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EBS/89/87

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May 3, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Costa Rica - Staff Report for the 1989 Article IV Consultation and Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1989 Article IV consultation with Costa Rica and its request for a stand-by arrangement. Draft decisions will be proposed in a supplement to this paper following the discussions on May 5 and May 10 of the papers on issues relating to debt (EBS/89/77, 4/19/89, EBS/89/78, 4/19/89 and EBS/89/79, 4/20/89).

It is understood that the Executive Director for Costa Rica will be requesting the Board for a waiver of the circulation period, to enable this subject to be brought to the agenda for discussion at an early date.

Mr. Linde (ext. 8500) or Mr. DeMilner (ext. 8502) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

COSTA RICA

Staff Report for the 1989 Article IV Consultation and Request for Stand-By Arrangement

Prepared by the Western Hemisphere Department

(In consultation with the Exchange and Trade Relations, Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by S. T. Beza and Eduard Brau

May 2, 1989

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I. Introduction

The 1989 Article IV consultation discussions with Costa Rica were held in San José from January 30 to February 16, 1989 and at Fund headquarters on February 27-28, 1989 in conjunction with continued negotiations on an economic program that could be supported with a stand-by arrangement. The staff met with the President of Costa Rica; the Ministers of Finance, Agriculture, Economy, Foreign Trade, Labor, and Planning; the Executive President of the Central Bank; the Auditor General of Banks; the President of the Stock Exchange; and senior officials from the ministries, the Central Bank, and other public institutions. The staff representatives were Messrs. A. Linde (Head), J. Berengaut, L. DeMilner, Ms. E. Suss (all WHD), Ms. M. Xafa (ETR), and Ms. M. Rubin (Secretary-WHD). The mission was assisted by Mr. I. Tampe, the Fund resident representative in San José. Mr. Ayales, advisor to the Executive Director for Costa Rica, participated in the main policy discussions.

Costa Rica has accepted the obligations under Article VIII, Sections 2, 3 and 4. The 1987 Article IV Consultation was completed on April 4, 1988 (EBM/88/56). A 17-month stand-by arrangement for SDR 50 million (equivalent to 42 percent of quota on an annual basis) was approved by the Executive Board on October 28, 1987. Access to Fund resources was reduced to SDR 40 million at the time of the first program review on April 4, 1989. Costa Rica made no purchases under the arrangement; the authorities elected not to make a drawing upon approval, and subsequently there were deviations from quantitative performance criteria and the external financing arrangements--which were to be subject to review by the Fund--were not concluded. 1/ During the period of the arrangement Costa Rica made repurchases equivalent to SDR 58.6 million (69.7 percent of quota), and by the end of March 1989 (when the arrangement expired) Fund credit to Costa Rica had been reduced to 58.2 percent of quota.

At the Executive Board discussion of the 1987 Article IV consultation, Directors urged the authorities to consolidate their adjustment efforts under the Fund arrangement and to intensify structural reforms with a view to establishing a stable policy framework. Directors encouraged the authorities to allow more interest rate flexibility and to continue the active use of exchange rate policy to maintain Costa Rica's competitiveness. In the program review discussion of August 4, 1988 Directors commented that Costa Rica's performance was broadly satisfactory, but noted the uncertain status of debt negotiations with commercial banks.

In the attached letter, the Costa Rican authorities request a 12-month stand-by arrangement in the amount of SDR 42 million (50 percent of quota); purchases would be made in four quarterly installments,

1/ Performance under the program was described in two midterm reviews (EBS/88/60 and EBS/88/133).

the first of SDR 11.25 million and the following three of SDR 10.25 million each (Table 1). The conditions necessary for these purchases are described in Appendix V. The external financing arrangements would include US$150 million of balance of payments assistance (US$80 million World Bank SAL with cofinancing and US$70 million U.S. AID), rescheduling of bilateral official debt, and a buyback of a substantial part of commercial bank debt to be followed by a menu of financing options for the remainder of such debt.

Table 1. Costa Rica: Position with the Fund During Period of Arrangement

	Outstanding Mar. 31, 1989	1989 Apr.-June	1989 July-Sept.	1989 Oct.-Dec.	1990 Jan.-Mar.
	(In millions of SDRs)				
Transactions under tranche policies (net)		2.25	6.15	1.25	6.15
Purchases 1/		11.25	10.25	10.25	10.25
Repurchases		9.0	4.1	9.0	4.1
Ordinary resources		3.1	2.1	3.1	2.1
Enlarged access resources		5.9	2.0	5.9	2.0
Total Fund credit outstanding (end of period)					
Under tranche policies 2/	49.0	51.25	57.40	58.65	64.8
	(In percent of quota)				
Total Fund credit outstanding (end of period)					
Under tranche policies 2/	58.2	60.9	68.3	69.7	77.1

Source: IMF Treasurer's Department.

1/ From ordinary resources only.
2/ Includes outstanding use under EAR, SFF, and EFF.

II. Economic Background and Performance Under the last Stand-By Arrangement

In the late 1970s and early 1980s the Costa Rican economy experienced strong external shocks in the form of a significant deterioration in the terms of trade, a sharp increase in international interest rates, and growing political and economic difficulties in the rest of Central America. Attempts to cushion these shocks resulted in a large fiscal deficit financed by substantial external borrowing on commercial terms, and led to major financial difficulties and a deep recession in 1981-82. During the following years, progress was made in reducing the deficit of the nonfinancial public sector, lowering inflation, and moving toward interest and exchange rate flexibility. However, Costa Rica's economy continued to be affected by structural constraints that have hampered the expansion of output on a sustained basis, and heavy foreign debt obligations have burdened the country's external position.

In these circumstances, the authorities adopted an economic adjustment program for 1987-88 aimed at reducing inflation, strengthening the external accounts, and creating conditions conducive to sustained economic growth. In addition to the correction of internal imbalances, the authorities sought an alleviation of Costa Rica's debt service burden. This program was supported by a stand-by arrangement from the Fund that was approved in October 1987 while negotiations with external creditors on financing arrangements were still in progress. After some initial difficulties in meeting program objectives, additional policy measures were implemented in early 1988, and were discussed by the Executive Board at the first review on April 4, 1988. Although program targets were not fully observed, performance in the first half of 1988 was generally in line with the program's domestic objectives. The second review was concluded on August 5, 1988; financing arrangements were not in place at the time, but there was evidence of progress in the negotiations with banks, and it was decided that financing arrangements would be the subject of a third review. In the event, the financing arrangements were not concluded, there were significant deviations from program targets, and the third review was not completed.

In the second half of 1988 there were slippages in the implementation of fiscal policies, and the end-1988 limit for the combined public sector deficit was missed by nearly the equivalent of 3/4 percent of GDP and central government expenditure exceeded the program limit by nearly 1/2 percent of GDP (Table 2). In addition, there were shortfalls in capital flows from abroad, and the limit on domestic credit to the public sector was breached by about 1 1/2 percent of GDP.

Inflation, which had surged at the beginning of 1988 and then subsided in subsequent months, accelerated again in the last three months of 1988 as food supplies were interrupted by hurricane damage and public utility rates were raised. The 12-month increase of consumer prices was 25 percent in December 1988, up from 16 percent one year earlier. Bank credit to the private sector expanded by 13 percent during 1988, faster than the 10 percent ceiling imposed by the authorities in January, but only about one half the rate of inflation.

Table 2. Costa Rica: Performance Under Stand-By Arrangement
(December 1988)

Target	Program	Outcome	Margin/ Excess (-)
(In millions of U.S. dollars)			
1. Net international reserves	20	-315	-335 1/
2. Stock of external payments arrears	--	379	-379 2/
(In millions of colones)			
3. Net domestic assets of the Central Bank	20,500	48,902	-28,402 1/
4. Cumulative central government expenditure (1/87-3/88)	110,100 3/	111,510	-1,410
5. Net domestic credit to the nonfinancial public sector	32,929 4/	39,420	-6,491

1/ When the shortfall in external financing and changes in rescheduling assumptions are taken into account, the deviation from the target was US$35 million. On this basis, the deviation from the ceiling on net domestic assets would have been ₡ 5,602 million.
2/ Includes interest in arrears due to commercial banks.
3/ Adjusted (+ ₡ 2,000 million) for overperformance of central government revenue.
4/ Adjusted (- ₡ 1,471 million) for increase in government bonds held by the private nonbank sector.

Real GDP in 1988 rose faster than projected (3.8 percent compared with 2.4 percent) mainly on the strength of exports (Table 3). Merchandise exports rose by 11 percent in U.S. dollar terms, as nontraditional exports expanded by one fourth. Revenues from tourism also grew by one fourth. Imports were moderately higher than in 1987, rather than contracting as had been projected. In all, the current account deficit was reduced to 5 1/2 percent of GDP from over 9 percent in 1987.

External financing was less than expected because agreements with commercial banks and with the Paris Club were not reached, the disbursement of the US$80 million World Bank structural adjustment loan was delayed, and shortfalls occurred in other loan disbursements. As a result, the year-end target for the reduction of payments arrears was not observed. Even after adjusting for the shortfalls in external financing, the year-end target for net international reserves was missed by US$35 million.

