FOR AGENDA

EBS/83/127

CONFIDENTIAL

June 20, 1983

To: Members of the Executive Board

From: *The Secretary*

Subject: Costa Rica - Staff Report for the 1983 Article IV Consultation and Review Under the Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Costa Rica and the review of the stand-by arrangement for Costa Rica. Proposed decisions appear on page 23. It is proposed to bring this subject to the agenda for discussion on Monday, July 18, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Bonangelino, ext. 74328.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

COSTA RICA

Staff Report for the 1983 Article IV Consultation and Review Under the Stand-By Arrangement

Prepared by the Staff Representatives for the 1983 Consultation with Costa Rica

Approved by E. Wiesner and W. A. Beveridge

June 20, 1983

I. Introduction

The 1983 Article IV consultation discussions with Costa Rica were held in San Jose during the period April 18-May 6, 1983.1/ The representatives of Costa Rica in the discussions included the Ministers of Finance, Planning, Economy, Exports, Industry, and Labor; the President of the Central Bank; and other senior officials of the Central Government and the rest of the public sector. The mission was also received by the President of the Republic. The staff representatives were M. E. Bonangelino (Head-WHD), L. Cardemil, C. Cha, and M. Figuerola (all WHD), J. Martelino (ETR), and Mrs. H. S. Koo (Secretary-WHD).

The Fund mission also conducted a review of the progress achieved in the implementation of the adjustment program being supported by the stand-by arrangement which was approved by the Fund on December 20, 1982 (EBS/82/214, Supplement 1) and amended on April 26, 1983 (EBS/83/80). This review, which was required under paragraph 4(c) of the arrangement and was scheduled to take place by June 30, 1983, was to cover the progress made in the implementation of the program, taking into account balance of payments developments, including the envisaged debt restructuring. At the time of approval of the stand-by arrangement, the Board also approved the existing multiple currency practices and restrictions on payments and transfers for current international transactions until June 30, 1983, or the completion of the review of the stand-by arrangement, whichever came earlier.

II. Background Developments

Costa Rica suffered a serious economic and financial deterioration during the last three years. For the first time in two decades real output declined in 1981 and domestic inflation reached unprecedented levels. The colon registered a large depreciation and substantial external imbalances developed.

1/ Costa Rica has accepted the obligations of Article VIII, Sections 2, 3, and 4.

The roots of Costa Rica's economic difficulties are to be found in the lack of timely domestic adjustment to changing external circumstances. Following the coffee boom of 1976-77, Costa Rica's terms of trade deteriorated sharply as a result of the decline in international coffee prices and another round of increases in world oil prices. At the same time, higher interest rates abroad made external financing more onerous and growing social and political difficulties in the rest of Central America resulted in serious limitations to trade and manufacturing production for export. Nevertheless, Costa Rica continued the expansionary policies which had been followed during the coffee boom period, thus compounding the negative effects of the exogenous factors and giving rise to large internal and external imbalances. Strong demand pressures stemming mainly from a large public sector deficit, which had been growing for some time, resulted in a widening of the current account deficit of the balance of payments from the equivalent of 7-1/2 per cent of GDP in 1977 to over 14 per cent of GDP in 1980. Despite the continued heavy foreign borrowing by the public sector, the balance of payments shifted from an overall surplus of US$102 million in 1977 to an overall deficit of US$456 million in 1980, including an accumulation of payments arrears of US$283 million.

The economic and financial situation continued to deteriorate in 1981 when the lack of adjustment in domestic policies to compensate for a lower level of foreign capital inflows led to another large overall deficit in the balance of payments (US$465 million), including a further accumulation of external payments arrears of almost US$360 million, and to a depreciation of the colon from ₡ 8.54 per U.S. dollar as of December 1980 to ₡ 36 per U.S. dollar as of end of 1981. Costa Rica encountered serious difficulties in servicing its external debt, and in August 1981 suspended foreign debt service payments and requested of foreign creditors a temporary rollover of short-term debt and a restructuring of its foreign obligations. That year the country suffered a decline in real GDP of almost 5 per cent, domestic inflation accelerated to 65 per cent, and unemployment rose to almost 9 per cent from around 4-1/2 per cent in 1977-79.

The overall deficit of the nonfinancial public sector continued to increase in 1981, reaching 14 per cent of GDP, compared with about 11 per cent of GDP in 1980; public sector savings were further eroded and reached a negative amount equivalent to almost 4 per cent of GDP in 1981. The poor performance of the public sector in 1981 reflected in large measure the deterioration in the finances of the public sector enterprises. To a great extent, the higher deficit was caused by the lack of adjustment in tariffs in an amount sufficient to cover increases in outlays resulting from the large devaluation of the colon.

A further weakening of the overall financial situation took place during the first half of 1982. This period was marked by uncertainty related to the presidential elections of February and the interregnum between the incoming and the outgoing administrations. Inflation continued to accelerate and pressures on the exchange rate increased;

the free market exchange rate rose as high as ₡ 62 per U.S. dollar by July 1982. The performance of the public sector continued to be weak, mainly because of further delays in the adjustment of public tariffs and prices, and overall bank credit continued to expand faster than private financial holdings in Costa Rica.

Soon after taking office in May 1982, the new Administration began to adopt fiscal and other measures to redress the serious economic and financial deterioration. Significant tax measures and large adjustments in public tariffs and prices were put into effect in the second semester of the year. As a result of this effort and a policy of expenditure restraint, the overall deficit of the nonfinancial public sector declined last year to about 9 per cent of GDP. In August 1982 the authorities took steps to reorganize and simplify the exchange system. The main change introduced was the closing of exchange houses, which until then had been operating in the free market. The closing of the exchange houses was aimed at counteracting speculative fluctuations in the free market rate and discouraging capital flight. Since then, the only institutions authorized to deal in foreign currency transactions are the Central Bank, the state commercial banks, and certain private banks authorized by the Central Bank. Three exchange rates remain in effect as a result of the August 1982 measures:1/ (a) an official rate of ₡ 20 per U.S. dollar, at which 1 per cent of export proceeds is liquidated;2/ (b) a banking market exchange rate (₡ 40 per U.S. dollar as of May 31, 1983), at which the majority of transactions take place, including the purchase of the remaining 99 per cent of export proceeds; and (c) a free market rate.

Following a virtual stalemate during the first half of 1982 in the rescheduling negotiations initiated by the previous Administration with foreign commercial banks, the new Administration reopened the talks shortly after taking office by resuming partial interest payments in accordance with a specified formula basically linked to foreign exchange receipts from exports and nonproject-related capital inflows.

While some progress was made last year toward improving the overall financial situation of the country, economic activity continued to be very weak--real GDP is estimated to have declined by over 8-1/2 per cent--and unemployment remained high.

III. Performance Under the Stand-By Program

The stabilization program framed by the Government and supported by the one-year stand-by arrangement approved by the Fund on December 20, 1982 was designed to contain inflationary pressures, to promote an

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1/ For a detailed description of the exchange system see EBS/82/213.

2/ The export surrender requirement at the official market was reduced from 5 per cent to 1 per cent of export proceeds on April 29, 1983.

orderly development of the exchange market, and to facilitate the resumption of public external debt service payments. The centerpiece of the stabilization effort is a substantial improvement in fiscal performance. The overall deficit of the nonfinancial public sector is to be reduced to 4-1/2 per cent of GDP in 1983 through a combination of revenue measures and the continuation of a policy of expenditure restraint initiated in 1982. The improvement in public finances would reduce pressures on domestic prices and the balance of payments. Implementation of the program was expected to lead to a decline in the rate of inflation from an estimated 100 per cent in 1982 to 40 per cent in 1983. An essential objective of the program is the unification of the banking exchange rate and the free market exchange rate before the end of the program period. Unification with the official exchange rate is not considered feasible for the time being in view of Costa Rica's constitutional requirements on exclusive congressional authority to change the exchange rate. It should be noted, however, that the official rate applies only to 1 per cent of export proceeds.

Performance under the program has been satisfactory so far. Costa Rica has complied with all performance criteria and has made considerable progress toward the achievement of the main objectives of the program. The domestic rate of inflation has decelerated sharply, the free market exchange rate has stabilized, and there are signs that confidence has begun to improve as indicated by a reflow of private capital to the country in recent months.

As of mid-May 1983, Costa Rica had ample margins with respect to the quantitative ceilings and showed an overperformance with respect to the balance of payments test (including arrears) which amounted to the equivalent of US$53 million (Table 1). Reflecting the tight credit policies pursued by the monetary authorities, the net domestic assets of the Central Bank of Costa Rica experienced a contraction of ₡ 2.0 billion through mid-May compared with a reduction of ₡ 60 million established in the program. The net credit of the banking system to the nonfinancial public sector also declined by about ₡ 2.0 billion through the same date, compared with an increase of ₡ 500 million permitted under the program. In another positive development, wholesale and consumer prices rose at an average monthly rate of 1 per cent and 1-1/2 per cent, respectively, in the first four months of 1983, compared with an average monthly rate of increase of about 5 per cent in the whole of 1982 (Chart 1). On an annual basis, the price increases of the first four months of the year would represent about 12-1/2 per cent for wholesale prices and 20 per cent for consumer prices.

