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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/163

10:00 a.m., December 20, 1982

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. B. Diao, Temporary
	C. Taylor
J. de Groote	H. G. Schneider
	A. Le Lorier
	M. Teijeiro
	C. Dallara
	S. R. Abiad, Temporary
	M. A. Janjua, Temporary
A. H. Habib	Jaafar A.
T. Hirao	T. Yamashita
	M. Casey
	C. Robalino
	G. Grosche
G. Lovato	C. P. Caranicas
	A. S. Jayawardena
	J. E. Suraisry
	T. de Vries
	K. G. Morrell
G. Salehkhou	O. Kabbaj
	M. Camara, Temporary
M. A. Senior	
	L. Vidvei
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present

Asian Department: H. Neiss, Deputy Director; E. Gurgen, A. N. Mansur, K. M. Meesook, K. Saito. Exchange and Trade Relations Department: M. Guitian, J. Martelino. External Relations Department: G. P. Newman. Fiscal Affairs Department: A. L. Antonaya. Legal Department: W. E. Holder, S. A. Silard. Research Department: N. M. Kaibni, T. K. Morrison, B. Rourke. Treasurer's Department: A. M. Al-Samarrie. Western Hemisphere Department: C. E. Sansón, Deputy Director; M. E. Bonangelino, C. Cha, M. T. Hernandez, I. C. Tandeciarz, S. Umana. Advisors to Executive Directors: J. R. N. Almeida, S. E. Conrado, J. Delgadillo, L. Ionescu, P. Kohnert, H.-S. Lee, I. R. Panday, P. D. Peroz. Assistants to Executive Directors: H. Arias, R. Bernardo, T. A. Connors, R. J. J. Costa, I. Fridriksson, G. Gomel, A. Halevi, M. Hull, P. Leeahtam, W. Moerke, V. K. S. Nair, Y. Okubo, G. W. K. Pickering, J. Reddy, J. Schuijer, H. Suzuki, P. S. Tjokronegoro, J. C. Williams.

1. BRAZIL - REPORT BY ACTING CHAIRMAN

The Acting Chairman stated that, as the Managing Director had indicated to Directors informally in the previous week, agreement had been reached between the Fund staff and Brazilian authorities on a Fund-supported program. The Managing Director had subsequently met with the head of mission and he was satisfied with the substance of the program negotiated with the Brazilian authorities. The program called for a reduction in the borrowing requirement of the nonfinancial public sector, i.e., the Central Government, state enterprises, and local government, from the equivalent of almost 14 per cent of GDP in 1982 to slightly less than 8 per cent in 1983; there would be significant further declines in 1984 and 1985. The current account deficit would be reduced under the program from almost $15 billion in 1982 to approximately $7 billion in 1983, $5 billion in 1984, and $4 billion in 1985. As a proportion of GDP, the current account deficit would be reduced from 4.7 per cent in 1982 to 2.2 per cent in 1983 and 1 per cent in 1985. A number of substantive measures had already been introduced.

The question remained of how the program was to be financed externally, the Acting Chairman continued. In that connection, the Managing Director, at the request of the Brazilian authorities, would take part in the discussions that the authorities were having with a number of commercial banks in New York. Directors would be informed of the outcome of the discussions. It would be an important influence on the decision to proceed with the Brazilian program.

The Executive Directors took note of the Acting Chairman's remarks.

2. BURMA - 1982 ARTICLE IV CONSULTATION; AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff report for the 1982 Article IV consultation with Burma (SM/82/222, 11/29/82), together with a proposed decision concluding the 1982 Article XIV consultation. In addition, they took up a request by Burma for a purchase equivalent to SDR 25.6 million under the compensatory financing facility (EBS/82/219, 11/29/82; and Sup. 1, 12/15/82). They also had before them a report on recent economic developments in Burma (SM/82/226, 12/6/82).

Mr. Habib made the following statement:

Burma is richly endowed with natural resources. It is self-sufficient in energy, and agriculture forms the major source of earnings. The country is centrally planned; it undertakes the implementation of its economic program and policies through the various State Economic Enterprises (SEEs). The development policies of Burma emphasize growth and stabilization, as well as social equity. The recent economic development of Burma and the various economic achievements have been covered extensively in the staff report for the 1982 Article IV consultation (SM/82/222) and the staff description of recent economic developments (SM/82/226).

Burma achieved an annual GDP growth of 6.6 per cent under its Third Four-Year Plan, 1978/79-1981/82. Inflation was kept at a very low level and income distribution was reported to have improved during this period. The impressive overall performance in growth was attributed mainly to the government program to raise productivity in rice cultivation. By the end of the Plan period, the program to promote the use of high-yielding seed varieties, fertilizer, and access to credit extended to about half of the total rice harvested area, resulting in an average annual growth of rice output of 11 per cent. The harvested area was unchanged under the Plan period. The yield per hectare for paddy, according to statistics of the Food and Agriculture Organization, at 2,941 kilograms for 1981/82 was one of the highest for the region.

During the Plan period, price inflation was minimum. The Rangoon consumer price index remained constant in 1980/81 and increased by only 1.1 per cent in 1981/82. The slight increase in the 1981/82 period was attributed to an increase in energy prices compensated for by a slight decrease in food prices.

A strong growth in exports was experienced during the Third Four-Year Plan period, averaging about 20 per cent a year. Burma, however, continued to rely on mainly two export commodities, rice and teak, which accounted for two thirds of total export receipts.

The recent large public sector deficit has been a major source of concern for the authorities. The deficit was largely due to the accelerated investment expenditure programs of the SEEs.

The Burmese authorities have embarked on an adjustment program in 1981/82, which is supported by the Fund stand-by arrangement. The objective is to strengthen the financial position of the SEEs through automatic price adjustments and a more liberal import policy (EBS/81/108). The authorities have successfully implemented this program and indications are that all performance criteria under the stand-by arrangement were met. The total number of SEE price adjustments rose sharply from 406 items in 1980/81 to 621 items in 1981/82 and to 1,591 items in the first five months of 1982/83. With the improved supply of imported materials into Burma, the capacity utilization ratio increased from 70.7 per cent in 1980/81 to 72.5 per cent in 1981/82. These adjustments have enabled many industrial SEEs to improve their operating surplus. As a whole the estimated increase of operating surplus of the SEEs has increased almost fivefold, from K 178 million in 1980/81 to K 860 million in 1981/82.

The present world economic recession has adversely affected Burma's economic performance in 1982. The weak demand for its traditional exports--rice and and teak--has halted the growth of total exports in 1982/83.

Consequently, the balance of payments was in deficit for the first time since 1978/79. The deficit for 1981/82 was SDR 42 million; this figure is expected to deteriorate further to SDR 75 million in 1982/83. As a result, public financial operations will be adversely affected. First, the lower demand from abroad and the bumper rice harvest last year have forced the authorities to maintain a high level of stocks, which is expected to further exacerbate the financial problems of the SEEs this year; second, the sluggish external sector will depress budgetary receipts; and third, less foreign exchange will be available for SEEs to finance their purchase of inputs from abroad. The operations and surpluses of the SEEs are therefore expected to be affected unfavorably. Consequently, public sector revenue is projected to decline by 2.1 per cent in 1982/83 and the public sector deficit is expected to remain high. Under these difficult circumstances my authorities have indicated that they will continue to maintain adjustment measures and to restrain public sector expenditure together with efforts to mobilize domestic resources.

With the current fiscal year, beginning in April 1982, Burma has entered into the Fourth Four-Year Plan. The development strategy under the Plan is aimed at diversifying agricultural production and promoting export-oriented industries. More efforts will be devoted to mobilizing public savings so as to meet the financial requirements of the public sector investment program. The Plan also recognizes the need to increase the role of private and cooperative sectors in the development program in the current Fourth Plan period.

Arising from the shortfall in export proceeds on the basis of the actual data for the period from October 1981 through September 1982 (EBS/82/219), the Burmese authorities have submitted a request to the Fund for a drawing of SDR 25.6 million under the compensatory financing facility to finance the shortfall. The authorities envisage that the shortfall is temporary in nature and is largely attributable to circumstances beyond their control. I was informed by my authorities that Burma will continue to cooperate closely with the Fund in their efforts to overcome the present economic and balance of payments difficulties and sustain the momentum of economic development. I sincerely hope that the Board will support and grant its approval to Burma's request for a compensatory financing facility purchase.

On behalf of my Burmese authorities, I wish to express my gratitude and appreciation to the staff in presenting a balanced and comprehensive report on the Burmese economy.

Mr. Hirao commented that the performance of the Burmese economy had been generally satisfactory from 1980 to 1982 when the Fund's stand-by arrangement had been fully drawn. A good harvest had contributed to both the high growth in real GDP and the moderate increase in consumer prices. The authorities had undertaken several measures to strengthen the State Economic Enterprises (SEEs), a major objective of the stand-by arrangement, and all the performance criteria had been met. However, other adjustment measures by the authorities were needed. First, export growth had been considerably less than expected due to a decline in export prices that in turn reflected a weakening in the world market for Burmese export products. Lower than expected foreign exchange earnings from exports had constrained expansion of imports of industrial raw materials and spare parts. Second, the expected improvement in the financial performance of the SEEs had not been realized. While the SEEs in industry and trade had increased their current surpluses substantially, the total deficit in the SEEs sector had risen rapidly as a result of the deterioration in the financial performance of the SEEs in agriculture, transportation, and power. Consequently, the overall public sector deficit had been larger than targeted.

In order to sustain economic growth, Mr. Hirao continued, the Burmese economy would continue to require a relatively large volume of imports of intermediate industrial goods and spare parts financed by export earnings. The recent stagnation in exports was therefore a worrisome development, and the authorities' export promotion efforts were highly desirable. In the agricultural sector--the principal source of traditional exports--the authorities had already implemented three export promotion measures: strengthening the market efforts for rice exports; shifting rice production to varieties that were in greater demand; and promoting a shift from rice to other crops. Those measures were certainly welcome. As for nonagricultural exports, it was worth noting that the export of heavy oil, a previously important export item, had virtually disappeared. The staff had suggested that increased domestic consumption was a major reason for the disappearance; it would be interesting to know more about the authorities' policies regarding heavy oil production.

Commenting on exchange rate policy, Mr. Hirao noted that the kyat had been unchanged relative to the SDR since May 1977, but that the appreciation of the U.S. dollar and Burma's low inflation rate had resulted in a gradual depreciation of the kyat since 1979. The result had been to strengthen the profits of exporting SEEs; there had been only limited influence on export production since domestic producer prices had remained unchanged. Flexible pricing policies might be effective in promoting exports, especially in light industries in which the private corporate sector was expected to play a significant role.

In 1982/83, the consolidated public sector deficit was likely to decline relative to GDP, Mr. Hirao remarked. The authorities' effort to restrain expenditure, especially the capital expenditure of the SEEs, would be largely offset by the continuing stagnation of tax revenues. If the deficit continued to be financed by external borrowing, it would further increase the debt burden. On the other hand, if it was to be financed by bank borrowing, it could adversely affect price stability. Such considerations emphasized the importance of revenue-raising efforts.

In view of the slow growth of tax revenues, the authorities had increased user taxes on irrigation facilities, and they had strengthened efforts to improve tax administration. While those efforts were commendable, they would not create sufficient revenues to adjust significantly the imbalance in the public sector. The adoption of more realistic and flexible pricing policies in the SEE sector would be important for the immediate improvement of the profitability of the SEEs and for their contribution to public sector revenues.

The authorities should be commended for their effective utilization of interest rate policies to ensure a steady growth in private savings, Mr. Hirao suggested. The real deposit rate had been positive, and private savings, calculated as a residual of public savings, were expected to increase to 15 per cent of GDP between 1980 and 1983 from an average of 7.6 per cent between 1977/78 and 1979/80, as indicated in Table 1 of SM/82/222. He invited the staff to comment on the change in the level of private savings and the role of positive real interest rates.

The requested purchase under the compensatory financing facility met all the requirements of the relevant decision, Mr. Hirao said. The export shortfall based on actual data was the result of weak world demand; it could be attributed to circumstances beyond the control of the authorities. Export earnings were expected to recover during the postshortfall years; therefore, the shortfall was temporary in character. The balance of payments need was clear. He had no difficulty in supporting the request.

