million from Core Four projects during 1981-84. [redacted] 25X1

On the domestic economic policy front, a retrospective look at national and IMF economic data shows that these countries did not take adequate economic adjustment measures in the face of these external shocks. In general, their actions indicated they hoped for a quick turnaround and tried to maintain living standards and curb political reactions by boosting government spending, raising consumer subsidies, and by maintaining unrealistic exchange rates. These policies only worsened the depressed and unstable economic situation. For example, by 1982 Costa Rica had run up a budget deficit equal to 14 percent of GDP, and inflation soared to triple-digit levels. According to Embassy reporting, subsidized electricity and other services provided by government corporations greatly increased both domestic and external debt obligations. IMF financial statistics show that all four countries maintained overvalued exchange rates, trying to avoid devaluing currencies that had maintained fixed values against the US dollar for almost 50 years. Costa Rica, facing the most severe external

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The Growth Years, 1961-78

The Central American countries—including Nicaragua—share important similarities and linkages that provided the foundation for fast-paced economic expansion during much of the period from World War II until 1979, the year of the Sandinista revolution. During 1961-78, for example, Central American official statistics show that economic growth rates matched the Latin American average of 5.6 percent per year and surpassed that of LDCs as a whole. These common growth paths—built on periodic booms in agricultural commodity prices, regionally protected manufacturing sectors, and foreign borrowing—failed, however, to foster steady, broad-based economic expansion. [redacted]

Agriculture, the keystone of the region's economic development, was the primary source of export earnings and employment. Despite wildly fluctuating international prices for major commodities—coffee, sugar, bananas, cotton, and meat—international trade data show that the region's longstanding dependence on these items for the bulk of export earnings did not lessen. Agriculture also provided the springboard for industrialization; [redacted] *in addition to the 26 percent of Central American economic activity directly attributable to agriculture in 1978, 75 percent of the fast-growing manufacturing sector was related to agriculture. Food processing accounted for nearly half of manufacturing activity.* [redacted]

The nascent manufacturing sectors provided the most energetic component of regional economic growth, expanding at an average annual rate of 7.4 percent during 1961-78. We believe this impressive performance was largely attributable to the expansion of the Central American Common Market (CACM), which was formed in 1960. As a result, intraregional trade boomed, and by 1980 accounted for nearly one-fourth of total international sales and absorbed virtually all the region's manufactured exports, according to trade data. At the same time, however, the composition of this trade suggests that CACM countries had not developed products that would be competitive outside the protected common market. [redacted] 25X1

The rapid economic growth was supported by moderate amounts of foreign borrowing. According to international financial statistics, Central America's external public debt was a manageable $4 billion at the 25X1 *end of 1979. Foreign interest and principal payments consumed just 11 percent of their export earnings during 1970-78, as compared with 23 percent for Latin America as a whole.* [redacted] 25X1

This dynamic economic growth performance was not without social shortcomings. Although many Central Americans benefited from the growth of the 1960s and 1970s, numerous observers have noted the lack of progress on political and social problems. 25X1 *Academic studies indicate that more than half of the region's* 25X1 *population lived in poverty in the late 1970s, while a third or more were classified as extremely poor. Rapid population growth and urbanization overwhelmed the region's social resources, while gains in the manufacturing sector were often unbalanced be-* 25X1 *tween and within countries. Despite the rising expectations stimulated by the aggregate improvement in economic conditions, few gains were made in public health, education, housing, and nutrition, and the deep gulf between rich and poor remained.* [redacted] 25X1 payments problems of the Core Four, finally was forced to make a much needed currency devaluation in 1982. [redacted]

At the same time, political turmoil in the region increased precipitously. Following the revolution in Nicaragua, existing insurgencies grew in El Salvador and Guatemala, while governments in Honduras and Costa Rica found themselves, to varying degrees, affected by the spillover. The cost of insurgency has been greatest in El Salvador. The US Embassy in San Salvador estimates the cumulative war losses from direct damage and lost production between 1979 and 1984 at $1.2 billion, with annual losses of about $250 million during the last two years. Guatemala's insurgency, although much reduced from the early 1980s, continues to have an adverse effect on the business climate and tourist industry. [redacted] Guatemalan tourist receipts fell from $90 million in 1979 to only $13 million in 1984. Although Costa Rica and Honduras have been spared the effects of active insurgencies, both have had to divert budget resources to security spending to meet the Sandinista military and subversive threat. [redacted]

The net impact of all this is evident in national income statistics, which show these countries in their deepest recessions on record. For example, by the end of 1984, average per capita GDP in the Core Four countries was 17 percent below the 1979 peak. Although similar factors contributed to the decline of economic activity throughout the region, local statistics show that the recession was more intense in some countries:

- The sharpest drop was in El Salvador, where average income fell by 30 percent. Insurgency gripped the country in 1979 when rebels, seeking to lessen support for the ruling junta, attacked the economic targets. In 1980 the government dealt an additional blow to the economy by instituting land reform and nationalizing banks and agricultural exports. According to Embassy reporting, both events seriously eroded business confidence and accelerated the flight of capital and entrepreneurs.

- Costa Rica and Guatemala, the most advanced economies in the region, experienced per capita income declines of about 15 percent. Both were heavily dependent on regional trade, and suffered disproportionately when trade within the Central American Common Market (CACM) shrank and idled much of the industrial capacity.[2] Costa Rica suffered the bulk of its decline in just one year, 1982, a year of 100-percent inflation and severe problems with external and internal finances. Guatemala's decline was slower and more prolonged, aggravated by diminishing demand in both domestic and foreign markets.

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- Honduras, although the poorest country in the region, experienced a smaller decline than the other three—about 11 percent. Tegucigalpa was shielded by the minor role of intraregional trade in its economy and the predominance of agriculture, which requires somewhat lesser amounts of imported resources and goods for continued production. [redacted]

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The social cost of the region's economic decline, although difficult to quantify, also was great. According to US Embassy reporting from El Salvador, the trend toward industrialization, which had moved workers from artisan to modern sector activities, has, at least temporarily, been reversed. While UN statistics suggest the population explosion of the 1960s poured about 200,000 new workers into the Core Four labor force each year during the 1979-84 period, government data underscores the fact that few new jobs were created. As a result, most of these new workers were unemployed or underemployed. At the end of 1984, official estimates placed the average unemployment rate in the region at about 20 percent, with some 1.3 million workers without jobs. In El Salvador, nearly a third of the labor force was out of

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[2] The CACM was founded in 1960 to facilitate free trade in manufactured goods among Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua. It has been buffetted by regional turmoil since 1980 and its future as an institution is clouded. For details see appendix A. [redacted]

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Table 1
US Aid to Core Four, 1984

	Estimated Population *(million)*	GDP *(billion US $)*	GDP Per Capita *(US $)*	US [a] Economic Assistance *(million US $)*	US Economic Assistance as Percent of GDP
Total/average	**19.5**	**19.9**	**1,021**	**771**	**3.9**
Costa Rica	2.6	3.2	1,231	174	5.4
El Salvador	4.8	4.3	896	328	7.6
Guatemala	8.0	9.2	1,150	30	0.3
Honduras	4.1	3.2	780	171	5.3
Regional aid				68	

[a] Represents funds approved for the US fiscal year 1984.

