**FOR AGENDA**

EBS/89/87
Correction 1

CONFIDENTIAL

May 8, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Costa Rica - Staff Report for the 1988 Article IV Consultation and Request for Stand-By Arrangement

The following corrections have been made in EBS/89/87 (5/3/89):

Page 1, para. 2, line 7: for "April 4, 1989" read "April 4, 1988"
para. 3, line 7: for "August 4," read "August 5,"

Page 2, lines 2 and 3: delete "The conditions...in Appendix V."

Page 4, Table 2, stub 4: for "(1/87-3/88)" read "(1/87-12/88)"

Page 7, column 7, line 2: for "65,550" read "65,530"
line 3: for "73,020" read "73,000 3/"
line 4: for "62,865" read "62,845"
Add footnote 3 to read: "Expenditure could increase...program projections."

Page 13, para. 3, penultimate line: for "to banks, new" read "to banks, no new"

Page 19, Table 7, line 2: revised
column 3, line 6: for "16.3" read "15.6"
line 7: for "15.0" read "14.3"

Page 20, line 6: for "efforts of" read "impact of"

Page 23, line 2: for "provide for the" read "provide the"

Corrected pages are attached.

Att: (8)

## I. Introduction

The 1989 Article IV consultation discussions with Costa Rica were held in San José from January 30 to February 16, 1989 and at Fund headquarters on February 27-28, 1989 in conjunction with continued negotiations on an economic program that could be supported with a stand-by arrangement. The staff met with the President of Costa Rica; the Ministers of Finance, Agriculture, Economy, Foreign Trade, Labor, and Planning; the Executive President of the Central Bank; the Auditor General of Banks; the President of the Stock Exchange; and senior officials from the ministries, the Central Bank, and other public institutions. The staff representatives were Messrs. A. Linde (Head), J. Berengaut, L. DeMilner, Ms. E. Suss (all WHD), Ms. M. Xafa (ETR), and Ms. M. Rubin (Secretary-WHD). The mission was assisted by Mr. I. Tampe, the Fund resident representative in San José. Mr. Ayales, advisor to the Executive Director for Costa Rica, participated in the main policy discussions.

Costa Rica has accepted the obligations under Article VIII, Sections 2, 3 and 4. The 1987 Article IV Consultation was completed on April 4, 1988 (EBM/88/56). A 17-month stand-by arrangement for SDR 50 million (equivalent to 42 percent of quota on an annual basis) was approved by the Executive Board on October 28, 1987. Access to Fund resources was reduced to SDR 40 million at the time of the first program review on April 4, 1988. Costa Rica made no purchases under the arrangement; the authorities elected not to make a drawing upon approval, and subsequently there were deviations from quantitative performance criteria and the external financing arrangements--which were to be subject to review by the Fund--were not concluded. 1/ During the period of the arrangement Costa Rica made repurchases equivalent to SDR 58.6 million (69.7 percent of quota), and by the end of March 1989 (when the arrangement expired) Fund credit to Costa Rica had been reduced to 58.2 percent of quota.

At the Executive Board discussion of the 1987 Article IV consultation, Directors urged the authorities to consolidate their adjustment efforts under the Fund arrangement and to intensify structural reforms with a view to establishing a stable policy framework. Directors encouraged the authorities to allow more interest rate flexibility and to continue the active use of exchange rate policy to maintain Costa Rica's competitiveness. In the program review discussion of August 5, 1988 Directors commented that Costa Rica's performance was broadly satisfactory, but noted the uncertain status of debt negotiations with commercial banks.

In the attached letter, the Costa Rican authorities request a 12-month stand-by arrangement in the amount of SDR 42 million (50 percent of quota); purchases would be made in four quarterly installments,

---

1/ Performance under the program was described in two midterm reviews (EBS/88/60 and EBS/88/133).

the first of SDR 11.25 million and the following three of SDR 10.25 million each (Table 1). The external financing arrangements would include US$150 million of balance of payments assistance (US$80 million World Bank SAL with cofinancing and US$70 million U.S. AID), rescheduling of bilateral official debt, and a buyback of a substantial part of commercial bank debt to be followed by a menu of financing options for the remainder of such debt.

