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Record

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CENTRAL INTELLIGENCE AGENCY
Office of Legislative Liaison
Washington, D.C. 20505
Telephone: 351-6136 25 Feb 86

TO: Permanent Select Committee on Intelligence
House of Representatives

Attn: Dave Addington

STAT

Per your request of [redacted] I am attaching unclassified economic data on Central America.

If you feel you need more information we recommend you get from the State Department copies of the cables listed on the attachment.

STAT

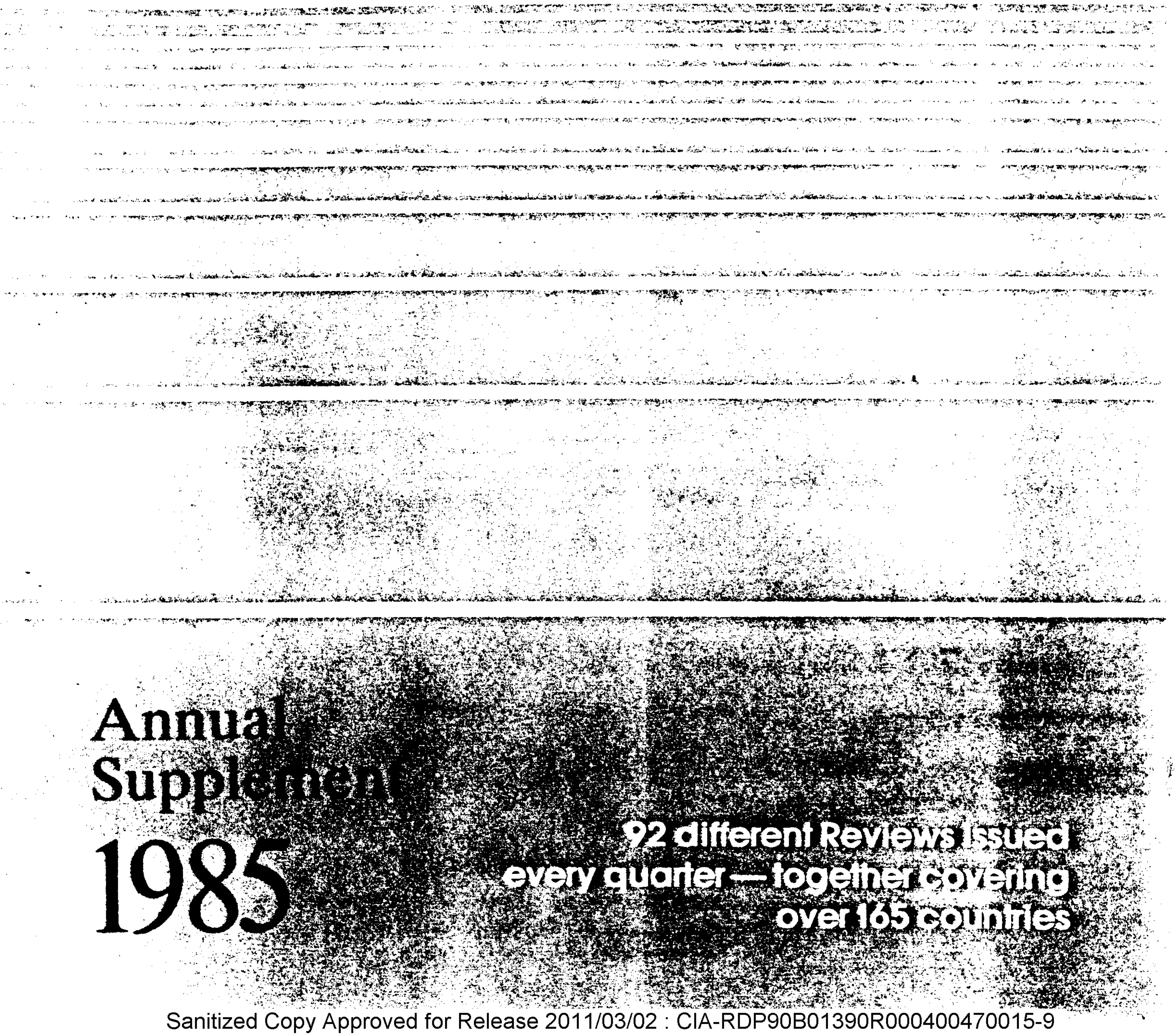
[redacted]

Office of Congressional Affairs

EIU The Economist Intelligence Unit

Quarterly Economic Review of

Nicaragua, Costa Rica, Panama



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CA 01

CENTRAL AMERICA

FRANCISCO DE PAULA GUTIERREZ

Recent Developments -- The evolution of the Central American economies during the first months of 1985 has not been as favorable as forecast in the spring 1985 Outlook. The foreign exchange scarcity has been more acute than previously anticipated, causing higher exchange rates and a lower capacity to import. Political events have clouded the environment and affected the investment climate. The institutional framework of the Central American Common Market suffered another setback when the multilateral payments scheme was virtually interrupted by Costa Rica. As a result, the outlook is in general more pessimistic, especially in the areas of growth and exchange rate stability.

