EBS/82/214
Supplement 1

CONFIDENTIAL

December 22, 1982

To: Members of the Executive Board

From: The Secretary

Subject: Costa Rica - Stand-By Arrangement

Attached for the records of the Executive Directors is the text of the stand-by arrangement for Costa Rica agreed at Executive Board Meeting 82/163, December 20, 1982.

Att: (1)

Stand-By Arrangement - Costa Rica

Attached hereto is a letter, dated November 23, 1982, from the Executive President of the Central Bank and Minister of Finance of Costa Rica requesting a stand-by arrangement and setting forth the objectives and policies that the Government of Costa Rica intends to pursue. To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For the period from December 20, 1982 to December 19, 1983, Costa Rica will have the right to make purchases from the Fund in an amount equivalent to SDR 92.25 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 18,450,000 until February 15, 1983, the equivalent of SDR 36,900,000 until May 15, 1983, the equivalent of SDR 55,350,000 until August 15, 1983, and the equivalent of SDR 73,800,000 until November 15, 1983.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Costa Rica's currency in the credit tranches beyond 25 per cent of quota, or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 per cent of quota.

3. Purchases under this stand-by arrangement shall be made from ordinary resources until purchases under this arrangement reach the equivalent of SDR 5,149,540, then each purchase shall be made from ordinary and borrowed resources in the ratio of 2 to 1 until purchases under this arrangement reach the equivalent of SDR 12,837,039 and then each purchase shall be made from ordinary and borrowed resources in the ratio of 1 to 1.2, provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Costa Rica will not make purchases under this stand-by arrangement, other than the initial purchase of SDR 18,450,000 that it may request not later than within 15 days of the effective date of this arrangement, that would increase the Fund's holdings of Costa Rica's currency in the credit tranches beyond 25 per cent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 per cent of quota:

(a) during any period in which

(i) the limit on the net domestic assets of the Central Bank of Costa Rica set forth in Table 1 annexed to the attached letter;

(ii) the limit on the domestic banking system's net outstanding credit to the nonfinancial public sector set forth in Table 2 annexed to the attached letter;

(iii) the target on net international reserve position of the Central Bank set forth in Table 3 annexed to the attached letter; or

(iv) the limit on the amount of new foreign loans contracted by the public sector set forth in paragraph 8 of the attached letter

is not observed; or

(b) during any period in which the intentions regarding no accumulation during 1983 of new external payments arrears described in paragraph 14 of the attached letter are not observed; or

(c) during any period after June 30, 1983 if the review contemplated in paragraph 16 of the annexed letter has not been completed or, if further understandings have been reached pursuant to the review, while such understandings are not being observed; or

(d) during the entire period of the stand-by arrangement, if Costa Rica:

(i) imposes any new or intensifies any existing restrictions on payments and transfers on current international transactions; or

(ii) introduces any new multiple currency practices, or modifies the existing multiple currency practice other than as described in paragraph 13 of the attached letter; or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII; or

(iv) introduces any new or intensifies any existing import restrictions for balance of payments reasons.

When Costa Rica is prevented from purchasing under this stand-by arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Costa Rica and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Costa Rica's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Costa Rica. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Costa Rica and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Costa Rica, the Fund agrees to provide them at the time of the purchase.

7. The value date of a purchase under this stand-by arrangement involving borrowed resources will be normally either the 15th day or the last day of the month, or the next business day if the selected day is not a business day. Costa Rica will consult the Fund on the timing of purchases involving borrowed resources.

8. Costa Rica shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

9. (a) Costa Rica shall repurchase the outstanding amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Costa Rica's balance of payments and reserve position improves.

(b) Any reductions in Costa Rica's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) The value date of a repurchase in respect of a purchase financed with borrowed resources under this stand-by arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that repurchase will be completed not later than seven years from the date of purchase.

10. During the period of the stand-by arrangement Costa Rica shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Costa Rica or of representatives of Costa Rica to the Fund. Costa Rica shall provide

the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Costa Rica in achieving the objectives and policies set forth in the attached letter.