Table 1. Costa Rica: Position with the Fund During Period of Arrangement

| | Outstanding Mar. 31, 1989 | 1989 Apr.-June | 1989 July-Sept. | 1989 Oct.-Dec. | 1990 Jan.-Mar. |
|---|---|---|---|---|---|
| | (In millions of SDRs) | | | | |
| Transactions under tranche policies (net) | | 2.25 | 6.15 | 1.25 | 6.15 |
| Purchases 1/ | | 11.25 | 10.25 | 10.25 | 10.25 |
| Repurchases | | 9.0 | 4.1 | 9.0 | 4.1 |
| Ordinary resources | | 3.1 | 2.1 | 3.1 | 2.1 |
| Enlarged access resources | | 5.9 | 2.0 | 5.9 | 2.0 |
| Total Fund credit outstanding (end of period) | | | | | |
| Under tranche policies 2/ | 49.0 | 51.25 | 57.40 | 58.65 | 64.8 |
| | (In percent of quota) | | | | |
| Total Fund credit outstanding (end of period) | | | | | |
| Under tranche policies 2/ | 58.2 | 60.9 | 68.3 | 69.7 | 77.1 |

Source: IMF Treasurer's Department.

1/ From ordinary resources only.
2/ Includes outstanding use under EAR, SFF, and EFF.

## II. Economic Background and Performance Under the last Stand-By Arrangement

In the late 1970s and early 1980s the Costa Rican economy experienced strong external shocks in the form of a significant deterioration in the terms of trade, a sharp increase in international interest rates, and growing political and economic difficulties in the rest of Central America. Attempts to cushion these shocks resulted in a large fiscal deficit financed by substantial external borrowing on commercial terms, and led to major financial difficulties and a deep recession in 1981-82. During the following years, progress was made in reducing the deficit of the nonfinancial public sector, lowering inflation, and moving toward interest and exchange rate flexibility. However, Costa Rica's economy continued to be affected by structural constraints that have hampered the expansion of output on a sustained basis, and heavy foreign debt obligations have burdened the country's external position.

In these circumstances, the authorities adopted an economic adjustment program for 1987-88 aimed at reducing inflation, strengthening the external accounts, and creating conditions conducive to sustained economic growth. In addition to the correction of internal imbalances, the authorities sought an alleviation of Costa Rica's debt service burden. This program was supported by a stand-by arrangement from the Fund that was approved in October 1987 while negotiations with external creditors on financing arrangements were still in progress. After some initial difficulties in meeting program objectives, additional policy measures were implemented in early 1988, and were discussed by the Executive Board at the first review on April 4, 1988. Although program targets were not fully observed, performance in the first half of 1988 was generally in line with the program's domestic objectives. The second review was concluded on August 5, 1988; financing arrangements were not in place at the time, but there was evidence of progress in the negotiations with banks, and it was decided that financing arrangements would be the subject of a third review. In the event, the financing arrangements were not concluded, there were significant deviations from program targets, and the third review was not completed.

In the second half of 1988 there were slippages in the implementation of fiscal policies, and the end-1988 limit for the combined public sector deficit was missed by nearly the equivalent of 3/4 percent of GDP and central government expenditure exceeded the program limit by nearly 1/2 percent of GDP (Table 2). In addition, there were shortfalls in capital flows from abroad, and the limit on domestic credit to the public sector was breached by about 1 1/2 percent of GDP.

Inflation, which had surged at the beginning of 1988 and then subsided in subsequent months, accelerated again in the last three months of 1988 as food supplies were interrupted by hurricane damage and public utility rates were raised. The 12-month increase of consumer prices was 25 percent in December 1988, up from 16 percent one year earlier. Bank credit to the private sector expanded by 13 percent during 1988, faster than the 10 percent ceiling imposed by the authorities in January, but only about one half the rate of inflation.