Growth -- The outlook has been revised downward for most of the Central American countries, again raising the possibility of another negative growth rate for the region as a whole. The uncertainty associated with the scarcity of foreign exchange and the policy to face the scarcity, the continuation of military confrontations in two of the countries, and the implementation of stabilization policies are some factors behind the lower growth rates in the region. Negative rates are now expected for Nicaragua and Guatemala, and stagnation or very much moderated growth is likely for Costa Rica, El Salvador, and Honduras. For 1986 the outlook has also been revised downward, but positive growth is expected for the region as a whole.

Inflation -- Despite the sharp increases in the exchange rate, inflation is still not a problem in some Central American economies, at least from the point of view of the official CPI. However, other indicators suggest that inflationary pressures are building rapidly in Guatemala and El Salvador, given the increased importance of the interbank rate in total trade. In Costa Rica and Honduras, on the other hand, inflation has decelerated compared with the rates observed during the previous years. In most countries, inflation will be higher in 1986 than in 1985.

External Sector -- Total trade has declined in some countries, since imports have been reduced for lack of foreign currency, and some exports have been affected by supply shocks and conditions in world markets. Trade balances for the region, however, will not show a sharp improvement since some of these effects cancel out, although the deficit will be lower than previously forecast. The drop in oil prices will contribute to an improving trade picture during the second half of 1985 and 1986, and the decline in world interest rates will be reflected in lower current account deficits.

Exchange Rate -- In general, the exchange rate situation has been worse than expected in three of the five countries. The shortage of foreign currency, due in part to limited official capital inflows, has caused an increase in the black-market rate, putting more pressure on the official and interbank markets. As expected, realignment of the rates was achieved not only by shifting goods from the official to the interbank market but through a faster depreciation of the interbank rate. For the rest of 1985 and 1986 we expect a continuation of this tendency in Guatemala, El Salvador, and Nicaragua, and a modification of the exchange rate system in Honduras so that a dual market can be created. Formal devaluations cannot be ruled out for the next 18 months in the countries.

For current developments, please turn to the section: Monthly Economic Indicators.

Business Latin America

WEEKLY REPORT TO MANAGERS OF LATIN AMERICAN OPERATIONS

AUGUST 7, 1985

Fallout from Peru's New Economic Measures . . . 249
Warnings of a New Phase in the Debt Crisis 249
. . . A Close Look at Key Countries' Burdens . . 254-55
Colombia and GM in a Win-Win Agreement 250
Reaction to Mexico's Import Liberalization 251
Business Outlook: Costa Rica 252-253
Bulletins 256

Peru's New Austerity: Business Reacts Cautiously And Awaits Further Changes

After closing the banks for two days last week, Peru's new government announced the first stage of its economic plan. As expected, the steps are tough and energetic. Though some of the measures will be harder on business, the strong start is generally welcomed, and most hope that Garcia stays the course.

From what has been announced so far, it is clear that the first priority is going to be inflation control—and preferably with fast short-term results. Garcia has taken a page out of Argentina's book, with a wage and price freeze that attempts to be even-handed. Some adjustments had to be made before the freeze, however The government also approved salary hikes averaging 18%, with a 50% increase going to minimum-wage earners, and then slapped on the freeze Some prices had to be hiked in keeping with deficit-reduction targets. The price of gasoline was raised (by 13% to $1.25 per gallon) along with substantial increases in electricity, water, telephone, telecommunications, mail tariffs, urban transport and certain basic foodstuffs. The new prices are supposed to apply until end-1985.

As was expected, exchange controls have been clamped on for at least 90 days: Now dollars can be obtained from the banking system only with authorization. The government has also frozen all foreign currency accounts (held domestically and abroad) for 90 days (withdrawals will be reimbursed in soles plus 3%). However, exchange transactions can still take place legally on the free market. The measures were accompanied by a 12% devaluation to

(Continued on page 251)

Latin Debt Crisis: The Outlook Is Grim Unless Changes Are Made

Latin America's chronic debt problem is about to move back into center stage, with a new attempt to find a "solution" due to begin soon. To put the problem into perspective for our readers, BL presents a rundown of the key indicators of the region's ability to pay in the article below and in the table on pp. 254-255. As the figures show, the picture is bad—and unless something changes, it will get worse.

