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EBS/89/243

CONFIDENTIAL

December 27, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Costa Rica - Debt and Debt-Service Reduction and Refinancing Operations Contemplated Under the 1989 Financing Package

There is attached for the information of the Executive Directors a note on Costa Rica's financing package from commercial bank creditors.

Mr. DeMilner (ext. 8502) or Mr. Feldman (ext. 8783) is available to answer technical or factual questions relating to this paper.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

COSTA RICA

Debt and Debt-Service Reduction and Refinancing
Operations Contemplated Under the 1989 Financing Package

Prepared by the Staff

Approved by S. T. Beza

December 27, 1989

1. On November 16, 1989, Costa Rica and the coordinating committee of its commercial bank creditors reached agreement on the tentative outline of a financing package. The coordinating committee circulated the term sheet on December 20, 1989, together with letters addressed to the coordinating committee by the Managing Director, the President of the World Bank, and the President of the Inter-American Development Bank, to all bank creditors and requested endorsement for all necessary waivers. The package has also been submitted to Costa Rica's Legislative Assembly for approval of the issuance of new debt instruments.

2. The Managing Director commented in his letter that performance under the present stand-by arrangement had been positive in many respects, but fiscal performance had fallen short of projections and corrective action would be needed to return to the medium-term path envisaged in the economic program. He observed that, in the context of the implementation of sound economic policies, the finalization of the proposed financing agreement would be a necessary step toward attaining payments viability for Costa Rica. The letter concluded that on the basis of policies that would assure performance in line with the medium-term path of the economic program, the Fund would be in a position to contribute resources for the economic program, consistent with the guidelines on the strengthened debt strategy adopted by the Executive Board in May 1989.

3. The proposed financing package deals with all outstanding medium-term public sector indebtedness to commercial banks, including that arising from the 1983 and 1985 Refinancing Agreements and credit arrangements associated with these refinancings, which amount to approximately US$1.5 billion. The package also deals with past-due interest relating to this debt of approximately US$325 million. The proposal is conditioned upon participation by banks holding at least 95 percent of the debt, and upon the tendering of at least 60 percent of that debt in a cash repurchase option.

4. The main components of the package are:

(a) A cash repurchase option at a price of 16 cents per U.S. dollar of debt. Related past-due interest will be recognized as a separate claim and also will be purchased at a price of 16 cents;

(b) Exchange of remaining unpurchased debt for one of two types of bearer bonds: banks tendering at least 60 percent of their debt and past-due interest for cash repurchase may exchange the unrepurchased debt for Type A bonds bearing a fixed interest rate of 6.25 percent a year and repayable in 20 years with a 10-year grace period; banks tendering less than 60 percent of their debt and past-due interest may exchange their remaining debt for Type B bonds paying the same rate of interest, but repayable in 25 years with a 15-year grace period. Type A bonds will receive a 12-month interest guarantee while Type B bonds will not carry such a guarantee;

(c) Treatment of unrepurchased past-due interest as a separate debt requiring a 20 percent cash downpayment and repayment of the balance over 15 years at a rate of LIBOR plus 13/16 percent per annum. Holders of these claims who have tendered at least 60 percent of their debt and past-due interest for the cash repurchase option will receive a 36-month interest guarantee on these claims; other holders will not receive such a guarantee;

(d) Implementation of a US$100 million five-year debt-equity conversion program for the new bearer bonds and interest claims with a minimum amount of US$20 million in transfer value each year; and

(e) A value recovery provision to take effect once Costa Rica's GDP exceeds by 20 percent the 1989 level of GDP in real terms. The provision would increase the amount paid to banks to a level that would raise the ratio of total payments (excluding amortization payments) to GDP so as to equal the ratio of interest on bearer bonds and past-due interest claims (annualized basis) to GDP in 1990. These value recovery payments would be subject to a cap of 4 percent of the aggregate outstanding amount of bearer bonds and past-due interest claims or, when the latter are repaid, a cap of 2 percent of outstanding principal on bearer bonds. These payments would first be applied to satisfy past-due interest claims and, when these are repaid, as a bonus payment on the bearer bonds.

5. To fund this financing package Costa Rica may require a total of US$265 million; US$172 million for the buyback option; US$26 million for the downpayment on past-due interest claims, and a maximum of US$67 million for interest guarantees--US$37 million for the Type A bonds, and about US$30 million for associated past-due interest claims. This calculation assumes application of the financing terms to the full US$1.5 billion of bank debt and decision by all banks to opt for Type A exchange bonds by tendering 60 percent of their claims for cash repurchases. The actual cash requirement may be lower than this amount; for

example, if it is applied to only 95 percent of the debt, the cash requirement falls to US$250 million. At present, the Costa Rican Government estimates it can raise about US$170 million of financial support for the buyback and downpayment from multilateral and bilateral sources. Costa Rica may also request US$65 million of support for interest enhancement from official financing sources, including multilateral institutions. Thus, Costa Rica may need to raise an additional US$15 million to US$30 million in financial assistance.

6. In the medium-term balance of payments projections developed in connection with the request for the stand-by arrangement that was approved in May 1989, it was estimated that Costa Rica would be able to pay banks about US$50 million a year in debt service over the period 1989-92. The total debt servicing requirement of the proposed financing package over the first five years (apart from Fund repurchases in years 4 and 5) would be approximately of the same magnitude. The financing gap in the SBA program's medium-term outlook (an average of US$120 million in 1990-91) was assumed to be covered by the rescheduling of commercial bank and official bilateral principal falling due. However, under the present proposal all bank debt would be bought or exchanged, and amortization requirements in those years would thereby be eliminated.

7. The financing package would provide an expected reduction of US$1,275 million in commercial bank debt; the buyback of 60 percent of debt and past-due interest eliminates US$1,077 of debt, the 20 percent downpayment on unpurchased past-due interest eliminates US$26 million, and the 6 1/4 percent interest on the bearer bonds is equivalent to a debt reduction of US$204 million. Against the latter must be netted out the present discounted value of the value recovery payments which is estimated at US$32 million. To obtain this debt reduction (70 percent of total bank claims) Costa Rica must put up US$265 million, part of which (US$67 million) would go into an escrow account as a guarantee of interest payments and would be recovered by Costa Rica if it remains current in its debt service to banks.

8. Analysis of the cost effectiveness of the proposed financing package indicates that a substantial discount is involved and that the transaction as a whole is to be carried out at a market related price. The net reduction in Costa Rica's contractual obligations is estimated to be equivalent to that which would result from a buyback carried out at a discount of around 80 percent of face value. This discount is broadly in line with the prevailing secondary market price for Costa Rica's obligations. 1/

1/ The price quoted in the secondary market, which refers to contractual debt with the past-due interest claims attached, is now 18-19 cents per U.S. dollar. Excluding past due interest, the equivalent price per dollar of claims would be about 15 1/2 cents.