Table 3. Costa Rica: Selected Economic Indicators

	1984	1985	1986	1987	Prog. 1988	Prel. 1988	Proj. 1989
	(Annual percent change, unless otherwise specified)						
National income and prices							
GDP at constant prices	8.0	0.7	5.5	5.1	2.4	3.8	[illegible]
Nominal GDP	26.1	21.4	24.3	15.9	13.8	25.0	22.0
Consumer prices (end of period)	17.3	10.9	15.4	16.4	10.0	25.3	14.0
(average)	11.9	15.1	11.8	16.8	14.8	20.8	18.0
External sector (on the basis of U.S. dollars)							
Total exports, f.o.b.	17.0	-5.9	15.5	2.0	5.7	10.9	9.5
Total imports, c.i.f.	11.0	0.8	4.5	19.6	-5.4	1.9	9.2
Non-oil imports, c.i.f.	16.0	0.6	12.1	19.8	-6.0	2.9	8.0
Export volume	14.4	-7.5	-4.2	13.6	-0.7	4.0	7.5
Import volume	12.8	7.5	6.5	14.1	-10.1	-2.8	3.9
Terms of trade (deterioration -)	4.0	8.2	22.9	-14.3	1.2	1.6	-2.2
Real effective exchange rate (end of period; depreciation -)	4.2	-9.4	-3.8	-17.7	-6.0	0.5	--
Central administration							
Revenue and grants	26.1	18.5	18.8	17.4	16.3	20.4	22.0
Total expenditure	22.8	12.4	28.2	8.8	14.7	21.5	[illegible]
Banking system							
Net domestic assets 1/2/	8.6	8.2	16.2	27.4	8.7	17.8	15.6
Of which: public sector 1/3/	-1.7	0.8	-1.6	-2.9	-3.0	-0.2	-0.4
private sector 1/		8.5	9.3	13.1	9.3	6.9	5.2
Liabilities to private sector	10.5	12.9	22.2	27.5	12.9	19.2	17.8
Interest rate (annual rate for six-month deposits, end of period)	20.0	22.5	17.8	20.5	...	20.9	...
	(In percent of GDP)						
Combined public sector deficit (-)	-6.2	-7.1	-5.4	-3.2	-3.0	-3.7	-2.9
Nonfinancial public sector deficit	-1.9	-1.9	-1.7	-0.3	0.8	-0.6	0.2
Domestic financing	-0.7	-1.5	-0.3	0.1	-1.7	1.3	-1.8
External financing	1.2	3.4	1.4	0.2	0.9	-0.7	1.6
Central Bank losses (commitment basis)	-4.3	-5.2	-3.7	-2.9	-3.8	-3.1	-3.0
Nonfinancial public sector savings	4.3	3.9	4.4	4.7	7.2	4.4	4.7
Central administration	0.3	1.0	0.5	0.4	1.0	0.3	0.6
Rest of public sector	4.0	2.9	3.9	4.3	6.2	4.1	4.0
Central administration deficit	-3.0	-2.0	-3.4	-2.0	-2.0	-2.1	-1.7
Gross domestic investment	22.7	21.8	20.4	21.0	...	21.5	22.8
Gross national savings	15.7	14.0	21.2	20.5	...	18.4	20.4
Trade balance 4/	-2.9	-4.6	-1.9	-6.5	-3.3	-4.0	-3.7
Current account balance (excluding official transfers for balance of payments support)4/	-7.0	-7.8	-3.8	-9.1	-4.9	-5.6	-4.9
External debt (including use of Fund credit)4/5/	103.7	101.7	97.3	92.8	...	88.1	70.1
	(In percent of exports of goods and nonfactor services)						
Debt service ratio 6/	52.8	53.8	49.1	55.2	51.0	49.0	37.4
Interest payments 6/	24.5	22.9	19.8	19.6	18.1	19.6	17.1
	(In millions of U.S. dollars)						
Change in net international reserves (increase -)	-126	-194	36	157	322	-23	50
Gross official reserves 7/	441	529	557	518	...	680	...
Gross official reserves (months of imports)7/	4.8	5.7	5.8	4.5	...	5.9	...
Total external payments arrears	214.5	45.9	187.1	559.4	--	892.9	44.0
Of which: due to banks	46.3	1.2	57.6	322.3	--	624.9	--
interest	44.5	1.2	57.2	153.1	--	247.8	--
principal	1.8	--	0.4	169.2	--	377.0	--

Sources: Central Bank of Costa Rica; Ministry of Finance; and Fund staff estimates.

1/ In relation to the stock of liabilities to the private sector at the beginning of the period.
2/ Excludes counterpart of external payments arrears included in net international reserves of the Central Bank.
3/ Excludes increases in credit arising from the assumption by the Central Bank of part of the external debt of the public sector.
4/ GDP in colones has been converted into U.S. dollars using a constant real exchange rate between the colon and the U.S. dollar at the 1988 level.
5/ Includes interest arrears.
6/ Before rescheduling; includes Fund charges and repurchases, and interest on short-term debt.
7/ A substantial portion consists of nonliquid reserve assets, mainly claims against other Central American central banks.

III. Policy Discussions and Program for 1989-90

The proposed adjustment program, described in the attached letter of intent, aims to raise domestic savings, promote private investment and to improve the efficiency of resource use. To achieve these objectives the authorities intend to reduce the combined deficit of the public sector, maintain an appropriate credit policy, pursue flexible exchange rate and interest rate policies, and continue with structural reforms. In support of this program the authorities seek a 12-month stand-by arrangement in the amount of SDR 42 million (50 percent of quota). They will also seek accommodations with external creditors to bring debt service payments to a level consistent with the Government's medium-term macroeconomic objectives.

1. Fiscal policies

The deficit of the central government relative to GDP widened slightly to 2.1 percent in 1988 (Table 4). Revenue declined as a share of GDP, reflecting mainly delays in the effective implementation of the tax reform adopted in late 1987. Current expenditure exceeded program projections in nominal terms, as the higher than projected rate of inflation gave rise to overruns in program outlays as well as to larger wage payments; nevertheless, owing to the continued freeze on public employment the ratio of the wage bill to GDP declined for the second year in a row.

The surplus of the rest of the nonfinancial public sector in 1988 narrowed to 1.5 percent of GDP from 1.7 percent in 1987, whereas the program had envisaged a surplus of 2.8 percent of GDP. This slippage was due in part to a delay in adjusting public utility tariffs in the face of higher inflation. Thus, the overall deficit of the nonfinancial public sector widened from 0.3 percent of GDP in 1987 to 0.6 percent in 1988, instead of shifting to a surplus of 0.8 percent as programmed. Central Bank losses rose slightly in 1988 to 3.1 percent of GDP. As a result, the combined public sector deficit was 3.7 percent of GDP, compared with a 1988 program limit of 3 percent and with a deficit of 3.2 percent registered in 1987.

Projections made in late 1988 of the 1989 combined public sector deficit in the absence of policy measures indicated that a serious deterioration of the fiscal position was in store, principally because of a decline in the surplus of the public enterprises and decentralized agencies. To forestall such a development, the authorities have introduced measures that would bring the combined public sector deficit down to 2 3/4 percent of GDP, nearly a full percentage point lower than in 1988.

Table 4. Costa Rica: Operations of the Nonfinancial Public Sector 1/

	1984	1985	1986	1987	Prog. 1988	Prel. 1988	Prog. 1989
			(In millions of colones)				
Central administration	-4,966	-3,941	-8,245	-5,713	-6,000	-7,405	-7,470
Revenue	27,012	32,005	38,030	44,642	51,750	53,750	65,550
Expenditures	31,978	35,946	46,275	50,355	57,750	2/61,155	73,020
Current	26,586	30,144	36,858	43,628	50,625	52,650	62,865
Fixed capital formation	3,662	3,390	2,834	2,395	2,750	2,350	2,500
Other capital and net lending	1,730	2,412	6,583	4,332	6,375	6,155	7,655
Rest of general government	1,870	2,704	3,534	3,472	4,798	3,483	4,039
Revenue	15,176	19,336	24,774	28,647	36,593	37,275	36,977
Current	14,909	18,765	24,292	28,349	35,548	36,869	36,974
Capital	267	571	483	298	1,045	406	1
Expenditures	13,306	16,632	21,240	25,175	31,796	33,792	32,938
Current	11,916	14,535	18,783	22,033	26,500	28,778	28,271
Fixed capital formation	219	474	1,150	985	1,743	1,229	1,762
Other capital and net lending	1,171	1,623	1,307	2,157	3,552	3,785	2,905
Public enterprises	7	-2,479	642	1,379	3,662	4,122	4,433
Revenue	34,152	36,950	43,269	47,455	62,320	60,727	73,167
Current	33,860	36,659	41,621	46,648	60,967	59,675	70,704
Capital	292	291	1,648	907	1,353	1,052	2,463
Expenditures	34,145	39,429	42,627	46,176	58,658	56,605	68,734
Current	30,217	35,065	37,358	40,717	51,068	53,245	61,802
Fixed capital formation	3,811	4,414	5,523	5,967	7,533	5,754	7,070
Other capital and net lending	117	-50	-254	-508	57	-59	-139
Current account deficit (-)	7,062	7,685	10,943	13,261	22,073	15,621	20,290
Central Administration	426	1,861	1,172	1,014	3,125	-1,235	2,685
Rest of general government	2,993	4,230	5,508	6,316	9,048	8,091	9,703
Public enterprises	3,643	1,594	4,263	5,931	9,900	8,765	9,902
Overall deficit (-)	-3,089	-3,716	-4,069	-862	2,460	-2,135	1,002
Change in floating debt and interest arrears	2,425	-2,536	2,597	-1,105	-2,960	1,763	-6,466
Of which: interest on foreign debt	1,589	-1,959	801	1,373	-3,460	1,763	-6,466
Net financing requirements	664	6,251	1,472	1,967	500	372	5,464
External (net)	1,971	6,730	3,338	528	2,775	-2,470	6,780
Disbursements	4,343	7,405	8,187	4,681	7,258	3,488	11,050
Amortization due	-2,884	-6,706	-10,253	-10,433	-11,195	-7,874	-9,895
Principal in arrears (net change)	512	-1,136	2,044	5,820	-10,373	-2,196	-14,711
Debt relief	--	7,167	3,360	460	...	4,112	20,336
Domestic	-1,307	-479	-1,866	1,439	-2,275	2,842	-1,316
Bank credit (net)	-959	505	-1,123	-789	-3,325	-279	-1,241
Other (net)	-348	-984	-743	2,237	1,050	3,121	75
			(In percent of GDP)				
Current account deficit (-)	4.3	3.9	4.4	4.7	7.2	4.4	4.7
Central Administration	0.3	1.0	0.5	0.4	1.0	0.3	0.6
Rest of general government	1.8	2.1	2.2	2.2	2.9	2.3	2.0
Public enterprises	2.2	0.8	1.7	2.1	3.2	1.8	2.0
Fixed capital formation	4.7	4.2	3.9	3.3	3.9	2.6	2.6
Overall deficit (-)	-1.9	-1.9	-1.7	-0.3	0.8	-0.6	0.2
Central Administration	-3.0	-2.0	-3.4	-2.0	-2.0	-2.1	-1.7
Rest of general government	1.1	1.4	1.4	1.2	1.0	1.0	0.9
Public enterprises	--	-1.3	0.3	0.5	1.2	0.5	1.0
Changes in floating debt and interest arrears	1.5	-1.3	1.1	-0.4	-1.0	0.5	-1.5
External financing	1.2	3.4	1.4	0.2	0.9	-0.7	1.6
Domestic financing	-0.8	-0.2	-0.8	0.5	-0.7	0.8	-0.3

Sources: Ministry of Finance; and Fund staff estimates.