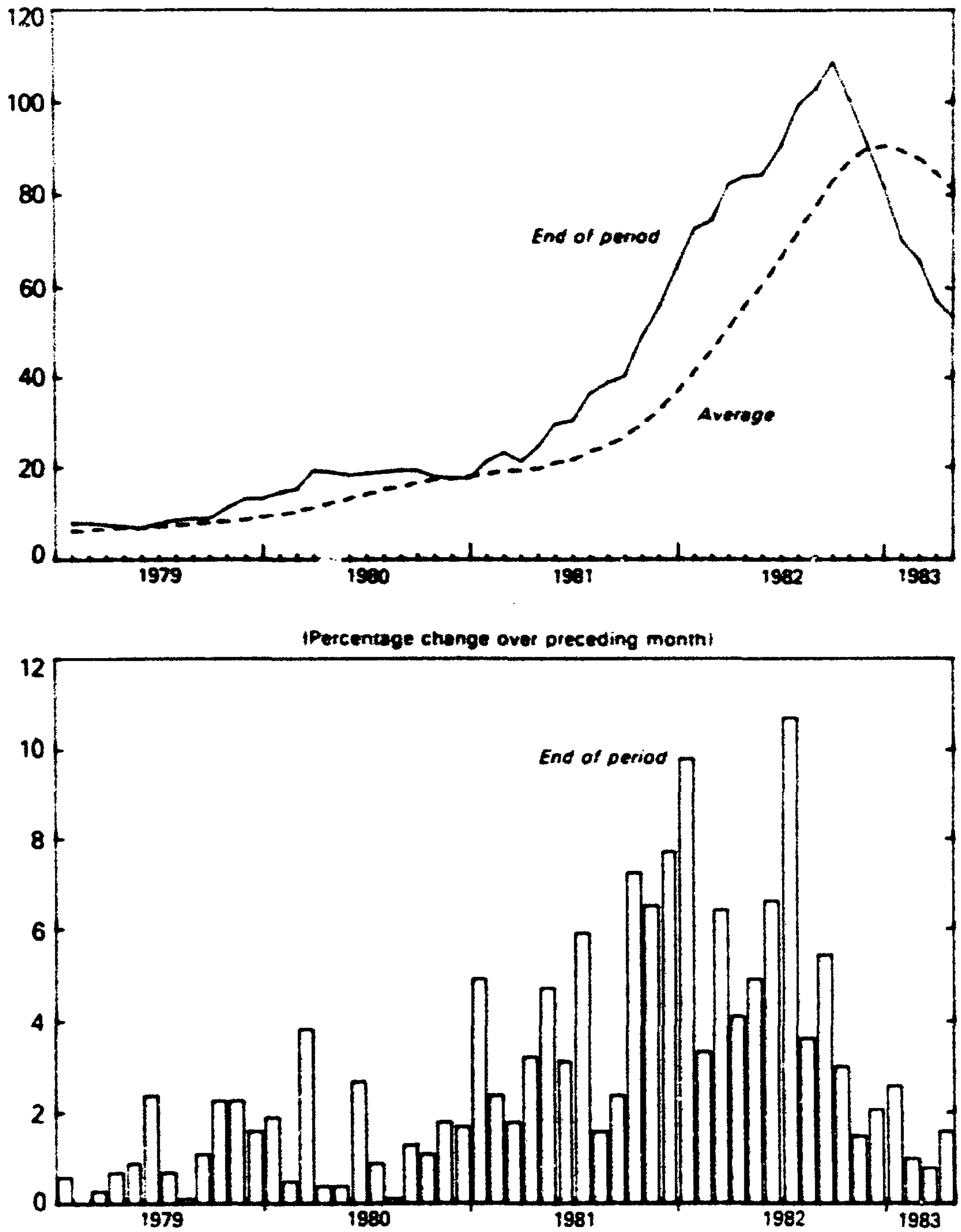
Regarding the exchange rate, the spread between the banking exchange rate and the free market exchange rate has been reduced in line with the program's exchange rate unification guidelines, from 15 per cent at the start of the program to slightly less than 10 per cent as of the end of May 1983. The reduction in the spread was achieved because the free market exchange rate has gradually appreciated from the peak of ₡ 62 per U.S. dollar in July 1982 to about ₡ 46 per U.S.

CHART 1

COSTA RICA

CHANGES IN THE CONSUMER PRICE INDEX

(Annual percentage change)



Source: Central Bank of Costa Rica.

Table 1. Costa Rica: Performance Under Stand-By Arrangement

	1982		1983			
	December 31		March 31		May 13	
	Program	Actual	Program	Actual	Program	Actual
	(In millions of colones)					
Net domestic assets of the Central Bank 1/	69,700	67,307	69,500	65,135	69,640	65,271
Net banking system credit to the nonfinancial public sector 2/	11,090	11,090	11,290	10,052	11,590	9,133
	(In millions of U.S. dollars)					
Net international reserves of the Central Bank 1/	-1,234	-1,207	-1,234	-1,177	-1,234	-1,181
New foreign loans contracted by the public sector						
1-5 years maturity	50	--	50	--	50	12
1-10 years maturity	100	25	100	25	100	37

Sources: EBS/82/214; and Central Bank of Costa Rica.

1/ The ceilings on net domestic assets of the Central Bank and the targets for net international reserves of the Central Bank have been adjusted on the basis of the actual payments arrears on external public debt subject to rescheduling as of the end of December 1982.

2/ As adjusted in EBS/83/80.

dollar at the start of the program and to ₡ 44 per U.S. dollar as of the end of May 1983; meanwhile, the banking exchange rate was depreciated from ₡ 38 per U.S. dollar to ₡ 40 per U.S. dollar in September 1982, and has remained unchanged since then (Chart 2). The appreciation of the free market exchange rate has reflected market conditions and not an intensification of restrictions, including the absence of new payments arrears other than those related to public debt service payments, which are permitted under the program on a temporary basis pending the conclusion of the debt rescheduling negotiations. The deposit requirement scheme for the purchase of foreign exchange established to monitor the possible emergence of arrears has been operated in conformity with the program; these deposits are being liquidated well within the specified maximum of 15 working days.

Costa Rica has made two drawings (the first in early May and the second in mid-June) subject to compliance with performance criteria in an amount equivalent to SDR 18.45 million. This first drawing was scheduled for mid-February 1983 but had to be delayed because of the need for adjustment of the ceilings on net banking system credit to the nonfinancial public sector as a result of a reclassification of deposit accounts of various public sector entities. Amendment of the stand-by arrangement to give effect to the technical adjustment to the ceilings was approved by the Executive Board on April 26, 1983 (EBS/83/80).

IV. Report on the Discussions

The mission's discussions with the Costa Rican authorities centered on a review of the progress achieved thus far in the implementation of the stand-by program and on the means to ensure compliance with the program in the period ahead. The Costa Rican authorities are satisfied with the progress made in the implementation of the stabilization program and the results achieved thus far. They are particularly encouraged by the substantial deceleration in the rate of inflation which has taken place and the normalization reached in the exchange markets. In their view the main objective of policies should now be to consolidate the gains made on the stabilization front and, at the same time, to seek ways to promote the reactivation of the economy. No growth in real GDP is expected for 1983, but the authorities would like to lay the basis for a resumption, as early as possible, of economic growth.

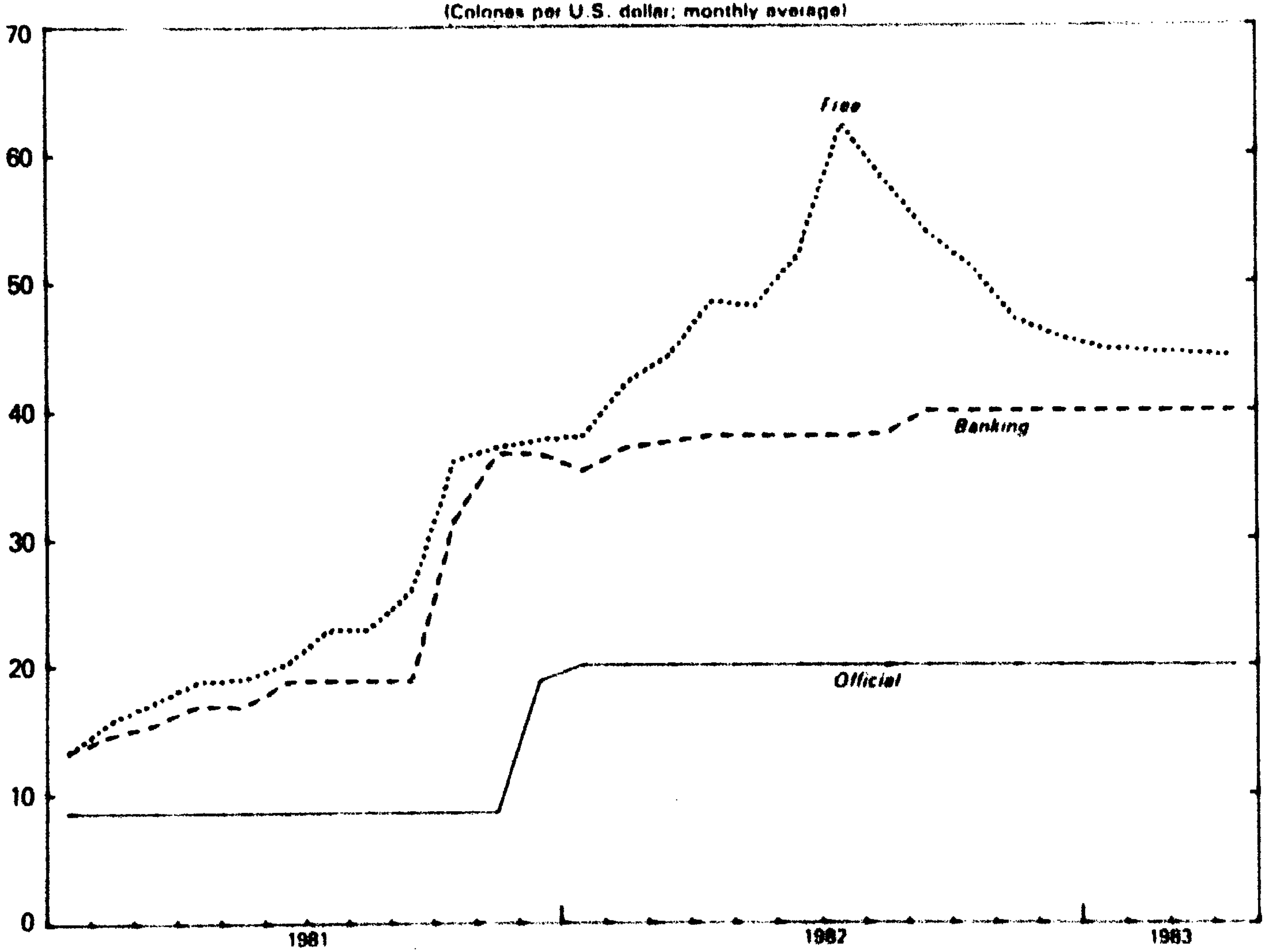
The authorities are keen on consolidating the progress made in stabilizing the economic and financial situation. On the basis of developments thus far, the authorities believe that it should be possible to reduce inflation to less than 20 per cent in 1983, or approximately half the level originally projected. They are aware, however, that the final outcome will mainly depend on the fiscal, monetary, and incomes policies that are pursued.

