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Statement by Mr. Senior on Costa Rica
Executive Board Meeting 82/163
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I would like to express the appreciation of my Costa Rican authorities for the excellent work done by recent Fund missions in relation to the request for use of Fund resources under a stand-by arrangement. The authorities are quite convinced that substantial adjustment of the economy is essential at the present junction, and they are determined to implement a stabilization program that should set the basis for more normal and sustained growth in the medium term. The Fund staff has been very helpful in the formulation of such a program.

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

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

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

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

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

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

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

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

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

- Social security contributions have been increased by 4 percentage points.

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

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

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

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

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

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

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

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

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

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

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

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

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