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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 81/93

10:00 a.m., June 17, 1981

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	O. Kabbaj
	E. M. Ainley, Temporary
	J. F. Williams, Temporary
A. Buira	M. A. Senior
	D. E. Syvrud
J. de Groote	H. G. Schneider
M. Finaish	
	H. Suzuki, Temporary
	R. T. Salazar
R. K. Joyce	M. Casey
A. Kafka	J. R. Gabriel-Peña
B. Kharmawan	V. Supinit
	F. Sangare
	G. Winkelmann
	C. P. Caranicas
	T. Aulagnon
	A. Alfidja
	D. L. Kannangara
Y. A. Nimatallah	
	T. de Vries
	B. Legarda
	L. Vidvei
	Tai Q.

J. W. Lang, Jr., Acting Secretary
J. B. Edgerly, Assistant

Also Present

African Department: N. Abu-zobaa, J. W. Kratz. Asian Department: R. G. Di Calogero. European Department: U. Dell'Anno. Exchange and Trade Relations Department: M. Guitian. External Relations Department: L. R. Azocar, S. J. Irving. Fiscal Affairs Department: A. L. Antonaya. Legal Department: J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, J. M. Ogoola. Middle Eastern Department: H. E. Jakubiak. Research Department: K.-Y. Chu, L. U. Ecevit, N. M. Kaibni, G. M. Khatchadourian, P. Radhakrishnan. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer; A. M. Al-Samarrie, D. S. Cutler, D. Gupta, R. W. Ley, A. F. Moustapha, M. Sami. Western Hemisphere Department: E. W. Robichek, Director; S. T. Beza, Deputy Director; C. E. Sansón, Deputy Director; E. O. Bell, L. A. Cardemil, C. Cha, R. A. Elson, P. Habanananda, M. E. Hardy, S. J. Stephens, Y. Ozeki, P. C. Ugolini, F. van Beek, E. V. Zayas. Advisors to Executive Directors: S. E. Conrado, A. B. Diao, J. U. Holst, M. A. Janjua, A. K. Mullei, P. D. Peroz, F. A. Tourreilles. Assistants to Executive Directors: A. F. P. Bakker, M. V. Carković, C. Chipeta, J. L. Feito, K. V. Jännäri, P. Kohnert, J. E. Leimone, J. S. Mair, M. Michelangeli, V. K. S. Nair, J. R. Novaes de Almeida, C. N. Pinfield, J. Reddy, M. Shadman, O. Uçer.

1. SPECIAL DRAWING RIGHTS DEPARTMENT - DESIGNATION PLAN FOR JUNE-AUGUST 1981

The Executive Directors considered a staff report on the designation plan for June-August 1981 (EBS/81/109, 6/2/81; and Sup. 1, 6/8/81).

The staff representative from the Treasurer's Department commented that, since the designation plan had been issued in early June, there had been additional transactions with designation amounting to SDR 143 million, and the designated participants were primarily the United States and the United Kingdom. However, the amount was not so large that it would necessitate a change in the proposal before the Board.

Mr. Kharmawan remarked that his Indonesian authorities accepted their inclusion in the plan; his Singapore authorities had not responded, but he assumed that they would not object.

The Executive Board then adopted the following decision:

> The Executive Board approves the designation plan for the quarterly period beginning June 17, 1981, as set out in EBS/81/109, Supplement 1.

Decision No. 6887-(81/93)S, adopted
June 17, 1981

2. OPERATIONAL BUDGET FOR JUNE-AUGUST 1981

The Executive Directors considered the proposed operational budget for June-August 1981 (EBS/81/110, 6/2/81; and Sup. 1, 6/8/81).

The Treasurer commented that while the operational budget usually incorporated an evaluation of the Fund's liquidity position, a recent discussion of the matter in the Executive Board had made further evaluation unnecessary. Still, some developments should perhaps be mentioned. First, the loan agreements with the Swiss National Bank and the National Bank of Belgium--which had already been approved by the Executive Board--would be in place before the following day. Second, loan agreements with the United Kingdom and Japan were being finalized and were expected to be submitted to the Board for approval on a lapse-of-time basis. Finally, an agreement in principle had been reached with the central bank of a smaller country, one outside the circle associated with the Bank for International Settlements.

The staff representative from the Treasurer's Department commented that, since the budget had been issued, there had been substantial sales under the existing budget; nearly SDR 640 million, mostly in U.S. dollars and SDRs, had been sold. However, as with the designation plan, the amount was not so large as to necessitate a recalculation of the June-August 1981 budget. It should be noted that, of the SDR 2 billion provided for in the existing budget, a total of SDR 1.5 billion had actually been used, which was a fairly substantial implementation.

The Executive Board then took the following decision:

The Executive Board approves the operational budget for the quarterly period beginning June 17, 1981 as set out in EBS/81/110, Supplement 1.

Decision No. 6888-(81/93), adopted
June 17, 1981

3. COSTA RICA - EXTENDED ARRANGEMENT, AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered requests from Costa Rica for an extended arrangement equivalent to SDR 276.75 million (EBS/81/123, 6/4/81), and for a purchase equivalent to SDR 30.1 million under the compensatory financing facility (EBS/81/124, 6/4/81; and Sup. 1, 6/16/81).

Mr. Buira made the following statement:

My Costa Rican authorities are in broad agreement with the staff paper. However, I will try to supplement the staff analysis by drawing attention to some important aspects of Costa Rica's economic performance and policies which may be helpful to the Board in gaining greater understanding of developments in that country and putting the current program in its proper context.

During 1976 and 1977, Costa Rica experienced the benefits of an unprecedented coffee boom that resulted in very high rates of growth in exports and domestic output. In effect, in those years the real annual growth rate of GDP in Costa Rica accelerated from 2 per cent in 1975 to 9 per cent in 1977. In these favorable circumstances, certain existing trends such as high levels of consumption and imports were reinforced and the true significance of the rise in oil prices of 1974 was not perceived.

In 1978/79, however, coffee prices declined very sharply, falling from more than $3.00 to less than $1.30 per pound. These prices have remained at low levels since that time and declined further to the present level of around $1.00 per pound. Over the same period, and through 1980, the prices of imports, particularly oil and manufactures, rose rapidly. This resulted in a very substantial deterioration in the terms of trade of Costa Rica and a marked decline in its real income. Such a deterioration over a short period of time requires a reduction in the living standards and other adjustments that are quite difficult for any country to make. In an open and democratic society and one which has developed a large welfare system such as Costa Rica, the country has to effect the necessary adjustments through the political process, and this requires full recognition by the society as a whole of the need for adjustment. This process of acceptance obviously takes time; meanwhile, export earnings as well as fiscal revenues continue falling as a proportion of GDP. On the other hand, import prices continue to rise, thus resulting in greater public expenditures and larger balance of payments and fiscal deficits. This was the experience of Costa Rica during 1978 and 1979, which gave rise to a current account deficit of 14 per cent of GDP in 1979 compared to the equivalent of 7.5 per cent of GDP in 1977, and to a fiscal deficit of 12.3 per cent of GDP in 1979 compared to 9.3 per cent of GDP in 1978.

In response to these developments, the Costa Rican authorities introduced a stabilization program in March 1980, which was supported by the Fund with a two-year stand-by arrangement of an amount equivalent to SDR 60.5 million.

The public sector deficit, which was estimated at 11.5 per cent of GDP for 1979, was expected to be reduced by 4.5 percentage points to 7 per cent of GDP in the first year of the program and further in the second year. This was clearly a very ambitious program at the best of times, but even more so in the circumstances of further continuing deterioration in terms of trade, slowdown in the world economy, and political and social unrest in the area leading to economic disruption in the Central American Common Market. Nevertheless, and even though performance under the stand-by program fell short of expectations, very significant progress was made in 1980.

The public sector deficit was reduced by an equivalent of 2 per cent of GDP, which resulted in a marked reduction in the growth of aggregate demand and imports. This reduction in the public sector deficit is substantially larger than that targeted for more than half of the stand-by arrangements in the upper credit tranches supported by the Fund over a ten-year period (see DM/80/7, which analyzes the content of over 100 financial programs, and was later published in Staff Papers, Vol. 27, No. 2, June 1980).

Indeed, imports during 1980 declined in real terms, partly as a result of this fiscal effort and of the exchange rate measures adopted late in the year. Exports, on the other hand, showed remarkable dynamism and complied with the program targets despite a further decline in coffee prices, which was compensated by the strong expansion of nontraditional exports. Nevertheless, the further deterioration of terms of trade resulted in a current account deficit substantially larger than programed.

The growing awareness of the external vulnerability of the Costa Rican economy, together with an increase in unemployment and the decline in economic growth, persuaded the authorities of the need to undertake profound structural reforms over the medium term, as well as to adopt further short-term adjustment measures, particularly in the exchange rate area.

II.

The present extended arrangement covers a three-year structural adjustment program aimed at reducing the balance of payments deficit through a combination of demand management and structural adjustment policies that will reduce the vulnerability of Costa Rica to external developments. My authorities attach great importance to the structural aspects of the program, as well as to the appropriate combination of demand management and supply-oriented policies. It is in support of this structural adjustment program that my Costa Rican authorities are now requesting the Board's approval of an extended Fund arrangement and the cancellation of the previous two-year stand-by arrangement.