CHART 2

COSTA RICA

EXCHANGE RATES

(Colones per U.S. dollar; monthly average)



Source: Central Bank of Costa Rica

1. Fiscal policy

The authorities reiterated their intention to maintain the overall deficit of the nonfinancial public sector for 1983 at not more than the 4-1/2 per cent of GDP estimated in the program. Such a target is still considered feasible but its achievement will require a lower level of nominal expenditure than originally planned. Public sector expenditures will need to be adjusted to compensate for the lower revenues implied by the lower rate of inflation now projected for 1983. Since external financing is now estimated to be somewhat less than had been expected earlier, an additional adjustment of expenditure will be necessary in order to maintain banking system credit to the nonfinancial public sector within program levels. Thus, total public sector outlays will need to be about 12 per cent less than originally estimated in the program. Such an adjustment will likely result in an overall nonfinancial public sector deficit for 1983 which will be about ₡ 1.4 billion smaller than the one estimated in the program, but approximately the same in terms of GDP (Table 2).

The authorities assign top priority to the implementation of an expenditure policy that would be consistent with a lower inflation rate than originally projected and with the banking system financing established in the program. The President of the Republic has instructed the public sector to reduce expenditures by 10 per cent from budgeted levels, over and above the normal underexecution of outlays. The Budgetary Authority and a presidential commission for the reduction of public expenditures, which was recently formed, are in the process of formulating concrete guidelines and adopting the measures considered necessary to ensure that the target for the total underexecution of expenditures by the public sector is realized.

The authorities explained that the salary increase granted to public sector employees in January 1983 ended up being somewhat higher than initially contemplated. At the time of the negotiations for the stand-by arrangement, the authorities had decided that salary increases in the public sector would be granted in absolute amounts, possibly twice during the year, on the basis of the changing cost of a basic basket of goods and services. Based on such a mechanism and on the projected rate of inflation, the estimates for the program had assumed two salary increases of ₡ 1,000 per employee per month, one in January 1983 and another one in July 1983. However, the salary increase granted in January 1983 was actually equivalent to ₡ 1,300 per employee and should have a total impact on the expenditure of the nonfinancial public sector only slightly lower than the one implicit in the original estimates of the program for the whole of 1983. The authorities recognized that the size of the salary adjustment was higher than what would have been advisable but explained that it was the result of strong political pressures. They shared the staff's views that given the recent deceleration of inflation there should not be a need for further adjustments of public sector salaries in the remainder of the year.

Table 2. Costa Rica. Summary Operations of the Nonfinancial Public Sector

	1980	1981	1982 Actual	1982 Reduced Actual 1/	1982 Stand-By Program 1/	1983 Stand-By Program 1/	1983 Revised Proj. 1/
(In millions of colones)							
Central Administration	-3,300	-2,999	-2,983	-2,983	-3,460	-3,510	-3,565
Current revenue	4,982	7,333	12,792	12,792	12,430	19,880	19,100
Expenditure (-)	-8,282	-10,332	-15,775	-15,775	-15,890	-23,390	-22,665
Current (-) 2/	(-6,357)	(-8,226)	(-13,698)	(-13,698)	(-13,210)	(-19,530)	(-19,665)
Capital (-)	(-1,930)	(-2,106)	(-2,077)	(-2,077)	(-2,680)	(-3,860)	(-3,000)
Rest of general government	-232	-401	426	-288	-600	-1,020	-105
Revenue	5,796	6,374	10,350	5,822	5,955	8,385	8,660
Current	(5,488)	(6,148)	(9,668)	(5,762)	(5,830)	(8,320)	(8,345)
Capital	(308)	(226)	(682)	(60)	(125)	(65)	(315)
Expenditure (-)	-6,028	-6,775	-9,924	-5,534	6,555	-9,405	-8,765
Current (-) 2/	(-4,953)	(-5,593)	(-8,749)	(-5,280)	(-5,925)	(-8,415)	(-8,217)
Capital (-)	(-1,075)	(-1,182)	(-1,175)	(-254)	(-630)	(-990)	(-548)
State enterprises	-1,970	-4,407	-6,639	-6,627	-5,530	-2,220	-1,645
Current account surplus 2/	-116	-1,839	-3,388	-3,513	-1,036	4,325	3,572
Capital revenue	52	759	148	81	95	246	258
Capital expenditure (-)	-1,906	-3,327	-3,399	-3,195	-4,589	-6,791	-5,475
Consolidated public sector deficit	-5,502	-7,807	-9,196	-9,322	-9,590	-6,750	-5,315
Residual 3/	867	-354	339		—	—	—
Overall deficit = financing	4,635	8,161	8,857		9,590	6,750	5,
External	1,936	6,767	2,094		1,970	4,675	3,110
Domestic	2,699	1,739	2,697		3,890	2,075	2,205
Banking system	(2,401)	(1,644)	(1,872)		(3,500)	(2,000)	(2,000)
Nonbank financial intermediaries	(80)	(20)	(99)		)	)	)
Private sector	(266)	(-76)	(582)		) (390)	) (75)	) (205)
Change in floating debt	(-48)	(131)	(144)		)	)	)
Interest in arrears	—	1,655	4,066		3,730	—	—
(Annual percentage change)							
Central administration revenue	17.6	47.2	74.4	74.4	70.5	59.9	49.3
Central administration expenditure	26.9	24.7	52.7	52.7	54.6	47.2	43.7
Current	(23.3)	(29.5)	(66.5)	(66.5)	(61.7)	(47.8)	(43.6)
Capital	(30.7)	(9.1)	(-1.4)	(-1.4)	(26.8)	(44.0)	(44.4)
(In per cent of GDP)							
Central administration deficit	-8.0	-5.2	-3.1	-3.1	-3.3	-2.3	-2.7
Revenue	12.0	12.8	13.2	13.2	11.9	12.9	14.5
Expenditure	-20.0	-18.1	-16.3	-16.3	-15.3	-15.1	-17.2
Current	(-15.3)	(-14.4)	(-14.1)	(-14.1)	(-12.7)	(-12.6)	(-14.9)
Capital	(-4.7)	(-3.7)	(-2.1)	(-2.1)	(-2.6)	(-2.5)	(-2.3)
Nonfinancial public sector deficit	-13.3	-13.6	-9.5	-9.6	-9.2	-4.4	-4.0
Current account	-2.3	-3.8	-3.5	-4.0	-1.8	3.0	2.4
Central Administration	(-3.3)	(-1.6)	(-0.9)	(-0.9)	(-0.7)	(0.2)	(-0.4)
Rest of general government	(1.3)	(1.0)	(0.9)	(0.5)	(—)	(—)	(0.1)
State enterprises	(-0.3)	(-3.2)	(-3.5)	(-3.6)	(-1.1)	(2.8)	(2.7)
Capital revenue	0.2	0.4	0.4	0.2	—	0.1	—
Capital expenditure	-11.2	-10.2	-6.4	-5.4	-7.4	-7.4	-6.4
Residual 3/	2.1	-0.6	0.4		—	—	—
Overall deficit = financing	11.2	14.3	9.1		9.2	4.4	4.0
External	4.7	8.3	2.1		1.9	3.0	2.3
Domestic	6.5	3.1	2.8		3.7	1.4	1.7
Interest in arrears	—	2.9	4.2		3.6	—	—
(In millions of colones)							
Memorandum item							
Nominal GDP	41,406	57,176	97,068		104,138	154,578	131,813

Sources: Ministry of Finance; General Comptroller's Office and annual reports; Central Bank of Costa Rica; and Fund staff estimates.