1/ Reduced coverage of the nonfinancial public sector for program purposes. Excludes about 5 percent (by expenditure) of total government, mainly local government and small regulatory agencies that report with a lag.

2/ Expenditure could increase by up to ₡ 2,000 million to the extent that revenue exceeded program projections.

In the central government, the authorities plan to reduce the fiscal deficit from 2.1 percent of GDP in 1988 to 1 3/4 percent in 1989. On the revenue side, tax collections are projected to improve as the full effect of the 1987 tax reform is felt; the legal challenges which led to delays in the implementation of the reforms in 1988 have largely been cleared up. Tax revenues will be supplemented by a contribution to the capital budget by banana exporters and growers in order to cover some of the costs of infrastructure improvements. On the expenditure side, current outlays are projected to decline with respect to GDP, in large part through continued restraint in outlays for wages and salaries; the freeze on public sector employment which has been in effect since 1986 will be continued. Investment plans have been reviewed, and priority will be given to those outlays that complement and support private activity in the agricultural and industrial sectors and to improvements in the provision of basic social services. Other capital outlays will be postponed.

The surplus of the rest of the nonfinancial public sector is projected to rise from 1 1/2 percent of GDP in 1988 to almost 2 percent in 1989. To counteract a prospective decline in revenue with respect to GDP, the Government has substantially increased electricity and telephone rates as well as grain prices charged by the National Marketing Board. In addition, some revenue will be raised through the completion of the program to privatize subsidiaries of the state development corporation. Capital outlays by the public enterprises will be reduced by postponing lower priority projects, particularly in the telecommunications and energy sectors.

As regards social security, the Government will resist attempts to generalize the higher level of benefits now received by a small portion of public sector employees, unless such an extension can be made self financing. It is expected that the results of a number of actuarial studies of the social security system that are now underway will become available in June 1989, and the authorities intend to revise contribution rates in accordance with the findings of these studies.

The authorities recognized that the use of asset sales to generate revenues and the postponement of investment outlays do not provide for a permanent solution to the fiscal problem. However, they noted that the passage of a major tax revision a little more than a year ago and the national elections scheduled for late 1989 and early 1990 constrained them in the choice of policy instruments.

The net operating losses of the Central Bank in 1988, as mentioned above, were equivalent to 3.1 percent of GDP, up from 2.9 percent in 1987 (see Table 3). 1/ Higher interest rates on external debt obligations figured in this rise, as did a reduction in the gains from debt conversion operations, which were curtailed from the high levels of 1987 in an attempt to slow monetary growth. In 1989 central bank losses are projected to remain virtually unchanged in relation to GDP; it is expected that debt reduction will result in lower losses in future years but will have only a minor effect in 1989.

2. Monetary policy

Credit grew more rapidly than intended in the first half of 1987 and stimulated a very rapid increase in imports. Attempts to reverse this trend were made in the second half of the year but were cut short by the emergence of a financial crisis precipitated by the failure of a number of finance companies. To bolster the liquidity of the financial system, the legal reserve requirement on shorter-term time deposits was temporarily lowered in the first half of 1988. The resources thereby released were made available for lending to troubled commercial banks or to regulated financial intermediaries, as well as to borrowers of these institutions in order to facilitate an orderly recovery of loan obligations. In addition, a contingency fund was created in the Central Bank with resources of financial intermediaries operating in the stock market, to be used by these institutions in case of liquidity problems. These measures proved adequate to restore confidence, and in the second half of 1988 reserve requirements were restored to their earlier level. Supervision and regulation of financial institutions was substantially strengthened and extended by legislation adopted in the fall of 1988.

During 1988 central bank policy aimed at a deceleration of credit to the private sector. In the context of the concern over banking system liquidity, however, it was decided to implement this policy by reimposing credit ceilings on individual banks, a traditional instrument whose use had been discontinued in 1987. These ceilings were designed to permit an expansion of credit to the private sector of only 10 percent during the year. In the event, such credit expanded by 13 percent, but with the acceleration of inflation it contracted substantially in real terms (Table 5).

1/ The marked imbalance between the interest-earning assets of the Central Bank and its interest-bearing liabilities gives rise to significant losses both in terms of net interest payments (operating losses) and losses associated with the reevaluation of accounts denominated in foreign currency insofar as external liabilities far exceed assets (accounting losses). The imbalance in the Central Bank's foreign currency assets and liabilities arose from heavy commercial borrowing abroad by the Central Bank beginning in the late 1970s, largely to finance deficits of the nonfinancial public sector, for which the Central Bank assumed all the exchange risk.

Table 5. Costa Rica: Summary Operations of the Banking System

	December 31									
	(₡ 50/US$1)		(₡ 56.5/US)		(₡ 63/US$1)		(₡ 76/US$1)		(₡ 85/US$1)	
	1984	1985	1985	1986	1986	1987	1987	1988	1988	1989 Proj.
I. Central Bank										
(In millions of colones)										
Net international reserves	-13,111	-3,317	-3,747	-8,202	-9,146	19,467	-23,484	-24,168	-5,661	-2,261
Official reserves	-2,256	-1,022	-1,154	1,979	2,207	-2,577	-3,109	4,864	5,440	1,462
Payments arrears	-10,855	-2,295	-2,593	-10,181	-11,353	-16,890	-20,376	-29,032	-11,101	1/-3,723
Net domestic assets	22,996	16,573	17,003	25,509	26,453	38,937	42,954	48,902	30,395	31,323
Public sector credit (net)	31,874	32,896	34,244	44,712	48,061	38,698	43,532	39,791	43,852	43,000
Rest of banking system credit (net)	-10,454	-11,108	-12,443	-11,106	-12,072	-6,627	-8,724	-12,776	-14,248	-13,225
Government trust funds	-4,478	-10,985	-10,985	-18,263	-18,263	-15,656	-15,656	-23,736	-23,736	-23,681
Counterpart arrears	9,542	2,295	2,593	10,165	11,334	16,495	19,890	29,032	11,101	3,723
Operational losses (cash basis)	22,523	37,359	37,359	42,118	42,118	43,982	43,982	46,193	46,193	-8,207
Medium- and long-term foreign liabilities	-76,806	-83,171	-93,983	-102,979	-114,826	-101,821	-125,111	-125,967	-140,884	-95,787
Stabilization bonds	-4,895	-4,900	-4,900	-5,079	-5,079	-7,648	-7,648	-11,204	-11,204	-14,621
Other accounts net	55,690	54,187	65,118	65,941	75,180	71,534	92,709	107,585	119,321	122,555
Of which: valuation adjustments	28,118	28,118	38,050	38,050	47,289	47,289	68,464	68,464	80,200	80,200
Currency issue	9,885	13,256	13,256	17,307	17,307	19,469	19,469	24,734	24,734	29,062
II. Banking System										
Net international reserves	-11,475	-1,331	-1,504	-4,761	-5,309	-15,288	-18,443	-19,015	103	3,639
Net foreign assets	-620	964	1,089	5,420	6,044	1,602	1,933	10,017	11,204	7,362
Payment arrears	-10,855	-2,295	-2,593	-10,181	-11,353	-16,890	-20,376	-29,032	-11,101	-3723
Net domestic assets	73,354	71,205	73,223	92,419	95,044	125,170	134,030	163,400	160,444	185,502
Public sector credit (net)	26,985	23,848	26,161	35,690	38,956	31,762	36,530	39,420	43,443	42,202
Of which: adjusted net credit 2/	17,073	17,578	26,161	25,038	38,956	30,807	36,530	36,279	43,443	42,202
Credit to private sector 3/	32,490	37,733	38,183	44,824	45,081	56,806	57,369	63,400	63,859	71,587
Medium- and long-term foreign liabilities	-79,806	-86,881	-98,181	-104,209	-116,198	-103,273	-126,863	-127,880	-143,006	-163,474
Other accounts (net) 4/	93,685	96,505	107,060	116,114	127,205	113,579	172,436	188,360	196,148	235,187
Liabilities to private sector 3/	61,879	69,874	71,719	87,658	89,735	114,393	121,028	144,285	160,547	189,141
Money	25,710	28,970	28,970	39,901	39,901	40,225	40,225	54,936	54,936	64,542
Quasi-money	36,169	40,904	42,749	47,757	49,833	74,169	80,804	89,349	105,612	124,599
(Annual percentage change)										
Net domestic assets 5/6/		8.2		16.2		27.4		17.8		15.6
Public sector credit 2/5/		0.8		-1.6		-2.9		-0.2		-0.8
Credit to private sector		16.1		17.4		26.0		14.6		13.5
Liabilities to private sector		12.9		22.2		27.5		19.2		17.8
(In percent of GDP) 7/										
Credit to private sector		18.2		16.9		17.9		17.3		15.3
Central Bank losses (cash basis)		7.7		1.9		0.7		0.6		-12.5
Liabilities to private sector		34.2		32.4		35.8		37.2		40.2
Money		14.2		14.0		14.1		13.3		13.7
Quasi-money		20.0		18.4		21.7		23.9		26.5

Sources: Central Bank of Costa Rica; and Fund staff estimates.