11. In accordance with paragraph 16 of the attached letter, Costa Rica will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Costa Rica has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Costa Rica's balance of payments policies.

San Jose, Costa Rica
November 23, 1982

Mr. Jacques de Larosiere
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Larosiere:

1. Important changes occurred in the world economy in recent years that called for adjustments in domestic policy. The prices of our main export products deteriorated, while the import bill for petroleum products increased substantially, and the rates of interest abroad rose to all-time highs making external financing increasingly onerous. Growing social and political difficulties in the rest of Central America resulted in serious limitations to trade and output in manufacturing. The required domestic adjustments, however, were not made; this greatly compounded the negative effects of the exogenous factors and resulted in unprecedented internal and external disequilibria of the country's economy.

2. The economic situation weakened rapidly in 1978-79 and became serious in 1980, when the nonfinancial public sector deficit reached almost 13 per cent of GDP, and the deficit in the current account of the balance of payments widened to 14-1/2 per cent of GDP. Despite the continued heavy recourse to foreign borrowing by the public sector during the year, foreign capital inflows were insufficient to offset the increase in the current account deficit. As a consequence, the net international reserves of the Central Bank declined by about US$170 million in 1980 and, in addition, there was an accumulation of external payments arrears of US$280 million. The rate of growth of real GDP declined to less than 1 per cent in 1980, from an average annual rate of more than 6 per cent during the preceding four-year period, the rate of unemployment rose considerably, and the domestic rate of inflation started to depart significantly from the rate of price increase abroad.

3. These developments signaled the onset of an acute economic and financial crisis. The lack of adjustment in demand management policies, to compensate for a lower level of foreign capital inflows in 1981, led to further losses of net official international reserves and accumulation of external payments arrears and, ultimately, to a large depreciation of the colon. In light of the worsening financial situation, the Government suspended last year foreign debt service payments, and requested of foreign creditors a temporary rollover of short-term debt and a restructuring of its foreign obligations. By the end of 1981 the country had suffered a decline in real GDP, was experiencing a very high rate of inflation, and had accumulated payments arrears of almost US$650 million.

4. The present Administration, which took office in May 1982, is determined to redress the serious economic and financial deterioration. The authorities are aware that, in view of the severity of the crisis, it will take more than one year to achieve a satisfactory internal and external situation. To cope with the most immediate problems, however, the Government has decided to implement a one-year emergency adjustment program whose principal features are described in the following paragraphs. The main objectives of this program, which should be viewed in a medium-term context, are to contain inflationary pressures, to promote an orderly development of the exchange market, and to facilitate the resumption of foreign debt service payments, while minimizing the impact of the adjustment on economic activity and employment. In support of this effort, the Government of Costa Rica requests the use of Fund resources under a one-year stand-by arrangement in an amount equivalent to SDR 92.2 million. In so doing, the Government is mindful that in the recent past the Fund's financial assistance has been sought on two occasions: through a stand-by arrangement and through an extended arrangement which supported programs that were not carried out. The Government hereby notifies the Fund of the cancellation of the existing extended arrangement as of the date of approval of the new arrangement. The Government would also like to indicate, at this time, its wish to negotiate an extended arrangement to follow the stand-by arrangement, in support of its medium-term adjustment effort.

5. The program has as its main fiscal policy objective that of reducing the overall deficit of the nonfinancial public sector to not more than 9-1/2 per cent and 4-1/2 per cent of GDP in 1982 and 1983, respectively, from a level of about 15 per cent of GDP in 1981. In the case of the Central Government, the deficit is expected to be reduced to about 3 per cent of GDP in 1982 and 2 per cent of GDP in 1983, compared with 5 per cent of GDP in 1981. The reduction of the central government deficit in 1982 will be achieved through a combination of revenue and expenditure measures. On the revenue side, this outcome takes into consideration the increased yields of foreign trade taxes as a result of changes in the exchange rate, and the introduction in December 1981 of a new tax on exports based on the differential between the official exchange rate and the rate at which export proceeds are surrendered. An increase in revenue equivalent to about 1/2 per cent of GDP is also expected from a temporary income tax surcharge, applicable this year and also in 1983, approved by the Legislative Assembly on November 11, 1982. On the expenditure side, a policy of restraint is being pursued, as a result of which current outlays of the Central Government are projected to decline in real terms by about 16 per cent and real investment expenditures by 8 per cent in 1982.