Mr. Morrell observed that the performance of the Burmese economy had conformed to all the criteria under the 1981-82 stand-by arrangement with the Fund. He commended the authorities for the resilience of the economy in the face of continued deterioration in the world economic environment. The large public sector deficit was mainly attributable to the activities of the SEEs; therefore, he encouraged the authorities to continue their efforts at adopting more flexible pricing and import policies. The staff correctly recommended the broadening of the tax base and the increased profitability of the SEEs. There was a planned slowdown in investment growth, from 17 per cent a year during the previous four years to only 8 per cent in 1982. Was it realistic to assume that the efficiency of investment for the Plan period would be sufficient to double the incremental capital/output ratio, as implied by the planned targets?

His authorities supported the requested purchase under the compensatory financing facility, Mr. Morrell stated; it met all the normal criteria. The forecast for the two postshortfall years appeared somewhat optimistic, but the nature of primary product markets around the world inevitably made such estimates difficult. Like Mr. Hirao, he was interested in knowing more about the production of heavy petroleum, the export of which had ceased.

Mr. Suraisry said that he supported the request for the use of Fund resources under the compensatory financing facility. The request clearly met all the requirements under the relevant decision. In addition, he was in general agreement with the staff conclusions regarding the Article IV consultation, and he supported the proposed decision.

On balance, the Burmese authorities had managed the economy quite well, Mr. Suraisry commented. Relatively high growth rates, low inflation, and a reasonable external payments position had been achieved in recent years. Furthermore, the authorities had met all the performance criteria specified in the 1981-82 stand-by program; they should be commended on that basis. Some financial imbalances had begun to emerge in the economy during 1981/82. The consolidated public sector deficit had risen sharply, and the balance of payments had recorded an overall deficit for the first time in several years. The pressures on the balance of payments were projected to continue in 1982/83, and the overall deficit was expected to increase to SDR 75 million. It was, therefore, important that the authorities intensified their adjustment efforts. It was encouraging that they envisaged a greater role for the private sector in the context text of the Fourth Four-Year Plan.

Mr. Wang stated that he supported the request by the Government of Burma for a purchase of SDR 25.6 million under the compensatory financing facility. The request met all the requirements of the compensatory financing facility decision. The shortfall was temporary in nature and it was largely attributable to circumstances beyond the authorities' control.

Mr. Salehkhou said that he agreed with the thrust of the staff appraisals, with regard to both the Article IV consultation and the requested purchase under the compensatory financing facility; he warmly supported the two proposed decisions. Despite growing external difficulties, as exemplified by the widening current account deficit, Burma's balance of payments position remained manageable and the Burmese economy had had a relatively high level of real growth and a very low inflation rate. Such success was due mainly to the authorities' careful economic policies that were appropriately aimed at sustaining economic growth, which was crucial to the Burmese economy, as per capita GDP--SDR 125 in 1981/82--was among the world's lowest. As a centrally planned economy, in which the public sector accounted for about 40 per cent of GDP, Burma used planning as the main instrument of its economic policy. Although the private sector was relatively large, particularly in agriculture and services, it was also significantly affected by planning through the public sector's activities, the system of distribution, and the state monopoly of trade. However, in Burma, the plan was less rigid than that of other centrally planned economies, and it was supplemented by market-oriented policies, such as credit control and taxation of State Economic Enterprises.

Cautious economic policies in Burma had been supported by a one-year stand-by arrangement with the Fund in 1981, Mr. Salehkhou noted. Performance under the stand-by arrangement had been largely satisfactory, since all performance criteria had been met and all objectives had been achieved, with the exception of lower than projected public sector savings. The performance of real GDP, which had grown by 7 per cent, had been particularly remarkable, while inflation had been only 4 per cent despite a large number of price adjustments to pass on higher import costs to the consumer and to narrow the gaps between official and unofficial prices. Both growth and inflation had benefited from the record agricultural output and the resulting stable food prices. They had also been affected by the flexible price and import policies introduced under the stand-by arrangement aimed at increasing public investment markedly and at improving SEE capacity utilization and efficiency in order to increase supplies of intermediate inputs and spare parts.

However, performance under the stand-by arrangement had been lower than expected with regard to the imbalances in the budget and in the external accounts, Mr. Salehkhou commented. Since an acceleration of growth had been projected for 1981/82, the stand-by arrangement had provided for a widening of the overall budget deficit from 8 per cent of GDP to 12 per cent. It had eventually risen to 14 per cent, due mainly to higher investment growth and to slower improvement of the financial position of the SEEs. Although high, such a deficit had certainly been sustainable since it had been financed largely through external aid programs and public sector savings. However, the latter were a matter for real concern, as the ratio of public savings to GDP had declined under the Third Plan from 6 per cent to 4 per cent, while capital expenditure had accelerated. He therefore shared the staff's view that Burma needed to make further efforts to increase the mobilization of domestic resources. The continuation by the authorities of the action initiated under the stand-by program aimed at strengthening revenue administration was welcome, as was their intention to restrain the growth of capital expenditure to avert a further increase in the overall public sector deficit and in its financing through the banking system.

Commenting on the external position, Mr. Salehkhou observed that unfavorable export developments had had an adverse impact on the current account deficit, which had risen to 6 per cent of GDP, slightly wider than projected in the program but still within manageable bounds. The impact on the overall balance of payments deficit had been offset by a larger than expected inflow of concessional loans. A sharp slowdown in exports, resulting mainly from a downturn in world market demand and in prices for Burma's main exports--rice and teak--was, therefore, largely beyond the control of the authorities. Imports had also contributed to the increased current account deficit, because the stand-by program had aimed at speeding up cash imports of industrial raw materials and spare parts to overcome the problem of capacity underutilization of the SEEs. Such action had greatly improved the productivity of the SEEs; it should have a favorable impact on Burma's imports in 1982. Despite significant capital inflows and a wide budget deficit financed largely through external resources, Burma had managed to contain its external debt/GDP ratio to 28 per cent in 1981/82, a relatively low level compared with other developing countries. The structure of external debt was also favorable, as concessional loans with maturities of 15 years and interest rates below 3.5 per cent represented one third of all outstanding loans. However, the ratio of service payments to exports was rapidly increasing; it should be a matter of concern to the authorities, even though part of the marked increase in 1981/82 had been due to advance repayments of certain commercial debts.

The authorities' intention to continue their efforts in favor of rapid growth through structural adjustment and diversification of the economy in the Fourth Four-Year Plan was most welcome, Mr. Salehkhou said, particularly as it gave priority to the development of agriculture and agro-based industries and as it emphasized the need for further extension of the private and cooperative sectors. As to the request for the use of Fund resources under the compensatory financing facility, the amount involved was low and the requirements with regard to balance of payments need, cooperation with the Fund, and the nature of the shortfall were clearly fulfilled. There was no risk of overcompensation since the calculations were based on actual data for the shortfall year.

Mr. Jayawardena remarked that for many years Burma had relied on long-term economic planning with a 20-year plan under which successive four year plans were worked out. It was self-sufficient in energy, a factor that had considerably helped the investment process since the early 1970s. The state sector, accounting for about 40 per cent of GDP, was large, but lower than in some industrial countries with predominantly market-oriented economies. Burma had achieved substantial and noteworthy economic growth in recent times, averaging almost 5 per cent in the 1970s and even higher growth in the 1980s. The main thrust of growth had come from the privately owned agricultural sector and from the Government's investment in infrastructure that had helped that private sector.

With the rise in agriculture income, Mr. Jayawardena noted, household savings had risen sharply, although the tax system had not been able to capture a substantial share for public investment because income in the nonagricultural sector was largely able to escape taxation. As a result, and because of inflexible public enterprise prices in previous years, the public sector deficit had not only been large but had tended to increase and it had partly restricted resource flows. Bank credit to the public sector had, therefore, come to assume an increasingly important role in recent years. Despite an increase in trade, the external deficit had tended to grow, a fact that could be largely attributed to the Government's investment program, which was partly funded by foreign assistance. The debt service ratio had risen recently. Burma had kept inflation to very low rates--it could be considered a model for other countries in that respect--due largely to the record grain output achieved in recent years. The authorities had been successful in observing the performance criteria of the 1981-82 stand-by program, and they had continued in the same policy directions.

Despite a growing adverse external situation, Mr. Jayawardena continued, several positive developments in the Burmese economy were encouraging. It was evident that the authorities were persevering with their flexible pricing and import policies. The strong public sector was continuing to follow a flexible pricing policy that was particularly effective because of its automatic adjustment features. Public expenditure was being slowed down and projects yielding rapid returns were being emphasized. There was a reallocation of resources to export-oriented projects. There was also a greater domestic resource mobilization effort, particularly evident in the proposed taxes on irrigation and in the measures being taken to strengthen tax administration. Finally, greater flexibility was being considered for the resource control and allocation system. That was particularly important if further gains were to be made in Burma's agricultural output from unchanged acreage. More liberalized credit would help to generate higher productivity in agriculture.

The requested purchase of 23 per cent of quota under the compensatory financing facility was justified, Mr. Jayawardena considered. He agreed fully with the staff appraisal and he supported the proposed decision.

Mr. Dallara remarked that the Burmese authorities should be commended for successfully implementing the recent stand-by program. Although the overall public deficit had not turned out as well as expected, the objectives had been broadly achieved with respect to growth, balance of payments, and prices. Virtually all countries sought to achieve solid real growth with lower inflation and sustainable balance of payments; it was encouraging to see a country making progress toward those objectives in the current international environment. The Burmese authorities should continue to pursue appropriate structural policies. In particular, flexible pricing and import policies would help to attain the development goals of a sustainable domestic financial situation and a sustainable external environment through a more stable and realistic overall budget position, including the activities of the State Economic Enterprises.

The economy appeared to be well positioned to continue to benefit from the significant foreign aid flows that had been attracted, Mr. Dallara considered. Such aid would be critical to the maintenance of rapid economic growth in the medium term. Increased attention to domestic resource mobilization and to structural changes in output, particularly in the export sector, would also be very important. As other Directors had noted, the rise in the overall public sector deficit was a worrying trend that called for vigorous action to broaden the tax base and to improve tax collection, as well as to increase the operating surpluses of the State Economic Enterprises. Policies relating to the SEEs held the key to the restoration of a more realistic fiscal situation, with regard to both mobilizing resources and ensuring an adequate set of incentives for producers. Agricultural production could usefully be diversified away from rice to other crops with export potential. In that connection, appropriate pricing policies would be instrumental and the authorities should not ignore the contribution that a flexible exchange rate policy could make. Finally, he agreed that all the requirements for a purchase under the compensatory financing facility had been met. He could support the request.

Mr. Janjua commented that he was broadly in agreement with the staff analysis. In recent years, the economy of Burma had achieved a high rate of growth along with improvements in income distribution. In 1981, the stabilization program had been completed successfully and the performance of the economy had generally been satisfactory. Recently, the country's balance of payments had come under strain. The authorities had shown an awareness of the need to take the necessary measures, and it was encouraging to learn from Mr. Habib that the authorities planned to continue adjustment measures even under difficult circumstances. Efforts at resource mobilization, together with supply-oriented policies, would continue under the Fourth Five-Year Plan. The staff had correctly emphasized the need for structural changes in output and for increased domestic resource mobilization as essential elements in economic development over the medium term. However, the international economic environment would continue to be an important factor. The requested purchase under the compensatory financing facility met all the requirements. He had no difficulty in supporting it.

The Deputy Director of the Asian Department observed that increased private savings in recent years had occurred after interest rates had been raised at the end of 1977 and after the virtual cessation of inflation was in earlier years had averaged 20 per cent to 25 per cent. That was a strong indication that real interest rates had been effective in stimulating private savings, as Table II of SM/82/222 indicated. Quasi-money, representing mainly household savings deposits and savings certificates, had risen at an annual rate of about 40 per cent since 1977/78, and its share in total money had increased from 11 per cent to about 34 per cent.

The staff lacked detailed information on oil policy, the Deputy Director continued. Oil production was recovering from earlier setbacks that had resulted from technical difficulties, but it was not expected to increase rapidly in the coming years, despite reported new discoveries. The principal aim of the authorities' policy was to supply the domestic market first and to export whatever surplus was available. Given the expected increase in demand and the rather modest increase in output, the export surplus was likely to remain low over the next several years and it would consist mainly of those refinery products that were less in demand in the domestic economy. It could be assumed, therefore, that Burma would continue to export some heavy oil.