1/ The reduced nonfinancial public sector includes the Central Administration, the Social Security Institute (CCSS), the Agricultural Development Institute (IDA), and the following state enterprises: ICE, RECOPE, CODESA, CNP, ICAA, and FECOSA. The stand-by program columns for 1982 and 1983 differ from those presented in EBS/82/214 (Table 4, p.7) in that IDA has been reclassified as part of the "rest of general government".

2/ Includes all contractual interest (paid and unpaid).

3/ Includes discrepancies arising from reporting on an accrual and cash basis, from reporting periods that differ from the calendar year, and from the operations of the nonconsolidated public sector.

With respect to revenues, the authorities pointed out that central government revenues in 1982 were somewhat higher than estimated and that so far this year they have grown at a satisfactory pace, as the revenue measures introduced late last year--mainly the increase in the sales tax and the introduction of an income tax surcharge on corporations--are beginning to produce results. Nonetheless, the authorities believe that revenue collection can be improved and intend to strengthen the administration of taxes. Technical assistance from U.S. AID would be received shortly for that purpose, especially in the area of customs and income tax administration. The authorities also explained to the mission that they were analyzing the feasibility of reducing somewhat the tax on exports that is based on the exchange rate differential, for the purpose of improving the competitiveness of exports.1/

Regarding the state enterprises, the estimates of the mission and the Costa Rican technicians, indicate that the state-owned refinery (RECOPE) would generate this year a surplus equivalent to approximately 1 per cent of GDP at the present oil import prices and exchange rate. However, pressures for a reduction of domestic oil prices in line with the recent drop in the import price of crude seemed to be mounting. The authorities indicated that they were studying the possibility of reducing domestic oil prices to reflect only part of the drop in the import price of crude, and of using the remaining portion of RECOPE's estimated surplus to offset the loss of revenue to the Central Government that would result from the reduction in the taxes on exports mentioned above, if finally decided upon. The authorities were made aware, however, that any reduction of domestic oil prices and/or of export taxes would have to be compensated by further expenditure underexecutions, as RECOPE's estimated surplus has already been taken into consideration in arriving at the overall public sector deficit for 1983 referred to earlier.

A possible partial reversal of the adjustment made in electricity rates and its implication was discussed with the mission. Following a rise of 70 per cent in June 1982, the Costa Rican Electricity Institute (ICE) approved in the third quarter of last year an additional increase in electricity rates of about 90 per cent in monthly cumulative increases starting in November 1982. These increases were estimated to cover ICE's operating costs, the service of its foreign debt at the exchange rate of ₡ 40 per U.S. dollar, and the domestic counterpart of investment financed with foreign loans. In the second week of May 1983, after the mission's return to Washington, the decision was made to reverse the last phased increase of 13 per cent in electricity rates which became

1/ This tax, which was introduced in December 1981, applies to the local currency proceeds from exports in the banking market in excess of those calculated at the official rate of ₡ 20 per U.S. dollar. The rates are presently 10 per cent for traditional exports, 5 per cent for nontraditional exports to the Central American Common Market, and 1 per cent for nontraditional exports to other countries.

effective in April. The authorities communicated to the staff that such a decision will imply a loss of revenue to ICE of about ₡ 220 million in 1983 which would be compensated through a reduction in expenditures.

The authorities explained the efforts that they had been making in trying to sell some of the enterprises controlled by the state-owned development corporation (CODESA). A committee composed of representatives of the public and private sectors has been formed with the purpose of selling CODESA's enterprises. The authorities reported that there are good prospects for selling certain small enterprises, as well as a cement plant valued at about ₡ 350 million (US$8 million), in the near future. However, the Costa Rican representatives recognized that despite their efforts, progress in this area has been slower than it would have been desirable.

The mission acknowledged the efforts involved in the measures already implemented by the authorities to strengthen the public finances, but noted the importance of persevering in those efforts and of adjusting the public expenditure policy to accommodate the changes in the behavior of domestic prices and in the amount of estimated foreign financing. The mission also expressed concern about the pressures to reduce domestic oil prices and electricity rates and emphasized that any such actions would have to be compensated with further adjustments in expenditures or alternative revenue measures. It also pointed out that for the successful implementation of the program it will be very important that the authorities keep their commitment to adjust without delay the prices of oil derivatives and electricity rates for changes in oil import prices and/or the exchange rate.

2. Monetary policy

As occurred in 1980-1981, monetary developments during 1982 were heavily influenced by the accumulation of large external payments arrears and the realization of considerable exchange losses. Mainly because of this, the net domestic assets of the banking system expanded substantially in 1982 and exceeded by far the increase in liabilities to the private sector (Table 3). In the first few months of 1983, the monetary situation has improved considerably. The banking system liabilities to the private sector have been growing at a stronger pace and improving in real terms, while the expansion of net domestic assets has decelerated sharply. The moderation in credit expansion was achieved despite a considerable increase in credit to the private sector, and was due largely to a reduction of credit to the public sector and the elimination of exchange subsidies. The net domestic assets of the Central Bank actually declined in the first five months of the year because of sharp increases in placement of stabilization bonds and deposits of the commercial banks. As a result, the net international reserve position of the Central Bank, including payments arrears, has improved considerably.

Table 3. Costa Rica: Summary Operations of the Banking System

	US$1 = ₡ 40.00		US$1 = ₡ 50.00			
			Stand-By Program		Actual	Revised Projection
	1981	1982	1982	1983	1982	1983
	(In millions of colones)					
	I. Banking System					
Net international reserves 1/	-34,940	-47,794	-65,435	-65,435	-59,745	-59,745
Net domestic assets	85,956	114,515	141,405	163,755	134,842	149,880
Net credit to public sector	9,294 2/	11,166 2/	13,171	15,171	11,092 2/	13,090 2/
Central Government 3/	(7,370)	(6,596)	(...)	(...)	(6,581)	(...)
Rest of public sector 3/	(1,924)	(4,570)	(...)	(...)	(4,511)	(...)
Credit to private sector 4/	13,241	18,094	18,420	27,345	18,231	24,590
Valuation adjustment	32,319	32,319	41,839	41,839	42,032	42,032
Other	5,430	8,816	9,125	20,550	8,337	17,968
Counterpart arrears	25,672	44,120	58,850	58,850	55,150	52,200
Counterpart unrequited foreign exchange	1,140	1,140	1,425	1,425	1,425	1,425
Long-term foreign liabilities	22,556	25,028	31,445	40,545	31,290	37,940
Liabilities to private sector 5/	27,320 2/	40,553 2/	43,100	56,350	42,382 2/	50,770 2/
	II. Central Bank					
Net international reserves 1/	-35,420	-48,[illegible]95	-66,035	-66,035	-60,370	-60,370
Official reserves	-9,748	-4,175	-7,185	-7,185	-5,220	-8,170
Payments arrears	-25,672	-44,120	-58,850	—	-55,150	—
Rescheduling	—	—	—	-58,850	—	-52,200
Net domestic assets	39,846	55,232	73,995	76,935	67,309	68,970
Net credit to public sector 3/	9,651 2/	11,872 2/	13,151	15,151	11,857 2/	13,857 2/
Net position with banks	-8,117	-11,120	-11,154	-8,412	-12,908	-11,335
Stabilization bonds	-1,542	-4,755	-5,450	-9,750	-4,755	-6,394
Long-term foreign liabilities 6/	-20,336	-22,414	-28,670	-37,820	-28,020	-34,670
Valuation adjustment	30,267	30,267	39,026	39,026	39,217	39,217
Other	4,251	7,262	8,242	19,890	6,766	16,095
Counterpart arrears	25,672	44,120	58,850	58,850	55,150	52,200
Currency issue	4,426	6,937	7,960	10,900	6,937	8,600
	(In per cent change)					
Banking system						
Net domestic assets 7/	62.9	104.5		51.9		35.5
Net credit to public sector	21.2	20.1		15.2		18.0
Credit to private sector	9.8	36.7		48.5		34.9
Liabilities to private sector 5/	27.3	48.4		30.7		19.8
	(As per cent of GDP)					
Net credit to public sector	16.6	11.5		9.8		9.9
Credit to private sector	22.8	18.6		17.7		18.7
Liabilities to private sector 8/	35.8	33.4		31.6		34.6
	(In millions of colones)					
Memorandum items						
Exchange subsidies to public sector (cumulative)	886	2,257		3,066		2,887
Central Government	(360)	(453)		(450)		(453)
Rest of public sector	(526)	(1,804)		(2,616)		(2,434)
Consumer price (change in per cent)	65.1	81.7		40.0		19.3

Sources: Central Bank of Costa Rica; and Fund staff estimates.

1/ Includes payments arrears.
2/ Adjusted for reclassification of public sector deposits in the commercial banks previously classified as private sector deposits.
3/ Includes exchange subsidies.
4/ Includes credit to nonbank financial intermediaries.
5/ Includes liabilities to nonbank financial intermediaries.
6/ Includes SDR allocation and gold revaluation.
7/ In relation to liabilities to the private sector, including liabilities to nonbank financial intermediaries, at the beginning of the period.
8/ Ratio of two-year average of liabilities to the private sector, including liabilities to nonbank financial intermediaries, in relation to GDP. Foreign currency deposits are valued at the average banking market rate of each year.