6. The Central Government intends to continue its policy of expenditure restraint in 1983. Current outlays are projected to decline by a further 5 per cent in real terms. To this end, the Government will continue to pursue a prudent salary policy and will carry out significant adjustments in real terms in current transfers for social security and public higher

education. Capital expenditures are projected to drop by about 7 per cent in real terms, and to be financed to a large extent by long-term foreign loans. Central government revenues are projected to increase by 60 per cent in 1983 on the basis of the effect of a tax package recently approved, including the income tax surcharge, and the extension through the end of 1983 of the tax on exports based on the exchange rate differential. The tax package includes modifications to the property tax, an increase in selective consumption taxes, an increase in the sales tax rate from 8 per cent to 10 per cent, and the extension of the sales tax to several new products in substitution of several specific excise taxes which have been eliminated. At the same time, a significant number of revenue earmarkings have been eliminated. The 1983 budget recently submitted to the Legislative Assembly reflects the expenditure and revenue policies just described, with the aim of limiting the central government deficit to 2 per cent of GDP in 1983. Next year the Government will seek legislation and carry out needed administrative reforms to further reduce earmarking and spending patterns dictated by special laws, which have limited heretofore the scope for discretionary expenditure cuts. These actions, together with the strengthening of the Budgetary Authority, will facilitate the achievement of a better control over expenditure and ought to make it possible to continue to reduce the public sector deficit in future years.

7. The strengthening of the public finances depends greatly on adjustments of the prices and tariffs charged by state enterprises. One of the first measures adopted by this Administration was to increase significantly the prices of petroleum products and public transportation, as well as electricity, telephone, and water rates. A further rise of about 90 per cent in electricity rates in monthly cumulative increases, became effective in November 1982. In addition, the National Electricity Board (SNE) already approved a further increase of about 15 per cent in domestic prices of oil derivatives to become effective in January 1983, to cover debt service payments of the state-owned refinery (RECOPE). The SNE also adopted a mechanism of automatic adjustments in prices of oil derivatives and electricity rates for changes in oil import prices and/or the exchange rate; such adjustments will be made without delay whenever those changes take place. Following the first adjustment of domestic oil prices in June 1982, the subsidized sale of foreign exchange to RECOPE was eliminated. The Government has also taken the decision to sell some of the major enterprises controlled by the state-owned development corporation (CODESA). To make this possible, the Legislative Assembly authorized in September 1982 the partial sale of these enterprises. These sales will permit the reorientation of CODESA's future operations and the elimination of Central Bank financing to the Corporation from 1983 onward. If by the end of June 1983 no sale has been made, the Government will adopt alternative measures to close CODESA's potential financial gap without increasing the public sector deficit. In addition, the National Production Council (CNP) has eliminated the subsidies granted through the sale of basic staples and other food items, and the Social Security Institute increased its quotas by a total of 4 percentage points effective January 1, 1983.

8. The Government intends to reverse the trend to use foreign financing for unproductive purposes. Accordingly, it will use foreign credit increasingly in the financing of productive investment projects of the public sector and to complement domestic financial resources in extending credit, through the banking system, to the private sector for productive activities. An important consideration for the scale of the Government's external borrowing operations during the period of the program will be the need to become current on its external debt service obligations within the constraints of its critical balance of payments situation. Much of the present debt servicing difficulties have arisen from inappropriate external borrowing policies in the recent past, particularly the heavy utilization of relatively short-term loans. In accordance with the Government's policy of improving the external debt profile over the medium term, the contracting by the public sector, including public financial institutions, of new foreign loans with maturities of over one year up to and including ten years will be limited to US$100 million during the period of the program. Within this overall ceiling, new commitments with maturities of over one year up to and including five years will be limited to US$50 million. This ceiling will also apply to officially guaranteed private sector loans and suppliers' credits, but will exclude any new loans directly related to the refinancing or rescheduling of existing external public debt, and credits under the Mexico-Venezuela oil facility.