One Director had drawn attention to the marked slowdown in investment in the coming year, the Deputy Director noted, and he had pointed out that the slowdown was part of an overall policy in response to the external resource constraint. For the period of the Fourth Five-Year Plan, investment would grow by about 7-8 per cent a year compared with 17 per cent during the Third Five-Year Plan. The growth of imports would also be much smaller. The policy had been devised with the intention of keeping the external situation manageable, given that debt service payments were projected to amount to a large share of exports of goods and services. It was true that the relative decline in investment could affect total output growth unless the efficiency of investment was substantially increased. The authorities planned to increase the efficiency of investment: first, by diverting resources to key sectors, i.e., agriculture and light industries, rather than capital-intensive industrial development; second, by expanding the share of rehabilitation investment in total investment, a policy that could yield quick returns, given that much of the capital stock was old; and third, by encouraging the private sector to take up a larger share of investment, a development that could contribute to overall efficiency. Nevertheless, overall growth rates might be lower than expected.

Some speakers had expressed concern about Burma's rising debt burden, the Deputy Director of the Asian Department continued, a concern shared by the staff. Debt service projections indicated that the debt burden was particularly sensitive to the amount of nonconcessional aid. In response, the authorities had drastically reduced the contracting of nonconcessional aid in 1981, and both the Fund and the World Bank had appealed to aid donors to maintain a steady flow of concessional aid. Given such a flow, in conjunction with appropriate policies, Burma should be able to carry the currently projected debt burden because the country had substantial resources. It had a good deal of usable arable land not yet under cultivation, about 80 per cent of the world's known teak resources, large mineral resources, a still largely unexploited, rich marine life, and a relatively skilled population. A further optimistic element was that there was little pressure from population growth in Burma.

Mr. Habib expressed his Burmese authorities' appreciation for the staff's balanced report. They were determined to continue to cooperate closely with the Fund in carrying out their adjustment program and to overcome the country's economic imbalances and payments difficulties in order to maintain the momentum of Burma's economic development that had already significantly increased the well-being of the Burmese people. He thanked the Board for its support, which he would convey to his authorities in Rangoon.

The Acting Chairman made the following summing up:

> Executive Directors were pleased to note that in 1981/82, despite unfavorable external conditions, Burma's output had continued to grow strongly. Inflation had remained low and the balance of payments deficit had been contained within reasonable bounds. Output and productivity in the rice sector had increased rapidly during the previous year with the successful implementation of the Government's rice program and a substantial export surplus was currently being produced.
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> Concern was expressed that, despite the favorable macroeconomic performance, public sector savings had fallen and that, with a sharp increase in public investment, the public sector's overall deficit had continued to rise. In that context, it was emphasized that the strengthening of public sector finance should remain a major policy objective. Efforts to achieve that objective had been complicated

by the recent deterioration in export market conditions that had depressed export earnings, limited the scope for import expansion, and thereby lowered public sector revenues.

In such circumstances, Directors considered it appropriate to pursue a policy of public expenditure restraint for 1982/83 that, combined with efforts to improve revenue collections, would contribute to limit overall monetary expansion. They welcomed Burma's flexible interest rate policies that had contributed significantly to the marked increase in private savings in recent years. It was also important, in their view, to continue the various supply-oriented measures, including ongoing adjustments of official prices, diversification of output, and a flexible import program that would permit, within the constraint of available financing, an adequate supply of raw materials and spare parts. In all of those respects, the performance of the State Economic Enterprises would be crucial.

Directors noted the need for an expanded investment program in the longer run to maintain the momentum of Burma's development and stressed the importance of domestic resource mobilization to provide for adequate financing of investment. It was equally important, in their view, to achieve sustained export growth through greater diversification and appropriate pricing policies in order to meet import requirements, while maintaining a sustainable external position.

Noting the rapid rise in the external debt service ratio in recent years, Directors stressed the importance of prudent external debt management. In particular, the authorities' policy of carefully scrutinizing new investment projects and maintaining a tight limit on external nonconcessional borrowing was supported.

The Executive Board then took the following decisions:

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision in concluding the 1982 Article XIV consultation with Burma, in the light of the 1982 Article IV consultation with Burma conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Burma maintains restrictions on payments and transfers for current international transactions in accordance with Article XIV as described in SM/82/222 and SM/82/226. The Fund welcomes the efforts made by the authorities to maintain a flexible policy with regard to the foreign exchange budget for cash imports in the present difficult external circumstances.

Decision No. 7273-(82/163), adopted
December 20, 1982

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request by the Government of Burma for a purchase of the equivalent of SDR 25.6 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

2. The Fund approves the purchase in accordance with the request.

Decision No. 7274-(82/163), adopted
December 20, 1982

3. COSTA RICA - STAND-BY ARRANGEMENT, AND EXCHANGE SYSTEM

The Executive Directors considered a request by Costa Rica for a stand-by arrangement equivalent to SDR 92.25 million (EBS/82/214, 11/29/82; and Cor. 1, 12/13/82), together with a staff paper on Costa Rica's exchange system (EBS/82/213, 11/29/82).

The staff representative from the Western Hemisphere Department made the following statement:

> I would like to report that last week the Costa Rican authorities and the Steering Committee, representing 180 international banks, reached an agreement, in principle, regarding the payment of past due interest and interest falling due in 1983. Costa Rica has agreed to pay next year to the banks all past due interest as well as interest falling due during the year. In turn, the banks have agreed to grant Costa Rica a trade credit facility, of a revolving nature, in amount equivalent to 50 per cent of the total payments made by Costa Rica to the banks during 1983. It is estimated that this credit facility will be equivalent to about 80 per cent of total past due interest owed to banks. There are also good indications that an extension through the end of January 1984 will be granted by banks to Costa Rica on the principal falling due in 1983. We have been informed that the Costa Rican authorities and the banks will be meeting shortly to finalize their agreement regarding interest payments, the trade credit facility, and the extension of payments of principal. Negotiations on a definitive rescheduling of principal, including past due principal, will be taking place during the course of 1983. These arrangements are broadly in line with what has been assumed in the program. Regarding bilateral debt, a Paris Club meeting has been tentatively scheduled for January 17, 1983.

Mr. Senior made the following statement:

I would like to express the appreciation of my Costa Rican authorities for the excellent work done by recent Fund missions in relation to the request for use of Fund resources under a stand-by arrangement. The authorities are quite convinced that substantial adjustment of the economy is essential at the present juncture, and they are determined to implement a stabilization program that should set the basis for more normal and sustained growth in the medium term. The Fund staff has been very helpful in the formulation of such a program.

The current economic and financial situation of Costa Rica is critical. This crisis has its origin in the external developments of 1978-79, when the prices of Costa Rica's main export products seriously deteriorated, while the prices of imports, especially oil, increased substantially. At the same time, the social and political situation in the Central American region started to have its effect on capital flows, and interest rates made the burden of an increasing external debt practically unsustainable. More recent external developments have accelerated the crisis, which has been deepening over the last 18 months.

However, it must be said that the current situation is also in great part due to internal factors and accommodating policies that aggravated substantially an already serious economic and financial deterioration. Serious efforts were made to redress the situation--through the adoption of a two-year stand-by arrangement in March 1980 and a three-year extended arrangement in June 1981--but perhaps the cost and the magnitude of the required adjustment were not perceived in their entirety from the beginning. Thus, both efforts supported by the Fund were very rapidly overtaken by unforeseen developments, causing the programs to depart significantly from the original targets and quantitative performance criteria. A case in point is the extended arrangement, which went off track only two months after its approval. The main objective of this program was to strengthen the external position of Costa Rica and to set the stage for medium-term growth. A crucial element was the maintenance of a flexible exchange rate policy to ensure the achievement of the program's short-run balance of payments objectives. Traditionally, Costa Rica has operated with a fixed exchange rate regime, and its experience with a floating system had, at the inception of the extended arrangement, been very limited. More importantly, the change to the new system occurred when Costa Rica was perhaps less able to sustain it, given the size of its economy, its level of international reserves, and the uncertainties that arose with the political turmoil in the region and other external developments already mentioned. Thus, almost immediately after the program started, the colón was subjected to strong speculative pressures, which resulted in a much larger than envisaged depreciation. This immediately had significant effects on the public sector deficit, import prices, and credit needs, which practically made compliance with the agreed criteria impossible, and also brought about social and political pressures for large wage increases and exchange rate guarantees. Maybe more significantly, the very large depreciation of the colón that ensued, more than offset the positive effects of rate increases on the revenues of the public sector enterprises, giving rise to very large deficits in these enterprises.

I wish to clarify that it is not my intention to minimize or perhaps justify past performance. On the contrary, I wish to bring out the positive aspects of a negative experience, and to highlight the much more solid grounds on which the present effort is to be sustained. At present, Costa Rica's experience with a floating exchange rate regime is, indeed, much richer, and the exchange market has gradually shown greater stability. As stated in the staff paper, the current spread between the bank rate and the free market rate is of the order of 15 per cent, quite smaller than the more than 50 per cent spreads observed at the beginning of this year; and the program contemplates that such a spread will be narrowed to no more than 2 per cent by the end of the program period. At the same time, the crisis itself has brought about a greater awareness of the need and urgency for determined adjustment efforts; thus the political perception and climate for adopting and implementing strong measures clearly have improved. I should mention that in an open and democratic society such as Costa Rica's, adoption of such measures may not always be easy even when the authorities are determined, as proven by the experience with some measures and policies related to the last program.

The present Administration, which took office in May 1982, is determined to redress the serious economic and financial deterioration. In the view of the Administration, given the severity of the current crisis and the long-standing structural problems that have hindered growth and rendered the Costa Rican economy more vulnerable to external developments, the attainment of a satisfactory and sustainable internal and external situation can only be achieved in a period of more than one year. Thus, the authorities consider that an adjustment program can be considered appropriate under these circumstances only if viewed in a medium-term context. And a program based on demand management policies alone could only be accepted if there were reasonable expectations that once the critical period is over, the basis could be set for the required structural reform that would render the productive structure of the country adequate enough to resume the process of growth on a sustainable basis. The authorities are well aware, however, that it is essential first to cope with the most immediate problem, and they have decided to implement a one-year emergency adjustment program, for which the Fund's support has been requested. But at the same time, the authorities now have indicated their intention to negotiate a three-year extended arrangement with the Fund at the outset of this emergency program.

The program, adopted by the authorities on an emergency basis, is comprehensive and even ambitious. In a forceful and even speedy way the authorities are determined to tackle the fundamental short-term problems of the economy and to set the basis for more structural reforms in the future. Some of the measures included in the program are indeed already directed toward the medium-term problem. The program clearly deserves the Fund's support.

The program is detailed in the staff paper, so there is no need to repeat all its different aspects. Nevertheless, I should mention that this program is a continuation of the adjustment effort initiated by the new Administration since it took office in May. Indeed, in 1982 practically all of the measures contemplated in the program have already been adopted and are being implemented; or they have already been approved this year to become effective in 1983. Thus the adjustment effort will take effect even in the present year. As mentioned by the staff, the overall nonfinancial public sector deficit will be reduced in 1982 to 9 1/2 per cent of GDP, compared with a deficit of 15 per cent of GDP in 1981. Public sector savings will be increased by the equivalent of 3 per cent of GDP in 1982 in relation to 1981. The current account deficit of the balance of payments is being reduced to 8 per cent of GDP in 1982, compared with more than 11 per cent of GDP in 1981. Imports in nominal terms in 1982 are estimated to be more than 30 per cent less than in 1981 and more than 50 per cent less than in 1980. Of course, this adjustment has been accompanied by increasing arrears, negative overall growth rates, and increasing inflation.

In general terms, the program's objectives are to contain inflationary pressures, to promote an orderly development of the exchange rate, and to facilitate the resumption of foreign public debt service payments. The main targets for 1983 are to reduce the overall nonfinancial public sector deficit to no more than 4 1/2 per cent of GDP, increase public sector savings by the equivalent of 5 per cent of GDP, reduce domestic bank financing of the nonfinancial public sector by the equivalent of 2 per cent of GDP, and significantly slow down the inflation rate, from about 95 per cent in 1982 to about 55 per cent in 1983.

The centerpiece of the stabilization program is the adjustment effort to be implemented in the fiscal field. As indicated by the staff, the Central Government's operations have improved significantly in 1982, and it is envisaged in the program that they will be further strengthened in 1983, with the deficit being reduced to 2 per cent of GDP, compared with 5 per cent of GDP in 1981. This further improvement in 1983 is to be achieved on the basis of increased revenue yields (reflecting a depreciated exchange rate), new income from a tax surcharge on corporate income, and the extension into 1983 of taxes introduced in 1982. At the same time, current expenditures in real terms are to be further decreased, by 5 per cent, in 1983, after a reduction of 16 per cent in 1982.