[redacted] 25X1

work, and the situation was not much better in Honduras. Moreover, nearly half of those with jobs in El Salvador, Honduras, and Guatemala were underemployed, because their jobs were only seasonal or part time, according to Embassy reporting. [redacted]

The region's economic problems eased somewhat in 1984 with a dramatic infusion of US economic assistance. Annual commitments of US aid to the Core Four rose from $83 million in 1979 to $771 million in 1984, with the first installment from the Jackson Plan based on recommendations made by the Kissinger Commission on Central America.[3] Balance-of-payments support has been instrumental in funding productive imports. Development assistance also has played an important role by taking up some slack where governments had cut development spending and public investment outlays to control fiscal deficits. [redacted]

In the opinion of a number of private-sector observers, expanded US aid to the region probably was the determining factor that stemmed the economic decline in 1984 of the Core Four countries. Despite still negative per capita income trends, official estimates indicate regional GDP growth was nearly 2 percent, the first economic expansion of any kind in four years. Each country experienced positive real GDP growth, led by Costa Rica at 5.5 percent and trailed by Guatemala with 0.2 percent growth. Gains also were made on the inflation front, with all countries except El Salvador reducing the rate of consumer price increases. On the other hand, Core Four balance-of-payments positions deteriorated as current account deficits expanded across the board. With the exception of Guatemala, which receives only a little US aid, these wider deficits were largely offset by increases in US balance-of-payments assistance. [redacted]

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The Setting for Economic Growth

In our assessment, a number of factors will continue to limit the region's economic performance. Each country faces common external constraints and an array of serious internal problems that must be overcome if the region is to achieve even moderate growth. Moreover, without a substantial improvement in the area's political environment, even greatly increased foreign assistance would be inadequate to restore past levels of economic expansion. [redacted]

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[3] See *Report of the National Bipartisan Commission on Central America*, January 1984. [redacted]

External Factors

International economic conditions clearly will affect the economies of Central America, both directly and indirectly. Despite recent moderate world economic expansion and decreasing energy prices, we do not expect Central America's traditional markets to grow anywhere near the pace of the 1960s and 1970s. Moreover, from a narrower regional perspective, CACM is unlikely to be revived in the near future without a major reduction in trade barriers and settlement of clearinghouse balances on a timely basis. The region's exports of nontraditional products outside the common market—such as light manufactures, fruits, and vegetables—are likely to post only modest gains, despite favorable tax treatment, until the overall investment climate improves.

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While prospects for most Core Four exports are dim, better coffee prices could boost traditional exports somewhat. Despite current record inventories, world coffee prices strengthened at the end of 1985 as commodity analysts began to project lower 1985/86 coffee output because of an extended drought in Brazil's key producing states. International commodity experts, however, forecast continued depressed prices for sugar, cotton, and bananas, the Core Four's other principal commodity exports. The benefits from selling sugar to the United States at premium prices are diminishing as US quotas continue to contract. Moreover, world sugar prices have been hovering near a 15-year low, and large stocks worldwide probably will hold down prices for years to come. The outlook for cotton and banana prices also is dim because of intense competition among producers for a share of world markets. Banana prices began to strengthen somewhat in the first half of 1985, but industry sources do not expect this trend to be sustained over the longer term.

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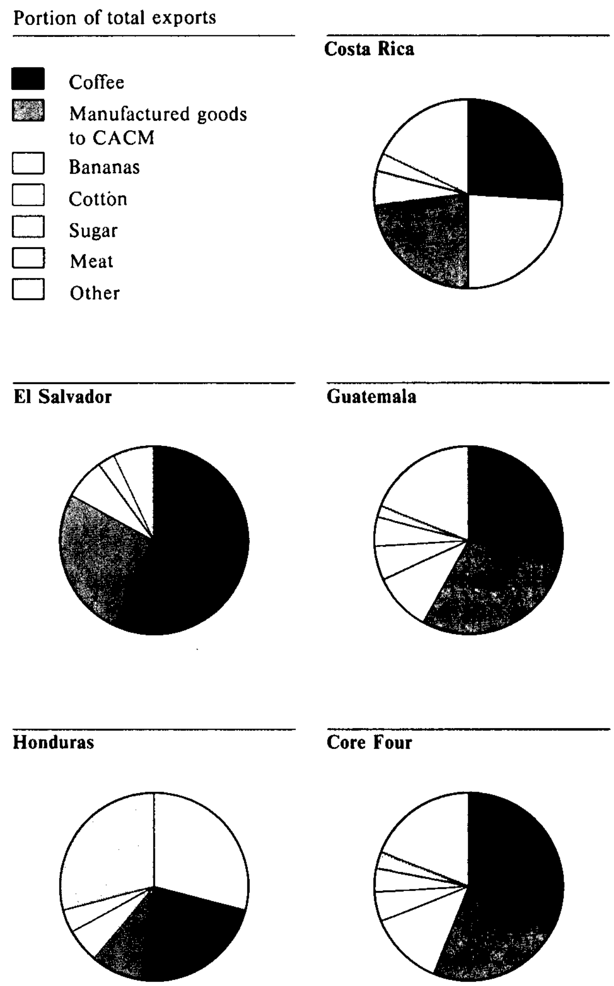
Figure 2
Core Four Composition of Exports, 1980-84



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Prospects for the region's nonagricultural exports also are poor. Virtually all of the Core Four's manufactured goods are sold in the CACM and continuing balance-of-payments problems are prompting member governments to maintain or even strengthen existing trade barriers.[4] According to Embassy reporting from the area, Costa Rica has halted credit sales to CACM countries to stem the accumulation of bilateral debts. Honduras has restricted access to foreign currencies to narrow its growing trade deficit within CACM. As

[4] See appendix A, Regional Economic Integration.

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Table 2
Core Four Debt Indicators, 1985 [a]

	Total External Debt *(midyear 1985, million US $)*	Debt to GDP *(percent)*	Debt Service *(million US $)*	Debt Service Ratio *(percent)*
Latin America	**380,000**	**48**	**56,000**	**41**
Core Four	11,000	53	1,510	36
Costa Rica	4,100	123	500	53
El Salvador	2,100	47	335	33
Guatemala	2,400	25	475	37
Honduras	2,400	74	200	30

[a] Based on US Embassy reporting, IMF statistics, and open sources.

a result, the regional market for manufactured products is shrinking. Producers cannot easily tap into well-established outside markets after being shielded from competition for 25 years by a protective common external tariff.

In these circumstances, export expansion over the longer haul probably will require a change in Central America's export base. This, in turn, will depend on an improvement in the region's political environment and the creation of a climate more conducive to private-sector investment. Recent domestic policy measures, which grant tax holidays for new investments, complemented by incentives flowing from the Caribbean Basin Initiative (CBI), are having some impact in each of the Core Four countries. Exports of nontraditional products from Central America to the United States were up 10 percent in 1984, according to IMF trade data, compared to only a 5-percent rise in all categories of exports. Preliminary trade data for 1985 indicate that nontraditional exports will not match last year's gain, but will still slightly exceed overall export growth.