9. The strengthening of the financial position of the public sector should permit it to lower its dependence on domestic credit and, thus, to allow for a more adequate supply of bank credit to the private sector, with fewer risks of pressures on domestic prices and the exchange rate. The distribution of bank credit in the program is intended to ensure that sufficient financial resources are available to support a gradual reactivation of private sector production and investment. The interest rate policy of the Government attempts to balance the need to provide adequate incentives to the growth of financial savings with the need to avoid hampering the productive efforts of the country. Therefore, the basic rate on six-month deposits, to which most credit rates are related, was raised by 3-1/2 percentage points to a level of 25 per cent effective December 1, 1982. The rate applied to commercial agriculture, representing most agricultural loans, was also increased from 18 per cent to 25 per cent as of the same date. During the period of the program, interest rates will continue to be adjusted taking into account the current and expected rates of domestic inflation, movements in interest rates abroad, the demand for credit from the private sector, and the growth of domestic financial savings, with a view to approach and ultimately establish rates that are positive in real terms.

10. The authorities are aware of the problems that previously issued exchange rate guarantees are imposing on the monetary policy and, thus, intend to reschedule, as part of the renegotiation of public external debt, the maturities of outstanding U.S. dollar-denominated certificates of deposit which were issued as a form of exchange guarantee (US$345 million). It also is the firm intention of the authorities not to grant

any new exchange rate guarantees. In this context, the exchange guarantees that applied to foreign debt service payments by the state-owned commercial banks in accordance with the Central Bank regulation of April 1982 have been eliminated.

11. Consistent with the policies described above, the monetary program specified quarterly ceilings on the net domestic assets of the Central Bank as detailed in the attached Table 1, and quarterly ceilings on domestic bank credit to the nonfinancial public sector, as presented in the attached Table 2. The ceilings on the net domestic assets of the Central Bank are consistent with a target of no loss of net international reserves of the Central Bank in 1983, including external payments arrears as a reserve liability, and with a moderation in the rate of inflation. Quarterly targets for net official international reserves, incorporating seasonal factors, have been established and are shown in the attached Table 3.

12. The Government is determined to ensure that the burden of economic adjustment is distributed equitably. This will be done in a manner consistent with the conviction of the authorities that in the present circumstances and for the foreseeable future, market forces should be the main determinant of prices, and that administrative controls and subsidies should be limited to a minimum number of basic consumer products, mainly benefiting the low-income groups. Wage policy will be geared to reducing inflationary pressures, while minimizing the effects of price increase on low-income groups. Therefore, during the period of the program, public sector salaries and minimum wages will be adjusted in absolute amounts in January and June 1983, on the basis of the increased cost of a basic basket of goods and services.

13. External sector policies will be directed toward unification of the exchange rate and a decline of the outstanding external payments arrears, the bulk of which constitutes delays in foreign debt service payments by the public sector. The authorities are determined to achieve these objectives within the framework of a flexible exchange rate system which will allow for a more efficient use of scarce foreign exchange resources, while keeping Costa Rican exports competitive in foreign markets. The objective of exchange market unification in the context of a flexible exchange rate policy will be achieved through periodic adjustments of the exchange rate, which will result in a narrowing of the spread between the interbank rate and the free rate over time, from 15 per cent at the beginning of the program to no more than 2 per cent by the end of the program period. Regarding trade policy, the Government plans to review the system of export incentives, as well as the levels of effective protection in certain industries, with the intention of shifting the promotion efforts toward sectors with a high component of domestic value added.

14. The success of the adjustment program is critically dependent on the restoration of confidence in the Costa Rican economy and in its capacity to meet international obligations. To this end, the normalization of relations with external creditors is of paramount importance.