The main adjustment effort in the public sector, however, is to be carried out in the decentralized public institutions, with major increases in contribution rates and in tariffs and prices charged by state enterprises. At the risk of being repetitive, it is worth mentioning the most important of these adjustments:

- Social security contributions were increased by 4 per cent.

- The state-owned refinery's exchange rate subsidy was abolished in mid-1982, and domestic prices of oil derivatives were increased by 66 per cent in July 1982.

- Public transportation fares were increased, with a doubling of bus fares in San José.

- The National Electricity Board increased by 15 per cent the domestic prices of petroleum products, effective January 1, 1983; and it also adopted a mechanism for automatic adjustments in the prices of oil derivatives and electricity rates for changes in the domestic cost of oil imports.

- Electricity rates were increased by 70 per cent in June 1982, and by a further 90 per cent in monthly cumulative increases starting November 1982.

- Water and sewerage rates were increased by 95 per cent in seven cumulative monthly increases, starting July 1982.

- Telephone rates were raised by 55 per cent effective November 1982.

- Subsidies originating from the sale of wheat were eliminated in 1982.

These increases are, indeed, a very significant adjustment, and and it is estimated that current savings of public sector enterprises will increase to a positive 3 per cent of GDP in 1983 from a negative 3 per cent of GDP in 1981. Taking into account all adjustments since the new Administration took office in May 1982, an illustrative sample of total adjustments in rates and prices is the following:

	Increase Since May 1982 to Date	Increases in 1983	Total Increases
	(In percentage changes)		
Electricity	87	75	227
Telephone	55	--	55
Railroad transport	95	22	138
Water and sewerage	153	46	270
Oil derivatives	80	15	107

In the monetary area, the reduced requirements of the non-financial public sector for net credit will allow an increase of 50 per cent in credit to the private sector. The program as a whole is designed to avoid further losses in net international reserves.

An important part of the monetary program is the significant adjustment made in interest rates. The basic rates on six-month deposits, to which most lending and deposit rates are related, was increased by 3 1/2 percentage points to a level of 25 per cent. While these rates are still negative in real terms, they are well above international levels and signify a basic movement toward adjustment. The authorities consider, in this regard, that in the current circumstances of Costa Rica, immediate adjustments to positive real rates would have a significant negative effect on the objective of gradually reactivating economic activity; and it would also make it much more difficult to bring down the inflation rate to an acceptable level. The authorities consider that their policies and efforts will succeed in moderating demand pressure and, more important, in changing expectations. Thus they consider it appropriate to adjust interest rates on the basis of expected inflation and of the changes in confidence that would come about with the success of economic policy. In this regard I should recall our recent discussion on interest rate policies in developing countries, where this issue was given much attention by Directors. I would like to quote from SM/82/213, where it stated: "This consideration is particularly relevant when the interest rate reform is being adopted as part of a comprehensive set of policies of structural adjustment and stabilization. Under these circumstances, it may be advisable to gear interest rates not to the current rate of inflation but to the rate of inflation that is expected to prevail as the new policies take hold. Such an approach is likely to be successful if the authorities are viewed by the public as carrying out a program based on realistic objectives, which is steadfastly adhered to, while sufficient flexibility is being maintained to counteract unforeseen difficulties." The Costa Rican authorties have indicated that they maintain a flexible approach to interest rate adjustment, and that they will take further measures if necessary.

The authorities' external sector policies, which are related to the monetary program, involve a commitment to the unification of exchange rates within the framework of a flexible exchange rate system. In this regard the authorities are committed to unify the banking rate and the free market rate during the program period. As mentioned before, since the inception of the last extended arrangement to date, there has been quite a significant improvement in the stability of the exchange market. The new Administration has determinedly moved toward the achievement of an orderly market, and gains have indeed been substantial.

To conclude, I would mention that an essential part of the stabilization program and effort of the authorities is the normalization of relations with foreign creditors. The rescheduling of the external debt and the elimination of external payments arrears are given the highest priority by the authorities, and considerable time and effort have been put into the negotiations. Nonetheless, it should be clear that these negotiations take more time than any of the parties would wish, given the complexity of the problem and the great number of parties involved. The Costa Rican authorities have made much progress toward concluding these negotiations; agreement has been reached in principle between the banks and the authorities on the rescheduling of the public external debt with foreign commercial banks. Specific provisions have been introduced in the program to take account of any delay in the rescheduling negotiations.

Mr. Taylor said that his authorities were concerned about the length of time since the previous Article IV consultation with Costa Rica. It was particularly surprising that, despite the breakdown of two successive programs and despite the series of contacts between the staff and the authorities since then, the Board had been given no opportunity to explore the reason for the breakdown in the context of an Article IV discussion. The communications that the Board had received concerning the exchange rate system were welcome, but they were not substitutes for a proper discussion of Costa Rica's exchange rate policies. The external circumstances confronting the economy had admittedly been difficult during the period, but in such circumstances the need for active Fund surveillance in the fullest sense increased, not diminished.

Nevertheless, the authorities and the staff should be congratulated for managing to put together a courageous and well-devised emergency stand-by program in difficult circumstances, Mr. Taylor continued. A one-year stand-by arrangement was the appropriate vehicle for a strong effort at stabilization to overcome the serious economic and financial crisis in Costa Rica. The right lessons seemed to have been drawn from the disappointing performance under the 1981 extended arrangement. The experience of Costa Rica and of other Fund members facing pressing and basic economic difficulties in the previous eight months suggested that, in the more acute cases, a prior period of stabilization, supported by a one-year stand-by arrangement, was more likely to set the scene for a successful multiyear program.

The focus in the proposed program was on a strong fiscal effort in 1982 and 1983, Mr. Taylor noted, supported by a more flexible monetary policy and by some reform in exchange rate policies, together with firmer wage restraint. The combination was appropriate in the circumstances, as was the fact that the stabilization effort had been placed in a medium-term perspective. He agreed with the staff that the severity of the crisis would require more than one year of continued restraint to restore internal and external balance. There were evidently serious structural maladjustments in the economy and they would have to be tackled in due course. It would, therefore, be helpful if the next Article IV consultation report described more fully the nature of the structural changes required with reference to expanded assistance from the World Bank through a structural adjustment loan, and with reference to assistance from other major sources.

Commenting on fiscal policy, Mr Taylor suggested that the target of halving the deficit of the nonfinancial public sector to 4.5 per cent of GDP was ambitious. He recalled the previous slippages in fiscal performance under the 1980 and 1981 programs, and he urged the authorities to do everything they could to achieve the target. Among a number of encouraging developments, it was particularly noteworthy that legislative approval had been secured for the new taxation measures on trade and property. Those measures, combined with the effect of the depreciation of the colón on revenue from export taxes, offered the best prospect for strengthening the revenue base. He noted, with approval, the strengthening of the powers of the budgetary authority in consolidating its control over public expenditure since 1980 when the staff had first encouraged its establishment. The major steps that had been taken in the previous six months to reduce subsidies and to reorganize various public sector tariffs and charges were welcome. The tariffs should continue to reflect any major exchange rate adjustments, and they should not be allowed to decline in real terms. It would also be important to ensure that public sector wage increases were contained within limits that the country could afford.

With reference to monetary policy, Mr. Taylor welcomed the authorities' intention to adjust interest rates, both to boost domestic savings and to assist resource allocation in the longer term. Progress in that area should be a key element in the mid-term review. Achievement of positive real interest rates would be desirable in any program focusing on structural adjustment. At the moment, interest rates were still negative in real terms, but the steady decline in the rate of inflation expected during 1983 should enable the real differential to be reduced. The staff's proposal for a reform of the financial system to ensure a more efficient allocation of financial resources deserved strong support. The dismantling of the exchange rate guarantees was also an important step in that direction.

It was disappointing, Mr. Taylor considered, that the program did not contain a commitment to eliminate exchange arrears completely in 1983. He recognized that the arrears were considerable and that the foreign exchange position would depend in part both on the level of bilateral support and on progress in the negotiations with the commercial banks for debt relief, both of which were still uncertain. He welcomed the staff's announcement that agreement had been reached on some important elements of the debt rescheduling. If rescheduling produced a greater availability of foreign exchange than had been projected, he strongly urged the authorities to reduce arrears faster and further than planned.

With a debt service ratio of over 60 per cent in 1982, unlikely to be reduced much in 1983, Costa Rica clearly had a burden of external obligations among the heaviest of any Fund member, Mr. Taylor noted. He agreed with the authorities' statement in the letter of intent that heavy utilization of short-term loans had been particularly responsible for the present difficulties. Therefore, it might have been better if the program had included an undertaking to limit short-term borrowing for general balance of payments purposes. As his chair had observed on other occasions, limiting the borrowing ceilings to medium-term maturities offered the authorities an inducement to switch to greater reliance on short-term borrowing. In Costa Rica's case there had been a succession of programs with medium-term and long-term external borrowing ceilings. In the formulation of Fund programs, the staff should consider more closely whether ceilings should be introduced for short-term general purpose credits, since continuously rolled over short-term debt, while possessing some of the desirable characteristics of medium-term debt, brought with it additional dangers.

The commitment to move toward a unified exchange rate during the course of the stand-by arrangement was welcome, Mr. Taylor commented, although it might prove difficult initially in view of the foreign exchange shortage. The staff was right to recommend approval under Article VIII only until the midyear review. In recent weeks the differential between the free market rate and the banking rate had widened further than had been indicated in the paper. Did the staff have more recent information on the differential between those rates of exchange? Was it correct that the official rate would be merged with other rates as part of the planned reform?

Since the Board was dealing with a country that had a significant private sector and high external debt, Mr. Taylor suggested that it would be useful in such cases to have some information on direct investment flows and some reference to the authorities' policies in the area of inward direct investment. In particular, it would be helpful to know what steps the authorities were taking to encourage foreign participation in industry and what role such inflows could play in the future financing of the balance of payments.

Mr. Teijeiro said that the Costa Rican authorities should be commended for having already taken a number of important measures. However, interest rates remained low relative to current inflation. For almost two years, the monthly inflation rate had averaged about 5-6 per cent. Recently, the interest rate had been raised to about 2 per cent a month. What really mattered in terms of interest rate policy was expected inflation rather than past inflation. It was doubtful whether expectations could be reduced so quickly and so drastically as to render the current interest rate policy appropriate. If expectations of inflation did not improve significantly at the beginning of the program, interest rate policy could work against the program's success. In particular, private capital movements could behave negatively, as they had done since 1980, damaging confidence in the program and putting great pressure on the exchange market, possibly making adjustment even more painful than it had been so far. The economy could not be revived through negative interest rates. Money was fungible and it was impossible to ensure that an expansion of credit to the private sector at negative rates of interest would be invested in the country instead of financing capital outflows. Only confidence in the future economic and political developments in the country would produce the recovery. Therefore, it might be better for the adjustment of the Costa Rican economy if the authorities were to be more pessimistic about the reduction of inflation expectations in the short run, to adjust interest rates accordingly at the outset, and to be ready to reduce interest rates quickly if the pessimistic assumption proved wrong.

He had reservations about the proposed increases in taxes, Mr. Teijeiro noted, because, once tax increases had been sanctioned, they were difficult to reverse. Therefore, an increase in taxes aimed at solving a deficit arising from temporary causes would ultimately finance a permanent increase in the role of the public sector. Once the economy recovered, the associated increase in revenues would permit the financing of a permanent increase in public expenditure, not an unusual outcome in developing countries. Perhaps the public sector's financial situation should be judged on the basis of a concept similar to the "full employment" deficit or surplus. Debt financing would then be used for transitory deficits arising from a fall in revenues caused by a recession. Although less credit would be available to the private sector in such circumstances, an equivalent amount of additional disposable income would be made available. Crowding out of the private sector was determined by total expenditure, not by the way the expenditure was financed. He invited the staff to comment on those points.

Mr. Suraisry stated that he was disappointed that there had not been an Article IV consultation with Costa Rica since early 1980. As a result, Executive Directors had not had a chance to comment on the performance of the economy since the collapse of the extended arrangement in mid-1981 and to indicate their opinions about the degree of adjustment that might be needed. EBS/82/214 described Costa Rica's performance under the extended arrangement:

> The EFF arrangement had been inoperative since August 1981, only two months after its approval by the Executive Board. Major departures from the program included noncompliance with the commitment to pursue a flexible exchange rate policy; intensification of restrictions on current international payments, including the accumulation of large payments arrears; and nonobservance of the ceilings on the net domestic assets of the Central Bank, the limits on the nonfinancial public sector deficit, and the balance of payments test.