Debt service obligations of $1.5 billion each year also will undercut the Core Four's ability to support its import-dependent industries for the rest of this decade, in our view. Official data show that the Core Four's external debt represents a substantially higher share of GDP than in Latin America as a whole. Even so, because a larger portion of the region's debt is owed to multilateral and bilateral lenders on concessional terms, its ratio of debt service to exports is somewhat less than the Latin American average. 25X1

Regional Constraints

Numerous factors at work within the region itself also limit economic prospects for the region. The region's governments lack the political consensus needed to make tough economic policy changes, such as establishing and maintaining trade-competitive exchange rates, overhauling tax systems and collection methods, and trimming overgrown public enterprises. Moreover, candidates for elections in Guatemala, Honduras, and Costa Rica have focused consumer discontent on declining living standards and have deterred governments from austerity measures. Labor unions and consumer groups have also increasingly opposed the government on these questions. 25X1

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In some ways the region's economic constraints are beyond the control of the individual governments. Despite almost no insurgent activity in Honduras and Costa Rica, for example, violence in the other countries has made foreign investors wary of the entire region, according to both Embassy and private-sector observers. Data from the US Department of Commerce show that the fall in US investment in Honduras and Costa Rica during 1980-84 equalled the decline in investment in El Salvador and Guatemala. In addition, as the Sandinistas continue to shift their trading focus from the region to the Soviet Bloc, the Core Four loses Managua as a market for manufactured exports. 25X1

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Before investors return to the area, they will need to be convinced that the governments can provide adequate security and favorable economic policies over at least the medium term. We expect it would take two years or more of consistent, pro-investment policies as well as a reduction in political tension and insurgent activity, before Central American entrepreneurs could be expected to repatriate capital. Foreign investors would probably require an even longer track record. While all Core Four countries have been confronted with similar regional and domestic problems, different social and political pressures have resulted in unique policy mixes in each country. Each has identifiable short- and long-term implications. 25X1

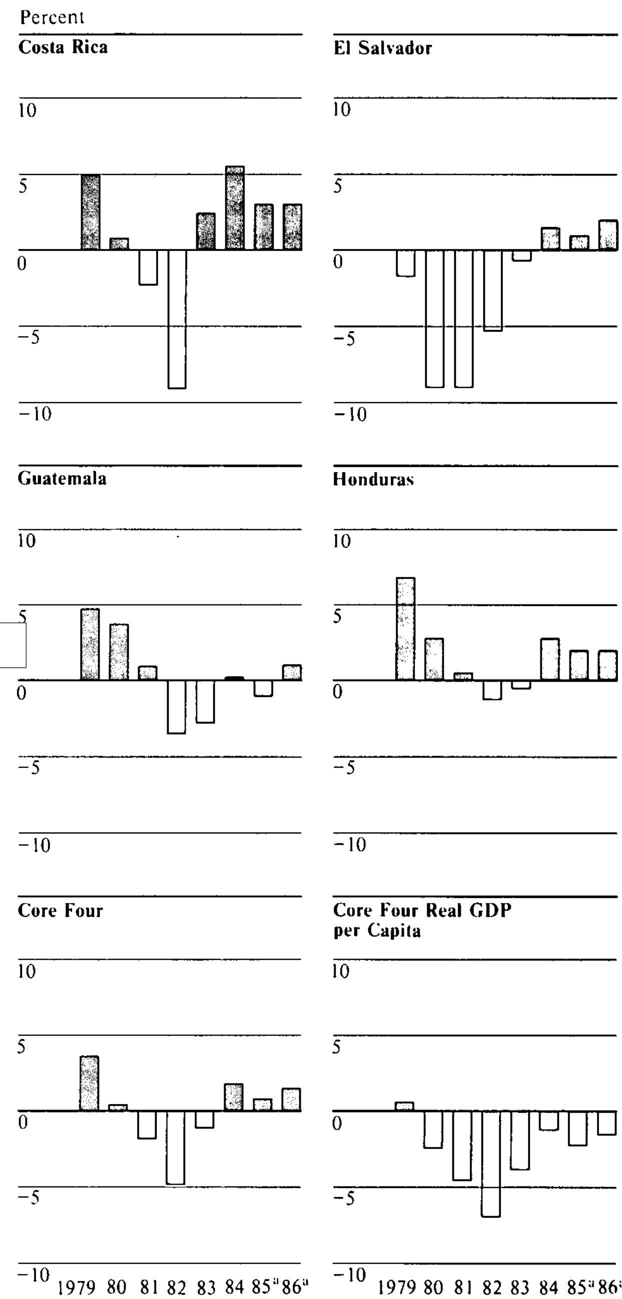
Country Prospects

Based on a review of growth prospects in each country, we believe Core Four GDP will rise only 1 percent in 1985, down from nearly 2 percent in 1984. The lower growth rate stems from this year's decline in the Guatemalan economy—the largest in the region—and lower, but still positive, growth in the other countries. For 1986 we see slightly better conditions facing the Core Four as Guatemala again registers positive growth. Even so, we expect that growth will be limited to around 1.5 percent. Internally, the new civilian presidents in Guatemala, Honduras, and Costa Rica will probably begin to implement some needed economic adjustments, at least along the margin. 25X1

On the external side we expect serious and persistent trade, debt, and security problems to cap real GDP gains. Because the predicted modest growth falls short of projected population increases, average living standards will continue to erode except in Costa Rica, where a slight gain is likely. Regional unemployment problems will persist and probably worsen as new job creation fails to match the demographics of the work force. Despite our forecast of sluggish economies through 1986, modest Core Four growth is a substantial improvement over the early 1980s. 25X1

The *Guatemalan* Government failed to implement economic reforms in 1985. According to Embassy reporting, the key reasons for lack of action was an absence of consensus among interest groups and Chief of State Mejia's unwillingness to bear the political repercussions of tax increases or spending restraint. The impact of lack of action was compounded by developments on the foreign exchange front. A poorly planned transition to a dual currency rate system in

Figure 3
Core Four Real GDP Growth, 1979-86



[a] Projected.

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late 1984 sharply reduced Central Bank foreign exchange receipts: exporters withheld funds from the official market to obtain better rates on the free market. The quetzal depreciated rapidly as Guatemalans converted cash holdings to dollars in response to uncertainty over transferring power to a civilian president and negative rates of return on domestic savings from controlled interest rates. All told, Guatemala experienced a 60-percent devaluation during the year, well above the country's 45-percent rate of inflation. Production during the year was disrupted because government foreign exchange receipts were inadequate to pay for fuel supplies and other priority imports. Indeed, independent forecasters suggest that Guatemala will likely register a 1-percent decline in GNP for 1985. By August and September, demonstrations by labor and consumer groups, angry over inflation and shortages forced Mejia to abandon any thought of preelection austerity measures and to fire two ministers favoring devaluation and fiscal restraint, according to Embassy reporting. [redacted]

Looking ahead, the civilian president scheduled to take office in January will inherit even greater economic problems as a result of Mejia's postponement of fiscal and monetary restraint. Even so, some improvement can be expected for 1986. According to Embassy and press reporting, foreign economic assistance is likely to increase somewhat if the transition to civilian rule goes smoothly. Such aid could boost depleted foreign reserves by the second half of 1986 and lead to a rebound of crucial imports. Donor conditions for expanded aid programs, however, will require policies to stabilize exchange rates, raise taxes, and slow credit expansion—moves that will be politically difficult for a democratic government. On balance, the best we see for the economy is a rebound during the second half of 1986, and overall GDP growth of 1 percent for the year. [redacted]

Costa Rica's economic growth probably will slide in 1985 to about 3 percent, according to several independent forecasts. That is just one-half of last year's level but still the highest in the region. The lower growth is largely the result of reduced production for export and falling domestic demand. For example, according to press [redacted] a major drop in banana 25X1