Table 2. Costa Rica: Performance Under Stand-By Arrangement
(December 1988)

| Target | Program | Outcome | Margin/ Excess (-) |
|---|---|---|---|
| *(In millions of U.S. dollars)* | | | |
| 1. Net international reserves | 20 | -315 | -335 1/ |
| 2. Stock of external payments arrears | -- | 379 | -379 2/ |
| *(In millions of colones)* | | | |
| 3. Net domestic assets of the Central Bank | 20,500 | 48,902 | -28,402 1/ |
| 4. Cumulative central government expenditure (1/87-12/88) | 110,100 3/ | 111,510 | -1,410 |
| 5. Net domestic credit to the nonfinancial public sector | 32,929 4/ | 39,420 | -6,491 |

1/ When the shortfall in external financing and changes in rescheduling assumptions are taken into account, the deviation from the target was US$35 million. On this basis, the deviation from the ceiling on net domestic assets would have been ₡ 5,602 million.
2/ Includes interest in arrears due to commercial banks.
3/ Adjusted (+ ₡ 2,000 million) for overperformance of central government revenue.
4/ Adjusted (- ₡ 1,471 million) for increase in government bonds held by the private nonbank sector.

Real GDP in 1988 rose faster than projected (3.8 percent compared with 2.4 percent) mainly on the strength of exports (Table 3). Merchandise exports rose by 11 percent in U.S. dollar terms, as nontraditional exports expanded by one fourth. Revenues from tourism also grew by one fourth. Imports were moderately higher than in 1987, rather than contracting as had been projected. In all, the current account deficit was reduced to 5 1/2 percent of GDP from over 9 percent in 1987.

External financing was less than expected because agreements with commercial banks and with the Paris Club were not reached, the disbursement of the US$80 million World Bank structural adjustment loan was delayed, and shortfalls occurred in other loan disbursements. As a result, the year-end target for the reduction of payments arrears was not observed. Even after adjusting for the shortfalls in external financing, the year-end target for net international reserves was missed by US$35 million.