1/ Definition of payments arrears was changed to include only amounts expected to be paid in cash.
2/ For program purposes, excludes counterpart of external debt assumed during the year.
3/ Includes nonbank financial system.
4/ Includes Government trust funds, counterpart arrears, and Central Bank operational losses.
5/ In relation to the initial stock of liabilities to the private sector.
6/ Excludes counterpart of external payments arrears.
7/ Average of the stocks at the beginning and end of year in relation to the GDP of the same year, except for the Central Bank losses for which the numerators of the ratios are yearly flows.

Monetary policy in 1989 will aim at reducing the rate of inflation to 12-14 percent during the year. For program purposes, it is assumed that currency in circulation and private sector financial savings will grow at the same rate as nominal GDP. The authorities have targeted an expansion of net domestic assets of the Central Bank during 1989 which is consistent with a reduction in the domestic debt of the nonfinancial public sector equivalent to 1/4 percent of GDP and with the program target of a build-up in net international reserves of US$40 million, while allowing an increase in bank credit to the private sector of 13 1/2 percent. There will continue to be reliance on the use of credit ceilings for individual banks. The authorities explained that the use of these ceilings, even though the period of financial uncertainty has passed, was a matter of prudence. Within these ceilings, the authorities will attempt to maintain flexibility in the allocation of credit.

Since 1984 the authorities have been pursuing a financial liberalization program, which by the end of 1986 had given banks considerable freedom to set interest rates. In late 1987, at the outset of the financial crisis referred to above, interest rates offered by private banks and financial companies rose sharply; rates offered by state banks and the yield on government and central bank bonds at first followed, but as the Government took measures to restore confidence much of the run-up in interest rates on these instruments was reversed. Rates offered by private banks also declined somewhat, but in 1988 a higher than usual spread above bond rates prevailed. After the position of financial intermediaries was stabilized in the spring of 1988, the monetary authorities tightened credit conditions by raising the rate on three-month stabilization bonds from 17 percent to 22 percent. At present, except for a certain amount of agricultural credit that is subsidized, interest rates are positive in real terms and it is the intention of the Government that this continue to be the case in 1989.

To safeguard the progress achieved to date in financial liberalization, the authorities intend to avoid any general bank debt restructuring that would improve banks loan portfolios at government expense. In addition, the Government will not subsidize any operations of the state banks.

3. External policies

The current account deficit widened markedly in 1987 to over 9 percent of GDP as the export price of coffee dropped sharply and the reductions in import tariffs and consumption taxes, along with a liberal supply of credit, boosted merchandise imports by 20 percent. Although the colon was devalued by 17 1/2 percent in real effective terms during 1987, most of this change occurred toward the end of the year.

Early in 1988 the colon was devalued by 6 percent and, as noted, credit ceilings were reimposed to restrain the growth of consumption. There was a run-up of prices early in the year, and in order to dampen expectations of rising inflation crawling peg adjustments of the exchange rate were subsequently made at a moderate pace throughout 1988. As it turned out, the acceleration of inflation late in the year as well as some strengthening of the U.S. dollar vis-a-vis other currencies left the real effective value of the colon at the end of 1988 at about its level one year earlier (Chart 1). The growth in the U.S. dollar value of merchandise imports slowed to 2 percent in 1988; the program had envisaged a decline of over 5 percent. Traditional exports were virtually unchanged, but nontraditional exports continued their rapid expansion, increasing by over one fourth. As noted above, the current account deficit narrowed to 5 1/2 percent in 1988, just slightly above the projected deficit of 5 1/4 percent of GDP.

For the past several years, Costa Rica has conducted an active exchange rate policy, which lowered the real effective value of the colon by one third from end-1984 to end-1988. For 1989 the Government intends to maintain Costa Rica's competitive position through periodic adjustments of the exchange rate in the light of relative price movements and developments in the balance of payments. It is the Government's intention not to permit an appreciation of the colon in real terms with respect to its level in December 1988. Exchange rate policy adjustments would also be made in response to the planned reductions in import tariffs (discussed below). Moreover, attention will be paid to the relationship between the exchange rate and wages. The Government will emphasize the central role of productivity changes in wage determination in order to minimize the inflationary pressure arising from wage adjustments.

In 1989 the current account deficit is projected to narrow further to around 5 percent of GDP. This projection assumes that the terms of trade will deteriorate by 2 1/4 percent, that export volume will grow about 7 1/2 percent and import volume by 3.9 percent (see Table 3). Allowing also for some improvement in the capital account and debt relief from bilateral official and commercial creditors (as described below), there would be an accumulation of official reserves of US$40 million during 1989.

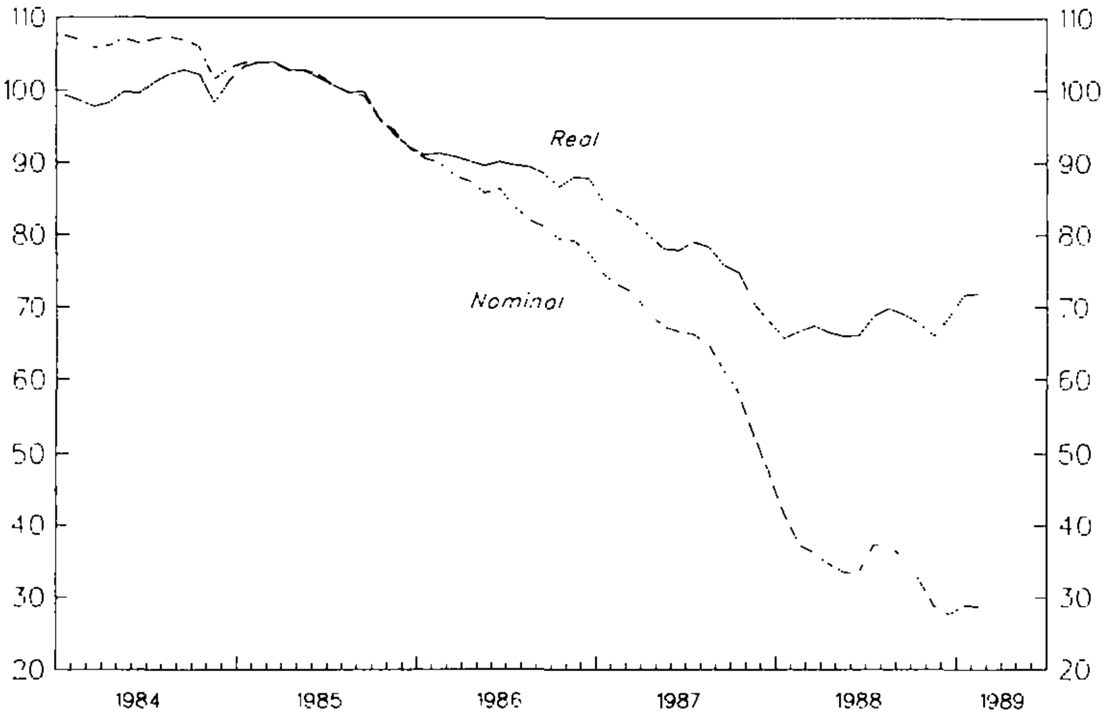
Costa Rica's external public debt amounted to US$4.1 billion at end-1988 (including interest in arrears), equivalent to 88 percent of GDP. Debt due to commercial banks accounted for 40 percent of the total, with the remaining due mainly to official bilateral creditors (26 percent) and multilateral institutions (31 percent). Arrears on external debt service obligations increased by US$334 million to US$893 million during 1988. The bulk of the accumulation of arrears in 1988 consisted of principal and interest obligations to commercial banks, although arrears to bilateral creditors and to the Central American Bank for Economic Integration also increased. Debt service obligations amounted to 49 percent of exports, nearly half of which were due to commercial banks.

CHART 1

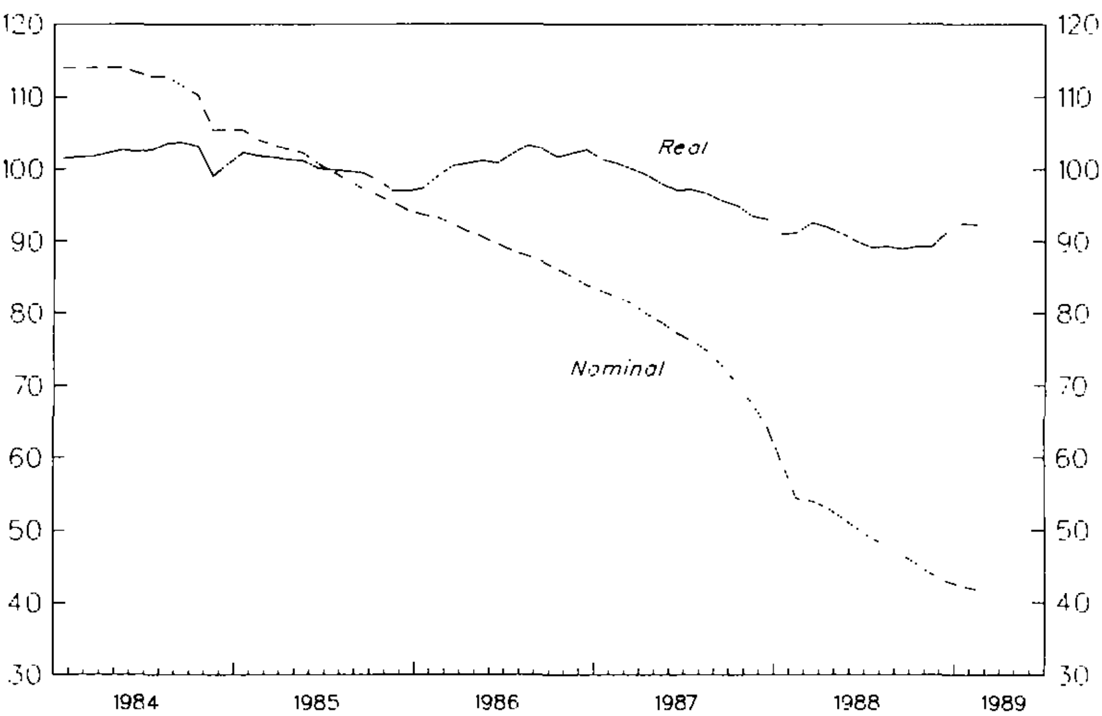
COSTA RICA

EFFECTIVE EXCHANGE RATES [1,2]

(1985=100)



BILATERAL EXCHANGE RATES WITH U.S. [1]



Source: IMF, *International Financial Statistics;* and Fund staff estimates.