In their view, a program based on demand management policies alone could only be accepted if there were reasonable expectations that once the critical period is ended the productive structure of the country would be adequate to resume the process of growth on a sustainable basis. However, it has already been proved that the existing productive structure of the country is no longer adequate to sustain development and to accommodate an acceptable rate of growth in income for a growing population in the current international environment.

On the other hand, sole reliance on supply-oriented policies would not be possible in view of present limitations in the external sector or in light of the existence of excessive aggregate demand. Within this framework the Costa Rican authorities have designed a program that in its structural aspects concentrates in the areas of energy, full utilization of the agricultural potential, promotion and diversification of exports, and reorientation of import substitution policies, as well as a number of institutional reforms in the public sector in order to increase its efficiency and responsiveness to economic management.

From September 1980 to date, the colón has been adjusted from ₡ 8.57 per U.S. dollar to currently about ₡ 20.00 per U.S. dollar, a devaluation of the order of 130 per cent in less than a year. In addition, the Government has introduced significant policy changes in other fields which should serve as a basis for a comprehensive development program in order to restructure the economy during the coming years.

In the energy area, Costa Rica's efforts are concentrated on the development of alternative sources of energy and the reduction of oil consumption. Energy projects include the development of hydroelectric and geothermal power plants and the substitution of alcohol for gasoline. Oil explorations are being carried out jointly with Petroleos Mexicanos in certain areas along the Atlantic continental shelf. With regard to the area of conservation, it should be noted that fuel prices were adjusted by an average of 27 per cent in March 1981 and by a further 19 per cent in May. The authorities are committed to continue adjusting fuel prices so as to pass to the consumer the full increase in costs resulting from higher oil import prices.

In the area of agriculture, the development plan calls for an expansion in agricultural production through the introduction of new crops, the opening up of new lands to cultivation, the construction of new feeder roads, irrigation facilities, port expansion, and others that will facilitate access to markets. These projects will result in an increase in production from lands that are now only marginally exploited. Particular emphasis is being given to the expansion of production of sugar cane, beef and dairy products, and basic grains. This will permit a further expansion and diversification of exports and import substitutes. The Government is clearly committed to the strengthening of public finances as a means of facilitating the balance of payments adjustment process. To this effect, a number of institutional reforms as well as more traditional measures have already been adopted.

In the institutional field, the budgetary authority has been strengthened and a comprehensive tax reform proposal has been presented to the Legislative Assembly which includes modifications to the land tax and income tax and other changes to the tax system aimed at both strengthening the tax base and improving the distribution of the tax burden. Furthermore, during the first year of the extended Fund facility program the Government will propose to the Legislative Assembly legal and administrative reforms to reduce the earmarking of revenue and spending patterns dictated by law which have created rigidities in the allocation of fiscal resources. Other measures adopted include increases in the prices of goods and services provided by the public sector and the liberalization of interest rates. Altogether, these actions should facilitate a better management of fiscal policy and of the budgetary process.

III.

> These adjustments, in combination with policies for the first year of the arrangement, constitute a formidable range of measures that should ensure the success of the program. Of course this success will require discipline and a sustained effort on the part of Costa Rica. In this regard, there is now widespread recognition of the need to make the necessary adjustments not only on the part of the Costa Rican Government but also on the part of various sectors of the Costa Rican society, business and labor leaders, as well as representatives of all major political parties. They have all come to see adjustment programs as a matter of survival for the Costa Rican economy, its existing institutions, and the preservation of its social peace. This commitment constitutes the best guarantee that any financial program can have; it ensures that whatever additional measures that might be needed for its success will be adopted.

Mr. Salazar commented that Costa Rica's currency difficulties could be attributed to a fall in traditional export volumes and prices, combined with a rise in the cost of energy imports and the authorities' inability to control the economic expansion that had followed the 1976-77 coffee price boom. As a result, both the Government deficit and the current account deficit had grown to a significant proportion of GDP and an outflow of private capital had led to a substantial loss in foreign reserves.

In an effort to resolve that situation, Mr. Salazar observed, the Costa Rican authorities had introduced a stabilization program in March 1980 which the Fund had supported with a two-year stand-by arrangement. Unfortunately, the authorities had not been able to secure the Legislative Assembly's approval for the package of tax increases included in the program; and although efforts had been made to control public expenditure, including the creation of a special Budgetary Authority, the performance criteria of the stand-by arrangement had not been adhered to.

The authorities' decision to employ both structural adjustment and demand management measures in order to overcome the current difficulties was quite appropriate, Mr. Salazar remarked, and therefore he could support Costa Rica's request for an extended arrangement and for a purchase under the compensatory financing facility. Structural adjustments--particularly in the area of energy--fuller utilization of agricultural potential, promotion and diversification of exports, and reorientation of import substitution policies were necessary in order to eliminate the economy's essential weaknesses, particularly the balance of payments problems.

The program also included targets in demand management that would help to correct both internal and external imbalances, Mr. Salazar noted.

Most crucial for the success of the program would be control of the the fiscal deficit, but that would only be possible if the authorities could successfully implement the new tax reform, raise the rates charged by public enterprises, and restrain government spending. Failure to reduce the federal deficit from the present level of 10.5 per cent of GDP would result in continued suboptimal allocation of resources and further inflationary and balance of payments pressures.

The improvement of the fiscal situation in 1981 was expected to come about primarily as a result of a reduction in government expenditure and an increase in operating surpluses among state enterprises, Mr. Salazar said. Public sector revenues were projected to remain approximately constant as a percentage of GDP due to the implementation of temporary fiscal measures. Achievement of public sector targets for the remaining two years of the program would be dependent upon the Legislative Assembly's approval of the April 1981 tax reform, which would then replace temporary taxes and provide the necessary increment in revenue. The reduction in 1981 public expenditures was to be achieved primarily through restraint in public wage increases; the 15 per cent nominal increment anticipated for the whole of 1981 was well below the 40 per cent expected rate of inflation.

Monetary targets included in the program would have to be strictly adhered to if external imbalances were to be corrected, Mr. Salazar continued. In that connection, he asked the staff why the currency issue level projections in the staff report showed such strong seasonality: specifically, a drop between December 1980 and June 1981, followed by a sharp increase between June and December of 1981, and another reduction between December 1981 and June 1982. He questioned what effect that behavior would have on the evolution of the total money supply. He welcomed the authorities' decision to set interest rates at positive real levels in order to promote higher domestic savings and more efficient allocation of capital resources.

The recent exchange rate adjustment and the successful implementation of fiscal and monetary targets were expected to improve the disequilibrium in Costa Rica's current account, Mr. Salazar remarked. In the long run, however, balance of payments equilibrium could not be achieved without major structural adjustments in energy and agriculture. Improvement of the overall external balance would also depend on the authorities' ability to reverse the current outflow of private capital, reduce arrears, and follow through on the proposed limitations of public external borrowing.

Mr. Gabriel-Peña expressed strong support for the Costa Rican request for use of Fund resources under the extended Fund facility and the compensatory financing facility. The deterioration of the Costa Rican economy had been continuous since the end of the 1977 coffee price boom. The fall in the terms of trade, combined with the expansionary demand trends that had been initiated in the previous period, had led to an increase in the current account deficit, from SDR 174 million in 1977 to SDR 500 million in 1980. And diminishing levels of capital inflow had further reduced international reserves in Costa Rica's Central Bank.

The Costa Rican authorities were now asking for approval of a purchase under the compensatory financing facility, as well as a program under the extended Fund facility to substitute for the earlier stand-by arrangement, Mr. Gabriel-Peña remarked. The longer period for adjustment and the more reasonable targets under the extended arrangement should give authorities more leeway in carrying out the difficult task of economic adjustment. The goal of reducing the current account deficit by 3.5 per cent of GDP in the first year of the previous program had been reduced to a 2.5 per cent of GDP reduction during the first year of the extended arrangement. A decrease of 5.3 per cent of GDP in the current account deficit after three years of the extended arrangement also seemed more plausible than the 4.3 per cent of GDP reduction that had been called for under the two-year stand-by arrangement.

While the process of drawing up the extended arrangement program had taken about six months, Mr. Gabriel-Peña observed, the adjustment process itself was only just beginning; the chances for its success were good because most sectors of the Costa Rican society, including the opposition, had agreed to support the conditions included in the program. That nonpartisan support should be commended because only with free and total participation by all sectors of society could economic adjustment be successfully accomplished.

The exchange market was extremely sensitive and monetary authorities could not easily counterbalance excessive movements due to speculation, Mr. Gabriel-Peña continued. The fact that the colón had appreciated from ₡ 20 per U.S. dollar to ₡ 17 per U.S. dollar, after the reunification of the official and parallel markets last April, seemed to indicate that the currency might remain significantly undervalued. He wondered whether unification of the exchange rate market should be considered a performance criterion under the present arrangement.

The adjustment plan seemed primarily to emphasize fiscal and monetary restraint rather than the supply-oriented factors that would restore growth in output, Mr. Gabriel-Peña commented. Moreover, there was no clear reference to employment and output growth during the first two years of the program, nor specific details offered on structural measures for promoting export growth and an increase in the overall investment ratio.