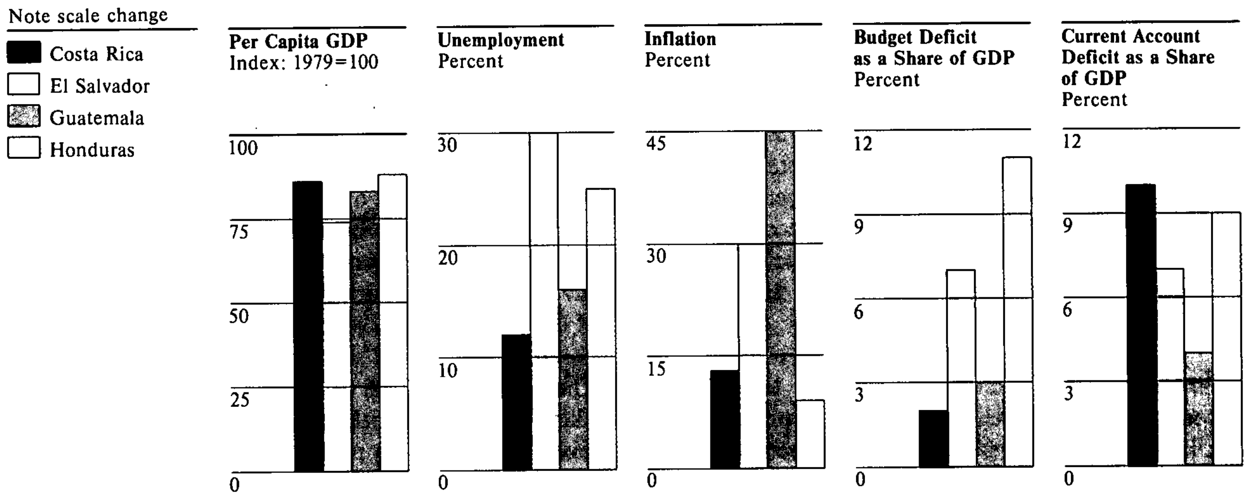
Budget Problems

In the current economic situation, public-sector budget deficit problems are likely to remain severe, limiting the usefulness of fiscal policy as a political tool. According to US Embassy reporting over the past few years, each of the Core Four governments has limited ability to increase public revenues. Their margin to cut expenditures is even less. [redacted] 25X1

The region's governments face a difficult challenge in boosting revenues. Higher tax rates could discourage production, increase tax evasion, and further harm the business climate. A rebound in the volume of foreign trade—from which the bulk of taxes is derived—could provide some relief, but much of any new export expansion will come from nontraditional categories that have recently been given special tax incentives. To both enhance revenues and smooth cyclical fluctuations, the region's governments probably will have to revise tax structures to reduce the reliance on export and import taxes as well as intensify efforts to assure compliance. [redacted] 25X1 25X1

Options for paring expenditures are equally constrained, and governments are having trouble maintaining reduced spending levels. Attempts to cut spending by paring public-sector employment are hindered by already high unemployment rates and strong unions capable of paralyzing many vital government services. Only limited progress has been made by governments to divest themselves of enterprises whose services could be provided by the private sector, and political considerations stand in the way of more decisive actions. US Embassy reporting from the Core Four countries indicates that public-sector employees are pushing for wage increases after five years of on-and-off wage freeze policies. These pressures have become particularly acute this year in El Salvador and Guatemala, where inflation has sharply reduced consumers' purchasing power. [redacted] 25X1 25X1

Figure 4
Core Four Economic Performance Indicators, 1985[a]



[a] All 1985 values are projections.

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output—as foreign producers abandoned their operations, citing low world prices, excessive taxes, and bureaucratic interference—has been the chief export problem. Based on preliminary government data, the economic expansion that is occurring is coming from slight industrial growth and a small boost in sales of nontraditional exports. While many financial observers believe that Costa Rica's financial stabilization program has been the most successful in the region—it is the only Core Four country that had an IMF-endorsed economic program during the year—political pressures have held up some needed initiatives. At midyear, for example, the US Embassy reported that San Jose temporarily fell out of compliance with its IMF program, in large part because election politicking caused the National Assembly to block progress on trade and budget deficits.

Economic prospects for 1986 are no better. To regain access to funds from the IMF and the rest of the international financial community, San Jose has publicly agreed to tougher austerity steps for next year, including spending cuts, new budget controls over state enterprises, and a wage freeze. Thus the new president scheduled to take over in May 1986 will have to rely on tighter budget restraints. On the basis of US Embassy reporting, we believe that widely discussed initiatives on trade promotion are unlikely to materialize because of opposition from influential domestic business interests who will seek to maintain their protected markets. While Costa Rica's 1986 austerity package will help set the stage for future growth, it will check economic activity at least in the short run. Overall, we agree with macroeconomic forecasters who see 3-percent economic growth as the best that San Jose can expect for next year.

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Although the *Salvadoran* Government and independent forecasters had been projecting 2- to 3-percent growth for 1985, recent Embassy reporting indicates that final growth figures will be lower, probably closer to 1 percent. Most observers believe that the failure to

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build on the positive growth of 1984 is largely due to poor macroeconomic policy and private-sector distrust of the socialist orientation of the Christian Democratic Party. A gradual improvement in President Duarte's strained relations with the business community was quickly reversed in August, according to Embassy reporting, when the government failed to consult the private sector on a decree that limited profit margins for some industries. The balance of payments continued to worsen because of Duarte's reluctance to adopt stabilization measures during his first year in office. In addition, inflation was up sharply according to Salvadoran statistics, spurred by an acceleration of monetary growth and a rapid currency depreciation on the free market. [redacted]

Various problems are likely to continue to constrain economic performance in 1986. Rising price levels will complicate efforts to keep government spending under control; workers will seek compensating wage hikes. Duarte probably will have to accede to workers' demands to prevent crippling strikes and work stoppages. At the same time persistent insurgent attacks against economic targets—such as electricity and transportation networks, and export crops—will continue. Moreover, we see no sign that Duarte will reverse the current policy drift that has further worsened inflation and the investment climate. Under these conditions, economic decline and deteriorating government finances will be avoided, in our view, only through sustained infusions of US economic and military assistance. Indeed, on balance we believe US aid should be enough to achieve 2-percent real growth next year. Because policy initiatives by Duarte could increase the effectiveness of US aid—for example, if the colon is devalued soon as promised, and if steps are taken to regain private-sector confidence—growth could be higher. [redacted]

For *Honduras,* most forecasters are estimating real growth of about 2 percent in 1985, although the government's midyear estimate projects more optimistic growth exceeding 3 percent. The key behind Honduras's performance, according to US Embassy and press reporting, is that high levels of government spending and international support have been sufficient to offset weaknesses in the private sector. [redacted] US Embassy [redacted] officials believe the economy requires a strong set of stabilization measures, particularly a devaluation of the lempira. Nevertheless, Embassy and press reporting indicates that Honduras's dependence on consumer and industrial imports has made politicians, the military, labor groups, and much of the private sector dead set against any currency devaluation. Instead, the government has openly opted to keep ailing export industries afloat by granting special tax incentives. We believe this bodes ill for long-term growth and investment prospects in an economy already overburdened with graft and favoritism. The Suazo government also has been unwilling to limit spending or raise taxes to control the fiscal deficit, which we estimate will be 11 percent of GDP this year. [redacted]