Table 4. Costa Rica: Operations of the Nonfinancial Public Sector 1/

| | 1984 | 1985 | 1986 | 1987 | Prog. 1988 | Prel. 1988 | Prog. 1989 |
|---|---|---|---|---|---|---|---|
| | (In millions of colones) | | | | | | |
| Central administration | -4,966 | -3,941 | -8,245 | -5,713 | -6,000 | -7,405 | -7,470 |
| Revenue | 27,012 | 32,005 | 38,030 | 44,642 | 51,750 | 53,750 | 65,530 |
| Expenditures | 31,978 | 35,946 | 46,275 | 50,355 | 57,750 | 2/61,155 | 73,000 3/ |
| Current | 26,586 | 30,144 | 36,858 | 43,628 | 50,625 | 52,650 | 62,845 |
| Fixed capital formation | 3,662 | 3,390 | 2,834 | 2,395 | 2,750 | 2,350 | 2,500 |
| Other capital and net lending | 1,730 | 2,412 | 6,583 | 4,332 | 6,375 | 6,155 | 7,655 |
| Rest of general government | 1,870 | 2,704 | 3,534 | 3,472 | 4,798 | 3,483 | 4,039 |
| Revenue | 15,176 | 19,336 | 24,774 | 28,647 | 36,593 | 37,275 | 36,977 |
| Current | 14,909 | 18,765 | 24,292 | 28,349 | 35,548 | 36,869 | 36,974 |
| Capital | 267 | 571 | 483 | 298 | 1,045 | 406 | 3 |
| Expenditures | 13,306 | 16,632 | 21,240 | 25,175 | 31,796 | 33,792 | 32,938 |
| Current | 11,916 | 14,535 | 18,783 | 22,033 | 26,500 | 28,778 | 28,271 |
| Fixed capital formation | 219 | 474 | 1,150 | 985 | 1,743 | 1,229 | 1,762 |
| Other capital and net lending | 1,171 | 1,623 | 1,307 | 2,157 | 3,552 | 3,785 | 2,905 |
| Public enterprises | 7 | -2,479 | 642 | 1,379 | 3,662 | 4,122 | 4,433 |
| Revenue | 34,152 | 36,950 | 43,269 | 47,455 | 62,320 | 60,727 | 73,167 |
| Current | 33,860 | 36,659 | 41,621 | 46,648 | 60,967 | 59,675 | 70,704 |
| Capital | 292 | 291 | 1,648 | 907 | 1,353 | 1,052 | 2,463 |
| Expenditures | 34,145 | 39,429 | 42,627 | 46,176 | 58,658 | 56,605 | 68,734 |
| Current | 30,217 | 35,065 | 37,358 | 40,717 | 51,068 | 53,245 | 61,802 |
| Fixed capital formation | 3,811 | 4,414 | 5,523 | 5,967 | 7,533 | 5,754 | 7,070 |
| Other capital and net lending | 117 | -50 | -254 | -508 | 57 | -59 | -138 |
| Current account deficit (-) | 7,062 | 7,685 | 10,943 | 13,261 | 22,073 | 15,621 | 20,290 |
| Central Administration | 426 | 1,861 | 1,172 | 1,014 | 3,125 | -1,235 | 2,685 |
| Rest of general government | 2,993 | 4,230 | 5,508 | 6,316 | 9,048 | 8,091 | 8,703 |
| Public enterprises | 3,643 | 1,594 | 4,263 | 5,931 | 9,900 | 8,765 | 8,902 |
| Overall deficit (-) | -3,089 | -3,716 | -4,069 | -862 | 2,460 | -2,135 | 1,002 |
| Change in floating debt and interest arrears | 2,425 | -2,536 | 2,597 | -1,105 | -2,960 | 1,763 | -6,466 |
| Of which: interest on foreign debt | 1,589 | -1,959 | 801 | 1,373 | -3,460 | 1,763 | -6,466 |
| Net financing requirements | 664 | 6,251 | 1,472 | 1,967 | 500 | 372 | 5,464 |
| External (net) | 1,971 | 6,730 | 3,338 | 528 | 2,775 | -2,470 | 6,780 |
| Disbursements | 4,343 | 7,405 | 8,187 | 4,681 | 7,258 | 3,488 | 11,050 |
| Amortization due | -2,884 | -6,706 | -10,253 | -10,433 | -11,195 | -7,874 | -9,895 |
| Principal in arrears (net change) | 512 | -1,136 | 2,044 | 5,820 | -10,373 | -2,196 | -14,711 |
| Debt relief | -- | 7,167 | 3,360 | 460 | ... | 4,112 | 20,336 |
| Domestic | -1,307 | -479 | -1,866 | 1,439 | -2,275 | 2,842 | -1,316 |
| Bank credit (net) | -959 | 505 | -1,123 | -789 | -3,325 | -279 | -1,241 |
| Other (net) | -348 | -984 | -743 | 2,237 | 1,050 | 3,121 | 75 |
| | (In percent of GDP) | | | | | | |
| Current account deficit (-) | 4.3 | 3.9 | 4.4 | 4.7 | 7.2 | 4.4 | 4.7 |
| Central Administration | 0.3 | 1.0 | 0.5 | 0.4 | 1.0 | 0.3 | 0.6 |
| Rest of general government | 1.8 | 2.1 | 2.2 | 2.2 | 2.9 | 2.3 | 2.0 |
| Public enterprises | 2.2 | 0.8 | 1.7 | 2.1 | 3.2 | 1.8 | 2.0 |
| Fixed capital formation | 4.7 | 4.2 | 3.9 | 3.3 | 3.9 | 2.6 | 2.6 |
| Overall deficit (-) | -1.9 | -1.9 | -1.7 | -0.3 | 0.8 | -0.6 | 0.2 |
| Central Administration | -3.0 | -2.0 | -3.4 | -2.0 | -2.0 | -2.1 | -1.7 |
| Rest of general government | 1.1 | 1.4 | 1.4 | 1.2 | 1.6 | 1.0 | 0.9 |
| Public enterprises | -- | -1.3 | 0.3 | 0.5 | 1.2 | 0.5 | 1.0 |
| Changes in floating debt and interest arrears | 1.5 | -1.3 | 1.1 | -0.4 | -1.0 | 0.5 | -1.5 |
| External financing | 1.2 | 3.4 | 1.4 | 0.2 | 0.9 | -0.7 | 1.6 |
| Domestic financing | -0.8 | -0.2 | -0.8 | 0.5 | -0.7 | 0.8 | -0.3 |

Sources: Ministry of Finance; and Fund staff estimates.