Not every country coming to the Fund for a purchase under the extended Fund facility could be expected to go to the World Bank for a structural adjustment loan, Mr. Gabriel-Peña remarked. However, it was possible that the deflationary impact of Fund financial programs could be offset by simultaneous utilization of development assistance programs; and he wondered if Costa Rica's financial arrangements with both the Fund and the World Bank would have that effect.

Mr. Syvrud said that he could support both requests by Costa Rica for purchases under the extended Fund facility and the compensatory financing facility. The country's balance of payments circumstances were consistent with the criteria established for an extended arrangement: the economy suffered from serious balance of payments problems that had resulted from structural maladjustments in production and trade and from price and cost distortions. The authorities were unable to pursue an active development program because the economy was characterized by slow growth and an inherently weak balance of payments position. They had, however, taken a number of commendable steps, including reducing the public sector deficit by an equivalent of 2 per cent of GDP in 1980, devaluating the colón by 130 per cent during the past several months, and adjusting prices in state enterprises. In particular, he cited the significant increases in fuel prices.

Despite his support for Costa Rica's requests, Mr. Syvrud continued, he was concerned that the adjustment might not be achieved unless measures beyond those prescribed in the program were taken. Additional measures would be needed to achieve fiscal targets because the import tax surcharge and the intention to underspend budgetary appropriations were only temporary measures. In the light of the past history of the legislature's support for tax measures, the implementation of tax reform was not assured and, therefore, more specific measures to reform and control state enterprises seemed necessary. The elimination of revenue earmarking and compulsory spending was also advisable, because those institutional arrangements had been major factors in the large fiscal deficits.

In a number of areas outlined in the staff report--including energy, agriculture, and export promotion--a more detailed assessment of the timing and significance of the measures was needed, Mr. Syvrud considered. Also, as the staff had noted, the proposed limitation on the growth of central bank credit would be difficult to implement because of the exchange losses and interest payments that had resulted from the unfortunate decision to extend central bank guarantees to foreign exchange transactions through April 30 at the previous exchange rate. The prospects for effectively covering those exchange losses were questionable, as was the prospect for success in the proposed sale of stabilization bonds. Finally, while the Costa Rican authorities' stated intention to pursue a flexible exchange rate policy was welcome, their poor record track under the previous stand-by arrangement seemed to raise doubts about their ability to implement the new program.

Despite his reservations, Mr. Syvrud noted, the proposed extended arrangement should be supported for three reasons: first, because of the successful adjustment measures already undertaken; second, because the World Bank had reviewed the adjustment program and had found that

60 per cent of capital formation was expected to be in the private sector, and furthermore, the Bank had stated that it had no reservations regarding the proposed extended arrangement; and finally, as noted by Mr. Buira, the new program appeared to have found widespread support in various sectors of the Costa Rican society. Not only government but also business and labor leaders and representatives of all the major political parties had indicated their willingness to participate in structural change. In fact, the negotiating team that had come to Washington to discuss the program included members of the opposition party as well as people from the private sector. That was reason to have a greater degree of confidence than might have been possible at the outset of the earlier arrangement.

Mr. Legarda remarked that he was enthusiastic in his support of Costa Rica's requests for an extended arrangement and for a purchase under the compensatory financing facility. The export shortfall, dominated by a decline in coffee earnings, clearly filled the criteria for access to the Fund's compensatory financing facility. The proposal for the extended arrangement was less clear cut because it contained elements of both demand management and structural change. Fortunately, however, budget expenditures were likely to be put to socially helpful or productive uses because Costa Rica had no army and was noted for an equitable income distribution, without extremes of either wealth or poverty. Still, an extended program was needed to help the authorities deal with a number of recent events beyond their control. First, there had been a steep drop in coffee prices, from $3.00 to $1.00 a pound, affecting one third of exports, coupled with a rise in oil prices. Moreover, some regional disturbances in adjacent areas spilled over into Costa Rica and complicated the management of the economy. The Central Bank had financed the fiscal deficit in the earlier stand-by program; but that result might have been due as much to the ambitious program--which had called for a reduction of the deficit by 4 per cent of GDP over just a two-year period--as to any deficiency in policy structure and implementation by the Government.

There was a significant element of speculation that had not been well documented in the staff report, Mr. Legarda observed. The first step in any program should be to dampen such speculation; fortunately, the Fund's approval of the program might help bring about that result. A tightening of domestic credit, followed by a free-floating exchange rate, might have been preferable to the interventionary tactics that had been used by the Costa Rican authorities. A 130 per cent currency devaluation had taken place, however, and now the currency appeared to be undervalued for a number of reasons. First, the currency had been subject to excessive speculation that had had no underlying structural basis. Second, the deterioration in the terms of trade was a problem that would be aggravated, rather than solved, by a devaluation, which usually was a means of compensating for excess demand; a decline in the terms of trade could only be corrected by more gradual structural measures. Third, the fact that from 1977 to 1980 nontraditional manufactured exports had risen by 67.5 per cent seemed to indicate that the exchange rate had not inhibited growth in exports that had not been affected by steep falls in primary prices. Finally, domestic price movements had not been so large as to warrant such a large exchange rate adjustment.

The staff had indicated that the steep devaluation would primarily affect Costa Rica's ability to compete in foreign markets, Mr. Legarda commented. An equally significant concern was the effect that the devaluation would have on Costa Rica's very equitable social system. A rapid increase in domestic price levels might have adverse consequences on the country's income distribution. That development should be of as much concern as the competitiveness of exports, and the authorities should seek to adopt policies that would help to achieve a balance between those two effects. The authorities had been wise to raise export taxes at a time when the steep change in exchange rates would bring windfalls in a number of sectors. While a consensus on the tax reform proposal did seem to exist and the success of legislation appeared hopeful, it might not have been prudent to announce a specific cutoff date for the export tax, as that would reduce additional leverage that authorities might need to pass the tax legislation.

The replacement of thermal power generation by hydroelectric power had made a major contribution to structural reform, Mr. Legarda said. Currently, 35 per cent of the country's energy needs were being filled by hydroelectric power; geothermal power was also being promoted. Supply-side adjustment measures primarily involved the development of alternative energy sources and the promotion of exports. There was already an element of export diversification, as evidenced in the good record for nontraditional exports, and there was no reason to expect that that trend would not continue. However, since the rate of adjustment of Costa Rica's external sector would be affected if other countries had barriers to Costa Rica's exports, he asked if any such barriers did indeed exist.

The authorities should have chosen a three-step approach to deal with the economy's problems, Mr. Legarda remarked. The first step was to dampen speculation, the second to implement measures of demand management, and the third to initiate structural change. In the area of demand management, the goal of reducing the public sector deficit to 7 per cent of GDP, originally set for 1980 but now reset for 1982, reflected gradualism and therefore greater realism on the part of both the Fund and the Costa Rican authorities. Fiscal discipline would also be crucial to the success of the plan and, as Mr. Syvrud had mentioned, revenue earmarking and compulsory spending were both undesirable features in the country's public finance process. Furthermore, the staff had understated the major role that the Central Bank had in credit policy: excessive government expenditure could not take place unless the Central Bank was willing to finance it. While the Central Bank did have pressure placed upon it from various quarters of the Government, a firm hold on central banking policy, coupled with strict fiscal discipline, might well be one of the key aspects of demand management in the proposed program. He strongly supported the Costa Rican request for the use of Fund resources under both facilities and felt that, if the targets and limitations were not breached, the goals incorporated in the adjustment program would be attainable.

Mr. Joyce commented that the proposed program could have a significant impact on the development of the Costa Rican economy. It appeared that the earlier stand-by program had been overambitious, but the experience gained in the first year of the stand-by arrangement had led the Costa Rican authorities and the Fund to become more realistic. Successful implementation of the new program would go a long way toward solving major problems in the economy, although that success was contingent upon widespread support in Costa Rica. Fortunately, as Mr. Buira's statement had indicated, there appeared to be a broad-based willingness to take the disciplinary steps called for in the program. With that reassurance, and after considering all the details of the proposal, he could support both requests.

The program was essentially a mixture of demand management and structural adjustment, Mr. Joyce remarked, although adjustment in the first year would primarily be dependent upon demand management measures in order to establish a climate of confidence in which structural changes could be implemented. Since the staff papers had focused mainly on the immediate future and had therefore dealt more extensively with the demand management measures, there was a need for more information on the nature and content of the structural programs and an assessment of their interaction and long-term impact on the economy. He hoped such information could be made available on the occasion of the next review.

He welcomed the emphasis that had been placed upon adjustments in the energy sector, as well as the effort to promote private investment, Mr. Joyce said. Of course, efforts in both areas would critically depend upon the restoration of the public's confidence in the economy and the consequent rebuilding of savings. Although levels of savings were anticipated to decline in relative terms during 1981, it was expected that the adjustment measures being initiated by the Government would lead to a restoration of confidence in the economy and an increase in savings.

In addition to monetary policy, the Government's fiscal policy was a key element in the effort to contain inflation, Mr. Joyce observed. And, although the decrease in the deficit thus far attained had fallen below the original target, the authorities should be commended for accomplishing the sizable reduction of 2 percentage points within a single year. The new plan called for a further reduction of approximately 1.5 percentage points in the current year.