EBS/81/123 (6/4/81) described performance under the previous stand-by arrangement:

> Performance under the stand-by program fell short of expectations in 1980. Costa Rica exceeded the credit ceilings shortly after purchasing the first credit tranche (plus supplementary financing), and, as of the end of 1980 the ceiling on the net domestic assets of the Central Bank was exceeded by about ₡ 1 billion and the ceiling on the Central Bank's net credit to the nonfinancial public sector was exceeded by ₡ 1.1 billion. As of the same date, the limit of US$300 million on the net use of foreign credit by the public sector was exceeded by US$40 million.

Those passages from the staff reports revealed two aspects of Costa Rica's performance under Fund programs in the past. First, Costa Rica had deviated substantially from the quantitative criteria set in the programs; and second, it had done so almost at the inception of those programs, after it had made the initial purchases following Board approval. Such a poor track record cast serious doubts about the ability of the authorities to implement effectively any new program with the Fund.

Apart from the issue of Costa Rica's poor track record in implementing Fund programs, Mr. Suraisry continued, the proposed program for 1982-83 contained a number of optimistic assumptions that would probably not materialize, thus leading to the collapse of the program as had happened to earlier programs. The projections regarding the balance of payments outcome in 1983, shown in Table 6 of EBS/82/214, were particularly worrisome. The program assumed that the authorities would succeed in obtaining a substantial rescheduling of their debts and arrears to both private and official creditors during the program period. For example, it was assumed that arrears would be reduced by about $1.2 billion in 1983. For that to happen, it was assumed that there would be a rescheduling of arrears in principal of $638 million, as well as what was called "contingent financing" of about $540 million. Those amounts were in addition to other official loans and debt relief. Given the hesitancy of the commercial banks to lend in general, due to the difficult international financial environment, and given Costa Rica's bad record in dealing with them, he did not believe that the program's projections would materialize, despite the fact that the staff had announced that an agreement between Costa Rica and some banks had been worked out.

Commenting on the exchange rate system, Mr. Suraisry remarked that there had been a lack of serious reform during the period of the program. Costa Rica's exchange system contained a number of multiple currency practices, but all that the program proposed was an eventual unification of the banking exchange rate and the free market exchange rate, with the narrowing of the spread between those rates from 15 per cent at the beginning of the program period to no more than 2 per cent at the end. Given the Fund's experience with Costa Rica, a schedule for the reduction should have been provided, the implementation of the schedule should have been made part of the performance criteria, and it should have been tied to the phased purchases.

It had been agreed that wages in the public sector would be increased during the program period, Mr. Suraisry noted. In light of an inflation rate of 95 per cent, the severity of the economic crisis, and the lack of confidence in the economy, the timing of the wage increase was not justified. The program was a test period and should not involve any action that might jeopardize the results. The increase in public sector wages clearly ran the risk of doing so. As a result of Costa Rica's poor track record with the Fund, and because of the weaknesses in the structure of the proposed program, he opposed the request.

Mr. Robalino observed that in recent years Costa Rica's economy had experienced serious difficulties. A number of factors had led to a deterioration of $456 million in the balance of payments in 1981 and to a worsening of the public external debt to almost $3 billion by the end of 1981; they included the most recent oil shock, the decline in international coffee prices, and the high public sector deficit relative to GDP, together with large payments arrears.

The authorities, well aware of the difficult situation, had taken immediate effective short-term measures, Mr. Robalino continued. First, they had restrained expenditures of the Central Government so as to reduce expenditures in real terms by 16 per cent in 1982 and a further 5 per cent in 1983; second, they had adjusted public enterprise tariffs, the major financial mechanism for improving the liquidity position of the nonfinancial public sector; and third, they had increased domestic food prices and taxes, measures that were to take effect at the beginning of 1983. Those measures would, in principle, contribute to reducing the overall public sector deficit from 15 per cent of GDP in 1981 to 9.5 per cent of GDP in 1982. A major effort would be needed by the authorities to strengthen fiscal policies by sharply reducing and controlling expenditure and by increasing revenues, as mentioned in paragraph 5 of the letter of intent.

The decision to eliminate wheat subsidies was welcome, Mr. Robalino said, as was the consideration being given to the partial sale of some of the main enterprises controlled by CODESA--the state-owned development corporation--a measure that would relieve to some extent the financial burden of the public sector. Did the staff or Mr. Senior have any further information on how advanced the studies of that partial sale were?

He fully supported the authorities' intention to stimulate private savings by increasing nominal interest rates, Mr. Robalino stated, and to adjust rates in the future to levels related to the rate of inflation and to movements in interest rates abroad, in order to maintain positive interest rates in real terms. The fact that the colón had depreciated by more than 350 per cent against the U.S. dollar in the previous two years reflected lags in monetary policy that had been creating inflationary pressures and maladjustments in the capital market, including delays in debt rescheduling negotiations. Therefore, he agreed with the authorities' intention to pursue the establishment of an orderly exchange market by unifying the exchange system, a measure that would undoubtedly reduce the financial pressure in the economy and strengthen confidence in the financial system. The progress being made in the negotiations with foreign commercial banks on Costa Rica's external debt was welcome. It demonstrated that the authorities were making efforts and that they were willing to achieve the targets and adjustments necessary for internal and external viability.

Mr. Casey commented that he shared the concern expressed by Mr. Taylor and other Directors that the previous Article IV consultation with Costa Rica had taken place almost three years earlier. It would have been useful to have combined an Article IV consultation with the present request for a stand-by arrangement. It might have provided a better framework within which the serious structural and other problems could have been assessed. However, the present paper contained a good deal of supplementary data, for which he thanked the staff.

The sudden increase in the inflation rate to over 100 per cent in 1981 had not been fully explained, Mr. Casey continued. The rate had accelerated further in 1982. One explanation was the 350 per cent depreciation of the colón against the U.S. dollar over the previous two years. However, the sudden increase in the inflation rate might have been more apparent than real, if prices had already been high before the devaluation and if they had not been measured because they were being paid on the black market. Following the devaluation, the high prices became "official," and they could then be measured. He invited the staff or Mr. Senior to comment on the question of the inflationary impact of devaluation in Costa Rica's circumstances, and on how the process of wage determination affected the expected rate of inflation.

The program for 1982 and 1983 was broadly appropriate, Mr. Casey considered. Given the severity of the crisis in Costa Rica, it was likely to take more than one year to attain a satisfactory internal and external position, and a further stand-by or extended arrangement would probably be required. Mr. Senior had indicated that the authorities would be seeking to arrange a follow-up extended arrangement; that provided a strong incentive to make the proposed stand-by program work.

It was therefore surprising that the proposed program did not have a "Plan B," Mr. Casey remarked, i.e., a series of supplementary measures that might be needed in the event that some of the assumptions did not remain valid. He agreed with Mr. Suraisry that some of the assumptions might be unduly optimistic and that there should have been a contingency plan. The central piece of the adjustment effort was the strengthening of the public sector's finances. It would be important to reduce the overall deficit of the nonfinancial public sector from 15 per cent of GDP in 1981 to no more than 9.5 per cent of GDP in 1982, and to 4.5 per cent of GDP in 1983. Prices and tariffs charged by the state enterprises would clearly need to be adjusted to achieve those targets. He invited the staff or Mr. Senior to comment on whether the Central Government should exert closer control over the state enterprises, since the program envisaged a further strengthening of central government operations.

The deficit of the Central Government had not been especially large in 1981, about 5 per cent of GDP, Mr. Casey observed. It appeared likely that the targets of 3 per cent of GDP in 1982 and 2 per cent of GDP in 1983 could be achieved. Many measures had already been taken by the Costa Rican authorities, or would be taken in 1983, to raise revenues. It was particularly commendable that the salary increases in the public sector would be granted in absolute amounts on the basis of changes in the cost of a basic basket of goods and services. He hoped that the resultant salary increases would be well below the expected rate of inflation, presumably the target rate of 45 per cent for 1983. Would the changing cost of the basic basket of goods and services produce a figure below the 45 per cent expected rate of inflation? And if the expected sharp reduction in the inflation rate was not believed by employees, how did the Government intend to persuade them to accept its wages policy? What was the relationship between wages in the public sector and wages in the private sector--was there a demonstration effect?

It was the intention of the authorities to design a monetary policy that would avoid further losses in net international reserves while providing an adequate amount of credit to the private sector, Mr. Casey noted. They intended to reduce substantially the net demands of the public sector; but it was important to stress that the authorities had little leeway in that regard. While there might be some need for an increase in credit to the private sector, it had to be consistent with the other objectives of demand management policy, i.e., to reduce inflation and to restore the balance of payments to a sustainable position. The authorities had raised the basic lending rate from 18 per cent to 25 per cent, and other rates had been raised. However, it appeared to be the authorities' intention to continue to adjust interest rates on the basis of present expectations regarding the inflation rate. The ultimate objective was to establish or move toward positive real interest rates; there remained a long way to go in that regard, despite the fact that the inflation rate was expected to come down significantly.

The onerous debt servicing difficulties facing Costa Rica were particularly striking, Mr. Casey commented. At 62 per cent, the debt service ratio was one of the highest among Fund members. The authorities' current difficulties had arisen from inappropriate policies in the recent past, and consequently it would be of the utmost importance that they limited their recourse to external borrowing. Costa Rica's public external debt had risen from less than $1 billion in 1977 to almost $3 billion by the end of 1981. In that respect, it was fully appropriate that a limit of $100 million had been placed on the contracting of new public and publicly-guaranteed external debt of one to ten years' maturities, and that a sublimit of $50 million had been applied to debt of one to five years. However, it did not appear that there was any provision to discourage borrowing in maturities of less than one year, a point that Mr. Taylor had repeatedly made in the Board. He himself had believed that there had been some consensus in recent Board discussions to close that type of loophole, and he invited the staff's comments on the amount of short-term borrowing and on whether the performance criteria should have covered maturities of less than one year.

He wholly endorsed the intention of the authorities to reduce external payments arrears in 1983, Mr. Casey continued, and he had been encouraged by the staff's announcement in that regard. It was a priority area if the authorities wished to normalize relations with foreign creditors. Furthermore, it would be essential for the success of the program that the authorities concluded negotiations on the rescheduling of their public external debt with foreign commercial banks, and that they rescheduled debt owed to official bilateral creditors. Table 6 of EBS/82/214 showed that the capital account projection for 1983 included an estimated inflow of $285 million. That inflow included disbursements of $100 million from the United States under the Caribbean Basin Initiative, $60 million from the World Bank, and $15 million from the Inter-American Development Bank. Did the staff or Mr. Senior have any information on where the remaining $110 million would come from? It was important for the Board to have that information, to be assured that the current account deficit and the intended reduction in arrears could be financed.

The authorities' intention to unify the exchange rate at more realistic levels was welcome, Mr. Casey stated, as it would result in a more efficient allocation of foreign exchange and contribute to ensuring that exports remained competitive. The authorities intended to reduce the spread between the banking rate and the free market rate to no more than 2 per cent by the end of the program. Was that related to the Fund's legal definition of a multiple currency practice? He noted the existence of three multiple currency practices and one exchange restriction.

Mr. Grosche noted that Costa Rica was facing an acute economic and financial crisis, illustrated by the fact that external payments arrears and debt service payments had reached $865 million in June 1982, equivalent to 85 per cent of export receipts. Public external debt had risen to more than $3 billion, and the debt service ratio had risen to more than 60 per cent. The inflation rate was about 100 per cent. The proposed stand-by arrangement was a one-year emergency program, an approach that he welcomed.

However, the disappointing outcome of the extended arrangement program, which had become inoperative soon after it had been approved, created some doubts about developments in Costa Rica in the near future, Mr. Grosche considered. The crisis had been aggravated by inappropriate policy measures. Apart from halfhearted actions, the announcement of the suspension of foreign debt service payments had led to an exhaustion of normal credit lines, thus worsening the situation. The new Administration was showing a stronger commitment to solving the problems in a realistic way. The immediate actions that the authorities had taken to reduce the fiscal deficit by raising taxes and tariffs and by reducing subsidies were welcome. It was particularly encouraging that those measures had already been approved by Parliament. The authorities' intention to narrow the spread between the exchange rates so as to lead eventually to unification during the program period was also welcome, as was the aim of increasing interest rates to more realistic levels. However, the increase in the basic lending rate to 25 per cent was 75 per cent below the current rate of inflation and 25 per cent below the authorities' expected rate of inflation for 1983. Why had the staff not urged faster action to bring interest rates to positive real levels?