1/ Reduced coverage of the nonfinancial public sector for program purposes. Excludes about 5 percent (by expenditure) of total government, mainly local government and small regulatory agencies that report with a lag.

2/ Expenditure could increase by up to ₡ 2,000 million to the extent that revenue exceeded program projections.

3/ Expenditure could increase by up to ₡ 1,500 million to the extent that revenue exceeds program projections.

In the central government, the authorities plan to reduce the fiscal deficit from 2.1 percent of GDP in 1988 to 1 3/4 percent in 1989. On the revenue side, tax collections are projected to improve as the full effect of the 1987 tax reform is felt; the legal challenges which led to delays in the implementation of the reforms in 1988 have largely been cleared up. Tax revenues will be supplemented by a contribution to the capital budget by banana exporters and growers in order to cover some of the costs of infrastructure improvements. On the expenditure side, current outlays are projected to decline with respect to GDP, in large part through continued restraint in outlays for wages and salaries; the freeze on public sector employment which has been in effect since 1986 will be continued. Investment plans have been reviewed, and priority will be given to those outlays that complement and support private activity in the agricultural and industrial sectors and to improvements in the provision of basic social services. Other capital outlays will be postponed.

The surplus of the rest of the nonfinancial public sector is projected to rise from 1 1/2 percent of GDP in 1988 to almost 2 percent in 1989. To counteract a prospective decline in revenue with respect to GDP, the Government has substantially increased electricity and telephone rates as well as grain prices charged by the National Marketing Board. In addition, some revenue will be raised through the completion of the program to privatize subsidiaries of the state development corporation. Capital outlays by the public enterprises will be reduced by postponing lower priority projects, particularly in the telecommunications and energy sectors.

As regards social security, the Government will resist attempts to generalize the higher level of benefits now received by a small portion of public sector employees, unless such an extension can be made self financing. It is expected that the results of a number of actuarial studies of the social security system that are now underway will become available in June 1989, and the authorities intend to revise contribution rates in accordance with the findings of these studies.

The authorities recognized that the use of asset sales to generate revenues and the postponement of investment outlays do not provide for a permanent solution to the fiscal problem. However, they noted that the passage of a major tax revision a little more than a year ago and the national elections scheduled for late 1989 and early 1990 constrained them in the choice of policy instruments.

The authorities intend to seek understandings for a comprehensive rescheduling of Costa Rica's bilateral official debt service obligations, including previously rescheduled debt, with Paris Club creditors as soon as the proposed stand-by arrangement from the Fund is approved. Even after taking into account this rescheduling and projected balance of payments support from bilateral and multilateral sources, Costa Rica would still be faced with a financing gap equivalent to more than 2 percent of GDP in 1989 and subsequent years.

The authorities' aim is to cover this gap through a debt reduction arrangement with commercial bank creditors. They have proposed a two-stage scheme with which the banks agree in principle; the first stage would be a debt buyback and the second would consist of a menu of refinancing choices for the debt remaining after the buyback. The authorities believe they will be able to buy back about one half of the outstanding commercial bank debt at a price related to the current value of Costa Rican debt in secondary markets, and that such a transaction could be accomplished by early October 1989 using mainly funds borrowed from official bilateral sources. The second stage would be negotiated before the end of the year and would offer creditors a choice among such options as debt equity exchanges, exit bonds, and further debt buybacks. In the meantime Costa Rica has agreed to make partial interest payments to commercial banks at the rate of US$11 million a quarter, equivalent to somewhat less than 30 percent of the amount due.