The authorities reaffirmed their intention to continue to observe the limits on banking system credit to the public sector and of assuring an adequate availability of financing to the private sector. The Costa Rican representatives pointed out that they were contemplating a reduction of domestic interest rates by a small amount, and contended that such a move would be within the spirit of their commitment to maintain a flexible interest rate policy, the ultimate objective of which is the establishment of rates that are positive in real terms. The authorities pointed out that, in view of the reduction which has already taken place in domestic inflation, interest rates were now positive in real terms. Taking this into account, as well as the expected rate of inflation for the year as a whole and the drop in interest rates abroad, they considered that a small reduction in interest rates was justifiable at this time.

The mission believed that such a measure would be acceptable in the light of recent developments in domestic inflation and interest rates abroad, but emphasized that the authorities should be prepared to raise interest rates promptly if inflation accelerated in the future and expressed concern about the likely resistance to do so if such a need were to arise. The mission also pointed out that a reduction of interest rates, however small, may result in pressures on the free market exchange rate, in which case the authorities have to be prepared to increase the banking exchange rate to keep within the permissible spread between the two exchange rates. The Costa Rican authorities shared the staff's views on this issue and indicated that by deciding to reduce interest rates they were taking a calculated risk and were aware that they should be ready to reverse their action if it was necessary because inflation accelerated or if deposit and/or credit developments so warranted.

After the mission, on May 17, 1983 the Board of Directors of the Central Bank approved a reduction in the basic interest rate on six-month deposits, to which most deposit and loan rates are related, from 25 per cent to 22 per cent. The lending rates applied to commercial agriculture and to manufacturing will continue to be the same as the basic deposit rate and 3-1/2 percentage points higher than the basic rate, respectively, while the one applied to cattle raising was adjusted downward to 4 percentage points below the basic deposit rate. The rate applied to all other loans will remain unchanged at 30 per cent.

3. Incomes and price policies

The authorities confirmed their intention to adjust public sector salaries and minimum wages in absolute amounts on the basis of the changing cost of a basic basket of goods and services, composed mainly of food products, transportation, water and electricity. It is estimated that this mechanism of wage adjustments will result in salary increases below the expected rate of inflation. Real wages for both public and private sector employees have declined considerably in the last two years, with the decline being more pronounced for public sector employees. A further deterioration of real wages is anticipated for this year, but the authorities believe that the best way to stop the deterioration of real wages is through the lasting abatement of inflation.

The Costa Rican representatives explained that a law had been passed at the end of 1982 to standardize wages in the public sector, which will imply the establishment of a new salary scale. The change into the new scale will cause additional expenditures for the public sector. Because of this, the authorities were planning to implement the shifting into the new scale in stages, so as to minimize its impact in 1983. Minimum wages, which serve as a guideline for the adjustment of private sector salaries, were most recently adjusted in January 1983 by 16 per cent across the board. The next revision is scheduled to take place in July 1983.

With respect to price controls, the authorities agreed that market forces should be the main determinant of prices and noted that administrative controls were limited to a relatively small number of basic consumer goods and inputs. While the number of items under control has been increased somewhat since the new Administration took office, the Costa Rican representatives indicated that the controls were being applied flexibly, permitting the prompt adjustment of prices whenever there was justification for it. They also indicated that in the majority of cases it was the profit margins that were being controlled and that only a small number of products were subject to price ceilings.

4. External policies

The Costa Rican authorities believe that considerable progress has been made toward the achievement of the main objectives in the external sector, namely exchange rate unification, a resumption of normal service payments on Costa Rica's external debt, and the settlement of external payments arrears.

The Costa Rican representatives indicated that the spread between the banking exchange rate and the free market exchange rate has been kept within the prescribed limits, and that the exchange system has been operated in conformity with the principle that foreign exchange will be furnished for all genuine payments and transfers for current international transactions. They also pointed out that the appreciation of the free market exchange rate (as described in Section III of this paper) has been the result of market forces and confirmed their intention of completing the unification of the exchange rates before the end of the program period. In view of the recent improvement of the official reserve position, the authorities have decided to allow the purchase of up to 40 per cent of the foreign exchange needed to service private sector debt at the banking exchange rate (previously all such purchases were made at the free market rate).

In discussing the exchange rate policy with the authorities, the mission expressed its concern about the need to improve the competitiveness of exports. According to preliminary calculations made by the staff on the effective exchange rate, there has been a considerable gain in competitiveness in the recent past (Chart 3). However, such a situation could change in 1983 depending on exchange rate and domestic price developments in coming months. The authorities indicated that they were analyzing the situation, and that they were in the process of preparing a study of some specific cases to check on the competitiveness of exports. They also informed the mission that they were working under the coordination of the recently appointed Minister of Exports in the formulation of a comprehensive set of export promotion measures to be introduced later in the year. Exports, which in 1982 declined by 12-1/2 per cent, are estimated to rise by only 3 per cent in 1983 (Table 4). The authorities' view was that while the competitiveness of exports might need to be improved, factors such as the weak world market conditions for their main agricultural exports and the economic difficulties prevailing in the rest of Central America, the major market for their nontraditional exports, have had an adverse impact on the recent developments in the export sector.

As part of the set of measures being contemplated to promote exports, there is the possibility of depreciating the banking exchange rate in the near future, which might mean a faster unification of the exchange rate than envisaged in the program. Another measure which is being studied is the already mentioned reduction of the tax on exports based on the exchange rate differential, which would also serve as another step toward the elimination of the multiple currency practices. In a recent move in the direction of improving the competitive position of the export sector, on April 29, 1983, the Central Bank reduced from 5 per cent to 1 per cent the amount of export proceeds that have to be sold at the official rate of ₡ 20 per U.S. dollar; correspondingly, export proceeds surrendered at the banking exchange rate have now been increased from 95 per cent to 99 per cent.

Significant progress has also been made toward Costa Rica's normalization of its relations with foreign creditors. In January 1983, Costa Rica concluded a rescheduling agreement with its bilateral official creditors under the aegis of the Paris Club. Relief was obtained for principal and interest payments both in arrears and falling due in 1983.1/ Regarding the debt negotiations with foreign commercial banks, a memorandum of understanding was signed on April 22, 1983 by the Chairman of the banks' steering committee and the Costa Rican authorities. The memorandum sets the terms for the rescheduling of principal owed to banks (in arrears and falling due in 1983 and 1984) and for the establishment of a trade credit facility in an amount equivalent

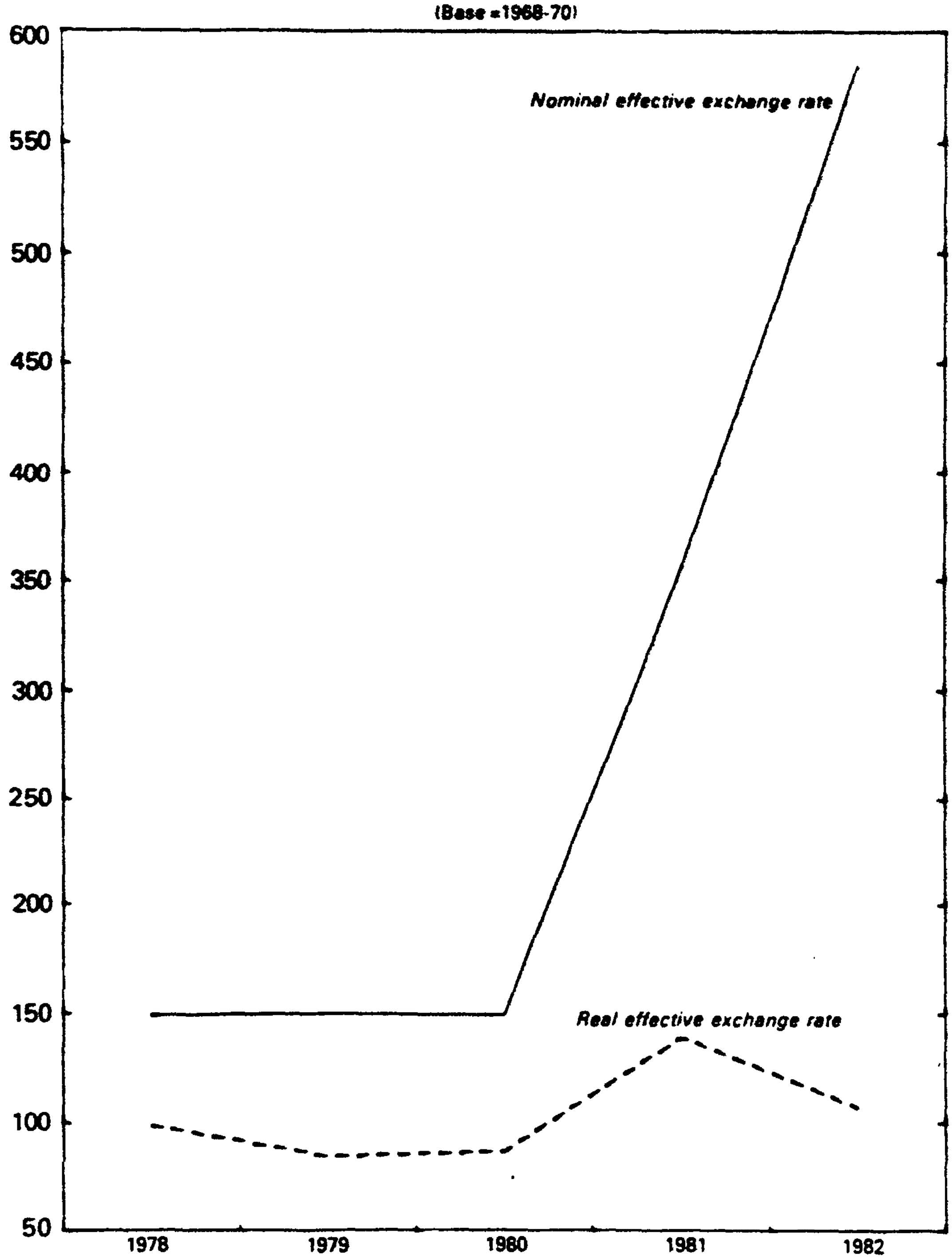
1/ For a detailed description of the rescheduling agreement, see SM/83/51.