Proposals to increase government revenues and to establish more control of the expenditure side were most welcome, Mr. Joyce remarked. In particular, efforts to reduce the government deficit would be aided by the elimination of "earmarked expenditures"; the proposal to strengthen the budgetary authority was also welcome. Execution of those measures to reduce the deficit was crucial to the success of the program and the measures would have to be carefully reviewed at the end of the first year to see if they went far enough in achieving the hoped-for goals. If progress in the first year was found insufficient it would be necessary to consider additional measures on either the revenue or expenditure side to keep the government budget under control.

From a short-term perspective, Mr. Joyce commented that increased interest rates were also welcomed, but only because they were needed to restore confidence and increase savings. The debate on whether or not the Costa Rican currency had been undervalued could only be resolved if the market was allowed to take its course. The Costa Rican authorities should therefore be commended for their efforts to unify the exchange rate and end the import deposit schemes and other measures that had been unduly interfering with market forces.

Finally, Mr. Joyce noted that the staff papers on Costa Rica did not provide sufficient information on the development of monetary aggregates and on projections of the country's future inflation rates. The intentions of the proposed program were good, but only the execution of the program would show whether or not the projections were realistic. As always, the review process would be very critical.

Mr. Aulagnon said that he could support the two requests by the Costa Rican authorities because the program would effectively confront the acute difficulties currently affecting the country's economy. Costa Rica was suffering from a shortage of external resources, partially due to circumstances beyond the control of the authorities, but also due to excessive demand pressures. In order to restore overall equilibrium in the economy and a rate of growth consistent with the objectives of economic development, a wide range of structural reforms would be necessary.

Perseverance and determination by the authorities would be a key element in the ultimate success of the program, Mr. Aulagnon remarked. They would be afforded only a very narrow margin for maneuver because of the unfortunate combination of an external liquidity crisis--as evidenced in the level of present arrears and the level of official reserves--and acute structural imbalance. However, the program for the first year correctly included both demand management and structural reforms and, in accordance with the Fund's guidelines on conditionality, appropriate consideration appeared to have been devoted to the political and social circumstances prevailing in Costa Rica.

While it was still too early to accurately assess the potential of the program, since many projects were only just under way, the favorable view expressed by the World Bank regarding the proposed investment was reassuring, Mr. Aulagnon commented. He hoped that the implementation of the supply-side policies contemplated in the program would bring acceptable income growth for Costa Rica's growing population. Efforts already made to develop alternative sources of energy and reduce oil consumption were very encouraging.

The most urgent task facing the authorities in the coming period, Mr. Aulagnon considered, would be implementation of the strict demand management policy prescribed in the adjustment program, designed to contain inflationary pressures which, measured in terms of the GDP deflator, were currently estimated to be as high as 40 per cent. Particularly crucial in that regard was the objective of keeping 1981 real government expenditures below the 1980 levels primarily through the underexecution of budgetary appropriations. So as to be consistent with the medium-term objectives of the program, that underexecution should primarily come from current expenditures rather than investment expenditures. The strengthening of the Budgetary Authority would be most appropriate in carrying out the new spending program; prompt adoption of the proposed tax reform by the Legislative Assembly was also seen as essential.

Because of the importance of moderating the external imbalance, the authorities should radically reduce the country's arrears, Mr. Aulagnon continued. Furthermore, since the success of the proposed program was predicated upon increased participation of the private sector, the adoption of a detailed schedule for debt payments might be helpful in restoring the private sector's confidence in the Costa Rican economy. With the level of external arrears currently at $283 million, the proposed reduction by one third during 1981 seemed somewhat inadequate, and acceleration of the repayment schedule in the early part of the program, consistent with the trends in the capital account, might be necessary.

The efforts of the authorities to promote a more orderly exchange market after the disruptions of 1980 and early 1981 were commendable, Mr. Aulagnon said. The appreciation of the colón following the recent exchange rate unification seemed to indicate that international as well as domestic investors had responded favorably to Costa Rica's monetary policies. While the overall financial program contained a number of uncertainties, it appeared to be consistent with the authorities' long-term goals for development. The Costa Rican authorities appeared to be strongly committed to adjustment and there was growing recognition in the Costa Rican society that the success of the program would be crucial to the country's long-run economic stability. Obviously, future economic developments would have to be closely monitored and, if circumstances required, policy changes promptly implemented.

Mr. Vidvei, supporting both requests, agreed that there was basis for a compensatory financing facility drawing because the export shortfall was largely beyond the country's control. If sales during the marketing year 1979/80 had been more evenly distributed, the shortfall would have appeared smaller; however, distribution of sales within the year had largely been market oriented. Since quotas established under the International Coffee Agreement had also had an impact on exports, he asked the staff to provide information on Fund guidelines concerning the treatment of shortfalls in exports due to international agreements.

In light of the country's current economic difficulties, the proposed extended arrangement for up to 450 per cent of quota also seemed appropriate, Mr. Vidvei said. The medium-term program adopted by the authorities to tackle the current problems included many initiatives worthy of Fund support. It was important to bring the fiscal situation in Costa Rica under better control. During the first year of the program, the overall deficit of the nonfinancial public sector was expected to decline from 10.4 to 9 per cent of GDP, mainly due to the temporary increase in export taxes. However, the deficit was expected to show a sharper decline to 7 per cent of GDP in 1982 and then to 5.5 per cent of GDP in 1983. During the period, the temporary export tax would be phased out and reductions in the deficit would be dependent upon a comprehensive tax reform and expenditure restraint. The success of the medium-term program was therefore critically dependent upon the Legislature's approval of the proposed tax reform and the reinforcement of the Budgetary Authority's control over expenditures. Experience had shown that the implementation of tax reform was a time-consuming process that would fail unless the authorities were very determined. The same was true for expenditure control, and he wondered what the prospects for success would be in those areas. Extensive technical knowledge would be required if the authorities were to carry through with the proposed expenditure controls and he wondered whether the Fund could, if necessary, provide technical assistance.

Maintenance of a consistent exchange rate policy should also be a priority during the period of adjustment, Mr. Vidvei remarked. He suggested that the authorities' activities in foreign exchange markets throughout the program period should be carefully monitored to enable the staff to give appropriate advice and recommendations on the occasion of the consultations during the second and third years of the program.

Mr. Kannangara considered that Costa Rica's current economic difficulties were the result of a sharp deterioration in the balance of payments--due to a decline in international coffee prices and increased world oil prices--and excessive demand pressures due to large public sector deficits. The earlier coffee price boom had encouraged the Government to accelerate the country's economic growth. There should not have been, however, a stop-and-go position in governmental financial activities to accord with such movements outside the economy.

Although the Costa Rican authorities had been unable to adopt the appropriate demand management measures, the direction was correct and, in general, they deserved commendation for the courageous steps that they had taken to confront factors beyond their own control, Mr. Kannangara continued. The authorities now recognized that much more needed to be done; in that connection, they had proposed a strengthening of the Budgetary Authority, and had prepared a comprehensive tax reform proposal that included modifications in land and income taxes.

The Government also planned to pay attention to redesigning investment priorities and to promote structural adjustment in agriculture, energy, and trade, Mr. Kannangara said. The proposal to increase irrigation, feeder roads, and other support facilities should provide an impetus for opening up new lands to cultivation and increasing production from lands that were being only marginally exploited. That improvement in agricultural output would directly contribute to strengthening the balance of payments through export expansion and import substitution. The authorities had also made an encouraging commitment to the energy sector, allowing for considerable domestic price adjustments and undertaking intensive efforts at developing alternative energy resources based upon domestic endowments.

The devaluation of the Costa Rican colón by 130 per cent since September 1980 had been justified because it had brought the exchange rate into alignment with international prices, Mr. Kannangara remarked. Combined with other policy changes, the sizable devaluation should make a positive contribution to the adjustment process. Finally, the extended arrangement requested by the authorities was clearly preferable to a stand-by arrangement, which was most useful in cases where an acceptable balance of payments situation could be sustained through demand management policies alone; where structural adjustment was the dominant need--combined of course with appropriate demand management policies--an extended arrangement was more appropriate. He therefore had no hesitation in supporting the requests for an extended arrangement and a purchase under the compensatory financing facility.

Mr. Winkelmann noted that the previous stand-by arrangement had not been successful, in part because the adjustment process had been interrupted by what the authorities had termed institutional rigidities that had made it impossible to control the overall macroeconomic demand. Demand restrictions and supply-oriented measures included in the proposed extended arrangement appeared to be headed in the right direction, although the same rigidities remained in the government budgetary process. Decreases in expenditure and improvements on the revenue side would be entirely dependent upon support from the Legislative Assembly. Fortunately, as Mr. Buira had noted, a national consensus was emerging that recognized the importance of economic stability in Costa Rica.

According to Table 1 attached to the Letter of Intent, Mr. Winkelmann continued, over the next three years the national savings rate was expected to increase by over 50 per cent, from below 10 per cent in 1980 to about 15 per cent. Until recently, less than half of investment had come from domestic sources because of decreasing export earnings, undisciplined fiscal and monetary policy, and capital flight due to uncertainties in the exchange market. Having discovered that even strong market intervention could not prevent short-term capital from leaving the country, the authorities had instituted import restrictions, causing a further loss of confidence on the part of investors. To re-establish that confidence would require a stabilization program designed to balance demand and supply, decrease the government deficit, and win the support of the Legislative Assembly. Only then could investment and growth be expected to increase. Fiscal policy would be a key element in the success of the program, and he hoped that future reviews would show progress so that the granting of waivers would not be necessary.