Tariff increases in parastatal services were appropriate to reduce the public sector deficit to the planned level, Mr. Grosche commented, but they might not be sufficient to reflect properly the relative scarcity of resources in Costa Rica. Did the staff believe that those prices would be kept in line with increases in the general price level? In that context, he shared some of Mr. Casey's concerns regarding wages policy. Since water and electricity prices were to be included in the basket for indexing wages, and since public sector tariffs should be kept in line with inflation, how could the staff expect that salary increases would be well below the rate of inflation?

The external financing of the prevailing current account deficit was a matter of concern, as Mr. Suraisry had suggested, Mr. Grosche continued. The staff stated optimistically that the overall balance of payments would move into equilibrium in 1983. The predicted current account deficit of $285 million was to be financed exclusively by official capital inflows from the World Bank, by bilateral agreements, and by the request under discussion. The question arose how the deficit would be financed in 1984 and beyond, after the disbursement of the funds provided under the stand-by arrangement.

He shared the concerns of those Directors who had remarked on the length of time since the previous Article IV consultation with Costa Rica, Mr. Grosche stated. It had been three years since that consultation, and the Board was considering the third successive request within that period. In general, the relevant background information about a country's economic developments should be provided before a program was brought to the Board. Why had the staff not done so, given that there had been extensive contacts between the staff and the Costa Rican authorities during that period? The Board should be given the opportunity to discuss Costa Rica's situation in an Article IV consultation at least by the time of the mid-term review.

Mr. de Vries suggested that Costa Rica was a dramatic example of an economy out of control. The debt service ratio was more than 60 per cent, the current account deficit would reach 15 per cent of GDP in 1982, at which point, as Directors had seen in other cases, economic stagnation resulted. The program called for a drastic reduction in demand through emergency budget measures. GDP had already fallen 10 per cent, and as a result of the program, it was not expected to increase in the coming year. Strong measures had been taken to improve the situation, and the program deserved the Board's support on those grounds. If carried out, the measures represented very significant changes in policy.

He shared the doubts that had been expressed, particularly by Mr. Teijeiro, with regard to monetary policy, Mr. de Vries continued. Interest rates were negative and they were expected to remain negative in the coming year, even if the inflation rate improved. But the procedure of setting interest rates at a negative level, while hoping that inflation would come down in order to move to positive interest rates, was open to question. Directors had seen a number of programs in which such expectations had not come about, as he had mentioned in the discussion of interest rate policies in developing countries (Seminar 82/9, 12/10/82). The program placed a good deal of reliance on private savings and investment, a reliance that could not be justified if interest rates remained so negative. Such rates also created difficulties with regard to international capital movements.

The exchange rate measures were welcome, Mr. de Vries remarked, although it was unclear why two exchange rates should be kept in existence and why the intention was to narrow the gap to only 2 per cent. It could only be explained in the context of a lax monetary policy. Negative interest rates encouraged people to borrow, to make inflationary profits, and, perhaps, to send money abroad, thus influencing the exchange rate.

The new program was an emergency program, intended to be contractionary in the short run, Mr. de Vries noted. It was, therefore, not clear how the economy would begin to grow in the medium term. A reduction in demand was supposed to come about through a reduction in the public sector deficit but, as Mr. Teijeiro had pointed out, the question of a "review" of the level of expenditures and taxation was relevant. That medium-term question could be addressed in greater detail in papers that the Board might expect to receive in the context of an Article IV consultation or mid-term review.

The revival of the economy was based on the hope that the private sector would begin to function again, Mr. de Vries observed. Mr. Senior had correctly referred to the adverse effects of the social and political situation in Central America, which had not contributed to stable economic development. In that context, what was the likelihood that the private sector would revive? Was there not a risk that demand would be reduced, simply creating idle capacity and unemployment, while hoping for the private sector to take off, a development that might not occur because of circumstances largely beyond the control of the authorities? Furthermore, the private sector would not revive in the absence of stable and predictable economic policies.

There had to be confidence that the program as presented to the Board would in fact be carried out, Mr. de Vries continued. A number of areas were critical, including the level of expenditure, taxation, interest rates, the exchange rate, and foreign debt. At the moment, a flexible exchange rate appeared to be the appropriate policy but, from a longer-term perspective, it might be more sensible to gear economic policy and the exchange rate policy toward the U.S. dollar, an issue that could be relevant for other small economies in the area. The foreign debt situation was particularly difficult, creating doubts as to whether the program would be adequately financed. The position of countries like Costa Rica was not altogether dissimilar from that of larger countries like Brazil and Mexico, and the question therefore arose of the appropriate role for the Fund management and staff in relation to other sources of external financing. Perhaps that general question could be discussed by the Board at a later date.

Miss Le Lorier commented that the prospect of a new arrangement with Costa Rica was welcome because it involved the resumption of financial relations and cooperation with the Fund after an interruption of almost six months. The change to a one-year stand-by arrangement from the original extended arrangement was appropriate in the present circumstances. However, in view of the protracted nature of the difficulties facing Costa Rica and the seriousness of the imbalances in the economy, she hoped that a follow-up program, perhaps in the framework of a new extended arrangement, would be sought. She looked forward to a fruitful and extended period of close cooperation between Costa Rica and the Fund to find solutions commensurate to the size of the problems being experienced not only by Costa Rica but by many other countries in the region.

EBS/82/214 made clear that implementation of the program in the months ahead would play an essential role in laying the groundwork for the medium-term stabilization of the economy, Miss Le Lorier continued, and, perhaps as important, for stimulating confidence in the private sector and in the international financial community. The program correctly emphasized the crucial role of fiscal policy in achieving the required stabilization. There were indications, on the basis of estimated data for 1982, that the authorities' objective of reducing the deficit of the nonfinancial public sector was attainable. Did the staff have any recent information that might confirm the apparent trend?

A key aspect of the program would be the ability of the authorities to maintain the present momentum with regard to the reduction of the overall public sector deficit from its current level to 4.5 per cent of GDP in 1983, Miss Le Lorier considered. In contrast to the adjustment undertaken in 1982, which had reflected essentially the effects of expenditure restraint, adjustment in 1983 would hinge on the ability to raise new revenues and to make the current operations of state enterprises profitable again. In that regard, she was particularly interested in the staff's replies to the questions raised by Mr. Casey. A return to financial balance by the state enterprises was a necessary condition of a lasting and sustained improvement in public finances. In the previous year, those enterprises had accounted for the largest part of the imbalances of the overall public sector and there was therefore substantial scope for adjustment. The staff appraisal had not paid sufficient attention to that aspect of the financial situation of the public sector; the problem of state enterprises had only been mentioned indirectly in the context of energy prices and water rates. Perhaps there was no need to insist on close monitoring of the position of the state enterprises if the recent increases in public tariffs were considered sufficient to bring about the expected improvement, but that had not been clearly brought out in EBS/82/214; she invited the staff to comment further on the question.

The revenue-raising measures were appropriate, Miss Le Lorier went on, except, perhaps, in relation to the proposed exchange rate policy. The revenue measures for 1983 included the extension of a tax on exports based on the existing exchange rate differential. To what extent was that extension consistent with the authorities' plan to narrow the spread between the present exchange rates and, eventually, to unify those rates in the course of 1983? It would seem that progress toward unification of the two rates would be at the cost of progress toward a better fiscal balance. Could the staff comment on that point?

Apart from the exchange rate issue, Miss Le Lorier observed, the most pressing problem on the external side was the conclusion of a satisfactory agreement on the rescheduling of external debt and the phasing out of arrears. Negotiations with commercial banks had progressed at a slower rate than expected, and the announcement made by the staff was therefore particularly welcome. She hoped that the remaining aspects--the rescheduling of principal--would be dealt with as speedily as possible in 1983. She welcomed the obligation of the Costa Rican authorities to match, by an equivalent increase in official reserves, any further increase in arrears that might arise in the absence of a timely agreement on the rescheduling of public external debt. Although that would allow Costa Rica to continue to comply with the balance of payments test, it might be necessary to revise the present balance of payments projections, particularly with regard to capital inflows and the ability to sustain a sufficient level of imports. The issue underlined the importance of a prompt return to normal and satisfactory relations between Costa Rica and the international financial community. She noted that the authorities themselves attached due importance to that point. Working out a satisfactory settlement of the external debt situation and bringing the overall public sector back to reasonable balance would constitute two major tests for the program; she looked forward to positive results on both accounts.

It had been suggested by some previous speakers that two additional performance criteria might have been included in the program, Miss Le Lorier noted, namely, a ceiling on borrowing in maturities of less than one year, and a performance criterion related to the payment of arrears. The question of placing a ceiling on short-term borrowing had been discussed in the Board before, when it had been pointed out then that it was extremely difficult to estimate the amount of short-term financing necessary for the orderly functioning of an economy. She could not support a performance criterion for short-term borrowing if it was impossible to assess accurately the appropriate level of short-term financing. Such a criterion would run the risk of being either too generous or too restrictive. As for arrears, it would appear that in Costa Rica's case it would be difficult to place a floor on cash payments on arrears in 1983. The reduction in arrears was to derive from rescheduling arrangements; she could not support a performance criterion that, in effect, involved the Fund in stipulating to creditors the degree of rescheduling required.

In future presentations of developments in countries in which the rate of inflation was 100 per cent or higher, Miss Le Lorier suggested, it might be easier for the reader if some tables were presented in constant prices. The wide fluctuations in nominal values associated with rates of 100 per cent or more made comparison from one year to another very difficult, hindering the overall evaluation of relevant figures and the perception of effective trends. The use of an appropriate deflator, such as a GDP deflator, would be helpful.

Mr. Dallara stated that he wished to associate himself with the comments made by Mr. Taylor and other Directors concerning the length of time since the previous Article IV consultation with Costa Rica. The Board was searching for ways to strengthen the surveillance process and cases such as that under discussion might provide opportunities to do so. Those cases were subject to the principles and procedures for Article IV consultations and to the Managing Director's special responsibilities and prerogatives under the surveillance principles and procedures.

The Costa Rican authorities had begun to address with realism and decisiveness the serious financial and economic problems that they faced, Mr. Dallara observed. They had taken a number of important steps, particularly in the fiscal and exchange rate areas, but success in overcoming their extremely difficult financial problems would require perseverance in the current approach. He agreed with the staff and with other Directors that Costa Rica's economic difficulties would require more than one year to attain a satisfactory internal and external position. The current stand-by arrangement represented a significant step--but only a step--in the right direction. The unfortunate delays in comprehensive adjustment actions that had led to the disorderly economic and financial circumstances of early 1982 would take time to redress. He welcomed the fact that the authorities recognized the need to view the current program in its medium-term context.

The centerpiece of the adjustment effort was fiscal policy, Mr. Dallara noted. The fiscal goals were rather rigorous, with the overall deficit of the nonfinancial public sector being reduced from 15 per cent of GDP in 1981 to 4.5 per cent in 1983. In parallel, public sector savings would substantially improve. Hence, there would be a significant reduction in the expansion of net bank credit to the nonfinancial public sector that would allow for the provision of an adequate amount of credit to the private sector. Did Mr. Senior or the staff believe that there would in fact be adequate credit available to the private sector if entrepreneurial confidence returned during 1983? It would be most important for the authorities to act swiftly to correct any departures from the rigorous targets. He noted that many detailed measures had been taken both with regard to expenditure reductions and revenue raising, but it was not clear whether the measures already in place or in the parliamentary process were adequate, in the staff's view, to achieve the targets. He invited the staff to comment further on that question.

On monetary policy, Mr. Dallara continued, he associated himself with the comments made by Mr. Teijeiro and other Directors on the question of whether it would be appropriate to increase nominal interest rates more than had already been done, in order to avoid any negative effects that the current interest rates might have on capital outflows, as well as to stimulate private savings. He noted, however, the arguments put forward by Mr. Senior. The critical factor in external policy was the successful negotiation of foreign official debt rescheduling, thus the announcement made by the staff was especially welcome. The authorities' stated intention to unify the banking rate and the free market exchange rate before the end of the program period was also welcome. Although there might be appropriate reluctance to be too specific in that regard, it would have been helpful if the staff paper had been able to indicate in more detail the timing envisaged.