CHART 3

COSTA RICA

EFFECTIVE EXCHANGE RATE INDEX

(Base =1968-70)



Sources: Central Bank of Costa Rica, and Fund staff estimates.

Table 4. Costa Rica: Balance of Payments

(In millions of U.S. dollars)

	1980	1981	Prel. 1982	Proj. 1983 Orig.	Proj. 1983 Rev.
Current account	-663.9	-426.4	-241.0	-285.0	-283.0
Merchandise trade	-526.6	-210.7	16.4	135	—
Exports, f.o.b.	1,000.9	1,002.6	876.3	1,085	900
Imports, c.i.f.	-1,527.5	-1,213.3	-859.9	-950	-900
Services	-151.8	-242.7	-291.3	-465	-328
Other services	64.4	76.6	112.5	105	129
Factor	-216.2	-319.3	-403.8	-570	-457
Direct investment and private interest	(-37.9)	(-11.4)	(-15.8)	(-25)	(-20)
Official interest	(-178.3)	(-307.9)	(-388.0)	(-545)	(-437)
Contractual: paid	/-178.3/	/-160.3/	/-106.0/	/-374/	/-283/
unpaid	/—/	/-147.6/	/-171.0/	/—/	/-33/
Interest on arrears/ rescheduled	/—/	/—/	/-111.0/	/-171/	/-112/
Interest reschedule of current principal	/—/	/—/	/—/	/-4/	/-9/
Transfers	14.5	27.0	33.9	45	45
Capital account	185.9	-44.2	-80.9	285	283
Private (including net errors and omissions)	-180.7	-64.3	-15.7	—	25
Public Sector	366.6	20.1	-65.2	285	258
Disbursements	597.1	330.3	186.8	408	315
Repayments	-230.5	-310.2	-252.0	-235	-222
Contractual: paid	(-230.5)	(-99.0)	(-72.8)	(-123)	(-90)
unpaid	(—)	(-211.2)	(-179.2)	(-112)	(-132)
Refinancing of current payments					
Principal	—	—	—	112	132
Interest	—	—	—	—	33
Other (SDRs/revaluation and transactions with non-monetary agencies)	22.3	5.4	—	—	—
Net international reserves (overall balance)	-455.7	-465.2	-321.9	—	—
Accumulation (+) or reduction (-) of arrears	283.0	358.8	461.2	-1,177	-1,103
Principal	(283.0)	(211.2)	(179.2)	(-708)	(-673)
Interest	(—)	(147.6)	(282.0)	(-469)	(430)
Rescheduling of arrears	—	—	—	638	783
Principal	(—)	(—)	(—)	(638)	(639)
Interest	(—)	(—)	(—)	(—)	(144)
Repayment of arrears	—	—	—	...	...
Principal	(—)	(—)	(—)	(...)	(...)
Interest	(—)	(—)	(—)	(...)	(...)
Conversion of CDs (P+I)					36
Contingent financing (rescheduling/refinancing/ new loans)	—	—	—	539	225 1/
Official reserves (increase -)	172.7	106.4	-139.3		59

Sources: Central Bank of Costa Rica; and Fund staff estimates.

1/ Revolving trade credit facility.

to 50 per cent of the total interest payments (past due and falling due in 1983) to be made by Costa Rica to the banks in 1983; this facility is estimated to amount to approximately US$225 million. It is expected that the legal contract regarding the rescheduling and trade credit facility will be signed in the near future. One hundred per cent of the principal (including short term) in arrears and falling due in 1983 (US$515 million) will be rescheduled over a period of seven and a half years including three years' grace period.1/ Similarly, 100 per cent of the principal falling due in 1984 (approximately US$150 million) will be rescheduled over a period of six and a half years with three and one quarter years' grace period.2/ The three-month LIBOR plus a spread of 2-1/4 per cent, or the U.S. prime rate (or the adjusted three-month CD rate, whichever is higher) plus 2-1/8 per cent, will be applied on the rescheduled debt, while an interest rate of 1-3/4 per cent over the three-month LIBOR or 1-5/8 per cent over the U.S. prime rate (or the adjusted three-month CD rate, whichever is higher) will apply to the trade credit facility.

The Central Bank of Costa Rica approved in mid-May 1983 the terms for the rescheduling of outstanding U.S. dollar-denominated certificates of deposit (CDs), most of which were issued in recognition of external payments arrears accumulated by the private sector before the end of 1980. The authorities have decided to reschedule these certificates at the same maturity terms at which the debt owed to foreign commercial banks is being rescheduled, including capitalization of interest in arrears.3/ One issue that is still to be resolved and which affects the relationship between Costa Rica and the foreign commercial banks is the interest rate that applies to the rescheduled CDs. While Costa Rica has decided to maintain the original interest rate (LIBOR for six-month deposits), the banks are maintaining that a spread over the applicable interest rate be paid on CDs held by banks and which have been accepted at face value from Costa Rican private firms in payment of their debts.

The authorities indicated that the conclusion of the rescheduling agreement with bilateral official creditors and foreign commercial banks, as well as the arrangements made to reschedule CDs and the proposals for the payment of bonds, all at terms basically in line with the assumptions made in the program, will enable them to eliminate the existing payments arrears by the end of 1983, as had been intended.

1/ The maturity period extends from the end of the consolidation period (i.e., end of 1983) to the date of the last repayment. Of the total principal rescheduled 5 per cent is due in 1984 and the balance of 95 per cent must be repaid over the period described above.

2/ Of the total principal rescheduled in 1984, 5 per cent due in 1985, and the 95 per cent balance is rescheduled over the period described above.

3/ A separate but similar proposal was made in respect of CDs being held by foreign commercial banks.

They further stated that since the beginning of this year they have virtually kept current on total interest payments, including payments to the banks in an amount substantially larger than those which would have been made in accordance with the formula in effect since July 1982 (referred to in Section II). As soon as the legal document is signed with the banks, the authorities would initiate the payment of interest in arrears, as well as completely normalize the payment of current interest falling due in 1983.

As a result of the debt rescheduling that has been negotiated, the burden of servicing the debt is expected to ease somewhat this year and in 1984. The debt service ratio is projected to rise to over 50 per cent in 1985 and to remain approximately at that level through 1988 (Table 5). In contrast, the debt as a proportion to GDP is expected to decline from 118 per cent in 1982 to about 90 per cent in 1988, and the ratio of interest payments to exports of goods and services is also projected to decline from 35 per cent to 27 per cent over the same period.

The mission also discussed with the authorities the medium-term outlook for Costa Rica's external debt situation on the basis of some tentative projections through 1988 prepared by the staff. Costa Rica will need to make a strong export effort in the next few years. Even assuming an export growth averaging about 5–7 per cent in real terms, the debt service ratio will be about 50 per cent of exports of goods and nonfactor services by 1988. In this context, the authorities indicated that they were convinced that the only way in which the country could attain and maintain a satisfactory rate of growth of the economy and a viable balance of payments situation in the medium term was through the diversification and growth of exports. A more dynamic export strategy would require an expansion of exports primarily outside the Central American Common Market, without neglecting the possibilities of increased trade within the region. The authorities expressed agreement with the view that the efforts to diversify exports would require a rationalization of existing duties on imports to lower protection and indicated that they were in the process of studying the proposal made by the Central American Common Market Secretariat for the reform of the external common tariff.

In this connection, the Costa Rican representatives have stated their intention to deal with problems of a structural nature in the context of a SAL loan from the IBRD, presently in the initial stages of negotiation. The authorities also confirmed their wish to negotiate an extended arrangement from the Fund to follow the current stand-by arrangement, in support of their medium-term adjustment effort.

V. Exchange Practices Subject to Fund Approval

The exchange system currently in effect in Costa Rica involves multiple currency practices and restrictions on payments and transfers for current international transactions subject to Fund approval under

Table 5. Costa Rica: Summary of External Public Debt Operations and Projections

	Prel. 1982	Projections 1983	1984	1985	1986	1987	1988
	(In millions of U.S. dollars)						
Outstanding debt (end of year) 1/	2,975	3,744 2/	3,944	4,135	4,324	4,508	4,714
Net drawings by the public sector 1/	164	364	200	191	189	184	206
Debt service payments 1/ (after rescheduling)	656 3/	549	587	776	820	938	995
Amortization	260	103	134	299	320	417	446
Interest 4/	396	446	453	477	500	521	549
	(In per cent)						
Outstanding debt/GDP	118.0	127.8	120.2	112.5	105.1	97.8	91.3
Net drawings/GDP	6.5	12.4	6.1	5.2	4.6	4.0	4.0
Debt service/exports of goods and services	57.6	47.5	45.2	52.4	50.1	51.7	49.5
Interest/exports of goods and services	34.8	38.6	34.9	32.2	30.5	28.7	27.3

Source: Fund staff estimates.