Mr. Kharmawan considered Costa Rica's request for a drawing under the compensatory financing facility to be convincing, and he therefore supported it. He could also support the request for a purchase under the extended Fund facility, the program for which encompassed demand policies and structural adjustment measures that might be regarded as a model for similar requests by others. The Costa Rican authorities were to be commended for their willingness to accept such an intense and comprehensive program.

He wondered whether, in adopting the credit and financial policies under the new program, the authorities had given adequate consideration to the impact that the recent devaluation would have on the price level, Mr. Kharmawan continued. After a devaluation, additional liquidity was required to carry on the normal operations of an economy. Generally, a 30-50 per cent devaluation would be considered very large, and strenuous measures would be needed to adapt liquidity so that the economy could operate efficiently. The Costa Rican devaluation of 130 per cent should thus be regarded as extreme, and the adjustment program should pay considerable attention to the financial policies needed to provide the additional liquidity that the economy would now require.

He could accept the necessity of a program under the extended Fund facility because the performance criteria for the earlier stand-by arrangement had not been met, Mr. Kharmawan said. However, he wondered whether the earlier program had paid sufficient attention to the stiff rigidities to which Mr. Winkelmann had alluded earlier. The stand-by arrangement had looked good on paper and, indeed, according to the statistics, the economy should have attained equilibrium. However, Fund programs did not operate in a void but rather in societies with very specific political and social structures. When a country was unable to abide by the performance criteria of a program, the Fund should ask itself whether the program had been too harsh or had called for too much in the context of the political and social structure of that country. It appeared that the Costa Rican stand-by arrangement had called for an unreasonably stiff reduction in government expenditures. In such cases, the Fund should be willing to reconsider its own judgment and recommendations rather than automatically placing the blame on the relevant country.

Some doubt had been raised about the prospects for success of the proposed extended arrangement, Mr. Kharmawan remarked, and it had been noted that there was a risk that important parts of the program would not be legislated. However, the interests of the Fund were well protected by the performance criteria.

Mr. Sangare said that he agreed with the staff views and those of Mr. Buira and that he was willing to support Costa Rica's two requests.

Mr. Caranicas stated that there was perhaps no clear answer to the question Mr. Kharmawan had raised with regard to whether the country or the Fund was to blame for the inability of Costa Rica to abide by the performance criteria of the earlier stand-by program. Certainly, the staff could not be blamed because the management and the Executive Board had backed the program. But it was just as important to ask, in all such cases whether conditionality was too harsh or programs were overambitious in the face of certain institutional rigidities as to ask whether the authorities themselves had faltered in the application of the stabilization program. In any event, the Fund should be patient with the implementation of programs, allowing time for social consensus to emerge.

Very recently, several proposed programs had come before the Board that had perhaps been accepted on faith, Mr. Caranicas observed. Fortunately, the Costa Rican case was quite different. As Mr. Buira had indicated in his statement, there was a consensus emerging in all sectors of society in Costa Rica--including political parties and business circles--for a strong program. Traditionally, Costa Rica had been a model of democracy in Central America. Due to overspending by the Government and persistent demand generated by the relatively high standard of living of the people, the economy had reached a state of imbalance, and austerity measures were now required. Assistance by the Fund was necessary to put the economy back on the right path and he could therefore support the Costa Rican request.

Mr. de Vries expressed his full support for the proposed extended arrangement and the requested purchase under the compensatory financing facility.

Mr. Alfidja said that he too supported both requests. As far as Costa Rica's track record was concerned, he agreed with the comments by Mr. Kharmawan.

The staff representative from the Western Hemisphere Department agreed with Directors that the viability of the program under the extended arrangement would depend largely on successful fiscal adjustment and, in particular, on the passage of the proposed tax reform and measures for improving expenditure control. In that connection, the Costa Rican authorities were aware of the demand management problems that had resulted from the system of revenue earmarking, and there seemed to be a good chance that the Legislature would pass the tax reforms. It should be noted that the temporary export tax was a revenue measure that the Government had been able to adopt without legislative approval. The expectation had been that the tax would be phased out once more basic measures had been enacted.

As to whether sufficient consideration had been given to the impact of the devaluation on domestic credit needs, the staff representative remarked that the calculations included in the program had been developed in close cooperation with the authorities and technicians of Costa Rica's Central Bank, and both the implications that the program would have on economic growth and the need to contain inflation stemming from the devaluation had been carefully considered. It was expected that the implementation of the proposed arrangement with the Fund would bring greater stability to the exchange market and that the exchange rate would then come to reflect actual economic conditions in the country.

The program had been designed to limit the country's dependence on external financing, the staff representative continued, and it was to be hoped that there would be a decline in commercial borrowing so that, by the end of the third year of the program, Costa Rica's financial needs would be largely met by long-term development loans.

No estimates had been made of the decline in real salaries that would result from the Government's decision to limit 1981 public sector wage increases to 16 per cent, the staff representative noted. However, the program had assumed an average inflation rate of about 40 per cent, and it was expected that, with the full implementation of the program, domestic inflation would taper off during the latter part of the year.

Addressing a question by Mr. Syvrud, the staff representative observed that the Costa Rican authorities for some time had been making an effort to diversify exports, particularly to other parts of Central America. As a result of the unsettled political conditions in the region, the demand for Costa Rican exports had declined. However, the recent devaluation and the current implementation of other export incentives should help to improve the situation.

The Central Bank's stabilization bonds, which had been used by the authorities for some time to affect domestic credit conditions, should enable the authorities to comply with the monetary limits set in the program, the staff representative remarked. The authorities were well aware of the need to keep the stabilization bonds competitive in the market, and the Central Bank had thus recently increased interest rates on those bonds from 22 per cent to 25 per cent.

The staff paper had indicated the main thrust of structural adjustment policies and cited major investment projects in energy, roads, and agriculture, the staff representative from the Western Hemisphere Department concluded. Furthermore, the Costa Rican authorities had discussed with the World Bank the idea of developing a comprehensive and articulated development plan, including many elements that were already in place.

The staff representative from the Exchange and Trade Relations Department explained that the question of exchange rate unification had been discussed between the Costa Rican authorities and the staff during the negotiations of the financial arrangements. But since the authorities intended to maintain a flexible exchange rate policy, a dual exchange rate market would no longer be necessary, and the unification of the exchange rate markets had therefore not been established as a performance criterion in the arrangement. However, if a dual market was reopened for some reason, the general clause in the extended arrangement against exchange restrictions and multiple currency practices would, of course, become operative.

The authorities had indicated that one of the major objectives of exchange rate policy was to attain a balance of payments equilibrium, the staff representative continued. A number of speakers had questioned the extent of the recent devaluation, and had indicated that the colón might have fallen to a level that did not accurately reflect the underlying conditions of the Costa Rican economy. While that might be the case, it was extremely difficult to estimate what the correct level of the exchange rate should be under current circumstances. The presence of large-scale speculation and regional instability made the task even more hazardous than it already had been under more stable conditions. It was expected, however, that with the proposed adjustment policies in place, with Fund support, and with the resumption of capital flows, a flexible exchange rate management would result in an appropriate exchange rate level.

The question of how financial and monetary programs should account for the impact of devaluation was very relevant, the staff representative observed. Generally, a devaluation was perceived as a once-and-for-all event that had a once-and-for-all impact on the price level, and therefore financial policy should be designed to accommodate that effect so as to prevent fueling the rate of inflation. However, in the present economic environment, where exchange rates--rather than being subjected to once-and-for-all changes--were constantly fluctuating, it was quite difficult, a priori, to adapt policies to exchange rate developments. In the case of Costa Rica, a scheme for international reserve--and hence exchange rate--management had been included in the adjustment program. Within the general principle that the exchange rate would be flexible, balance of payments developments would serve as an indicator of the appropriateness of the exchange rate. Increases in international reserves would tend to indicate that the exchange rate--the price of foreign exchange--was too high; conversely, a decline in reserves might indicate that the exchange rate was too low.

The question by a number of Executive Directors whether the conditionality attached to the stand-by and extended arrangements might have been too harsh encompassed issues of a general nature, the staff representative from the Exchange and Trade Relations Department said, that were scheduled for discussion July 29, 1981. Some Directors seemed to have felt that the recent proliferation of waivers and modifications indicated that programs were not working. There were, however, two sides to the issue: on the one hand, too many waivers or modifications might imply that the performance criteria had been too strictly set; on the other hand, absence of waivers and modifications could imply that the performance criteria had been too lax.

The Acting Chairman considered that the impressive growth rate of nontraditional exports might be partially explained by Costa Rica's access to the relatively free Central American Common Market. Other exports were perhaps not growing at a commensurate rate because they did not enjoy similarly free markets elsewhere.

The staff representative from the Research Department commented that eligibility to draw under the compensatory financing facility was not affected when products involved in a shortfall were subject to international regulation. Generally speaking, the purpose of such arrangements was to stabilize commodity prices and, to the extent that such arrangements succeeded in stabilizing export earnings, claims for use of the compensatory financing facility would in fact be reduced. The Costa Rican shortfall might have been partially attributable to export limitations imposed under the International Coffee Agreement, but the main cause had been adverse weather conditions, which had reduced exports considerably during the first six months of the shortfall year.