At end-1984, 13 Latin American debtors owed a total of $344.2 billion to international creditors. With only the happy exception of Trinidad, not one single country was struggling with a debt-service ratio of less than 25% of exports of goods and services last year, and six of them were burdened with ratios higher than 50%. (Peru's 16% is not representative because of its arrears.) What's worse, in light of the dim trade expectations of many regional debtors, nine out of the 13 face a worsening service load next year, despite the fact that no significant rise in interest rates is expected. Most countries' current accounts are already in deficit and just a one percentage point change in interest rates would make some of them significantly higher.

Peru's President Alan Garcia is pushing the issue to the forefront with his controversial recognition of a simple fact—Peru will not pay more than 10% of its export earnings in debt service because it cannot pay more at present. However, the problem goes much deeper, as the plight of the region's model debtor, Mexico, is beginning to show.

Both creditors and debtors will soon have to face the fact that the deals they are trying so hard to work out are

INSIDE: What's Next in Mexico

"First and foremost, companies that have the funds to do so are trying to get imports in before the rules of the game change . . . The conviction that more changes are in the offing is widespread." See p. 251.

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Special Document

The recent evolution of the Salvadoran economy[*]

In 1984 the Salvadoran economy entered its sixth consecutive year of a profound depression, resulting from a wide variety of both economic and non-economic factors amply described in the Annual Report and other ECLA documents.[1] Nevertheless, following the strong GDP drop from 1979 to 1982, in 1983 the negative trend began to bottom out and in 1984 real GDP grew 1.5%. (Global national income, however, drained by net interest and profit payments, remained stagnant.) In addition, the low growth rate of the Salvadoran population, due to the significant emigration (either for economic reasons or to escape the direct and indirect effects of the civil war) enabled per capita production to increase slightly (0.8%) over the level of the year before.

The year 1984 was full of contrasts and contradictions. The internal armed conflict continued, and in some ways worsened, at the same time as a civilian government was voted into office. The country's two principal products, coffee and cotton, both suffered important declines, but output as a whole registered moderate growth. Per capita income rose slightly, but in real terms barely reached the level of 1960. Finally, the government's fairly expansionist wage, credit, and fiscal policies were carried out at the expense of a further deterioration in the balance of payments.

In part the result of the civil war, these contradictions were also rooted in the multiple and complex reactions the conflict provoked in both national and international sectors.

Among the causes explaining the slight reversal in the negative growth trend, one must first mention the elections carried out in the first semester of the year. The taking of power by a civilian government, with a four-year term and an apparently expansionist economic program,[2] as well as the announcement and later holding of talks between the government and the insurgents, seemed to improve expectations in regard to the nation's economic future. Though "business confidence" is difficult to measure, various members of the private sector expressed their willingness to resume investment, and private investment did rise 4% over the year before.

Secondly, the recovery of the international, and especially the US, economy stimulated the Salvadoran economy, albeit slightly. Among other factors, there was a 13% rise in the price terms of trade index, the first improvement in this decade.

Finally, and most importantly, the growing support of the international financial community, and especially of the US, brought an important injection of resources into the economy, increasing its import capacity, and with that its productive capacity and overall demand. Although net capital income was down from the year before, this flow was strongly complemented by increased unilateral foreign transfers that helped mitigate both the costs of the economic policies applied throughout the year, and the escalating war expenditures.[3]

The principal goal of the government's economic policy —explicitly spelled out in their economic program— was the stimulation of internal demand and the global supply of goods and services.

On the demand side, the 1982 Law of Economic Stabilization, which for more than two years had strictly imposed International Monetary Fund (IMF) adjustment policies, including a general freeze that strongly eroded real wages, was reversed in 1984 with a rise in public sector salaries and various minimum wage increases in private industry and commerce. This expansive wage policy was accompanied by an increase in government consumption, especially in the growing security and defense expenditures.

Also significant was the increase in personal income of those Salvadorans receiving transfers from family members living abroad.

On the supply side, favorable weather, a moderately expansionist credit policy, and a greater supply of foreign exchange for importing production inputs resulted in a rebound in agricultural production, achieved despite the strong contraction in cotton and coffee production —due in great part to the disruptions of the civil war— and those changes in production patterns caused by the Agrarian Reform process. Of special note were the reduction in interest rates during the first semester, and the Central Bank's later decision to refinance the past-due credit payments accumulated by many important productive sectors (especially rural producers).