1/ Includes IMF and short-term debt; projected based on the revised 1982 figures.
2/ Includes capitalization of interest in arrears of US$405 million.
3/ Includes unpaid debt service.
4/ An implicit interest rate of 12 per cent is assumed for 1984-88.

Article VIII, Sections 2 and 3 of the Articles of Agreement. These are described in detail in EBS/82/213 of November 29, 1982. The only changes which have taken place in the system since that time have been the reduction from 5 per cent to 1 per cent in the surrender requirement of export proceeds at the official exchange rate, with the corresponding increase from 95 per cent to 99 per cent of the amount of export proceeds to be surrendered at the banking exchange rate, and the transfer to the banking exchange market of 40 per cent of the purchases of foreign exchange for the servicing of private external debt.

The multiple currency practices and restrictions arise from:

(a) The operation of a multiple exchange rate system comprising an official rate of ₡ 20 per U.S. dollar (buying), a banking exchange rate (i.e., ₡ 40 per U.S. dollar as of May 31, 1983), in which the colon is adjusted in line with underlying trends in the free market, and a free market rate (i.e., ₡ 44 per U.S. dollar as of May 31, 1983);

(b) A multiple currency practice arising from the mixing rate that results from the surrender of export proceeds described above;

(c) Multiple currency practices arising from the imposition of exchange taxes on the local currency proceeds from exports in the banking market in excess of those calculated at ₡ 20 per U.S. dollar; and

(d) An exchange restriction arising from payments arrears on the external debt service of the public sector.

VI. Staff Appraisal

Costa Rica has been experiencing a serious economic and financial deterioration since 1980, which reached crisis proportions in August 1981 when practically all service payments on official foreign debt were suspended. The deterioration was the result of an inappropriate exchange rate policy and expansionary fiscal and monetary policies, the effects of which were compounded by an adverse change in the terms of trade and the negative impact on trade and manufacturing production of growing social and political difficulties in the rest of Central America. During this period, Costa Rica's real GDP declined for the first time in 20 years, domestic inflation reached unprecedented levels as the colon suffered a large depreciation, and large external imbalances emerged, including the accumulation of major external payments arrears.

To redress the serious economic and financial situation, the new Administration, which took office in May 1982, framed a stabilization program in support of which a one-year stand-by arrangement was approved on December 20, 1982. The program was mainly designed to contain inflationary pressures, to promote an orderly development of the exchange market, and to facilitate the resumption of foreign public debt service payments. Achievement of these objectives would help create the basis for other adjustments that would facilitate the return to satisfactory and sustained economic growth.

At the heart of the program is a substantial improvement in the public finances so as to reduce pressures on domestic prices and the balance of payments. Other important aims of the program are the unification of the banking exchange rate and the free market exchange rate, and the normalization of relations with foreign creditors.

As soon as the new Administration took office it began to adopt fiscal and other measures to ensure that the adjustment process would be started without delay. It also reopened debt negotiations with the foreign commercial banks which had come to a virtual standstill in the last months of the previous Administration, by resuming partial interest payments in accordance with a specified formula linked to foreign exchange receipts from exports and certain capital inflows.

Performance under the current stand-by program has been satisfactory so far. Costa Rica has complied with all performance criteria and considerable progress has been made toward the achievement of the main objectives of the program. Domestic inflation has decelerated sharply, the exchange market situation has become more stable, and there are signs that confidence has begun to improve. In January 1983, Costa Rica concluded a rescheduling agreement with its bilateral official creditors at the Paris Club and in late April it reached a debt rescheduling agreement with the foreign commercial banks. The signing of the legal documents pertaining to this latter agreement is pending and is expected to take place in the near future.

The authorities have reaffirmed their intention of continuing to comply with the program and have indicated that they are prepared to take the measures that may be necessary for that purpose. In the fiscal area, the authorities are in the process of adjusting expenditure policy of the public sector in view of the lower inflation and more limited external financing than had been expected, in order to keep the banking system credit to the public sector and the overall deficit within the program levels. The staff would note the authorities' intention to pursue a fiscal policy which will be consistent with the program and wishes to stress the importance of maintaining a level of public sector expenditure which not only will be consistent with the availability of financing, but which will also serve to hold down domestic inflation and the pressures on the balance of payments. The staff would also wish to express its concern about the recent reversal of the last phased increase in electricity rates which was adopted under strong pressure from consumers. Not only will the effects of this action need to be offset, but it should be emphasized that the authorities cannot afford to accede to pressures that weaken the revenue base of the program. Furthermore, for the successful implementation of the program it will be essential that the authorities keep their commitment to increase without delay the prices of oil derivatives and electricity rates for increases in oil import prices and/or the exchange rate.

In accordance with the policy intention stated in the program, some efforts have been made in trying to sell some of the enterprises controlled by the state-owned development corporation (CODESA). The staff would note that progress in this area has been slow and would like to emphasize the need to act decisively on this front. Only through the sale of some of these enterprises will CODESA be able to improve its financial situation and avoid recourse to Central Bank financing.

The authorities have recently decided to lower by a small amount domestic interest rates in the hope that such a measure would provide some encouragement to economic activity without weakening the overall performance under the program. The authorities believe that, given the reduction which has taken place in domestic inflation as well as the expected rate of inflation and the drop of interest rates abroad, a small reduction in domestic interest rates is justifiable. The staff feels that such measure is acceptable in light of recent developments in domestic inflation, but would like to emphasize that the authorities should be prepared to raise interest rates promptly if circumstances should warrant it. In this regard, it will be crucial to monitor closely the demand for domestic financial assets in real terms to ensure avoidance of pressures on domestic prices or the exchange rate.

Regarding incomes policy, it will be important that the authorities implement in future months a prudent wage policy as the final degree of success in the abatement of inflationary pressures will depend crucially on it. Given the salary adjustment granted public sector employees at the beginning of the year and the recent deceleration of inflation, there should be no further adjustments of public sector salaries in the remainder of the year. It will also be important that the authorities continue to apply price controls in a flexible manner, allowing market forces to be the main determinant of prices.

The staff recognizes that progress has been made toward the unification of the exchange rates and that the exchange system has been operated in conformity with the understandings under the program. It also notes the authorities' reaffirmation of their intention to complete the unification of the rates before the end of the program period. However, the staff wishes to express its concern about the need to assure export competitiveness, and supports the authorities' plans to keep exchange rate policy under close review.

Progress has also been made toward Costa Rica's normalization of its relations with foreign creditors. It is expected that with the entering into effect of the debt rescheduling agreements Costa Rica will be in a position to eliminate its external payments arrears by the end of the year. Costa Rica's debt management problem, however, will be solved on a lasting basis only through the reduction in the public sector's reliance on foreign borrowing and the achievement of a strong and sustained growth of exports.

The authorities have given assurances that the multiple currency practices and restrictions on payments and transfers for current international transactions described in EBS/82/213 and in this paper are transitional measures with a view toward the unification of the exchange system. At the same time, negotiations on the settlement of all external payments arrears have almost been completed. The staff therefore recommends temporary approval of these measures. It is recommended that the next Article IV consultation with Costa Rica be held on the standard 12-month cycle.

VII. Proposed Decisions

The following draft decisions are proposed for adoption by the Executive Board:

A. 1983 Consultation

1. The Fund takes this decision relating to Costa Rica's exchange measures subject to Article VIII, Sections 2 and 3, in light of the 1983 Article IV consultation with Costa Rica conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Costa Rica maintains multiple currency practices and restrictions on payments and transfers for current international transactions described in EBS/82/213 and EBS/83/127. In light of the continuing implementation by Costa Rica of policies for balance of payments adjustments, which are supported by a stand-by arrangement, the Fund grants approval for the retention of these multiple currency practices and restrictions until the termination of the stand-by arrangement or December 19, 1983.

B. Review Under the Stand-By Arrangement

The Fund and Costa Rica have concluded the review pursuant to paragraph 4(c) of the stand-by arrangement for Costa Rica (EBS/82/214, Supplement 1). The Fund finds that no further understandings are necessary.

Fund Relations with Costa Rica

Status: Article VIII.

Quota: SDR 61.5 million.

Fund holdings of Costa Rican colones:

As of April 30, 1983	Millions of SDRs	Per Cent of Quota
Total	158.6	257.9
Of which:		
Credit tranche	(17.9)	(29.2)
EFF	(11.3)	(18.3)
SFF & EA	(22.0)	(35.8)
CFF	(45.5)	(73.9)
Oil facility	(0.4)	(0.7)

SDR Department:

As of April 30, 1983	Millions of SDRs	Per Cent of Allocation
Net cumulative allocation	23.7	100.0
Holdings	3.0	12.5

Gold distribution: Costa Rica has received gold distributions in the amount of 27,387.0 fine ounces.

Direct distribution of profits from gold sales: Costa Rica has received US$5.1 million.