[1] A decline in the indices denotes a depreciation of the colon.

[2] 1980 trade weights exclude Nicaragua and oil.

The authorities intend to seek understandings for a comprehensive rescheduling of Costa Rica's bilateral official debt service obligations, including previously rescheduled debt, with Paris Club creditors as soon as the proposed stand-by arrangement from the Fund is approved. Even after taking into account this rescheduling and projected balance of payments support from bilateral and multilateral sources, Costa Rica would still be faced with a financing gap equivalent to more than 2 percent of GDP in 1989 and subsequent years.

The authorities' aim is to cover this gap through a debt reduction arrangement with commercial bank creditors. They have proposed a two-stage scheme with which the banks agree in principle; the first stage would be a debt buyback and the second would consist of a menu of refinancing choices for the debt remaining after the buyback. The authorities believe they will be able to buy back about one half of the outstanding commercial bank debt at a price related to the current value of Costa Rican debt in secondary markets, and that such a transaction could be accomplished by early October 1989 using mainly funds borrowed from official bilateral sources. The second stage would be negotiated before the end of the year and would offer creditors a choice among such options as debt equity exchanges, exit bonds, and further debt buybacks. In the meantime Costa Rica has agreed to make partial interest payments to commercial banks at the rate of US$11 million a quarter, equivalent to somewhat less than 30 percent of the amount due.

The partial interest payments to banks during the period of negotiations of the debt reduction operation gives rise to a temporary increase in arrears to banks. Other arrears will be eliminated during the program period, including by cash payment, according to a specified schedule. Apart from the temporary increase in arrears to banks, new arrears would be accumulated during the program.

4. Structural reforms

The authorities have underway a program of structural reform whose aim is to remove rigidities that inhibit the efficient allocation of resources and burden economic policy management. Many of these reforms are supported with financial and technical assistance from the World Bank and U.S. AID.

Structural reforms that to a large extent already have been implemented include a major overhaul of the tax system and privatization of subsidiaries of the state-owned development corporation (CODESA). The tax package adopted in late 1987 became effective in 1988; extensive changes were introduced to broaden the tax base, eliminate exemptions, and update property assessments and maintain them through automatic inflation adjustments. In addition, a number of changes were made to strengthen tax administration. With regard to the plan to divest CODESA's subsidiaries, most of these enterprises already have been sold, with the divestiture plan to be completed by the end of 1989. Since 1986 two major subsidiaries have been privatized, and three have been absorbed by other public sector entities. Some 15 smaller enterprises were liquidated and minority interest in six others was divested. In 1989, 40 percent ownership in two economically strategic enterprises will be transferred to the private sector.

The main structural reform efforts in 1989 will deal with the structure of import tariffs and export incentives, the supervision and regulation of the financial sector, and the pricing, marketing, and subsidy policies in the agricultural sector. In the external sector, the authorities have developed a program to reduce import tariffs (except for some non-competing final goods--primarily luxury items) to bring the maximum rate down to no more than 40 percent by the end of 1990; tariffs on raw and intermediate materials and capital goods would be reduced to below 20 percent. As part of this program, tariff rates were reduced by 10 percent in October 1987 and by a further 10 percent in September 1988; four additional equal reductions are scheduled to complete the reform. The effect of these reductions on central government revenue in 1989 is expected to be limited. In addition, the present costly scheme of tax credits for nontraditional exports will be modified to comply with membership in the GATT.

In the financial sector the reforms will be aimed at improving the quality of the state banks' loan portfolios, increasing competition in the banking sector, and strengthening further the supervision and control of financial intermediaries. A package of financial reforms was adopted by the Legislative Assembly for this purpose. Among the reforms included in the package were measures to give more realistic valuation to banks' loan portfolios, allow penalty interest rates on overdue loans, eliminate the recording as income of accrued interest on loans over 180 days in arrears, and extend the authority of the superintendency of banks to include nonbank financial intermediaries. In addition, all financial agents will have to submit to external audits and to publish their balance sheets and income statements.

In the agricultural sector the authorities will seek to reduce pricing and marketing distortions created by the National Grain Marketing Board's (CNP) monopoly on the distribution of domestically produced basic grains and the importation of wheat. Private trading in these commodities is being introduced, credit policy is being designed to facilitate the allocation of resources toward more efficient crops, and CNP's buying and selling prices will be adjusted to eliminate CNP losses by the end of 1989.

IV. Program Design and Monitoring Issues

One of the objectives of Costa Rica's economic and financial program is to deal with the country's debt service problem. With its sizable external indebtedness and heavy debt service obligations, Costa Rica faces a large financing gap over the medium term. New commercial bank lending to cover this gap is not available, largely because of the regulatory loan provisions required of many of Costa Rica's lenders following the build-up of payments arrears; nor would further commercial indebtedness be advisable from the perspective of Costa Rica's ability to meet future debt servicing obligations. To close the gap entirely through internal adjustment would entail a marked reduction in the growth of potential output, and the continued accumulation of payments arrears would run counter to the objective of normalizing the relations with external creditors and would have adverse implications for the investment climate.

The approach that would be supported by the proposed stand-by arrangement involves a combination of internal adjustment, rescheduling of official bilateral debt, and reduction of commercial bank debt through a buyback operation followed by a menu of financing choices for the remaining commercial bank debt. The Fund would support this effort in several ways. The planned internal adjustment would yield a balance of payments surplus, part of which could be used to finance the buyback of commercial bank debt. Upon completion of the buyback and in the context of a midterm review, the target for net international reserves would be adjusted by up to 20 percent of the access to Fund resources under the proposed arrangement; this provision is equivalent to setting aside proceeds from Fund purchases for the purpose of debt reduction. Also, at the request of the authorities and if approved by the Executive Board, a special account would be opened in the Fund to serve as a conduit for the external resources obtained for financing the buyback. 1/

The stand-by arrangement is proposed for approval prior to the conclusion of the necessary financing arrangements for a number of reasons:

-- First, approval of the Fund arrangement would provide a clear endorsement by the international community of the authorities' economic program. Such an endorsement would strengthen the hand of the authorities in implementing the program. The arrangement also provides a framework for monitoring the evolution of domestic and external performance.

-- Second, approval of the stand-by arrangement would signal the Fund's support of the overall plan for dealing with Costa Rica's indebtedness to other participants in the financing arrangements, and would facilitate the conclusion and implementation of such arrangements. These include the settlement of arrears and rescheduling of current obligations due to Paris Club creditors, the disbursement of the World Bank SAL and its associated cofinancing, and the balance of payments transfers from U.S. AID. To postpone approval of the arrangement until all the financing is in place would delay the flow of most of the resources needed to settle arrears to bilateral lenders.

1/ A staff report seeking authorization for the establishment of this account will be submitted to the Executive Directors shortly.

-- Third, although there has been considerable progress in the negotiations with the commercial bank advisory committee on a debt arrangement, it will take time to complete all of the financing arrangements under the intended two-step procedure. During this period a Fund arrangement would provide a balance of payments framework within which the total financing package may be developed and monitored.

In view of the special features of the Fund arrangement that are designed to support the debt reduction exercise, the monitoring procedures include a number of provisions that would permit the adaptation of the program targets to unforeseen developments in concluding the financing arrangements. If the partial interest payments to commercial banks were not maintained at the agreed rate, the deviation would be added to the net international reserve target in order to avoid a weakening of the domestic adjustment effort. Similarly, if the authorities were to obtain more favorable terms from Paris Club creditors than assumed in the program, the additional resources would be added to net international reserves. These adjustments would help protect those creditors making resources available to Costa Rica and also would provide for some discipline in the management of external arrears.

With regard to Costa Rica's ability to repay the Fund, the record of net repurchases during the last program noted above demonstrates that Costa Rica accords the Fund preferred creditor status. The financing arrangements outlined for the proposed program together with the maintenance of appropriate adjustment policies could be expected to allow Costa Rica to achieve viability in its external accounts over the medium term, as discussed below. For these reasons the staff believes the Fund's resources would be well protected.

V. Medium-Term Outlook

The scenario that has been developed for the medium term assumes a continuation of a blend of adjustment and structural change aimed at attaining a higher rate of economic growth and securing a sustainable balance of payments position in a context of reasonable price stability. It is thus assumed that fiscal policy would be designed to reduce further the public sector's net use of domestic savings, and that interest rate, exchange rate, and credit policies would be pursued that would promote savings and private investment and encourage the inflow of capital from abroad. These policies would be supported by a deepening of structural reforms aimed at encouraging capital formation and efficiency.

A medium-term scenario consistent with the framework just described and with the WEO projections of the external economic environment is set out in Tables 6 and 7. Export growth and diversification would continue to be fostered by the real effective depreciation of the colon that has occurred in recent years, by the planned reduction in the anti-export bias of the import tariff schedule, and by incentives for nontraditional exports. Accordingly, nontraditional exports are projected to grow quite rapidly over the period 1989-92, but total exports would rise at about the same as GDP measured in dollar terms 1/ (or by some 9 1/4 percent a year), because of lack of buoyancy of demand for traditional exports. Imports would grow at about 8 1/2 percent a year, and the trade deficit would decline from 4 percent of GDP in 1988 to 3 percent in 1992. Reflecting also the decline in interest obligations equivalent to more than 2 percent of GDP that would result from the debt reduction operation, the current account deficit (excluding official transfers for balance of payments support) would decline from 5 1/2 percent of GDP in 1988 to 1 1/2 percent in 1992. Under this scenario there would be no further reliance on exceptional financing from official creditors beyond 1991.