The industrial sector, especially consumer goods producers, also reacted favorably to the increased availability of credit and foreign exchange, with positive linkage effects for industry-related services, as well. All in all, the global supply of goods and services rose 2% over the year before, led by a 4% increase in the volume imports.

The slight economic recovery had, nevertheless, little impact on the high level of open unemployment of the last five years, which now affects more than 30% of the EAP. Those sectors traditionally generating the most jobs— coffee, cotton, and construction— remained the most depressed. In addition, a large part of the rural population emigrated from the conflict zones to the country's principal cities, swelling slum neighbourhoods already inadequately supplied with basic services, and stimulating the growth of the "informal sector," which acts in its turn as an important release to the unemployment problem.[4] On the other hand, the disruptive effects of the civil war have not brought excessive

[*] **Freely translated from the UN's Economic Commission for Latin America (ECLA), Notas para el Estudio Económico de América Latina y El Caribe, 1984, El Salvador.**

Special Document

The recent evolution of the Guatemalan economy

In 1984 Guatemala's recessive trend was interrupted by very slight growth in the Gross Domestic Product (GDP): virtually a stagnation, but an improvement compared to the very strong drops of the previous two years. Furthermore, private investment registered a hike for the first time in six years. Real per capita income, however, fell for the fourth straight year; internal and external financial imbalances continued, and unemployment worsened, becoming one of the most dramatic symptoms of the country's prolonged, deep recession. The bottoming out of the recessive slide, though positive, must not then be interpreted as a turning point presaging decided economic recovery.

The factors that helped maintain the recession in 1984 are the same that helped create it. First, although the terms of trade in goods and services improved slightly for the first time in various years (this, plus a relatively satisfactory year in agriculture, largely explains the bottoming out of the negative growth trend), the international situation continued unfavorable. The volume of exports experienced a new, though slight, decline, the servicing of the external public debt began to absorb a much larger proportion of scarce foreign exchange, and the country had increasing difficulty in contracting fresh external financing, both public and private. The severe lack of dollars hampered normal productive activity throughout the year, either through the absolute shortage of foreign currency needed to import spare parts, inputs, and raw materials, or through the increasing price of these import dollars in the free exchange market.

Second, in 1984 intraregional trade, which absorbs more than a quarter of Guatemala's total exports, continued to decline. The generalized depression of the regional market, complicated by problems in reciprocal payments and the bilateral trade difficulties of countries such as Honduras, led to an 8% fall in the value of Guatemala's regional sales, with serious consequences for the manufacturing sector.

Third, the financial situation of the public sector, especially the central government, worsened, leading, among other consequences, to a severe contraction in capital expenditures, the traditional motor of economic activity. Central government investment declined more than 33% compared to the previous year, and even so the fiscal deficit increased, with the necessary impact on the money supply.

Fourth, despite the mid-year election of a Constituent Assembly —an event officially marking the beginning of a return to a civilian and constitutional government— political and social tensions continued to foster private sector uncertainty over the economic future of the country. The 6.7% increase in private investment —the most dynamic element of global demand— appears to be more a response to having reached the minimum investment floor required to maintain the country's capital stock than to any deliberate decision to increase productive capacity. (The ratio of private investment to GDP stood at just 5.5% in 1984, compared to an average rate of 11% in the 1970's.) Despite some investments in new activities, almost all linked to non-traditional exports, the industrial sector generally had a high level of excess capacity, and construction activity continued to fall off.

Meanwhile, private consumption increased only 1%, a rate far inferior to the increase in population. This reflected the growing level of unemployment and a slight decline in real salaries, and could well also represent a continued deterioration in the structure of income distribution.

Paradoxically, the relatively satisfactory performance of the agricultural sector, especially in basic grain production, tended to accentuate the distributive aspects of the crisis. The production of corn and beans, the two most important elements in the national diet, increased almost 10% and 5% respectively. Not only was self-sufficiency reached in these crops (as well as in rice) but there were exportable surpluses. The size of the corn and bean harvests, however, combined with the inability of the National Agricultural Marketing Institute (Indeca) to buy up sufficient quantities at the guaranteed prices, caused a strong drop in the price of both products. This favored urban consumers but not rural producers.

With regard to other productive sectors, the value of manufacturing output remained at virtually the same depressed level as in 1983, due to the desintegration of Central American trade and the restricted internal demand. And, despite the potential opportunities offered by the US government's Caribbean Basin Initiative, and the Guatemalan government's new tax incentives for exports, it has not been possible to move significantly into new industrial goods markets.