The lack of attention to corrective economic policy is likely to catch up with Honduras in 1986. Sustained levels of US support probably will be sufficient to allow real GDP to grow by 2 percent, but other economic indicators are likely to decline. We believe the expansionary fiscal and monetary policies of the last two years will begin to accelerate inflation. This will further encourage demands by public-sector workers for higher wages, which will require even greater domestic financing of the deficit. On the trade front, the international competitiveness of Honduran products will continue to suffer from the unrealistic exchange rate. Manufacturers selling in the domestic market will be dealt a further blow by cheap goods from Core Four neighbors who already have devalued their currencies. We see little relief in sight since most leading presidential candidates have avoided discussion of economic policy issues during the campaigns, and have not indicated that they will make needed reforms top priorities after the elections. [redacted]

Looking Beyond the Short Term

As long as Nicaragua remains a threat to its neighbors and El Salvador and Guatemala are unable to eliminate their insurgencies, Core Four economic performance will remain substantially below potential. As pointed out by the Kissinger Commission in 1984, and others since then, Central America will not

Table 3
Core Four Balance of Payments [a]

Million US $

	1975	1980	1983	1984	1985 [b]
Costa Rica					
Current account balance	**−218**	**−664**	**−335**	**−376**	**−338**
Trade balance	−204	−527	−123	−136	−132
Exports (f.o.b.)	493	1,001	870	958	994
Imports (c.i.f.)	697	1,528	993	1,094	1,126
Net services balance	−23	−152	−243	−278	−246
Net transfers balance	9	15	31	38	40
Capital account balance, errors, and omissions	224	206	389	257	337
Net change in international reserves	6	−458	54	−119	−1
El Salvador					
Current account balance	**−93**	**−61**	**−229**	**−264**	**−322**
Trade balance	−66	−62	−156	−207	−280
Exports (f.o.b.)	533	969	736	761	772
Imports (c.i.f.)	599	1,031	892	968	1,052
Net services balance	−55	−27	−152	−162	−177
Net transfers balance	28	28	79	105	135
Capital account balance, errors, and omissions	123	−227	49	272	355
Net change in international reserves	30	−288	−180	8	33
Guatemala					
Current account balance	**−55**	**−163**	**−276**	**−397**	**−383**
Trade balance	−82	−71	−43	−147	−93
Exports (f.o.b.)	641	1,519	1,092	1,132	1,214
Imports (c.i.f.)	723	1,590	1,135	1,279	1,307
Net services balance	−51	−202	−264	−278	−350
Net transfers balance	78	110	31	28	60
Capital account balance, errors, and omissions	171	−91	305	415	383
Net change in international reserves	121	−254	29	18	0
Honduras					
Current account balance	**−112**	**−320**	**−225**	**−243**	**−275**
Trade balance	−84	−196	−127	−145	−195
Exports (f.o.b.)	310	835	694	766	804
Imports (c.i.f.)	394	1,031	821	911	999
Net services balance	−45	−145	−143	−178	−187
Net transfers balance	17	21	45	80	107
Capital account balance, errors, and omissions	166	242	207	235	260
Net change in international reserves	54	−78	−18	−8	−15

Table 3
Core Four Balance of Payments [a] (continued)

Million US $

	1975	1980	1983	1984	1985 [b]
Core Four					
Current account balance	**−478**	**−1,208**	**−1,065**	**−1,280**	**−1,318**
Trade balance	−436	−856	−449	−635	−700
Exports (f.o.b.)	1,977	4,324	3,392	3,617	3,784
Imports (c.i.f.)	2,413	5,180	3,841	4,252	4,484
Net services balance	−174	−526	−802	−896	−960
Net transfers balance	132	174	186	251	342
Capital account balance, errors, and omissions	589	130	950	1,179	1,335
Net change in international reserves	111	−1,078	−115	−101	17

[a] Based on US Embassy reporting, IMF statistics, and open sources.
[b] Figures for 1985 are estimated.

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Table 4
Central American Trade With the United States, 1984 [a]

	Percent of Exports to United States	Percent of Imports From United States	Exports as a Percent of GDP	Imports as a Percent of GDP
Core Four	45	35	18	22
Costa Rica	49	37	31	35
El Salvador	48	37	18	23
Guatemala	35	31	12	14
Honduras	53	36	25	30
Nicaragua	17	14	12	24

[a] International Monetary Fund figures.

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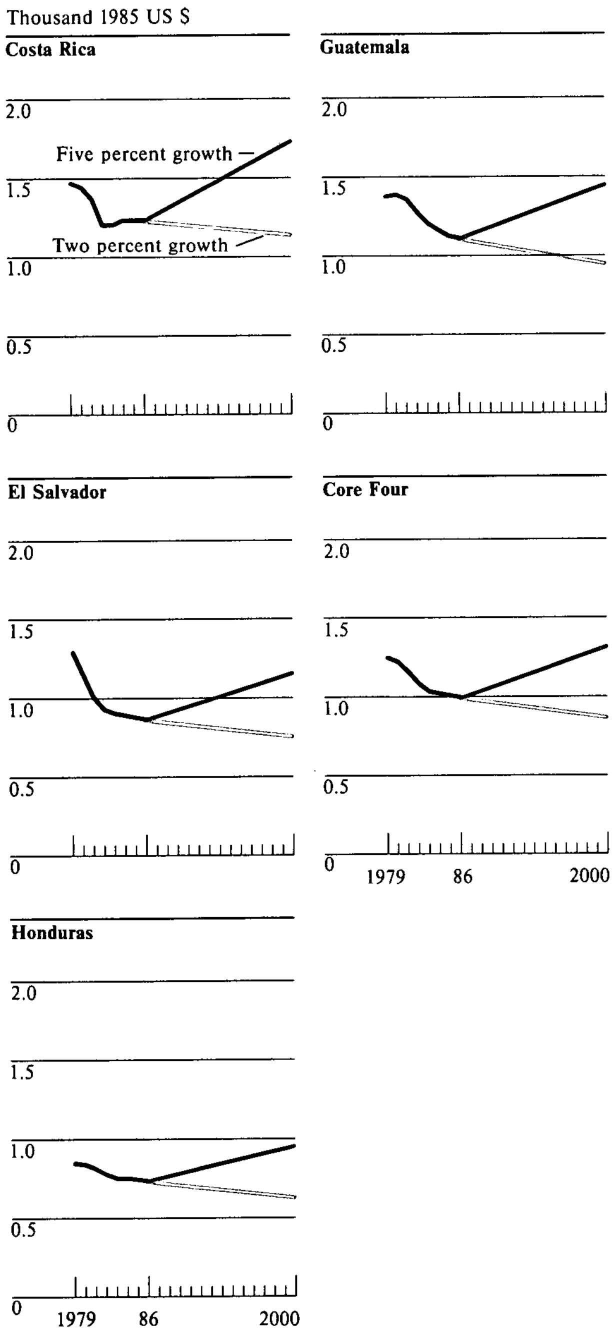
Figure 5
Core Four Growth Scenarios, 1979-2000[a]



[a] All 1985 thru 2000 values are projected. Figures cited are real per capita GDP.