Several medium-term outcomes are illustrated in Chart 2. The left column of graphs shows the outcome of the scenario based on debt reduction along the lines described above (baseline scenario). The alternative scenario presented in the right column of graphs assumes that there would be no debt reduction; instead, arrears to banks would continue to accumulate at a rate equivalent to about two thirds of the current interest obligations to commercial banks. Although external factors and domestic policies are assumed to be the same in both scenarios, in the alternative case the uncertainty over future taxation and exchange rate stability would yield more bearish expectations for the future and a lower rate of private capital inflows, investment, and economic growth. In the alternative scenario the current account deficit would remain in the range of 4 to 5 percent of GDP over the medium-term and the debt service ratio would exceed 24 percent by the end of the projection period. In 1992 external debt would be above 80 percent of GDP, compared with 58 percent under the baseline scenario.

In each panel, the results of assuming more favorable (variant A) and less favorable (variant B) behavior of coffee and petroleum prices and international interest rates are included to show the sensitivity of the results to changes in the external economic environment. In the favorable variant, coffee prices are 10 percent higher, petroleum prices 10 percent lower, and interest rates are 1 percentage point lower than in the central baseline or alternative scenarios. In the less favorable case the deviations from the central scenarios are in the opposite direction. Variants A and B imply a sustained 3 percent change in the

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1/ Nominal GDP in dollar terms is projected using domestic real growth and U.S. inflation. To the extent that domestic inflation differs from U.S. inflation, this would be reflected in adjustments of the nominal exchange rate.

Table 6. Costa Rica: Balance of Payments Outlook

	1986	1987	1988 Prog.	1988 Outcome	1989 Prog.	Projections 1990	Projections 1991	Projections 1992
	(In millions of U.S. dollars)							
Current account 1/	-151.3	-398.1	-222.5	-263.9	-249.3	-144.9	-129.2	-108.5
Trade balance	-76.6	-282.0	-133.2	-188.7	-187.2	-199.0	-202.9	-206.8
Exports, f.o.b.	1,084.8	1,106.7	1,176.8	1,227.0	1,344.2	1,463.2	1,599.9	1,748.2
of which: Coffee	391.9	334.5	333.4	328.2	310.7	332.5	352.2	372.9
Nontraditional	395.2	466.0	540.9	588.9	700.8	784.9	879.1	994.6
Imports, c.i.f.	-1,161.4	-1,389.7	-1,310.0	-1,415.7	-1,531.3	-1,662.2	-1,802.8	-1,955.4
of which: Non-oil	1,059.4	1,268.7	1,189.6	1,304.9	1,409.3	1,526.2	1,657.5	1,800.0
Oil	102.0	120.0	120.5	110.8	122.1	135.9	145.3	155.4
Factor payments	-280.7	-285.3	-300.9	-311.6	-312.1	-210.9	-207.2	-195.2
of which: Interest due (public sector)	-279.6	-284.7	-299.1	-303.4	-302.1	-200.9	-196.2	-183.2
Other services and transfers	206.0	169.2	211.6	236.4	250.0	265.0	280.9	291.5
Capital account	-201.4	-212.7	-170.0	-199.3	-192.3	-93.3	-78.9	17.1
Public	-235.3	-369.9	-325.8	-338.3	-257.3	-173.3	-158.9	-62.9
Disbursements 2/	144.3	83.7	123.9	96.8	101.0	105.0	110.0	120.0
Amortization due 3/	-379.6	-408.7	-449.7	-419.5	-358.3	-278.3	-268.9	-182.9
Private	33.9	112.3	155.8	124.4	65.0	60.0	80.0	80.0
Balance of payments support	120.6	120.0	205.0	125.0	150.0	188.0	85.0	114.0
U.S. AID (ESF)	80.6	120.0	125.0	125.0	70.0	68.0	55.0	44.0
IBRD (SAL) and cofinancing from Japan	40.0	--	80.0	--	80.0	120.0	30.0	70.0
Overall balance of payments before debt relief	-232.1	-490.8	-187.5	-337.2	-291.6	-50.2	-123.1	22.6
Rescheduling	145.9	42.9	609.9	108.6	762.1	...	...	...
Current obligations	133.0	21.8	309.4	25.0	...	...	...	...
Past obligations	12.9	21.1	300.5	83.6	762.1	...	...	...
Arrears subject to rescheduling (+ increase)	75.5	253.9	-300.5	212.2	-762.1	--	--	--
Overall balance of payments after debt relief	-10.7	-194.0	121.9	-16.4	291.6	-50.2	-123.1	22.6
Net international reserves 4/	-10.7	194.0	-321.9	16.4	-40.0	-81.3	7.6	-42.6
Nonrefinanceable arrears (+ increase)	65.7	118.4	260.2	121.3	-86.8	-34.0	--	-
Net official reserves (- increase)	-55.0	75.6	-61.7	-104.9	46.8	-37.3	7.6	-42.6
Net use of Fund credit	-36.0	-40.1	-15.1	-60.9	5.1	9.1	-6.8	-3.6
Other net official reserves	-19.0	115.7	-46.7	-44.0	41.7	-46.4	14.4	-39.0
Financing gap	--	--	-200.0 5/	--	-331.6	-131.5	-115.5	-20.0
Outstanding public debt 6/	3,916	4,056	...	4,133	3,574	3,849	3,866	3,912
Memorandum items:								
Export growth (in percent)	15.5	2.0	6.3	10.9	9.5	8.9	9.4	9.3
Import growth (in percent)	4.5	19.6	-5.7	1.9	8.2	8.5	8.5	9.5
Nominal GDP (in millions of U.S. dollars)	4,026	4,371	4,233	4,691	5,098	5,562	6,085	6,627
	(In percent of GDP)							
Trade balance	-1.9	-6.5	-3.1	-4.0	-3.7	-3.6	-3.3	3.1
Exports	26.9	25.3	27.8	26.2	26.4	26.3	26.3	26.2
Imports	-28.8	-31.8	-30.9	-30.2	-30.0	-29.9	-29.6	-29.3
Current account 1/	-3.8	-9.1	-5.3	-5.6	-4.9	-2.6	-2.1	-1.6
Capital account 7/	-5.0	-4.9	-4.0	-4.2	-3.8	-1.7	-1.3	0.3
Exceptional financing 8/	8.5	9.6	19.3	9.5	3.0	3.4	1.4	1.7
Overall balance (after debt relief)	-0.3	-4.4	10.0	-0.3	-5.7	-0.9	-2.0	0.3
Outstanding public debt 6/	97.3	92.8	...	88.1	70.1	69.0	63.5	58.6
Debt service ratio (as a percent of exports) 9/	49.1	55.2	...	49.0	37.4	26.4	22.8	16.5
Principal	29.3	35.6	...	30.4	20.3	15.9	13.3	8.3
Interest	19.8	19.6	...	18.6	17.1	10.5	9.5	8.2

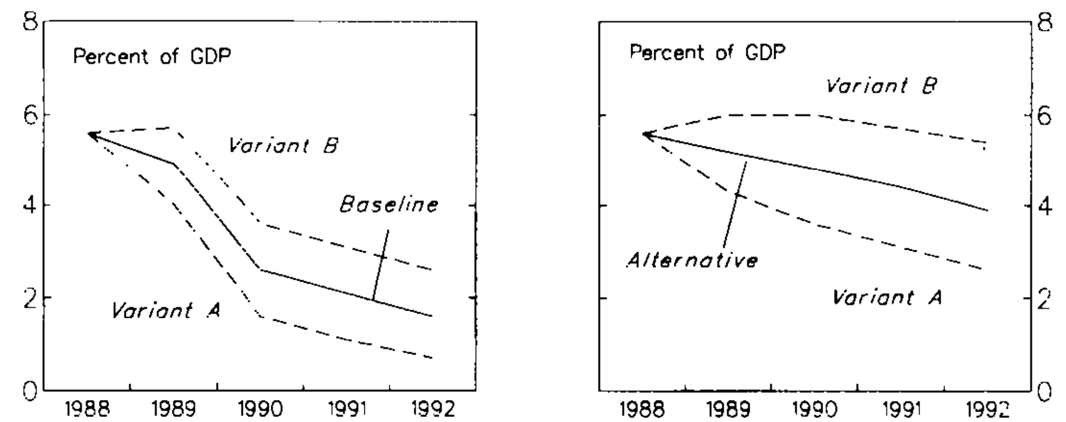
1/ Excludes official transfers for balance of payments support (U.S. AID).
2/ Excludes disbursements of IBRD structural adjustment loans, which are included under balance of payments support.
3/ Includes gain from conversion of external debt to equity at a discount in 1987 and 1988.
4/ Program definition; includes net official reserves and nonrefinanceable arrears. Movements in net international reserves in 1990-92 largely reflect the expected pattern of IBRD SAL disbursements and associated cofinancing.
5/ Expected new money package under the 1988 program.
6/ Includes IMF; interest in arrears is also included until 1988, after which they are eliminated through the debt reduction package.
7/ Excludes exceptional financing.
8/ Includes balance of payments support, rescheduling of current and past obligations, and changes in arrears subject to rescheduling.
9/ Before rescheduling, and including IMF.