In the petroleum sector, following the last decade's moderate growth, between 1980 and 1983 the drying up of various wells caused production to decline by nearly a third. Furthermore, the uncertain international petroleum market led to cutbacks in exploration —which the new Guatemalan petroleum legislation apparently failed to stimulate— so no immediate improvements could be expected. Finally, in 1984 the value added generated in the construction industry, depressed since 1982, suffered a further strong decline —only slightly alleviated towards the end of the year— due to the cutbacks in public investment.

As mentioned above, the internal and external financial imbalances that have characterized recent years continued and worsened. The main economic policy decisions of the second half of 1983 and throughout 1984 were oriented towards alleviating

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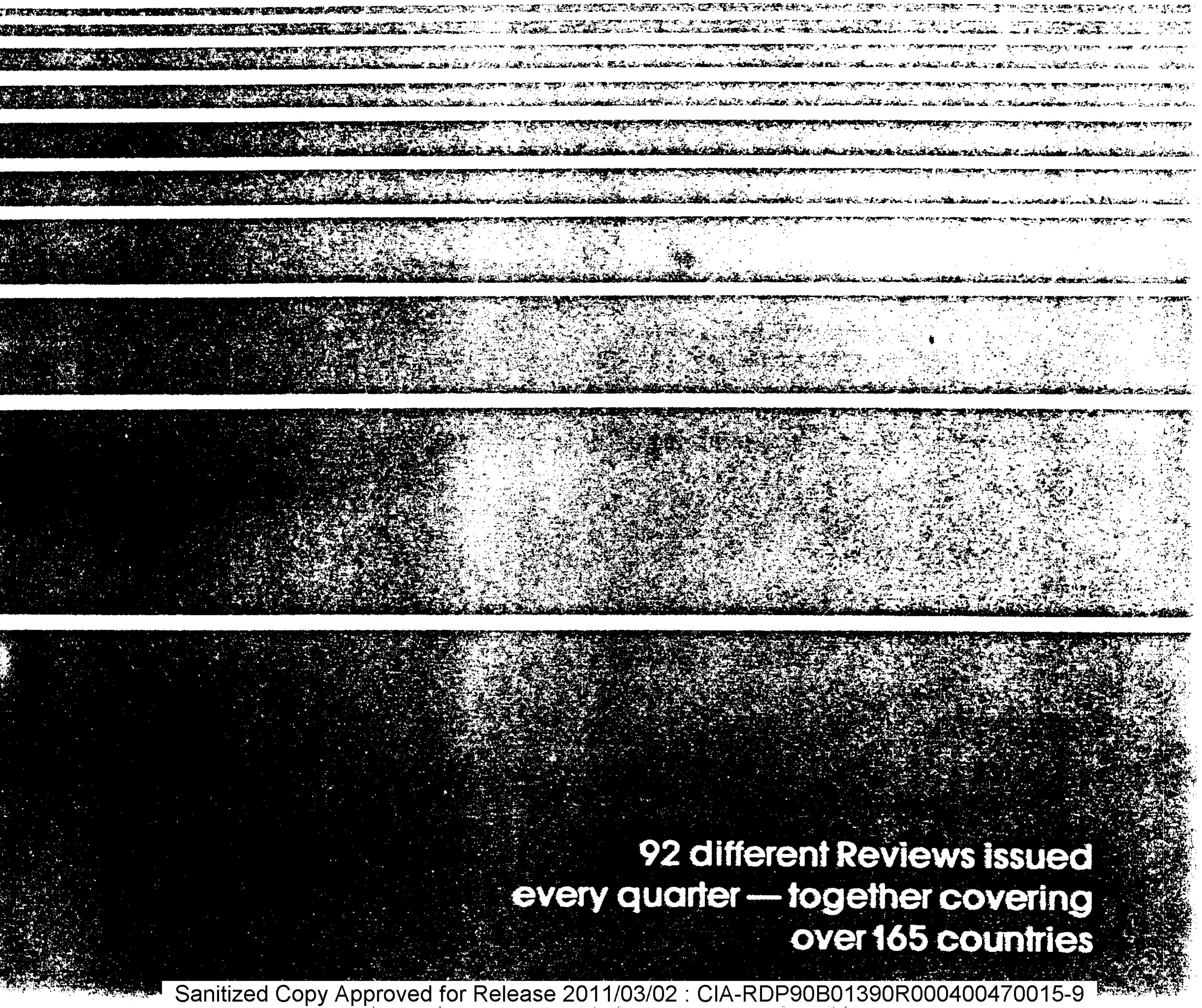

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