For about eight years prior to October 1980, quotas under the International Coffee Agreement had not been in force because prices had been well above the stabilization ceiling of the Agreement, the staff representative remarked. For the last six months of that period, from April to September 1980, Costa Rican coffee exports had been low because of the poor harvest. A recovery in Costa Rica's production in the season starting October 1980 had coincided with a sharp decline of coffee prices on the world market, which triggered the application of export quotas under the Agreement. Although Costa Rica's coffee supplies had increased, its exports during the second half of the shortfall year, from October 1980 through March 1981, had been restricted by quotas.

Mr. Kharmawan reiterated his point that if inflation was a problem during a stabilization program, the general policy was to restrain demand by reducing liquidity through budgetary and credit measures. In Costa Rica, however, the devaluation had caused an element of cost-push inflation that would counteract the tight credit policies. Moreover, although the devaluation had a once-and-for-all effect on the price level, it would have to be financed by an indeterminate amount of liquidity. If the stabilization program strictly limited liquidity without regard for the effect of the devaluation, then the effort of containing inflation might have a severe impact on economic growth. Those possibilities had to be taken into consideration when shaping a financial program.

Mr. Syvrud asked the staff representative from the Research Department whether the shortfall in Costa Rican coffee exports attributed to the International Coffee Agreement was included in the shortfall calculations.

The staff representative from the Research Department responded that calculation of the export shortfall was based on trade statistics covering the period after the stabilization operations of the International Coffee Agreement had been put into effect. Calculations had been based on actual data for the three years up to and including the shortfall year and on projections for the two years that would follow. The staff considered any reduction in export volume that occurred because of limitations imposed by commodity agreements to be a factor beyond the control of the member, and therefore eligible for inclusion in the calculation of the shortfall.

Mr. Buira commented that he was grateful for the sympathy, and interest, that Executive Directors had shown for Costa Rica. He agreed with them that in 1980 the Costa Rican authorities had made a credible effort at stabilization, reducing the fiscal deficit by 2 per cent and reducing credit expansion by approximately 40 per cent. It appeared that the Board had judged the previous stand-by arrangement to be somewhat overambitious. In some cases such a program might still be effective and helpful. In other cases, excessive expectations might prove to be counterproductive because the authorities might abandon the program in despair, and the failure would give the country a bad image abroad. The fact that the targets in the new extended program were somewhat lower than in the earlier program seemed to indicate that the staff did recognize that the stand-by arrangement had been overambitious.

Whether or not adequate consideration had been given in the financial program to the cost-push impact of the devaluation was a crucial question, Mr. Buira considered. Because conditions in Central America made large capital inflows unlikely, the effect of unreasonable credit ceilings would clearly be economic recession. However, as a number of Directors had commented, the exchange rate was probably grossly undervalued due to speculation. When the public became aware that the extended program was in place, and once the Central Bank had the reserves with which to manage the exchange market, the colón could be expected to strengthen.

As for central bank intervention in the exchange market, Mr. Buira referred to the guidelines that had been approved by the Executive Board, which stated that members with floating exchange rates should intervene in the foreign exchange market if it was necessary to prevent or moderate sharp, disruptive fluctuations in the day-to-day or week-to-week value of the member's currency. The member could act through intervention or through restrictions on the sale of currency. Such intervention was encouraged, if necessary, when factors affecting the value of the currency were recognized to be temporary in nature. The guidelines also stated that, when the authorities and the staff could agree on an appropriate exchange rate, a country could act aggressively to move the currency's value toward that target rate.

Allowing for sufficient liquidity to finance devaluation, as mentioned by Mr. Kharmawan, was certainly a crucial consideration, Mr. Buira continued. The staff response appeared to have begged the question, as it showed more concern for inflation than for economic growth. The proper approach to the liquidity dilemma would be to review credit limits in light of economic progress after the first few months of the extended arrangement. Adjustments in liquidity would be made if trends in the exchange rate, in inflation, or in economic growth seemed to make it necessary. In the area of trade restrictions, it had been noted that Costa Rica would have no trade deficit whatsoever if it was allowed to sell processed coffee rather than coffee beans to the United States. Export earnings had indeed been limited due to the enforcement of export quotas, but only to a minor extent.

Responding to questions on the details of the investment program, Mr. Buira indicated that he had received a document from the Government of Costa Rica, some 70 or 100 pages in length, that gave extensive details on investment projects. Directors might be interested in examining the document because it contained lists of projects and information on where they were located, how advanced their technology was, what types of raw materials were used, what the plant capacity was, what the final product would be, how much the product would cost, where the financing would come from, how many people the plant would employ, when it would start operation, and the like. A number of operations had started in 1981, indicating that major efforts were currently under way to diversify the structure of production and exports. Based on the contents of that study, the World Bank was now preparing an even more comprehensive investment plan.

The support that the Executive Directors had expressed for Costa Rica's extended arrangement and their appreciation for the emerging political consensus were very encouraging, Mr. Buira continued. However, as in any other program, there remained a major element of risk. Costa Rica was a small country, producing coffee and importing oil, located in the politically turbulent area of Central America. Furthermore, Costa Rica's effort to maintain a degree of political pluralism and civil liberty added an element of risk to the program. For all those reasons, in addition to the strictly technical considerations, Costa Rica deserved the Fund's full support.

Mr. Winkelmann, continuing the discussion on how to finance the effects of a devaluation, said that tight credit could discourage investment through high interest rates, and therefore endanger economic growth. However, experience in recent years, especially in South American countries, provided evidence that, when imported inflation was accommodated by additional liquidity, further depreciation of the currency might become necessary. If that was so, a vicious circle was generated, which after an extended period began to be incorporated into the public's inflationary expectations. The result was an immediate increase in the propensity to import and a delayed interest in export development. That in turn would lead to a slowdown in economic activity, a deterioration in the balance of payments, and increased inflation. Therefore, there was little to be gained from a policy of accommodating the effects of the depreciation through expanding liquidity, since that policy also risked a loss in economic growth. He did not suggest a harsh liquidity policy, but noted that in the long run it might be better to break the vicious circle by avoiding credit policies that sought to accommodate the cost-push that came as a result of depreciation.

Mr. Buira responded that financial policy had to strike a balance between accommodating the cost-push effect of inflation and excessive restrictions that might provoke depression or recession. Large devaluations were very risky and difficult to manage because of the complications that arose in devising balanced financial policies and overcoming inflationary expectations.

The Acting Chairman remarked that, since the devaluation had been exacerbated by speculation, inflationary expectations might be moderated when the exchange markets settled down.

The Executive Directors then took the following decisions:

Extended Arrangement

1. The Government of Costa Rica has requested an extended arrangement for a period of three years in an amount equivalent to SDR 276.75 million.

2. The Fund approves the extended arrangement set forth in EBS/81/123, Supplement 1.

3. The Fund waives the limitation in Article V, Section 3(b)(iii) of the Articles of Agreement.

4. In accordance with the request of the Government of Costa Rica, the Fund notes that the stand-by arrangement approved on March 12, 1980 is canceled as of June 16, 1981.

Decision No. 6889-(81/93), adopted
June 17, 1981

Compensatory Financing Facility

1. The Fund has received a request from the Government of Costa Rica for a purchase of the equivalent of SDR 30.1 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.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 6890-(81/93), adopted
June 17, 1981

4. ST. VINCENT AND THE GRENADINES - 1981 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1981 Article IV consultation with St. Vincent and the Grenadines (SM/81/122, 5/21/81). They also had before them a report on the recent economic developments in St. Vincent and the Grenadines (SM/81/128, 6/3/81).

Mr. Casey made the following statement:

St. Vincent and the Grenadines experienced severe natural disasters in 1979 and 1980 which halted the creditable growth performance of earlier years. However, a strong recovery is expected in 1981 based on agriculture, tourism, and light manufacturing--sectors which have good medium-term prospects also. A welcoming environment for the private sector, political stability, and an educated and competitive labor force are factors which underpin these prospects.

Despite improvements over the last five years or so, the unemployment rate is still around 20 per cent. However, given the favorable growth prospects and government emphasis on diversification, including the attraction of enclave industries, this high rate of unemployment should be reduced steadily over time. The Government is concentrating on a select number of directly productive projects with quick pay-back periods. There is now general recognition of the need to avoid spreading scarce technical and managerial skills too thinly.

In 1980/81 a reduction in the overall fiscal deficit to 4.5 per cent of GDP (from 8 per cent the previous year) is expected, due mainly to a slackening of project-related and rehabilitation expenditure. Nevertheless, the budgetary situation remains weak. Revenue performance is poor due to the tax exemption of goods imported for relief and rehabilitation, lack of inflation adjustment to specific taxes, and the award of income tax concessions. The finances of the state enterprises also remain weak despite recent increases in tariffs in certain cases. The new round of wage claims, and the need to attract higher qualified personnel to administer the development plan, will put pressure on the public sector wage bill, though, hopefully, the impact can be phased over time.