CHART 2

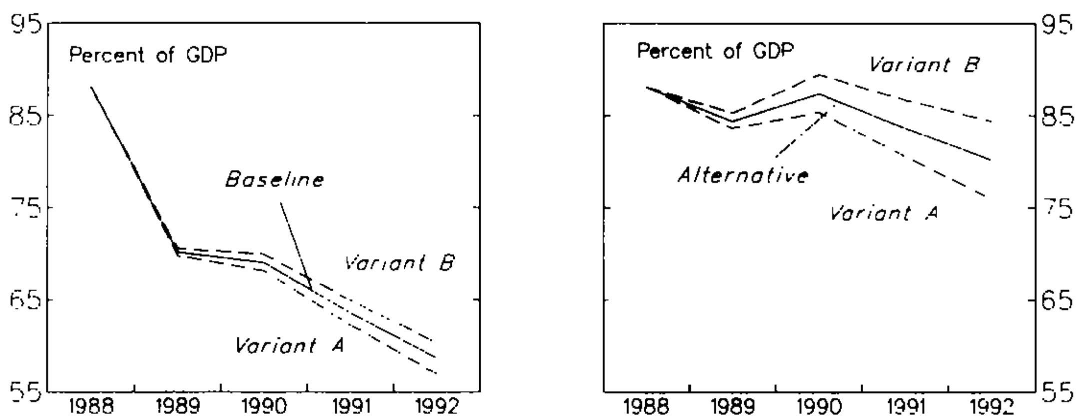
COSTA RICA

MEDIUM TERM SCENARIOS

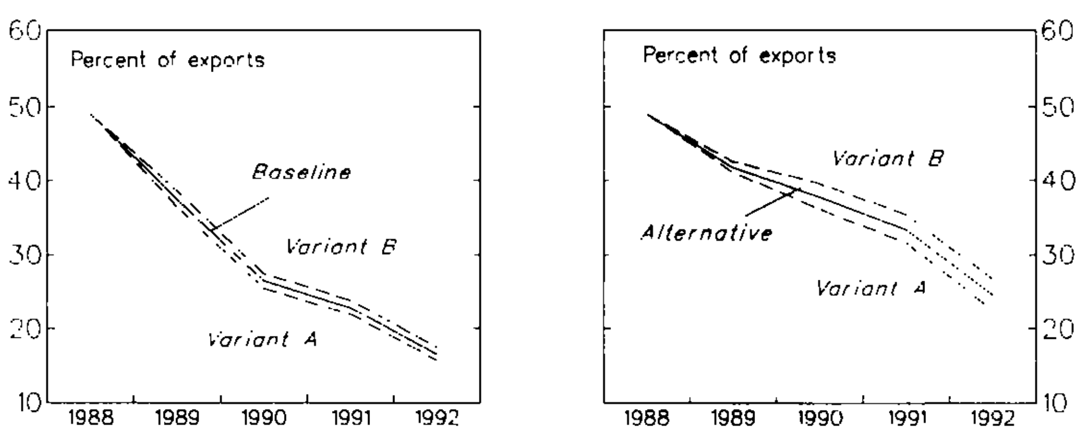
A. CURRENT ACCOUNT DEFICIT [1]



B EXTERNAL DEBT [2]



DEBT SERVICE RATIO [3]



[1] Excluding official transfers for BOP support.
[2] Including financing gap.
[3] Including IMF; before debt relief.

Table 7. Costa Rica: Baseline Scenario

	1986	1987	Prel. 1988	Prog. 1989	Projections 1990	1991	1992
	(In percent)						
Real GDP growth	5.5	5.1	3.8	4.3	4.8	5.2	5.5
ICOR	3.7	4.1	4.9	4.9	5.0	4.8	4.6
	(In percent of GDP)						
Fixed capital formation	18.7	19.4	18.6	21.1	21.8	22.5	23.0
Private	12.6	14.4	13.6	15.7	16.8	17.2	17.5
Public	6.1	5.0	5.0	4.5	5.0	5.3	5.5
Gross national savings	16.9	13.0	16.3	16.7	20.4	21.2	22.0
Private	16.2	11.2	15.0	15.0	15.8	16.2	16.5
Public	0.7	1.8	1.3	1.7	4.6	5.1	5.5
Official transfers for BOP support	2.0	2.7	2.6	1.4	1.2	0.9	0.6
External current account deficit 1/	-3.8	-9.1	-5.6	-4.9	-2.6	-2.1	-1.6
Overall public sector deficit	-5.4	-3.2	-3.7	-2.8	-0.4	-0.2	--
Nonfinancial public sector	-1.7	-0.3	-0.6	0.2	0.4	0.6	0.8
Central Bank losses	-3.7	-2.9	-3.1	-3.0	-0.8	-0.8	-0.8
External public debt	97.3	92.8	88.1	70.1	69.0	63.5	58.6
Of which: Commercial bank debt 2/	39.7	37.2	35.8	16.5	15.1	13.8	12.6
Interest due (public sector)	6.9	6.5	6.5	5.9	3.6	3.2	2.7

1/ Excludes official transfers for balance of payments support.
2/ Includes interest in arrears.

terms of trade relative to the central case. In the baseline scenario the difference in assumptions would cause the current account deficit to differ by about 1 percent of GDP a year on average from the baseline projection, the external debt by 2 percent of GDP, and the debt service ratio by 1 percent. In the alternative scenario the magnitude of the efforts of more favorable or unfavorable assumptions increases because the effect of interest rate changes is magnified by the higher stock of debt.

VI. Performance Criteria

The quantitative criteria (presented in Table 8) are: (1) quarterly limits on the expenditure of the Central Government; (2) ceilings on the stock of net domestic assets of the Central Bank; (3) limits for cumulative changes in the net domestic financing of the nonfinancial public sector; (4) targets for the stock of the net international reserves of the Central Bank; and (5) limits on the stock of external payments arrears that must be settled in cash. These performance criteria have been established for June, September, and December 1989, with indicative values for March 1989 (i.e., prior to the Executive Board discussion of the proposed arrangement).

New foreign loans contracted or guaranteed by the public sector with maturities of over one year and up to and including 12 years--apart from loans contracted with official creditors for the purpose of financing the debt buyback, as well as rescheduling of obligations with Paris Club creditors--will be limited to US$60 million in 1989. Within this ceiling, new commitments or guarantees of loans with maturities of over one year and up to and including five years will be limited to US$30 million.

The customary clauses on overdue financial obligations to the Fund and on exchange restrictions, bilateral payments agreement inconsistent with Article VIII, and import restrictions for balance of payments purposes are applicable during the program period; it is proposed that a multiple currency practice for certain student remittances be approved until the earlier of the mid-term review or November 30, 1989. A review with the Fund to assess the progress in concluding the external financing arrangements will be a performance criterion for purchases after the end of September 1989. The review will also assess performance through September 1989 and the adequacy of policies, including the exchange rate, for achieving the goals of the arrangement.

Table 8. Costa Rica: Limits, Ceilings, and Targets
Under the Stand-by Arrangement for 1989 1/

Variables and Periods	Amounts
	(millions ₡)
I. Limits for cumulative central government expenditure	
Cumulative change from December 31, 1988	
March 31, 1989 (indicative)	19,200
June 30, 1989	37,900
September 30, 1989	54,800
December 31, 1989	73,000
II. Ceilings on the stock of net domestic assets of the Central Bank	
December 31, 1988 (actual)	30,395
March 31, 1989 (indicative)	26,900
June 30, 1989	28,400
September 30, 1989	27,600
December 31, 1989	31,400
III. Limits for the cumulative change in the net domestic financing of the nonfinancial public sector	
Cumulative change from December 31, 1988	
March 31, 1989 (indicative)	2,200
June 30, 1989	3,900
September 30, 1989	1,000
December 31, 1989	-1,300
	(millions US$)
IV. Targets for the stock of the net international reserves of the Central Bank	
December 31, 1988 (actual)	-67
March 31, 1989 (indicative)	-51
June 30, 1989	-77
September 30, 1989	-64
December 31, 1989	-27
V. Limits for the stock of external payments arrears	
December 31, 1988 (actual)	131
March 31, 1989 (indicative)	131
June 30, 1989	100
September 30, 1989	72
December 31, 1989	44

1/ Definitions of the concepts to be measured and adjustments that may be invoked are included in the footnotes to the tables attached to the Letter of Intent.

VII. Staff Appraisal

Costa Rica experienced a deep recession and serious balance of payments difficulties in the early 1980s as a result of adverse external developments and shortcomings in domestic policies. The Government has made efforts in the past several years to lay the basis for sustained economic growth. The position of the nonfinancial public sector has been strengthened, interest rate and exchange rate management has been improved, inflation generally has been on a downward trend, and steps have been taken to reduce distortions and to open up the economy to foreign competition. However, the external position remains weak, in part reflecting the country's heavy debt burden, and the outlook for economic growth over the medium term is constrained by the magnitude of these debt obligations.

Under the program supported by the last stand-by arrangement, in 1987 there was a marked reduction in the overall public sector deficit and a sizable real depreciation of the colon, but there were slippages in credit policy associated in part with the failure of a number of finance companies. A rapid rise in credit to the private sector, together with the reduction in import duties and consumption taxes on certain imported goods, led to a strong expansion of imports and caused deviations from the balance of payments objectives of the program. Corrective measures were taken in early 1988 to bring the program back on track. Performance during the first half of 1988 was generally in line with the domestic objectives of the program, but in the second half the public sector deficit was significantly larger than programmed. Hurricane damage and adjustments of public tariffs added to the upward pressure on prices in the final months of the year. The external financing arrangements that had been contemplated under the program did not materialize and there were shortfalls in projected official capital disbursements, with the result that external payments arrears continued to accumulate.

When the stand-by arrangement was approved in October 1987, negotiations on financing arrangements were still in progress, and it was expected that an agreement with the advisory committee of commercial bank creditors on the rescheduling of principal and a new money package would be concluded in time for the second review of the program, initially scheduled for April 1988. In the event, despite considerable efforts and the extension of the period for securing the necessary financing, no agreement was reached. However, the advisory committee of commercial banks has accepted in principle a debt reduction plan, including a buyback to be followed by a menu of financing options for the holders of the remaining bank debt.

In entering into a new stand-by arrangement with the Fund, the authorities are seeking a lasting solution to Costa Rica's imbalances. In addition to the goals of reducing inflation, consolidating the recent improvement in the external current account, and promoting the conditions for sustained economic growth, they are seeking a reduction of

Costa Rica's external indebtedness to a more sustainable level. In this regard, it is important to provide for the appropriate incentives and policy support to ensure that any interest savings resulting from the new financing arrangements are channeled into investment. Economic policies should thus be aimed at raising domestic savings, creating appropriate incentives for private investment, and improving the efficiency of resource use.