The partial interest payments to banks during the period of negotiations of the debt reduction operation gives rise to a temporary increase in arrears to banks. Other arrears will be eliminated during the program period, including by cash payment, according to a specified schedule. Apart from the temporary increase in arrears to banks, no new arrears would be accumulated during the program.

## 4. Structural reforms

The authorities have underway a program of structural reform whose aim is to remove rigidities that inhibit the efficient allocation of resources and burden economic policy management. Many of these reforms are supported with financial and technical assistance from the World Bank and U.S. AID.

Structural reforms that to a large extent already have been implemented include a major overhaul of the tax system and privatization of subsidiaries of the state-owned development corporation (CODESA). The tax package adopted in late 1987 became effective in 1988; extensive changes were introduced to broaden the tax base, eliminate exemptions, and update property assessments and maintain them through automatic inflation adjustments. In addition, a number of changes were made to strengthen tax administration. With regard to the plan to divest CODESA's subsidiaries, most of these enterprises already have been sold, with the divestiture plan to be completed by the end of 1989. Since 1986 two major subsidiaries have been privatized, and three have been absorbed by other public sector entities. Some 15 smaller enterprises were liquidated and minority interest in six others was divested. In 1989, 40 percent ownership in two economically strategic enterprises will be transferred to the private sector.

The main structural reform efforts in 1989 will deal with the structure of import tariffs and export incentives, the supervision and regulation of the financial sector, and the pricing, marketing, and subsidy policies in the agricultural sector. In the external sector, the authorities have developed a program to reduce import tariffs (except for some non-competing final goods--primarily luxury items) to bring the maximum rate down to no more than 40 percent by the end of 1990; tariffs on raw and intermediate materials and capital goods would be reduced to below 20 percent. As part of this program, tariff rates were reduced by 10 percent in October 1987 and by a further 10 percent in September 1988; four additional equal reductions are scheduled to complete the reform. The effect of these reductions on central government revenue in 1989 is expected to be limited. In addition, the present costly scheme of tax credits for nontraditional exports will be modified to comply with membership in the GATT.

In the financial sector the reforms will be aimed at improving the quality of the state banks' loan portfolios, increasing competition in the banking sector, and strengthening further the supervision and control of financial intermediaries. A package of financial reforms was adopted by the Legislative Assembly for this purpose. Among the reforms included in the package were measures to give more realistic valuation to banks' loan portfolios, allow penalty interest rates on overdue loans, eliminate the recording as income of accrued interest on loans over 180 days in arrears, and extend the authority of the superintendency of banks to include nonbank financial intermediaries. In addition, all financial agents will have to submit to external audits and to publish their balance sheets and income statements.

In the agricultural sector the authorities will seek to reduce pricing and marketing distortions created by the National Grain Marketing Board's (CNP) monopoly on the distribution of domestically produced basic grains and the importation of wheat. Private trading in these commodities is being introduced, credit policy is being designed to facilitate the allocation of resources toward more efficient crops, and CNP's buying and selling prices will be adjusted to eliminate CNP losses by the end of 1989.

## IV. Program Design and Monitoring Issues

One of the objectives of Costa Rica's economic and financial program is to deal with the country's debt service problem. With its sizable external indebtedness and heavy debt service obligations, Costa Rica faces a large financing gap over the medium term. New commercial bank lending to cover this gap is not available, largely because of the