Provided that adequate measures are taken to offset the impact of the forthcoming wage settlement, the overall fiscal deficit may be kept to some 5 per cent of GDP in 1981/82. In this context the authorities are considering raising company and property taxes. Other tax increases are also being considered (gasoline, imports, and foreign exchange). The authorities are reluctant to increase taxation on income, exports, or savings deposits because of disincentive effects.

The withdrawal of budget support grants from the United Kingdom following the 1979 independence agreement and the unreliability of foreign assistance makes it important for St. Vincent to make fundamental improvements not only in the public finances but also in the balance of payments.

The current balance of payments deficit was about 20 per cent of GDP in 1980, financed mainly by official transfers and government borrowing. In absolute terms, the current deficit is likely to widen in 1981 and be less adequately financed, thus giving rise to a marked increase in the overall deficit.

As a member of the East Caribbean Currency Authority and lacking its own central bank, St. Vincent has very limited scope for exchange rate, monetary, and interest rate policy. Lack of funds to finance a balance of payments deficit tends to curtail economic activity. The situation is analogous to that of a small open economy under the gold standard. As the staff suggests, however, there may be some scope for an upward adjustment of interest rates, and this may be considered in due course.

The balance of payments, partly due to a drop in foreign aid, is likely to remain problematic over the foreseeable future. Given the automatic adjustment process of a fixed exchange rate system, growth could be impeded from time to time. One key to this problem is diversification, which in time will boost exports and alleviate the balance of payments constraint. But because of fiscal difficulties (including narrowness of the tax base and large though infrequent wage demands) the authorities cannot proceed with their diversification policy as quickly as needed. A higher level of foreign aid would be of enormous benefit to St. Vincent and the Grenadines at this juncture and would have a high leverage effect. The authorities may apply to the Fund for a tranche drawing in the near future and I hope that such a request would be favorably received by the Executive Board at that time.

The economy has proved its resilience in the past, and medium-term prospects are good, assuming no further natural disasters. The authorities recognize the priorities of (i) strengthening the public finances and building up savings in the longer term; and (ii) the need to increase investment and accelerate diversification of the production base. Success on these fronts will also strengthen the balance of payments.

My authorities are in broad agreement with the conclusions of this, the first Article IV consultation, and are grateful to the staff for their thorough and painstaking efforts in producing this excellent report, which they hope will be the forerunner of many more.

Mr. Ainley remarked that the economy of St. Vincent and the Grenadines had displayed remarkable resilience following the natural disasters of 1979 and 1980. The outlook for growth was particularly encouraging and a strong recovery was expected in 1981 based on agriculture, tourism, and light manufacturing. But serious problems also had to be addressed. Unemployment, despite some improvement in recent years, was still very high. The rate of inflation had reached 19 per cent in 1980. The current account deficit had widened to the equivalent of 20 per cent of GDP in the past year and, as Mr. Casey had pointed out, was likely to widen further in 1981 despite the expected recovery in exports.

The Government's diversification strategy was satisfactory, Mr. Ainley considered. The strategy had already been successful in attracting enclave industries. The limited availability of technical and managerial resources meant that it was appropriate for the authorities to concentrate on what Mr. Casey had called a "select number of directly productive projects with quick pay-back periods."

As was the case elsewhere in the Caribbean region, prudent fiscal policy would seem to be the key to economic stability, Mr. Ainley continued. Although the authorities were to be congratulated for the policies they had followed to date, the underlying budgetary situation was still weak. Substantial adjustments would be required in order to meet public sector wage increases and the need for greater domestic financing of development outlays. The authorities' recognition of the long-term importance of generating savings on current budgetary operations was welcome as was the intention to make a major effort at balancing current operations during 1981/82. Wage moderation would be essential in that context, particularly in view of the large share of the public sector wage bill in total expenditure. As the staff had advised, prospective wage increases in the current year should be kept as low as possible, and the impact of the increase should be spread over several years through modest annual increments. Had Mr. Casey any further information on the wage negotiations, or on how the authorities viewed the recent settlement made by the Central Water Authority?

On the revenue side, Mr. Ainley noted, the proposed 8 per cent increase in 1981/82 was unlikely to cover even inflation. The authorities were apparently considering raising company and property taxes, and he wondered whether duties on oil products might be switched to an ad valorem basis. He welcomed the Government's intention to sell shares in certain public projects, and asked whether the receipts from the sales were likely to be significant, and whether there might perhaps be room for further disinvestment of the same kind. The recent increase in prices charged by parastatal enterprises seemed to be an appropriate policy. Difficulties faced by the electricity services clearly demonstrated the risks of an inadequate tariff structure. Both the staff report and the recent economic developments paper highlighted the need to improve the financing and management of the public utilities, perhaps by establishing a long-term plan aimed at restoring the viability of those enterprises.

St. Vincent and the Grenadines clearly had very limited scope for an independent monetary and interest rate policy because of their membership in the East Caribbean Currency Authority, Mr. Ainley observed. However, the staff had presented a convincing case for a more liberal interest rate policy, which seemed particularly important in view of the contribution that remittances made to the economy. He hoped, as Mr. Casey had noted, that the authorities would consider an upward adjustment of interest rates in the near future.

St. Vincent's generally liberal trade and exchange regime were welcome, Mr. Ainley observed. He hoped that St. Vincent and the Grenadines would follow the example of St. Lucia and move to Article VIII status. Such a move could help to promote the confidence of potential investors.

It was somewhat disappointing that the adjustment program promised in the context of emergency assistance from the Fund last November had been so long delayed, Mr. Ainley concluded. He asked when the staff would provide the paper, promised in March 1980, clarifying the procedures for emergency assistance. It had been announced at that time that negotiations for a stand-by arrangement with St. Vincent would be completed within eight weeks, and Mr. Casey and the staff had referred to the possibility of a credit tranche drawing later in 1981. He asked whether further progress had been made in those stand-by negotiations.

Mr. Sangare welcomed the first Article IV consultation with St. Vincent and the Grenadines. Real GDP in the country had increased at an average annual rate of 8 per cent between 1975 and 1978. That growth was due to rapid gains in most sectors of the economy, especially in agriculture and tourism. Similar growth rates had been expected in subsequent years; however, a volcanic eruption in 1979 and a severe hurricane in 1980 had led to a steep decline in agricultural production. Recovery in agriculture in 1981 was expected to bring the rate of growth back to about 8 per cent.

Employment had expanded only marginally during the past five years, Mr. Sangare commented. As a result, the current rate of unemployment, estimated to be 20 per cent of the labor force, was both socially unacceptable and economically wasteful. The authorities had wisely cited expansion of agriculture, tourism, and light manufacturing as means of creating new employment opportunities. Accordingly, the authorities had agreed to make the best use of scarce technical and managerial personnel on directly productive and quick-yielding projects. At the same time, they were aware of the need to increase road, port, and electrical facilities so as to foster the overall development of the economy.

Agreeing with the staff appraisal, Mr. Sangare remarked that the prospects for economic growth in the medium term were favorable. Growth would be promoted by a policy that encouraged private investment and by the availability of a literate labor force at competitive wages. However, the authorities also realized that growth would depend on expansion in public savings and on whether or not adequate external financing could be found to support the public investment program. In 1978/79 and 1979/80, public savings had been reduced by the adjustment in civil service salaries and by outlays for relief and rehabilitation, which had offset the growth in revenue induced by new tax measures. In 1980/81, current expenditure was projected to rise by 12 per cent primarily due to further outlays for relief and rehabilitation. Revenue was expected to grow by only 7 per cent because several specific taxes had not been adjusted for inflation, tax exemptions had been granted on goods imported for relief purposes, and personal tax rates had been lowered. Therefore, the current government account was expected to move from equilibrium in 1979/80 to a deficit equivalent to 1.5 per cent of GDP in 1980/81.

In light of the government deficit in 1980/81 and the impending cessation of budgetary grants from the United Kingdom, the authorities were considering raising company and property taxes as well as taxes on gasoline, imports, and foreign exchange, Mr. Sangare indicated. However, they recognized that the scope for increasing taxes in other areas was limited because of the possibility of creating disincentives. Given the low level of St. Vincent's external debts and debt service ratio, the authorities might wish to contract more foreign loans on concessional terms.

A general concern had been expressed concerning the adverse effects of the negative real interest rates on capital movements, domestic savings, and the allocation of scarce bank credit, Mr. Sangare observed. However, independent action to adjust interest rates upward was constrained by membership in the regional currency area. The authorities might find it necessary to carry out interest rate adjustments in cooperation with the East Caribbean Currency Authority.

Concerning the external sector, Mr. Sangare stated, in 1980 the current account deficit had increased to 20 per cent of GDP because of a decline in export volume caused by the natural disasters and to an appreciable increase in the volume and prices of imports. The deficit had been covered mainly by official grants and credits. In 1981 the current account deficit was expected to increase further because of rising import demand, and there might be inadequate funds to cover it due to reductions in official grants. The resulting increase in the overall balance of payments deficit underscored the need for expanding the export base.

The implications of the choice between Article VIII and Article XIV status had been discussed between the staff and St. Vincent's authorities, who would reach their own decision on the matter, Mr. Sangare concluded. He asked whether the staff had an opinion on which status would be most appropriate for St. Vincent and the Grenadines.