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see a renewal of the vigorous—5.6 percent annual—economic growth the region enjoyed during 1961-78 until:
- The region's political turmoil is ended.
- Substantial net capital flows resume.
- Local governments adopt fundamental changes in economic policies. 25X1

Because of the current fluid political situation, there is considerable margin for error in long-term regional economic projections. The only consensus among forecasters is that prospects for renewed vigorous economic growth any time soon are virtually nil. 25X1

Because of the uncertainty over the future course of economic conditions in Central America, we have examined two post-1986 economic growth scenarios and their implications from social and security points of view. We believe these two scenarios bound the range of likely outcomes. The first case assumes a general continuation of the 1984-86 economic performance—real GDP growth of about 2 percent per year—through the rest of this century. The second scenario foresees a gradual restoration of security and investment patterns, yielding average annual real GDP growth of 5 percent—the best we believe the region would be likely to achieve based on the historical record of previous long-term expansion. 25X1

Without some further economic rebound, the 2-percent growth path—falling short of the region's 3-percent annual population increase—would see a steady decline in average living standards. Given current production levels the continued sluggish regional economy would absorb only about half of the estimated 200,000 new entrants to the labor force each year. Under these conditions, we believe frustrated youth will increasingly be channeled into the informal economy, worsening the region's income distribution and encouraging continued emigration. 25X1

On the other hand, while an average annual growth of 5 percent would provide gradual improvement in per capita income, most experts agree it still would be insufficient to create enough jobs to substantially

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Policies Capable of Boosting Economic Growth

Costa Rica

— *Vigorously implement the fiscal and monetary conditions of its IMF Standby Agreement, avoiding the lapses that have characterized recent experience.*

— *Encourage exports by lowering trade barriers, despite opposition from domestic business leaders, and by reducing export taxes and bureaucratic interference. These incentives are especially important for potential recovery in the banana sector.*

— *Increase productive efficiency through the divestiture of public enterprises, whose services can be provided better by the private sector.*

— *Carry through on current initiative to revitalize regional trade by working with other Core Four countries to eliminate intraregional trade arrears and restore former patterns of exchange.*

— *Work to phase out wage and price controls to allow more efficient and more productive employment of labor and raw materials.* [redacted] 25X1

El Salvador

— *Make peace with the private sector by demonstrating some willingness to make requested accommodations. This could involve some revamping of the 1980 reforms: allowing the private sector to compete with government monopolies in banking and agricultural export marketing, or making a stronger commitment to compensate those affected by the land reform program.*

— *More aggressive depreciation of the exchange rate by expanding the parallel market and allowing it to reflect market forces.*

— *Simplify bureaucratic procedures and end perceived political favoritism, especially for those dealing with obtaining foreign exchange.*

— *End discriminatory pricing policies for major export crops, particularly coffee and cotton, to encourage growers to increase plantings and take better care of current and future crops.* [redacted] 25X1

reduce current unemployment. Even at this growth rate, regional per capita income would not regain its 1979 peak level until 1997. Considered individually, 5-percent economic growth would return Costa Rica and Honduras to parity with their 1979 performance by 1993 and 1994, respectively. Guatemala would reach its former peak by 1997, while it would take El Salvador until 2006.[5] [redacted]

[5] We qualify this projection by noting that El Salvador has a greater potential to exceed 5-percent annual growth than the other Core Four countries if the military and political uncertainties are greatly reduced. This would encourage a repatriation of capital and entrepreneurial talent and speed the return to previous production levels. [redacted]

Actual long-term growth for the Core Four will, in our assessment, likely fall within the range of these two scenarios. Consequently, these four economies will have difficulty providing both improvements in average living standards and job opportunities. We further believe that these are two key popular expectations for which electorates are likely to hold their elected governments accountable. Growing popular frustration over these issues could rapidly erode confidence in the democratic systems and usher in a new period of political instability. [redacted]

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Guatemala

- *Establish policies early in the term of the new civilian president to build private-sector confidence and help stem capital flight.*
- *Bring the Chixoy hydroelectric project into operation as quickly as possible to ensure reliable electricity supply and allow for the much-needed repair of present thermal power plants.*
- *Reform the current regulations for converting foreign exchange earnings in the parallel market. Current regulations create strong incentives to rely on black markets.*
- *Improve public revenues by lowering government subsidies and carrying through tax reform, stressing collection enforcement to reduce the reported high rate of evasion.*
- *Quickly rein in the growth of the money supply to restore price stability and long-term confidence in the economy.*

Honduras

- *Curtail government monopolies that are inefficient and inhibit the diversification of the export mix, especially the government monoply on use of forest resources.*
- *Lower administrative barriers to both domestic and foreign investors. At present, rules hinder new entrants or those wishing to expand.*
- *Develop an exchange rate policy that provides for a realistic evaluation of the lempira and provides assurances to business firms that foreign exchange will be available for imports and repatriation of earnings by foreign investors.*
- *Develop fiscal restraints to stem the recent large increase in government spending, and get the large public-sector deficit under control.*

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We see a less than even but still significant chance that economic growth could fall short of the slow growth scenario, particularly during the next four or five years. Economic contraction could be triggered by renewed security threats—for example, a resurgence of guerrilla movements or border conflicts involving Nicaragua. Another potential threat to positive economic growth is that governments will bow to political exigencies and reject investment policies in favor of demands to boost consumption prematurely. The negative impact of such a policy path would be compounded if Western economic activity slowed or commodity prices further softened.

Implications for the United States

In our view, continuing economic troubles are likely to undercut social and political development in the region and put new strains on US relations with the Core Four countries. The failure to revive depressed economies is likely to deny Core Four governments the resources they badly need to address the area's critical social problems. At the same time, it is likely to limit their military and political maneuvering room when dealing with foreign-assisted insurgencies because weakened economic conditions would provide a

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breeding ground for radical discontent and would also limit governments' abilities to introduce new programs to counter unrest. In our judgment, the longer the region's per capita GDP continues to decline, the more vulnerable the Core Four will become to inroads by political radicals and the more difficult it will be to maintain the movement toward more open democracies.

Even in the best of circumstances—because it will probably take a decade or more to restore living standards to pre-1980 levels—we expect growing consumer impatience to erode political support for elected governments during the foreseeable future. As a result, even with preferential trade and aid from the United States, we expect growing criticism of close US–Core Four economic and political ties from regional press sources, opposition politicians, and labor unions.

Despite concern over possible anti-US backlash, we expect Core Four countries to continue to press for even higher levels of financial aid. In addition, the United States will almost surely be asked increasingly to intercede with the IMF, World Bank, and commercial bankers to provide the Core Four with easier terms on new lending and debt rescheduling. While official financial support clearly has the capability to help limit economic backsliding, it also entails some potential risks. Long-term economic recovery will be delayed if generous financial cooperation and continued assistance weakens Core Four resolve to take the tough steps needed to regain financial stability and rebuild business confidence. For the next few years, the Core Four governments are likely to be tempted to continue delaying economic adjustments as much as possible, believing they can obtain more resources at a lower political cost from the United States than they could by dealing with the IMF and complying with rigid stabilization programs. On the positive side, US financial and investment initiatives for the region are likely to strengthen substantially the Core Four's already strong trade ties to the United States. This will allow the region's economies to benefit from the present strong US economy, but it also will heighten vulnerability to any US economic contractions.