The staff should be commended for the clear and explicit manner in which they had placed the current short-term adjustment in the medium-term context, Mr. Dallara considered. Section IV of EBS/82/214 was a welcome contribution to the ongoing effort of the Executive Board to develop a broader and longer-range perspective from which to evaluate Fund-supported adjustment programs. A few Directors had questioned some of the assumptions underlying the medium-term scenario, but the main advantage of the procedure was to enable Directors to gain a clearer picture of where current policies might lead in the medium term, on the assumption of expected policies and developments in key economic variables. Further comments by the staff on the methodology that they had used to build the medium-term scenario for Costa Rica would be welcome. In particular, what further macroeconomic adjustment might be required to provide the proper incentives for the supply sector to respond as envisaged?

The staff had referred to work envisaged with the World Bank in the context of a structural adjustment loan, Mr. Dallara noted. It would be interesting to know the staff's view of the likely consequences if export performance in the 1984-87 period should turn out to be less than the 8 per cent growth rate stipulated in the scenario. How was the target of net international reserves equivalent to two months of imports determined? If the growth rate of the working age population was 30-50 per cent higher than the overall population growth, what were the implications for the unemployment rate? The questions were not intended as criticism, as the medium-term scenario was a very comprehensive and helpful effort, but only to indicate issues that might arise in considering the realism of that scenario.

The efforts that the Costa Rican authorities were making to restore viability were welcome, Mr. Dallara remarked, but, as other Directors had pointed out, the situation was very difficult with little room for error.

He shared the concerns expressed about the poor performance of Costa Rica under the previous program, which underscored the need during the period ahead for a determined and persistent offort to continue progress toward a viable external and domestic position.

Mr. Abiad commented that, as other Directors had noted, there were clear indications in EBS/82/214, as well as in earlier staff papers on the use of Fund resources by Costa Rica, that the performance of the Costa Rican economy under previous programs had been, to say the least, far from satisfactory. The severity of the economic conditions facing the country had increased sharply since the cancellation of the previous two Fund programs shortly after their approval. Yet, the new program, described in Mr. Senior's statement as "comprehensive and even ambitious," was expected to be feasible. He invited the staff to comment on the basis for a better expectation with regard to the proposed program.

He had noted the staff's statement regarding the progress of rescheduling arrangements between the authorities and the commercial banks, Mr. Abiad continued. Notwithstanding that progress, as Mr. Taylor and others had indicated, the fact that the program did not envisage a complete elimination of external payments arrears was worrisome; he therefore shared the concern expressed by others in that regard. Furthermore, given the country's performance under recent Fund programs, the question arose whether maximum access up to 150 per cent of quota under the proposed program was strictly warranted. In view of those considerations and other weaknesses highlighted by several Directors, in particular by Mr. Grosche and Mr. de Vries, he found it very difficult to support the program under consideration.

Mr. Kabbaj said that he associated himself with the statements by Mr. Suraisry and Mr. Abiad.

The staff representative from the Western Hemisphere Department noted that a number of Directors had expressed concern about the length of time since the previous Article IV consultation with Costa Rica. There had been frequent contact between the staff and the authorities since the request for an extended arrangement had been submitted to the Board in 1981. However, the change of Government in Costa Rica had made it difficult to find an appropriate time for an Article IV consultation, particularly since the new authorities had placed priority on the negotiation of a stand-by arrangement. The negotiations for that arrangement had been intense, involving several months of discussions and three missions. It had been, and it remained, the staff's intention to prepare a report for the Article IV consultation at the time of the mid-term review, probably around March or April 1983.

Directors had also expressed concern about the implementation of the program in light of Costa Rica's performance under previous programs, the staff representative continued, a concern shared by the staff. One reason that the negotiations had taken so long was that the staff had wanted to ensure that as many as possible of the required measures would be in place by the time the program was presented to the Board. The tax measures had already been approved by the Legislative Assembly. Similarly, the budget for 1983 and the increases in public sector prices, including those that would become effective in January 1983, had been approved. The authorities had also taken measures to ensure that the adjustment remained on course during the program. For example, if a change in the exchange rate resulted in a change in the price of imported oil, the National Electricity Board had authority to proceed with the automatic adjustment of oil product prices. The authorities were convinced that a large part of the deterioration in the fiscal situation was attributable to the long lags in the adjustment of prices of public sector services to the increases in their costs, and they wanted to be able to adjust prices more rapidly in the future.

The significant adjustment currently being undertaken by the Central Government and planned for 1983 was a continuation of the adjustment effort begun in 1981, the staff representative observed. The staff did not have more detailed information on the public sector as a whole than that presented in Table 4 of EBS/82/214, but on the basis of indirect information concerning credit expansion of the banking system to the public sector, it appeared that the overall fiscal situation was developing in line with the projections. The expenditures of the Central Government were relatively inflexible, a large proportion of them going to servicing the debt and to other obligations that could not be reduced rapidly. Several years earlier, the authorities had, with Fund support, set up a body to work on methods of improving control of expenditure; the staff hoped that it would be increasingly successful. There was also room for improvement in the efficiency of the public enterprises, an area on which the authorities intended to focus, but it had not been realistic to put more emphasis on that area, given the short-term nature of the program.

On the tax side, a number of the measures were temporary, the staff representative remarked. For example, the tax on exports, applied to the differential between the exchange rates, had been put in place in December 1981, and the staff had originally hoped it would have been possible to phase it out, beginning in 1983. Unfortunately, other elements in the tax package had been rejected by the Legislative Assembly, and therefore the authorities had had to retain the tax on exports. However, they recognized the need to maintain competitiveness in the export field, and it was their intention to phase out the tax as soon as conditions permitted. Similar considerations applied to the surcharge on income tax. In fact, the tax-raising effort was not especially onerous. In the absence of the revenue measures, revenues would have declined in 1983 as a proportion of GDP. Part of the increase in revenues was in nominal terms because of the effect of changes in the exchange rate that had an impact on all the trade-related taxes, an important factor in Costa Rica. The net increase in revenues as a proportion of GDP was estimated by the staff to be only about 1 per cent in 1982.

The staff shared the concerns of Directors with regard to interest rate policy, the staff representative commented, and it attached importance to the need to maintain flexible and realistic rates. The staff would have preferred to have seen further adjustment in interest rates, but the authorities had been very concerned about the negative impact that a substantial adjustment would have had on inflationary expectations and on their efforts to revive economic activity. In fact, the latest information indicated that the rate of inflation was declining: the increase in wholesale prices from January to November 1982 had been about 112 per cent, and in consumer prices about 91 per cent, compared with projections of 110 per cent and 93 per cent, respectively. The trend toward lower inflation was probably related to the more stable exchange rate conditions that had prevailed recently. The free market exchange rate of the colón was about ₡ 45 per U.S. dollar, i.e., a differential of about 11 per cent over the banking rate of ₡ 40 per dollar. At one point, the free market rate had climbed to ₡ 60 per dollar.

The authorities had stated in the letter of intent their commitment to adjust interest rates as needed during the course of the program, the staff representative remarked, a point that the staff had emphasized throughout its discussions with them. The suggestion by Directors that interest rates should move to positive levels in the future was one that the staff would very much take into account in its discussions with the authorities during the review in 1983. The staff had also discussed the desirability of setting a path for the reduction of the differential between the exchange rates, but, understandably, the authorities had been somewhat reluctant to commit themselves so specifically in the letter of intent. However, guidelines had been set out in a technical memorandum of understanding between the staff and the authorities, to the effect that the differential should not exceed 15 per cent in the period to the end of March 1983; from April to June, it should not exceed 10 per cent; from July to September, 5 per cent; and after September, 2 per cent. The final 2 per cent differential, mentioned in EBS/82/214, referred to the Fund's legal definition of a multiple currency practice; in effect, the authorities had agreed to unify the two exchange rates by the end of the program period.

It had been suggested that the staff's projections for capital inflows in 1983 were optimistic, the staff representative continued. On the contrary, if anything, they were conservative. Of the $400 million projected, $100 million was to come from the U.S. Caribbean Basin Initiative, and it represented an amount already approved. Another $60 million was to come from the World Bank: $25 million from an export sector loan currently being negotiated, and $35 million from the initial drawing under a structural adjustment loan. Another $15 million was expected to come from the industrial rehabilitation loan of the Inter-American Development Bank, and there would be disbursements of about $40 million from the Mexican-Venezuelan Oil Facility.

The remainder of the financing was project related, and it had been very carefully estimated by the authorities. Most of the projects were already in the pipeline. None of the expected inflow included new disbursements from commercial banks.

It would have been difficult to set a performance criterion for the payment of arrears, the staff representative considered, because the pace at which arrears would be eliminated could not really be determined until the outcome of the negotiations with lenders was known. However, the authorities' intention was clearly to reduce the arrears, and if possible eliminate them, in 1983. It was worth remembering that the payment of arrears in 1983 referred only to interest. It had always been understood that the commercial banks, as well as official creditors, would have been willing to reschedule payment of principal. The payment of arrears was therefore highly dependent on the rescheduling agreement reached by the Costa Rican authorities and the banks, as well as on the additional financial assistance expected. The announcement that he had made at the beginning of the meeting indicated that considerable progress had been made. The intention of the authorities was clearly to eliminate arrears as soon as possible, but it had been felt inappropriate by the staff to have set a specific period for their elimination. However, the memorandum of understanding with the authorities included a statement to the effect that, if the outcome of the rescheduling negotiations was significantly different from the assumptions made for the program, there would be an immediate consultation with the authorities. Furthermore, it was specifically mentioned in the letter of intent that the question of arrears and the status of negotiations with creditors would be looked at in the context of the mid-term review. The staff's projections for the balance of payments in 1983 had assumed a rescheduling of about 90 per cent of principal; present indications were that more than 90 per cent would be rescheduled, at least by the banks, thus easing the amortization problem in 1983. It was also likely that Costa Rica would be able to agree to rescheduling of principal owed to official creditors through the Paris Club. It was, therefore, highly probable that most, if not all, arrears would be eliminated in 1983.

The question of setting a limit on short-term borrowing raised a number of issues, the staff representative went on. In the 1981 program, there had been a limit on net disbursement of foreign credit because it had been desirable at that time to reduce the level of public sector borrowing. However, the present situation was quite different insofar as Costa Rica's access to credit was extremely limited. The staff had, therefore, sought to improve the structure of debt. Furthermore, setting a limit on short-term borrowing had a number of practical difficulties because such credits were often commercial credits related to the import of raw materials. That did not preclude the possibility that the staff would reconsider the idea of placing a ceiling on short-term borrowing at some future date. Short-term borrowing by the Central Bank, for example, was already covered because it was included in the definition of international reserves.

Some Directors had raised the question of wages policy, the staff representative noted, in particular how salaries were to be kept below the expected rate of inflation. The Central Bank had undertaken a study of future inflation trends and it had estimated that salaries would rise by 15 per cent to 20 per cent in January 1983, and by another 10 per cent to 15 per cent in July, considerably less than the expected increase in the cost of living. The basket of goods upon which they based their estimates included items such as electricity and water, but in making its assumptions the Central Bank had considered only minimum consumption levels. Thus, the price increases in the basket did not reflect fully the expected price increases in those goods. The basket had been negotiated with the main trade unions and agreement had been reached in principle. The real test would come once the authorities began to apply the formula in January; the staff would be in contact with them if it appeared that problems were likely to arise.

With respect to the medium-term outlook and the prospects for further rescheduling of debt and capital inflows, the staff representative suggested that rescheduling would probably have to extend beyond 1983 and that there was some initial indications that the banks might be willing to discuss in principle the payments due in 1984. The extension agreement reached to cover 1983 allowed the authorities more time to enter into negotiations on a final rescheduling agreement. As for capital inflows, the staff had projected inflows over the medium term based on the trend from 1968 to 1977. Based on those, more normal, years the staff believed that it was not unreasonable to assume total capital inflows of about 8 per cent of GDP. In 1983, it was assumed that all of those inflows would be going to the public sector, and none to the private sector. But it was further assumed that the public sector would be scaling down its borrowing in future years in relation to GDP, and that the private sector would begin to borrow again as the economy revived. The staff had therefore estimated that there would be a gradual decline in public sector borrowing to about 4 per cent of GDP and an increase in private sector borrowing to about 4 per cent. Data for the 1968-77 period indicated that average inflows to the private sector had been about 6 per cent of GDP.