Mr. Legarda observed that after having made impressive progress between 1975 and 1978, St. Vincent and the Grenadines had suffered a setback beween 1978 and 1980 primarily due to successive natural disasters. A sharp decline in agricultural production was offset by continuing growth in tourism and light manufacturing. Tourist receipts, in fact, exceeded receipts from merchandise exports. The economy was expected to expand by about 8 per cent in 1981 as agriculture recovered and new manufacturing facilities entered into production.

The balance of payments appeared likely to remain under pressure and the current account deficit of $11.9 million in 1980 was expected to increase to $13.2 million in 1981 due, in part, to an expected drop in foreign assistance, Mr. Legarda remarked. He therefore welcomed the Government's intention to diversify the economy and to improve the balance of payments, public finances, and the employment situation. Grants from the United Kingdom would soon terminate, and success in attaining those policy goals would be primarily dependent upon the development of domestic savings. It was also important that the Government should pursue the additional measures under consideration and, as the authorities were hoping, that overall wage increases should be moderate and their impact spread over several years. There was also an urgent need to improve the operation and financing of the public utilities so they would be able to contribute effectively to the expansion program. Finally, there appeared to be some need for adjustment of domestic interest rates in order to encourage savings, to improve the allocation of scarce resources, and, if possible, to attract outside funds.

The staff representative from the Western Hemisphere Department remarked that the staff had recommended adoption of Article VIII status for St. Vincent and the Grenadines since the country had no restrictions on current transactions and no multiple currency practices. The issue had been discussed in a cabinet meeting on June 16, 1981, and it was likely that the authorities would request Article VIII status in the near future.

Answering questions posed by Mr. Ainley, the staff representative commented that wage negotiations for the public sector were still in the preliminary stages. The Civil Service Association had put forward a working paper requesting an increase on the order of 120 per cent in an effort to compensate for the full cost of living increase since 1970. The Central Water Authority had won a wage settlement of 54 per cent on a compounded basis over three years. The position of the Civil Service Association was that the Water Authority had settled for the minimum acceptable increase. The authorities recognized that the earlier settlement was a very serious precedent for their negotiations with the Civil Service Association. The Government's recent introduction of an essential services law, designed to regulate strikes in the public sector, had caused great concern in the public service sector in light of the wage negotiations.

Regarding the possible sale of shares in public corporations, the staff representative noted that the dairy cooperative had made shares available to the public but had found a poor response from investors; it was expected that investors would wait to see how well the cooperative developed. Significant budgetary assistance was not to be expected from further disinvestment schemes.

As reported to the Board on the occasion of the compensatory financing drawing in March 1981, negotiations on an adjustment program had been initiated during the consultation discussions, the staff representative from the Western Hemisphere Department noted, and significant progress had been made at that time. The staff had explained the broad outlines under which the Fund could enter into a program with the authorities of St. Vincent. Emphasis had been placed on the effort to keep public finances and the current account of the budget in reasonable order. At that time, the authorities had been interested in a program but they had stated that they could not finalize the negotiations until the wage settlements in St. Vincent and the Grenadines had been completed. Once that was done, he expected that the staff would return to the country and complete discussions on an adjustment program.

The staff representative from the Exchange and Trade Relations Department stated that the question about the relationship between emergency purchases and subsequent compensatory financing facility drawings had come up at earlier Board meetings and was currently being studied in the Research Department. A paper would be prepared for discussion some time in the future.

Mr. Casey remarked that the authorities were still far from a settlement on the wage package and regarded the agreement with the Central Water Authority as a rather dangerous precedent. It was their intention to phase, over as long a time period as possible, whatever wage increases did come out of the process. Hopefully, that would ease the pressure on public finances. While authorities in St. Vincent had inherited a tradition of large and infrequent wage increases in the public sector, it appeared that they were prepared to accept a smoother evolution of the public sector wage bill in the future. The figures currently being discussed in the wage negotiations seemed excessive; however, those were not for annual increases in wages, but rather related to increases over a period of years. In fact, for quite a number of years, wages in the public sector had not even kept up with inflation.

The suggestion of a general shift toward ad valorem taxation was very helpful, Mr. Casey considered. The authorities were well aware that the revenue base in St. Vincent and the Grenadines was narrow and they might therefore give the proposal serious consideration. The adjustment program, discussed earlier by the staff representative from the Western Hemisphere Department, was in fact well under way. Indeed, the authorities wanted to conclude the wage settlement before requesting access to Fund resources. They were working to establish a balance on the current account and in the budget, but were somewhat hesitant to come to the Fund at the present time because their debt service had risen sharply. Although the debt service was not very high in relative terms, it had quintupled over the past six or seven years and the authorities were reluctant to increase external debt further at the present time. In addition, the authorities were taking time to consider the rates of Fund charges; they probably regarded them as somewhat on the high side, even for the use of ordinary resources. Nevertheless, it would probably be just a matter of time before St. Vincent came to the Fund for a credit tranche drawing.

The authorities of St. Vincent and the Grenadines were cognizant of the point several Directors had made regarding the need for reducing unemployment and increasing domestic savings and resources from abroad, Mr. Casey noted. At the present time there was a ceiling of 12.5 per cent on most lending rates while deposit rates were quite low, the rate on time deposits being about 4.5 per cent. The low interest rates had allowed private citizens to borrow for consumption of goods, causing an unfortunate misallocation of resources. However, some of that consumption actually took the form of investment because farmers had been purchasing cars and pickup trucks to get their products to market. While higher deposit rates might mobilize some additional domestic savings, the poor savings ratio probably had more to do with low income levels than low interest rates.

Whether or not higher interest rates would improve the balance of payments was a moot point, Mr. Casey remarked. Workers' remittances had not been particularly buoyant in recent years, although they did constitute an important part of the capital account. In general, the flow of immigrant remittances was related to family income maintenance rather than interest rate changes. Nonetheless, the authorities of St. Vincent and the Grenadines were considering raising interest rates, although unilateral action on their part would certainly not endear them to their East Caribbean colleagues.

The country did appear to be moving toward Article VIII status, Mr. Casey concluded. Recognizing that preparing the documents for the first Article IV consultation for any country was a demanding task, he extended special thanks to the staff.

The staff representative from the Western Hemisphere Department, replying to a question about St. Vincent being legally able to raise interest rates unilaterally, explained that the East Caribbean Currency Authority (ECCA) was not directly responsible for interest rates in the region. There was a new Central Bank Act under consideration which would probably give the ECCA increased power, but still not the authority to set interest rates. Theoretically the countries did have the right to set interest rates independently, as each had its own banking law. In practice, however, since all the banks in the region were thoroughly integrated, the interest rate structure was very similar among all the islands. Thus an interest rate increase by one would almost automatically force interest rates up throughout the rest of the region so as to avoid disrupting capital flows.

The Acting Chairman made the following summing up:

> Directors generally supported the staff appraisal in the first Article IV consultation with St. Vincent and the Grenadines. They commended the authorities for the rapid recovery of the

economy from earlier successive natural disasters, the favorable climate for investment, and the record of prudent financial and economic management. But they noted the need for a further strengthening of the public finances and a reduction of the high rates of unemployment and inflation.

Directors considered that an improved savings performance on the part of the public sector, including the public utilities, would be an essential element for the successful implementation of public investment programs in coming years. They commended, in general, the allocation of the resources in the development program, including the attention to agriculture. In light of the phasing-out of the traditional source of budgetary grants, hope was expressed that larger foreign assistance than is now in prospect could be secured.

Directors also attached importance to the pursuit of a prudent wage policy, including the use of appropriate phasing, aimed at ensuring the continued competitiveness and growth of the export and tourist sectors and the development of the manufacturing sector.

The hope was expressed that, within the framework of the East Caribbean Currency Authority, an upward adjustment in interest rates in the region would be brought about in order to help strengthen the balance of payments, as well as to encourage savings and improve the allocation of scarce financial resources. Finally, the hope was expressed that St. Vincent and the Grenadines would soon adopt Article VIII status.

5. BELIZE - MEMBERSHIP - EXPRESSION OF INTEREST

The Acting Chairman informed the Board that the Government of Belize had indicated its intention to apply for membership in the Fund on the attainment of independence.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/81/92 (6/15/81) and EBM/81/93 (6/17/81).

6. BORROWING - NATIONAL BANK OF BELGIUM

The Executive Board authorizes the conclusion of a borrowing agreement between the Fund and the National Bank of Belgium as set out in the Attachment to EBS/81/128 (6/12/81).

Decision No. 6891-(81/93), adopted
June 16, 1981

7. BORROWING - SWISS NATIONAL BANK

The Executive Board authorizes the conclusion of a borrowing agreement between the Fund and the Swiss National Bank as set out in the Attachment to EBS/81/129 (6/12/81).

Decision No. 6892-(81/93), adopted
June 16, 1981

8. UN ECONOMIC AND SOCIAL COUNCIL (ECOSOC)- SECOND REGULAR SESSION OF 1981 - FUND REPRESENTATION

The Executive Board approves Fund representation at the Second Regular Session of 1981 of the United Nations Economic and Social Council, to be held in Geneva, July 1-24, 1981 as set forth in EBD/81/168 (6/11/81).

Adopted June 16, 1981

9. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/81/198 (6/15/81) and EBAP/81/200 (6/16/81) is approved.

APPROVED: November 24, 1981

LEO VAN HOUTVEN
Secretary