To the extent that Central America falls short of its growth potential, economic troubles are likely to encourage advocates of radical economic policies. Nevertheless, we believe that the Core Four will continue to benefit from any comparison of economic trends with Nicaragua, which has continued to register declines even as performance in the Core Four has bottomed out. Nicaragua's track record will provide little incentive for radical political movements within the Core Four to point to Managua-style economic structures and institutions as a role model.

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Appendix A

Regional Economic Integration

The Central American Common Market (CACM) was for many years a highly successful experiment in economic integration. Since 1980, however, the institution has been wracked by regional turmoil and mounting trade and debt problems. While most member nations are working to get CACM back on track, we believe the short-term prospects are clouded. [redacted]

CACM was founded in 1960 to establish free trade for manufactured goods among Costa Rica, El Salvador, Guatemala, Honduras,[6] and Nicaragua. A regional bank, the Central American Bank for Economic Integration (CABEI), also was formed with the explicit goal of financing industrial projects—primarily import substitution industries—that would promote integration. A review of trade statistics shows that the wider market spurred growth in regional sales, so that by 1980 nearly one-fourth of all exports from CACM countries were bought by other countries within the region, compared to only 6 percent in 1960. According to US Embassy and press reporting, however, these emerging export industries developed under a highly protective common external tariff, and few of the products were competitive on world markets. Virtually all of the region's manufactured goods were either consumed in the producing country or exported to other CACM members. [redacted]

Two decades of vigorous growth ended in 1980 as a variety of factors acted to hamper intraregional trade. Insurgencies greatly reduced the export capacities of Nicaragua and El Salvador, and restricted transportation routes. Furthermore, balance-of-payments positions deteriorated in all five countries when agricultural commodity prices fell and petroleum prices soared. CACM members began unilaterally to restrict free trade to protect balance-of-payments positions by adopting foreign exchange controls, deposit requirements, and import restrictions. Trade volumes were cut nearly in half between 1980 and 1984. [redacted] 25X1 [redacted] the attempts by manufacturers to 25X1 replace lost markets were unsuccessful, because they were uncompetitive outside CACM. [redacted] 25X1

US Embassy reporting suggests that a principal barrier to CACM recovery has been the inability of deficit 25X1 countries to settle trade imbalances or guarantee repayment of extended credits. Timely settlement of the Central American Clearing House balances, which must be covered with dollars, is hampered by the restricted foreign exchange positions of the regions' central banks. Creditor countries—Costa Rica and Guatemala—have been reluctant to extend credits to cover the persistent and substantial deficits of Nicaragua, El Salvador, and Honduras. [redacted] 25X1

Of particular concern are the bilateral debts accumulated by Nicaragua since 1979, which, based on US Embassy and press reporting, we estimate now to exceed $435 million. Officials in Guatemala—and probably the other countries as well—believe it unlikely that Nicaragua's debts ever will be repaid, according to Embassy reporting. As a result, the Core Four members have tried to limit trade with Nicaragua to barter or advance-cash deals. The Core Four countries are reluctant to completely cut off trade 25X1 with Nicaragua because many of these exports have no other market and they hope some of the debt eventually may be recovered. [redacted] 25X1

The regional financing bank, CABEI, has practically no funds to lend because of the high bankruptcy rates among borrowing firms and public-sector arrears by the member governments. [redacted] 25X1 Without an infusion of new capital, the bank reports that by 1986 it will be unable to initiate new projects and will simply service existing loans. According to diplomatic reporting, CABEI is

[6] Honduras formally withdrew from the common market in 1971 but continued to participate in its regional institutions and maintain bilateral trade agreements with the other four members. [redacted] 25X1

Table 5 *Million US $*
Nicaraguan Debt to CACM Members, Mid-1985

Total	**435**
Costa Rica	195
El Salvador	50 [a]
Guatemala	150
Honduras	40

[a] CIA estimate.

trying to increase non–Central American participation in the bank, which is now supported by the United States, Mexico, Venezuela, European Community, and the World Bank.

The Central American governments continue to express an interest in maintaining and reinvigorating the common market. The Core Four did not join the US trade embargo of Nicaragua in May this year, in part, we suspect, because of the potential harm such a move would bring to the CACM and the regional institutions. Nicaragua continues to express public support for the preservation of the common market and regional institutions, despite its poor payments record. The general, regional commitment to preserving the common market was demonstrated this year when—after arduous negotiations—CACM members were able to agree on a new common external tariff schedule and adopted the Brussels nomenclature system.

Costa Rican President Luis Monge recently has publicly called for increased cooperation among the Core Four to reduce regional trade barriers and jointly approach multilateral lenders and donors for additional funding for the area. His plan, which has been favorably received by the other three governments, however, is unlikely to supplant existing arrangements that include Nicaragua.

Table 6 *Million US $*
CACM [a] Regional Exports by Country, 1979-85

	1979	1980	1981	1982	1983	1984	1985 [b]
Total	**901**	**1,169**	**962**	**782**	**798**	**715**	**674**
Costa Rica	175	270	238	167	187	176	157
El Salvador	267	296	207	174	174	164	151
Guatemala	307	441	380	337	321	291	297
Honduras	62	87	66	52	65	47	39
Nicaragua	90	75	71	52	51	37	30

[a] Central American Common Market.
[b] Figures for 1985 are estimated.

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The short-term prospect for the recovery of regional trade is bleak. Unilateral trade restrictions by member governments were expanded this year, and we believe, contributed to a further decline in trade volumes. Preliminary trade data for El Salvador, Honduras, and Nicaragua show a further decline in regional trade from 1984 levels. We also project a decline in Costa Rican exports to the CACM as a result of the government's decision to stop extending credits to common market members. Guatemala probably will show a slight increase in exports because the rapid depreciation of the quetzal has greatly raised demand. Despite a continuation of the downward trend in 1985, CACM trade will continue to hold a significant share of the region's exports, and the institutions are likely to be maintained in their weakened state.

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Appendix B

Central American Exchange Rate Adjustments

Most economic observers believe that the reluctance of Central American governments to adjust overvalued exchange rates has exacerbated economic problems by substantially undercutting potential exports, encouraging imports, and depressing import substitution industries. Governments already tightening their belts on budget and wage restraints are loath to change long fixed—and nearly sacred—exchange rates. A change in the rate is among the most visible policy options a government can take and one that virtually all citizens can feel almost immediately through shortages and inflation. Nevertheless, it also is among the most effective steps that can be taken. Over the longer run, realistic exchange rate adjustments can encourage exports, boost industrialization, and create jobs. The countries of the region are now in various stages of adjusting their exchange rate policies.

The Central American countries have a long history of stable currencies pegged to the US dollar. Foreign exchange rate trends show that Costa Rica and Nicaragua each took just one devaluation between 1960 and 1980, while Guatemala, Honduras, and El Salvador still maintain par values established in the 1930s, or earlier. Prior to 1980, according to academic studies, Central American governments seldom relied on foreign exchange controls to maintain unrealistic currency values.

The traditionally conservative monetary and fiscal policies were somewhat relaxed in the early 1980s when expansionary policies were implemented to reduce the adverse effects of a deep recession. At the same time, exchange rate adjustments were avoided even though inflation rates well exceeded those of principal trading partners, causing serious balance-of-payments problems. All five countries responded, according to Embassy reporting, by imposing exchange controls, and have since tightened them to maintain artificially high currencies values. We believe the creeping inconvertibility, however, contributed greatly to the region's capital flight and the decline of trade-dependent industries.