EBS/89/87
Corrected: 5/5/89

Table 7. Costa Rica: Baseline Scenario

| | 1986 | 1987 | Prel. 1988 | Prog. 1989 | Projections 1990 | 1991 | 1992 |
|---|---|---|---|---|---|---|---|
| | (In percent) | | | | | | |
| Real GDP growth | 5.5 | 5.1 | 3.8 | 4.3 | 4.8 | 5.2 | 5.5 |
| ICOR | 3.4 | 3.8 | 5.1 | 4.9 | 4.5 | 4.3 | 4.2 |
| | (In percent of GDP) | | | | | | |
| Fixed capital formation | 18.7 | 19.4 | 18.6 | 21.1 | 21.8 | 22.5 | 23.0 |
| Private | 12.6 | 14.4 | 13.6 | 15.7 | 16.8 | 17.2 | 17.5 |
| Public | 6.1 | 5.0 | 5.0 | 4.5 | 5.0 | 5.3 | 5.5 |
| Gross national savings | 16.9 | 13.0 | 15.6 | 16.7 | 20.4 | 21.2 | 22.0 |
| Private | 16.2 | 11.2 | 14.3 | 15.0 | 15.8 | 16.2 | 16.5 |
| Public | 0.7 | 1.8 | 1.3 | 1.7 | 4.6 | 5.1 | 5.5 |
| Official transfers for BOP support | 2.0 | 2.7 | 2.6 | 1.4 | 1.2 | 0.9 | 0.6 |
| External current account deficit 1/ | -3.8 | -9.1 | -5.6 | -4.9 | -2.6 | -2.1 | -1.6 |
| Overall public sector deficit | -5.4 | -3.2 | -3.7 | -2.8 | -0.4 | -0.2 | — |
| Nonfinancial public sector | -1.7 | -0.3 | -0.6 | 0.2 | 0.4 | 0.6 | 0.8 |
| Central Bank losses | -3.7 | -2.9 | -3.1 | -3.0 | -0.8 | -0.8 | -0.8 |
| External public debt | | | | | | | |
| Of which: | 97.3 | 92.8 | 88.1 | 70.1 | 69.0 | 63.5 | 58.6 |
| Commercial bank debt 2/ | 39.7 | 37.2 | 35.8 | 16.5 | 15.1 | 13.8 | 12.6 |
| Interest due (public sector) | 6.9 | 6.5 | 6.5 | 5.9 | 3.6 | 3.2 | 2.7 |

1/ Excludes official transfers for balance of payments support.
2/ Includes interest in arrears.

terms of trade relative to the central case. In the baseline scenario the difference in assumptions would cause the current account deficit to differ by about 1 percent of GDP a year on average from the baseline projection, the external debt by 2 percent of GDP, and the debt service ratio by 1 percent. In the alternative scenario the magnitude of the impact of more favorable or unfavorable assumptions increases because the effect of interest rate changes is magnified by the higher stock of debt.

## VI. Performance Criteria

The quantitative criteria (presented in Table 8) are: (1) quarterly limits on the expenditure of the Central Government; (2) ceilings on the stock of net domestic assets of the Central Bank; (3) limits for cumulative changes in the net domestic financing of the nonfinancial public sector; (4) targets for the stock of the net international reserves of the Central Bank; and (5) limits on the stock of external payments arrears that must be settled in cash. These performance criteria have been established for June, September, and December 1989, with indicative values for March 1989 (i.e., prior to the Executive Board discussion of the proposed arrangement).

New foreign loans contracted or guaranteed by the public sector with maturities of over one year and up to and including 12 years--apart from loans contracted with official creditors for the purpose of financing the debt buyback, as well as rescheduling of obligations with Paris Club creditors--will be limited to US$60 million in 1989. Within this ceiling, new commitments or guarantees of loans with maturities of over one year and up to and including five years will be limited to US$30 million.

The customary clauses on overdue financial obligations to the Fund and on exchange restrictions, bilateral payments agreement inconsistent with Article VIII, and import restrictions for balance of payments purposes are applicable during the program period; it is proposed that a multiple currency practice for certain student remittances be approved until the earlier of the mid-term review or November 30, 1989. A review with the Fund to assess the progress in concluding the external financing arrangements will be a performance criterion for purchases after the end of September 1989. The review will also assess performance through September 1989 and the adequacy of policies, including the exchange rate, for achieving the goals of the arrangement.

Costa Rica's external indebtedness to a more sustainable level. In this regard, it is important to provide the appropriate incentives and policy support to ensure that any interest savings resulting from the new financing arrangements are channeled into investment. Economic policies should thus be aimed at raising domestic savings, creating appropriate incentives for private investment, and improving the efficiency of resource use.