This Administration resumed negotiations for rescheduling of Costa Rica's external public debt with foreign commercial banks in June of this year. The program envisages, as the most likely outcome of these negotiations, the rescheduling of principal (both current and past due) owed to commercial banks and bilateral official creditors. The authorities intend to resume current contractual debt service payments on public external debt during 1983. In the event that the rescheduling agreements with foreign creditors have not yet been finalized by December 1982, arrears on external debt service payments will be temporarily accumulated in 1983 until such time that the rescheduling agreements become effective, but once the agreements are concluded these arrears will be eliminated. In the interim, any new arrears on account of these payments will be fully matched by an equivalent increase in official reserves of the Central Bank, in order to comply with the balance of payments targets established in the program. During the period of the program, there will be no accumulation of external payments arrears other than those that may materialize on debt service payment of public debt currently under negotiation for rescheduling. To monitor the emergence of any arrears in the future, other than those on public sector debt service, the authorities are now requiring that all applications for foreign exchange purchases be backed by a counterpart deposit in local currency equivalent to 50 per cent of the amount requested.

15. During the period of the program, the Government of Costa Rica does not intend to introduce any new multiple currency practice, or modify the existing multiple currency practice other than as described in paragraph 13 above, impose any new or intensify any existing restrictions on payments and transfers for current international transactions other than those that arise from the temporary accumulation of arrears referred to in paragraph 14 above, conclude any bilateral payments agreement which is inconsistent with Article VIII of the Articles of Agreement, or introduce any new or intensify any existing restriction on imports for balance of payments reasons.

16. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of the program, but will take any further measures that may become appropriate for this purpose. The Government will consult with the Fund on the adoption of any measures that may be appropriate, in accordance with the policies of the Fund on such consultation. Progress made in the implementation of the program, taking into account balance of payments developments, including the envisaged debt restructuring, will be reviewed with the Fund before June 30, 1983.

Sincerely yours,

Federico Vargas Peralta
Minister of Finance

Carlos Manuel Castillo Morales
President
Central Bank of Costa Rica

Attachments

Table 1. Costa Rica: Ceilings on Net Domestic Assets of the Central Bank 1/

(Outstanding balances in millions of colones)

Periods	Ceilings
October 1, 1982-December 31, 1982	74,000
January 1, 1983-March 31, 1983	73,800
April 1, 1983-June 30, 1983	73,940
July 1, 1983-September 30, 1983	75,440
October 1, 1983-December 31, 1983	76,940

1/ Defined as the difference between (1) currency issue and (2) net international reserves of the Central Bank. Net reserves will include all reserve liabilities of the Central Bank with less than one-year's maturity, all liabilities to the IMF, and US$50 million of the outstanding balance due to a consortium of Mexican commercial banks (COMERMEX). In addition, they shall include external payments arrears. These ceilings will be adjusted for the difference between the level of external payments arrears on external public debt, subject to rescheduling, projected for the end of December 1982, and the actual level as of the same date of such arrears.

Table 2. Costa Rica: Ceilings on Domestic Banking System's Net Credit to the Nonfinancial Public Sector 1/

(Outstanding balances in millions of colones)

Periods	Ceilings
October 1, 1982-December 31, 1982	13,200
January 1, 1983-March 31, 1983	13,400
April 1, 1983-June 30, 1983	13,700
July 1, 1983-September 30, 1983	14,700
October 1, 1983-December 31, 1983	15,200

1/ Defined as the difference between the banking system's gross credit to the nonfinancial public sector and the latter's deposits in the banking system. For this purpose the nonfinancial public sector includes the Central Government, municipalities, decentralized agencies, and state enterprises. These ceilings will be reduced by the amount of any U.S. economic support loans directly disbursed to the nonfinancial public sector.

Table 3. Costa Rica: Targets on Net International Reserve Position of the Central Bank 1/

(Outstanding balances in millions of U.S. dollars)

Dates	Targets
December 31, 1982	-1,320
March 31, 1983	-1,320
June 30, 1983	-1,320
September 30, 1983	-1,350

1/ Defined as the difference between the Central Bank's gross foreign assets and short-term foreign liabilities including net position with the Fund, US$50 million of the outstanding balance due to a consortium of Mexican commercial banks (COMERMEX), and all foreign payments arrears. These targets will be adjusted for the difference between the level of external payments arrears on external public debt, subject to rescheduling, projected for the end of December 1982, and the actual level as of the same date of such arrears.