The bureaucratic delays and corruption associated with the foreign exchange allocation systems contribute greatly to the region's poor investment climate, according to [redacted] Embassy sources, and 25X1
in some cases are a more important deterrent than political turmoil. Businesses often face long delays in acquiring foreign exchange for crucial imports, and many experience difficulties trying to remit dividends. For example, businessmen in El Salvador complain that a full-time employee is required to process foreign exchange requests through the various stages of approval. In Guatemala, businessmen report fewer bureaucratic delays and also less price checking, which has encouraged many to abuse invoicing procedures to funnel money out of the country.

Pressure from international financial institutions and bilateral lenders is slowly persuading governments to realign currencies by establishing dual exchange markets, with a depreciated parallel rate for specified transactions, in addition to the official exchange rate. Later, the governments can gradually expand the parallel market so that foreign exchange controls can be relaxed. Costa Rica was the first Central American country to follow this policy and has continued to show flexibility by accepting periodic minidevaluations based on inflation differentials with the United States. As of October, the Costa Rican colon had been devalued 18 times in 1985, for a total decline of 10 percent against the US dollar.

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Table 7
Central American Exchange Rates, 30 November 1985

	Currency	Official Exchange Rate *(currency/US $)*	Free Market Rate [a] *(currency/US $)*	Percent of Foreign Exchange Transactions in Official Market
Costa Rica	Colon	53.0 [b]	55.0	95
El Salvador	Colon	2.5	6.0	40
Guatemala	Quetzal	1.0	3.7	40
Honduras	Lempira	2.0	2.8	80
Nicaragua	Cordoba	28.5 [c]	750.0	90

[a] Represents a weighted average between legal parallel rates and black-market rates.
[b] The official rate is 20 colones to the US dollar, but less than 1 percent of transactions are valued at this rate.
[c] Nicaragua also has fixed official rates of 10, 40, and 50 cordobas per dollar for some trade categories.

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El Salvador and Guatemala have established parallel markets as transitions to devaluation. El Salvador legalized the second market in 1982, and has expanded its coverage over the last two years as a condition for US aid disbursements. In Guatemala, the already large second market was legalized in late 1984 because the government could not satisfy foreign exchange requests, and was further expanded in mid-1985. We believe much of the reluctance to devalue currencies has begun to dissipate in both El Salvador and Guatemala as the dual exchange markets have become firmly established.

Honduras has taken the strongest stand against devaluation among Core Four countries. Because of Honduras's dependence on imports, virtually every sector of the economy expresses strong opposition to devaluation or establishing a dual exchange market—a fact underscored by strong opposition in the local press. A significant black market exists—and is tolerated by the government—where people are willing to pay a premium for dollars to avoid the long delays and patronage in the official market. The government showed some flexibility in March of this year by agreeing to legalize parallel market transactions for the 10 percent of trade in the CACM as a condition of US aid disbursement, but has not helped in implementing the new regulations.

While the Core Four have taken steps to improve the convertibility of their currencies over the last two years, Nicaragua has moved in the opposite direction. Rapid inflation in 1984 and 1985 prompted the government to tighten exchange controls, making the cordoba virtually inconvertible. By last February, depleted foreign exchange forced the Sandinistas to devalue the cordoba for the first time since the revolution. Nevertheless, the inflexible multiple rate system—where rates depend on trade priorities—still greatly overvalues the cordoba. The Sandinistas have allowed some free foreign exchange trade for the small tourist transactions.

We believe the need to make exchange rate adjustments will continue to concern the region's governments. Although the Central American countries have been able to keep inflation under reasonable control, national statistics show price rises continue to exceed those of the region's principal trading partner,

Table 8
Central American Inflation, 1960-84

	1960-79	1979-84	1985 [a]
Costa Rica	5.9	35.6	13
El Salvador	5.0	13.7	30
Guatemala	4.8	8.2	45
Honduras	4.6	10.0	9
Nicaragua	NA	30.1	700
United States	4.8	7.4	3

[a] CIA estimates of 1985 price changes based on reporting and trends for the first nine months of the year.

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the United States. Even Costa Rica, after experiencing inflation of nearly 100 percent in 1982, saw consumer prices rise only 12 percent last year. The Salvadoran economy, despite the war, generated only 13-percent inflation in 1984, while Guatemala and Honduras experienced average price increases of only 5 percent.

The prospects for adopting the necessary exchange rate adjustments, however, depend on the balance between economic pressures and political realities. If the past few years are a guide, the region's leaders want to avoid sharp price increases that often follow currency depreciations and can quickly create an unstable political environment by creating a rallying point for economic, social, and political discontent. Such a scenario arose this year in Guatemala, where we estimate that the sharp depreciation of the quetzal added at least 15 percentage points to the annual rate of inflation. By contrast, Costa Rica's progress presents a positive example, since frequent minidevaluations during the last two years have maintained a realistic exchange rate without increasing inflation or generating strong public reaction.

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Appendix C

US Assistance to the Core Four

El Salvador and Costa Rica receive the largest portions of total US assistance to the area, according to official US data. In El Salvador, the insurgent war has strained government finances, caused direct damage to infrastructure, and contributed to the massive flight of capital and entrepreneurial talent. The overwhelming external debt accumulated by Costa Rica—123 percent of GDP—requires extensive concessionary foreign financing to keep the country solvent. Embassy reporting indicates that government policies in these countries have been generally accommodating to austerity measures required as a condition of US aid, although slow implementation has occasionally held up disbursements. [redacted] 25X1

Table 9
US Economic and Military Assistance to the Core Four, 1979-86

	1979	1980	1981	1982	1983	1984	1985	1986 [a]
Core Four								
Economic	83	135	181	340	608	771	863	907
Military	2	10	44	115	121	284	200	234
Total	85	145	225	455	729	1,055	1,063	1,141
Costa Rica								
Economic	18	14	13	51	212	174	202	187
Military				2	3	9	9	3
Total	18	14	13	53	215	183	211	190
El Salvador								
Economic	11	58	114	190	246	328	317	350
Military		6	35	82	81	197	128	133
Total	11	64	149	272	327	525	445	483
Guatemala								
Economic	25	8	9	8	28	30	73	78
Military								10
Total	25	8	9	8	28	30	73	88
Honduras								
Economic	29	51	34	78	103	171	134	143
Military	2	4	9	31	37	78	63	88
Total	31	55	43	109	140	249	197	231
Regional								
Economic		4	11	13	19	68	137	149
Military								
Total		4	11	13	19	68	137	149

[a] Figures from administration's 1986 foreign assistance submissions to US Congress.

[redacted] 25X1

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Honduras receives less aid than El Salvador or Costa Rica, in part because it faces less threatening economic problems and has a smaller capacity to absorb infusions of aid. Moreover, the Hondurans have been extremely reluctant to adopt reforms as a condition of US aid, according to Embassy reporting. The principal sticking point in recent years has been the government's steadfast refusal to modify its exchange rate system. 25X1

Guatemala receives the least US aid of the Core Four even though it has the largest economy in Central America and faces serious shortages of foreign exchange. Congressional restrictions on aid to the military government, prompted earlier by human rights abuses, have just begun to be eased. Aid levels expanded slightly following the Constituent Assembly elections in 1984, which were widely regarded as honest and free of military interference. Guatemalan officials hope for a further increase in US aid if the transfer of power to a civilian government—scheduled for January 1986—is carried out successfully. 25X1

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