The staff had also assumed that the required increase in reserves would occur over the medium term, the staff representative from the Western Hemisphere Department noted. It had also estimated that the current account deficit would decline gradually from 8 per cent of GDP in 1982 to 5 per cent in 1987, and that inventories would be built up again. On that basis, exports would have to grow at about 8 per cent a year in real terms, a considerable target. The staff had intended to highlight in that way the need to strengthen the export sector, an effort that would involve looking at markets outside Central America, without neglecting that region. The staff had not discussed those projections with the authorities, but it intended to do so at the earliest opportunity. It had worked closely with World Bank staff who had been considering similar issues in the context of a structural adjustment loan, and it would consider the question further if any medium-term program, such as an extended arrangement, was to be negotiated.

The staff representative from the Exchange and Trade Relations Department remarked that it was true that there had not been an Article IV consultation with Costa Rica since March 1980. However, it was also true that, since that time, the Executive Directors had discussed Costa Rica's economy when they had considered the country's request for an extended arrangement. There was, of course, considerable overlapping in the assessment of policies contained in a report for a consultation and in a report presenting a program to be supported by Fund resources. Both reports essentially dealt with the measures to be introduced and the policies to be pursued in the coming period. It should also be noted that there had been a change in government in May 1982; the new Government had needed some time to define a firm policy stance in a period of economic difficulty. To some extent, therefore, the present Board consideration of a member country's request for use of Fund resources could serve as a reasonable substitute for an Article IV consultation discussion.

A question had been raised whether a country's short-term borrowing abroad should be subject to a ceiling under a Fund-supported program, the staff representative said. That had long been a source of controversy, and in a staff report prepared for a Board discussion of external debt management policies that had been held three years earlier, the staff had distinguished between the terms and the amount of a member country's foreign borrowing. A first aspect of external debt management, related to the absolute size of a country's foreign borrowing, would suggest the need to limit the total net loan disbursements, as opposed to foreign loan contracts or authorizations. Such ceilings on net disbursements had been included in arrangements with Mexico, Panama, and several other Latin American countries. In limiting the total amount of foreign borrowing, an important characteristic of those ceilings was that they made no distinction among debt maturities.

Another major aspect of foreign debt management was concern with the terms on which the borrowing had been undertaken, the staff representative went on. In that connection, the Fund had tended to set external debt limits on the authorizations or contracts of foreign indebtedness, partly because it was at that point that most governments could influence the terms and amount of a loan contract. Loans with maturities of one year or less were particularly difficult to handle in that manner. There was a reluctance to set limits that could interfere with trade credit flows--typically short term. Moreover, money and financial resources were fungible, a property that made it operationally difficult to distinguish between trade-related credits and other short-term credits, for purposes of limiting only the latter. In addition, less information was normally available on short-term loans than on longer-term credits. Many member countries simply did not have sufficient data on short-term debt to permit the Fund to set a ceiling on it that could be monitored on a timely basis. Another problem in dealing with short-term indebtedness was that the stock of such debt was more important than the gross flows of borrowing associated with it. The Fund wished to see a member country control the rate of growth of the stock of its short-term debt in a given period; it was less concerned about how much money a country had to borrow on a gross basis every, say, 3, 6, or 12 months for purposes of exercising such control. Although there were practical difficulties involved, the staff would certainly continue to explore possible ways of establishing guidelines to monitor short-term foreign debt developments.

He had been somewhat surprised by Mr. Casey's suggestion of a "Plan B" to the effect that a member country should determine precisely in advance supplementary or alternative measures to be adopted if some of the assumptions under its program supported by the Fund did not actually materialize, the staff representative remarked. The staff believed that the interplay between performance criteria, review clauses, and consultation clauses, provided a clear means for the design of alternative options that Mr. Casey apparently wished to have. The failure of particular program assumptions to materialize was best handled through a thorough assessment of the reasons why they had not materialized and the implications for the program as a whole. It would be very difficult to establish a priori an alternative plan to be used in the event that specific assumptions under a program were found to be inaccurate.

A member country's policy track record was just one of the elements that the staff took into account in judging the country's ability to perform in the future, the staff representative commented. In the case of Costa Rica, a number of important measures had been introduced before the country's request to use the Fund's resources had been presented to the Executive Board. Those actions could be seen as an objective piece of evidence of the country's willingness to implement the proposed program. In turn, whether or not the program itself was excessively optimistic, as some Directors had implied, was of course a matter of judgment. For example, the balance of payments outcome for Costa Rica assumed under the proposed program could be interpreted as being optimistic because it implied that external equilibrium would be reached in 1983. On the other hand, it should be recalled that the overall balance of payments outcome was a performance criterion under the proposed program, and that Costa Rica would be unable to draw on the Fund's resources if, inter alia, that performance criterion was not observed. Hence, the resources of the Fund were protected from what some Executive Directors seemed to feel was the high degree of optimism about the external outlook for the economy.

Some Executive Directors seemed to believe that a quantified schedule for the reduction of Costa Rica's payments arrears should have been made a separate performance criterion, the staff representative said. However, such a formulation for a criterion on arrears would be difficult to establish in the present circumstances of Costa Rica. At present, it would not be realistic to set a quantitative path for the reduction of arrears because the outcome in the arrears position in the coming period would depend largely on the outome of Costa Rica's negotiations with its creditors. That being said, however, it should be noted that the status of the negotiations was subject to the proposed review clause, itself a performance criterion. The enlargement of the scope of the review clause to include the debt negotiations performed precisely the same role that a well-defined schedule of reduction arrears would have performed. The staff would have wished to see the authorities in a position that would have allowed them to eliminate the foreign payments arrears but, given Costa Rica's circumstances, it had not seemed feasible to ask the authorities to do so in a period of just one year.

The aim of the proposed program was the "unification" of the exchange markets, the staff representative from the Exchange and Trade Relations Department commented, even though the actual language did not indicate that complete unification would be achieved during the program. However, in legal terms, by bringing the exchange rate differential down to less than 2 per cent, the authorities would essentially be removing the present multiple currency practice. The staff agreed with Mr. de Vries that a flexible exchange rate was not the best exchange arrangement in the longer run for a country like Costa Rica. Small open economies usually found it advantageous in the longer run to follow the pattern established by a major currency, often that of a main trading partner.

The Acting Chairman remarked that in some cases short-term indebtedness presented real problems for a member and for the Fund in the effort to establish an appropriate program for a country. The issue of short-term debt would have to be kept under constant review, and the Fund should not hesitate to establish performance criteria for such debt whenever it seemed useful to do so and when the available techniques and data made such coverage possible.

Staff and management agreed with the position that most speakers had taken on interest rate policy in Costa Rica, the Acting Chairman commented. In paragraph 16 of the letter of intent it was mentioned that the review--which was a performance criterion--scheduled to take place before June 30, 1983 was to cover "progress made in the implementation of the program, taking into account balance of payments developments, including the envisaged debt restructuring." Therefore, if, as some speakers had suggested, interest rate policy proved to be an obstacle to the implementation of the program, there was an ample basis on which the Fund could take a strong position on interest rate policy during the review in mid-1983.

At a recent meeting with department heads following the Executive Board's discussion of the midyear budget review, the Acting Chairman recalled, the Managing Director had instructed the department heads to provide a basis for establishing firmer priorities with respect to the holding of Article IV consultations on an annual basis for all countries that were sufficiently large, and for all countries that were facing sufficiently serious balance of payments difficulties to warrant such a schedule of consultations. That approach was to be incorporated in the next staff paper reviewing Article IV consultation arrangements.

Mr. Senior considered that the adjustment effort that Costa Rica planned to make under the proposed program was substantial and rapid. It constituted a serious attempt by the new authorities to take a pragmatic approach to the immediate problems facing the country before trying to make more fundamental changes. The authorities' commitment and perseverance were beyond question. Almost all the measures described in the program had already been implemented or had been approved for implementation in 1983. Indeed, the new program was in effect a continuation of the serious adjustment effort that the authorities had undertaken since taking office in May 1982.

The basic assumptions behind the proposed program were conservative and realistic, Mr. Senior remarked. Real GDP was estimated to have declined by almost 6 per cent in 1982 and it was projected to remain constant in 1983; the expected improvement in inflation, although substantial, seemed attainable. Moreover, export prices were conservatively projected to rise by no more than 3.3 per cent in 1983, and capital inflows were projected to be limited to resources that had already been committed by multilateral financial institutions and bilateral official aid agencies. Because the main assumptions were conservative and actual developments were unlikely to depart from them in any substantial way, the risk of sizable departures from the targets was minimal. However, the authorities' determination to implement the program had been underscored by the measures that they had already adopted. While Costa Rica's early implementation of measures under a new program was understandable, it should not be seen as setting a precedent for future requests by other member countries to use Fund resources.

Some interesting comments on tax increases and their use in financing permanent increases in expenditure had been made by Mr. Teijeiro, Mr. Senior recalled. In making those observations Mr. Teijeiro had raised the question of the appropriate level of government operations in the economy. He himself doubted whether there was as yet an appropriate quantitative answer to that question; there was unlikely to be agreement on the appropriate size of the public sector in any member country. That issue was controversial even in countries that were wholly socialist or capitalist. There was no doubt that governments' social objectives differed from one country to another, and that the difference was reflected in the acceptable magnitude of government operations in various countries. In any event, the relative share of government operations in Costa Rica was not expected to increase under the proposed stand-by arrangement. Table 4 showed that central government revenues were expected to increase from 12.0 of GDP in 1980 to 12.9 per cent in 1983, while expenditures were expected to fall from 20.0 per cent of GDP in 1980 to only 15.1 per cent in 1981. There was no evidence that the tax increases were financing permanent increases in expenditures. Real current expenditures were projected to fall by 5 per cent in 1983, following a decline of 16 per cent in 1982.

He fully agreed with the authorities' interest rate policy, Mr. Senior stated. Widely different points of view on the appropriate interest rate policy for various kinds of economies had been clearly reflected in the recent seminar on interest rate policies in developing countries (Seminar 82/9, 12/10/82). Theoretical research and empirical evidence still did not provide a definitive guide to the actual formulation of interest rate policy. There had been widespread agreement that, while the interest rate mechanism served various policy objectives, it should not be overburdened and it should not be considered a panacea for all economic problems. Interest rates affected different variables in different ways. It was the obligation of the authorities to find the appropriate balance among the numerous policy tools.

In the case of Costa Rica, which had suffered substantial declines in overall economic activity in the previous two years, Mr. Senior went on, a gradual recovery would be essential if the adjustment effort was to succeed. Raising interest rates too abruptly to very high nominal levels might raise the needed savings in the medium term, but it could deter productive investment and overall economic activity in the shorter run. Moreover, such interest rate increases might make it very difficult to reduce inflation and, by changing expectations in the wrong direction, they might even give rise to a vicious circle in which inflation and interest rates rose together. Given the expected success of Costa Rica's program and the favorable impact that the authorities' efforts should have on confidence and expectations, it would be prudent for the authorities to bring about positive real rates only gradually while maintaining an acceptable rate of inflation. Interest rate policy could be correctly established only when the expected inflation rate, not the existing rate, was taken into account.

Some speakers had noted that the adjusted interest rates still had some way to go before becoming positive in real terms, even if account was taken of the rate of inflation expected in 1983, Mr. Senior remarked. That fact strongly suggested the wisdom of the authorities' gradual approach to adjusting interest rates. The authorities were justly confident in their ability to make further substantial improvement in inflation after 1983, when price and tariff adjustments would be much smaller than they would have to be in 1983. Costa Rica had traditionally succeeded in maintaining a rather surprising degree of price stability, and inflationary expectations had not yet become as strongly entrenched as in some other countries with a long tradition of high inflation rates.

The Executive Board then took the following decisions:

Stand-By Arrangement

1. The Government of Costa Rica has requested a stand-by arrangement for the period December 20, 1982-December 19, 1983, for an amount equivalent to SDR 92.25 million, and has notified the Fund of the cancellation of the existing extended arrangement as of December 20, 1982.

2. The Fund approves the stand-by arrangement attached to EBS/82/214, notes the cancellation of the existing extended arrangement, and waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7275-(82/163), adopted
December 20, 1982

Exchange System

1. The Fund grants approval for the retention by Costa Rica of the multiple currency practices and restrictions on payments and transfers described in EBS/82/213 until June 30, 1983, or the time of the mid-term review of the stand-by arrangement, whichever is earlier.

Decision No. 7276-(82/163), adopted
December 20, 1982

APPROVED: May 23, 1983

LEO VAN HOUTVEN
Secretary