As part of the program, the combined public sector deficit would be reduced from 3.7 percent of GDP in 1988 to 2.8 percent in 1989 through a combination of expenditure restraint, improved tax performance, and adjustment of public sector prices to strengthen the finances of the public enterprises. Some of the measures in the fiscal package, such as the sale of assets and the special contribution of banana growers and exporters to cover infrastructure costs, are of a short-term nature, and will need to be replaced with more permanent measures. Also, the fiscal adjustment in recent years has relied heavily on cuts in the public investment program; while some of these cuts may have reflected economic priorities, it will be important from the viewpoint of the country's longer term growth prospects that adequate attention be given to infrastructure investment.

The Central Bank credit program has been designed with the aim of halving the rate of inflation to the 12-14 percent range during 1989 and achieving a significant net international reserve gain. With the nonfinancial public sector expected to reduce its net indebtedness to the banking system, the program has room for a reasonable increase in credit to the private sector. Within the constraints imposed by the system of credit ceilings for individual banks, efforts need to be made to manage credit allocation in a flexible manner.

The success of the program will require a close monitoring of wage developments, not only in the public sector but in the private sector as well. To avert potential inflationary pressures and to enhance the reallocative effect of exchange rate adjustments, productivity gains should serve as the main determinant of wage increases.

Exchange rate policy is to be conducted with a view to maintaining Costa Rica's competitive position in world markets. The staff attaches great importance to the authorities' intention, as a minimum, to prevent any appreciation of the colon in real effective terms from the level of December 1988. It also is important that exchange rate policy take into account the phased reduction of import tariffs which is in the process of being implemented, to avoid adverse effects on the balance of payments.

Structural reforms are an important component of the program. Privatization of the entities of CODESA and the reform of the tax system already have been largely implemented. A program of phased reductions of the level and dispersion of effective protection is underway. Reform of export incentives is to be effected during the program period and should have fiscal as well as allocative benefits. In the agricultural sector, steps already have been taken to rationalize the system of support prices and improve the finances of the state marketing board, and further measures will be implemented to encourage more efficient use of resources. In the financial sector, a 1988 legislative package strengthened and extended the supervision of financial institutions; the implementation of this legislation is expected to enhance both the stability of and confidence in Costa Rica's financial system. Further efforts to promote greater competition and efficiency among financial institutions would yield substantial benefits.

The authorities have initiated contacts aimed at securing the resources needed for a debt buyback from commercial banks. An offer for such operation, at a secondary market-related price, would be made as soon as the necessary waivers and resources are obtained. In the meantime, Costa Rica will make partial interest payments to commercial banks at a rate of US$11 million a quarter. Negotiations with holders of the bank debt remaining after the buyback on the options and terms for regularizing these obligations would be initiated upon the completion of the buyback. Rescheduling of obligations to bilateral creditors of the Paris Club would be sought as soon as possible upon approval of the proposed stand-by arrangement. It is envisaged that Costa Rica would eliminate arrears with bilateral creditors by the end of June 1989. Arrears to other nonbank creditors would be eliminated by cash payments according to an agreed schedule. The proposed arrangement would provide Fund support for the planned financing arrangements and place them firmly within the framework of an adjustment program.

The authorities have presented an adjustment program that should improve Costa Rica's external position and strengthen economic performance more generally. The efforts of the authorities need to be complemented by external cooperation if the objectives of the program are to be met and an orderly external payments situation is to be restored. Assuming a continuation of present adjustment efforts, successful execution of the proposed debt reduction exercise should restore external viability over the medium term. In light of the measures already adopted and those that are being implemented, the staff believes that the authorities' program justifies the support of the Fund and proposes that the stand-by arrangement be approved. Costa Rica has given the Fund preferred creditor status, and the improvement in the balance of payments projected over the medium term should enable the country to meet its obligations to the Fund.

It is proposed that the next Article IV consultation be held on the regular 12-month cycle.