Exchange rate: A multiple exchange rate system consisting of three separate rates: an official rate, a banking rate, and a free rate. As of April 30, 1983 the exchange rates for the colon (buying rate) were ₡ 20 per U.S. dollar in the official market, ₡ 40 per U.S. dollar in the banking market, and ₡ 44 per U.S. dollar in the free market. The representative rate for valuation of the Fund's holdings of colones is the banking rate.

Last consultation (Article IV): Last consultation discussions were held in November 1979, concluded in January 1980, and completed by the Executive Board on March 12, 1980 (EBM/80/43).

Technical assistance: A panel expert from FAD is assigned to the Ministry of Finance.

COSTA RICA

Area and population	
Area	50,900 sq. kilometers
Population (mid-1982)	2.3 million
Annual rate of population increase (1978-82)	2.5 per cent
GNP per capita (1982)	SDR 993.7

	1982
Origin of GDP (1982 est.)	(Per cent)
Agriculture	19.9
Manufacturing	22.5
Commercial services	13.0
Construction	3.8
Other	40.8
Ratios to GDP (1982)	
Exports of goods and services	45.1
Imports of goods and services	56.1
Central government revenue	13.2
Central government expenditure	16.3
External public debt (end of year)	118.0
National savings	8.4
Investment	18.0
Money and quasi-money (end of year)	33.4 1/

Annual changes in selected economic indicators	1980	1981	1982
	(In per cent)		
Real GDP per capita	-1.7	-7.1	-11.3
Real GDP	0.8	-4.6	-8.8
GDP at current prices	19.7	38.1	69.8
Domestic expenditures (at current prices)	19.2	30.1	55.4
Investment	(25.7)	(9.6)	(44.8)
Consumption	(17.2)	(36.6)	(58.1)
GDP deflator	18.8	44.7	88.6
Consumer prices (annual averages)	18.1	37.1	90.1
Wholesale prices (annual averages)	23.7	65.3	108.2
Central government revenues	17.6	47.2	74.4
Central government expenditures	24.9	24.8	52.7
Money and quasi-money	15.1	27.3	48.4
Money	(16.8)	(46.7)	(59.9)
Quasi-money	(13.8)	(14.6)	(41.2)
Net domestic assets of the banking system 2/	51.5	62.9	104.5
Credit to public sector (net) 2/	(16.7)	(9.1)	(6.8)
Credit to private sector 2/	(10.0)	(6.4)	(17.8)
Counterpart arrears and others 2/	(24.8)	(47.4)	(79.9)
Merchandise exports (f.o.b.)	6.2	0.2	-12.6
Merchandise imports (c.i.f.)	9.3	-20.6	-29.1

Central government finances	1980	1981	1982
	(millions of colones)		
Revenue	4,982	7,333	12,792
Expenditure	8,282	10,332	15,775
Current account surplus or deficit (-)	-1,370	-893	-906
Overall deficit (-)	-3,300	-2,999	-2,983
External financing (net) 3/	678	1,487	2,457
Internal financing (net)	2,622	1,512	526

Balance of payments	(millions of U.S. dollars)		
Merchandise exports, f.o.b.	1,001	1,003	876
Merchandise imports, c.i.f.	-1,528	-1,213	-860
Factor services (net)	-216	-319	-404
Other services and transfers (net)	79	104	146
Current and transfer account balance	-664	-425	-242
Official capital (net)	227	67	-14
Private capital (net) 4/	-181	-64	-16
Financial intermediaries (net)	162	-43	-54
Accumulations of arrears	283	359	461
Change in net official international reserves (increase -)	173	106	-139

International reserve position	(millions of U.S. dollars)		
Central Bank (gross)	228	147	263
Central Bank (net)	-137	-244	-104
Rest of banking system (net)	—	12	13

IMF data (as of April 30, 1983)	
Article VIII status	
Intervention currency and rate	U.S. dollar at ₡ 40.00 per US$
Quota	SDR 61.5 million
Fund holdings of colones	SDR 158.6 million
From Fund resources	
Credit tranche purchases (including SBA)	SDR 17.9 million
EFF purchases	SDR 11.3 million
CFF purchases	SDR 45.5 million
Oil facility purchases	SDR 0.4 million
From Supplementary and Enlarged Access resources	
Stand-by purchases	SDR 10.75 million
EFF purchases	SDR 11.25 million
Fund holdings under Enlarged Access Policy 5/	83.3 per cent of quota
Total Fund holdings	157.9 per cent of quota
Stand-by arrangement (December 22, 1982-December 21, 1983)	SDR 92.3 million
Purchases thereunder	SDR 18.5 million
Status of drawing rights thereunder	Intact
Special Drawing Rights Department	
Cumulative SDR allocation	SDR 23.7 million
Net acquisition or utilization (-) of SDRs	SDR 20.7 million
Holdings of SDRs	12.7 per cent of allocation
Share of profits from gold sales	US$5.1 million

1/ Average of outstanding balance at the end of 1982 and 1981 in relation to GDP.

2/ Against the stock of liabilities to the private sector, including liabilities to nonbank financial intermediaries, at the beginning of the period.

3/ Includes accumulation of interests in arrears.

4/ Includes errors and omissions.

5/ Refers to Fund's holdings related to credit tranche (including SBA) and EFF purchases from Fund resources, plus purchases from Supplementary and Enlarged Access resources.

Costa Rica: Selected Economic and Financial Indicators

	Actual 1980	Actual 1981	Prel. 1982	SBA Program 1983	Est. 1983
(Annual per cent changes, unless otherwise specified)					
National income and prices					
GDP at constant prices	0.8	-4.6	-8.8	—	—
GDP deflator	18.8	44.7	86.5	48.4	35.8
Consumer prices (end of period)	17.8	65.1	81.8	40.0	19.3
(average)	18.1	37.1	90.1	55.0	37.9
External sector (on the basis of U.S. dollars)					
Exports, f.o.b.	6.3	0.2	-12.6	7.4	2.7
Imports, c.i.f.	9.4	-20.6	-29.1	4.4	4.7
Non-oil imports, c.i.f.	8.0	-22.4	-33.0	3.2	10.6
Export volume	-5.8	7.8	-11.9	4.0	2.5
Import volume	-3.6	-25.7	-34.4	—	1.6
Terms of trade (deterioration -)	-0.5	-13.0	-8.1	-1.1	-2.8
Nominal effective exchange rate (depreciation -)	0.4	-139.0	-64.0	...	...
Real effective exchange rate (depreciation -)	8.1	59.9	22.9	...	...
Government budget					
Revenue and grants	17.6	47.2	74.4	59.9	49.3
Total expenditure	24.9	24.7	52.7	47.2	43.7
Money and credit (banking system)					
Net domestic assets 1/4/	51.5	62.9	104.5	51.9	35.5
Public sector 1/	(16.7)	(9.1)	(6.9)	(4.6)	(4.7)
Private sector 1/	(10.0)	(6.4)	(17.8)	(20.7)	(15.0)
Couterpart arrears and others 1/	(24.8)	(47.4)	(79.9)	(26.6)	(15.8)
Medium- and long-term foreign liabilities 1/	6.3	2.2	9.0	21.1	15.7
Liabilities to private sector (M_3) 2/	15.1	27.3	48.4	30.7	19.8
Velocity (GDP relative to M_3) 3/	2.7	2.8	3.0	3.1	2.9
Interest rate (annual rate, six-month time deposit)	19.8	21.5	25.0	...	22.0
(In per cent of GDP)					
Overall public sector deficit 4/	11.2	13.9	9.1	4.4	4.0
Central government savings	-3.3	-1.6	-0.9	0.2	-0.4
Central government budget deficit 4/	8.0	5.2	3.1	2.3	2.7
Domestic financing	(6.3)	(2.6)	(0.6)	(0.8)	(1.7)
Foreign financing 4/	(1.7)	(2.6)	(2.5)	(1.5)	(1.0)
Gross domestic investment	26.6	21.1	18.0	18.1	20.5
Gross national savings	12.2	9.3	8.4	10.1	10.8
Current account balance (deficit -)	-14.4	-11.7	-9.6	-8.0	-9.7
Trade balance (deficit -)	-11.4	-5.8	0.7	3.8	—
External debt inclusive of use of Fund credit and short term	56.3	77.7	118.0	114.2	127.8
(In per cent of exports of goods and services)					
Debt service ratio 7/	33.4	51.7 5/	57.2 5/	58.0	47.5 6/
Interest payments 7/	14.6	25.6 5/	34.8 5/	40.5	38.6 6/
(In millions of U.S. dollars)					
Change in net official foreign reserves	-173	-106	139	...	59
Gross official reserves (months of imports)	1.8	1.5	3.7	3.3	4.0
External payments arrears (decrease -) 8/	283.0	358.8	461.2	-1,117.0 9/	-1,103.0 9/

Sources: Central Bank of Costa Rica; Ministry of Finance; and Fund staff estimates.

1/ Against the stock of liabilities to the private sector, including liabilities to nonbank financial intermediaries, at the beginning of the period.
2/ Includes liabilities to nonbank financial intermediaries.
3/ GDP of $year_t$ relative to the average M_3 of $year_{t-1}$ plus $year_t$.
4/ Includes accumulation of interests in arrears.
5/ Includes unpaid interest and amortization.
6/ After rescheduling of arrears and certain current payments.
7/ Inclusive of Fund charges and repurchases as well as interest on short term.
8/ Excludes arrears on short-term foreign liabilities of the Central Bank.
9/ Assumes rescheduling of payments arrears.