As part of the program, the combined public sector deficit would be reduced from 3.7 percent of GDP in 1988 to 2.8 percent in 1989 through a combination of expenditure restraint, improved tax performance, and adjustment of public sector prices to strengthen the finances of the public enterprises. Some of the measures in the fiscal package, such as the sale of assets and the special contribution of banana growers and exporters to cover infrastructure costs, are of a short-term nature, and will need to be replaced with more permanent measures. Also, the fiscal adjustment in recent years has relied heavily on cuts in the public investment program; while some of these cuts may have reflected economic priorities, it will be important from the viewpoint of the country's longer term growth prospects that adequate attention be given to infrastructure investment.

The Central Bank credit program has been designed with the aim of halving the rate of inflation to the 12-14 percent range during 1989 and achieving a significant net international reserve gain. With the nonfinancial public sector expected to reduce its net indebtedness to the banking system, the program has room for a reasonable increase in credit to the private sector. Within the constraints imposed by the system of credit ceilings for individual banks, efforts need to be made to manage credit allocation in a flexible manner.

The success of the program will require a close monitoring of wage developments, not only in the public sector but in the private sector as well. To avert potential inflationary pressures and to enhance the reallocative effect of exchange rate adjustments, productivity gains should serve as the main determinant of wage increases.

Exchange rate policy is to be conducted with a view to maintaining Costa Rica's competitive position in world markets. The staff attaches great importance to the authorities' intention, as a minimum, to prevent any appreciation of the colon in real effective terms from the level of December 1988. It also is important that exchange rate policy take into account the phased reduction of import tariffs which is in the process of being implemented, to avoid adverse effects on the balance of payments.

Structural reforms are an important component of the program. Privatization of the entities of CODESA and the reform of the tax system already have been largely implemented. A program of phased reductions of the level and dispersion of effective protection is underway. Reform of export incentives is to be effected during the program period and should have fiscal as well as allocative benefits. In the agricultural sector, steps already have been taken to rationalize the system of support prices and improve the finances of the state marketing board, and further measures will be implemented to encourage more efficient use of resources. In the financial sector, a 1988 legislative package strengthened and extended the supervision of financial institutions; the implementation of this legislation is expected to enhance both the stability of and confidence in Costa Rica's financial system. Further efforts to promote greater competition and efficiency among financial institutions would yield substantial benefits.

The authorities have initiated contacts aimed at securing the resources needed for a debt buyback from commercial banks. An offer for such operation, at a secondary market-related price, would be made as soon as the necessary waivers and resources are obtained. In the meantime, Costa Rica will make partial interest payments to commercial banks at a rate of US$11 million a quarter. Negotiations with holders of the bank debt remaining after the buyback on the options and terms for regularizing these obligations would be initiated upon the completion of the buyback. Rescheduling of obligations to bilateral creditors of the Paris Club would be sought as soon as possible upon approval of the proposed stand-by arrangement. It is envisaged that Costa Rica would eliminate arrears with bilateral creditors by the end of June 1989. Arrears to other nonbank creditors would be eliminated by cash payments according to an agreed schedule. The proposed arrangement would provide Fund support for the planned financing arrangements and place them firmly within the framework of an adjustment program.

The authorities have presented an adjustment program that should improve Costa Rica's external position and strengthen economic performance more generally. The efforts of the authorities need to be complemented by external cooperation if the objectives of the program are to be met and an orderly external payments situation is to be restored. Assuming a continuation of present adjustment efforts, successful execution of the proposed debt reduction exercise should restore external viability over the medium term. In light of the measures already adopted and those that are being implemented, the staff believes that the authorities' program justifies the support of the Fund and proposes that the stand-by arrangement be approved. Costa Rica has given the Fund preferred creditor status, and the improvement in the balance of payments projected over the medium term should enable the country to meet its obligations to the Fund.

It is proposed that the next Article IV consultation be held on the regular 12-month cycle.

Fund Relations with Costa Rica
(as of March 31, 1989)

I. Membership Status
(a) Date of Membership: January 8, 1946
(b) Status: Article VIII

(A) Financial Relations

II. General Department

(a) Quota: SDR 84.1 million

		Millions of SDRs	Percent of Quota
(b) Total Fund holdings of colones:		133.07	158.22
(c) Fund credit:	Total	48.95	58.20
Of which:	Credit tranches	11.00	13.08
	EAR	33.26	39.55
	Extended facility	4.69	5.57
(d) Reserve tranche position:		--	--

III. Recent Stand-By or Extended Arrangements and Special Facilities

(a) Stand-by and extended arrangements:

Type of Arrangement	Amount (SDR million)	Percent of Quota	Duration	Amount Drawn (SDR million)	Status
SBA	40.00	47.6	10/28/87-3/31/89	--	Expired
SBA	54.00	64.2	3/13/85-4/30/86	34.0	Expired
SBA	92.25	150.0	12/82-12/83	92.25	Expired
EFF	276.75	450.0	6/81-5/84	22.5	Canceled Dec. 1982
SBA	60.50	147.6	3/80-2/82	15.4	Canceled June 1981

(b) Special facilities:
Compensatory financing

Date of Approval	Amount Drawn: SDR Million	Amount Drawn: Percent of Quota
Sept. 1983	18.60	30.2
June 1981	30.10	48.9

IV. SDR Department

	Millions of SDRs	Percent of Allocation
(a) Net cumulative allocation:	23.73	100.00
(b) Holdings:	0.05	0.20
(c) Current designation plan:	--	--

V. Administered Accounts: None.

VI. Financial Obligations Due to the Fund (millions of SDRs)

	Overdue Financial Obligations (Mar. 31, 1989)	Principal and Interest Due Apr.-Dec. 1989	1990	1991
Repurchases	--	22.0	19.0	5.2
Charges and interest including SDR (provisional)	--	3.5	4.0	2.6
Total	--	25.5	23.0	7.8

(B) Nonfinancial Relations

VII. Exchange Rate Arrangements: The representative exchange rate for the Costa Rican colon is the unified banking rate which was quoted at ₡ 81.05 (selling) per U.S. dollar as of April 18, 1989. All transactions take place at this rate except for remittances to students registered with the Central Bank prior to 1981, to whom foreign exchange is sold at the official rate of ₡ 20.00 per U.S. dollar; this special exchange rate gives rise to a multiple currency practice under Article VIII, Section 3.

VIII. Exchange Restrictions: Costa Rica maintains a restriction on payments and transfers for current international transactions evidenced by external payments arrears and engages in a multiple currency practice for certain remittances for study abroad. On August 5, 1988, the Executive Board approved the retention of the multiple currency practice for certain remittances until the earlier of the completion of the 1989 Article IV consultation or May 30, 1989 (EBM/88/125). Costa Rica's exchange restriction, evidenced by arrears on external debt obligations, was not approved by the Fund at that time.

IX. Last Article IV Consultation: Consultation discussions were held in November 1987-February 1988 and completed by the

Executive Board on April 4, 1988 (EBM/88/56). Consultations are conducted on a 12-month cycle.

X. Technical Assistance:

(a) CBD: A staff mission reviewed the Central Bank and financial sector legislation in February 1986. From April to November 1986 an advisor was assigned to the Central Bank in the area of organization and methods. From April 1986 to March 1989 an advisor assisted the Central Bank in the area of accounting procedures. A panel expert was assigned to the Central Bank in September 1986 as an advisor on external debt management. In November 1986 a CBD mission visited San Jose to advise the authorities on procedures and techniques used in the formulation of monetary policy.

(b) Bureau of Statistics: In May 1986 a STAT economist assisted the authorities in the implementation of procedures to improve the classification and monitoring of the Central Bank's net unclassified assets. A government finance statistics mission visited the country in July 1986. In September 1987 Costa Rica was included in a technical assistance mission on the five countries of the Central American Monetary Council (CMAC) to promote methodological consistency in the preparation and formulation of monetary and financial accounts. Follow-up missions took place in September 1988 and January 1989. In October 1988 a mission visited San Jose to discuss improvements in procedures and coverage of data on international banking and external debt transactions. In January 1988 a mission visited the five countries of the CMAC to investigate the availability of balance of payments data on a quarterly basis.

XI. *Resident Representative/Advisor:* *Mr. Ignacio Tampe has been the* Fund's resident representative in San José since January 1988.

Relations with the World Bank Group

Costa Rica has received to date 32 Bank loans, 1 IDA credit, and financing through IFC of 5 investment projects, totaling US$628.60 million (see table below). Of this amount, US$128.6 million remains to be disbursed.

Prior to 1981, World Bank lending to Costa Rica was concentrated primarily on developing basic infrastructure. With the growing financial and economic deterioration in Costa Rica that occurred in the early 1980s, the Bank's strategy was redesigned to encourage long-term structural changes needed to restore dynamism to the economy, while also assisting the more directly productive sectors. In this context, the Bank's approach supports three key goals: (a) revamping the incentive framework to promote new sources of growth in the economy, with particular emphasis on developing exports to new markets outside the region; (b) improving public sector efficiency and resource use to increase the availability of resources for productive investments; and (c) strengthening Costa Rica's creditworthiness.

As a first phase of this effort, an Export Development Loan was approved in May 1983, which was fully disbursed by mid-1985. This operation was followed by a Structural Adjustment Loan (SAL) of US$80 million, that was approved in April 1985 and disbursed by mid-1986. The SAL aimed at supporting the Government's structural adjustment program, with the objective of promoting renewed export-led growth, with particular emphasis on expanding nontraditional exports to markets outside Central America. The main areas covered by the first phase of the Government's medium-term program included: (a) trade reform geared to a lowering of effective protection; and (b) fiscal reform directed to a reduction of the size of the public sector and improvement in the efficiency of public sector institutions and programs. In the area of trade policy, Costa Rica took initiatives for the reform of the regional tariff regime of the Central American Common Market. These initiatives included tariff reductions, a shift of specific tariffs to an ad valorem basis, introduction of a modern nomenclature, and reduction of import surcharges. Regarding public sector management, the program aimed at limiting the growth of the public sector, including curtailing certain public sector investments, reducing public sector employment, and initiating actions to improve the cost effectiveness of certain loss-making institutions.

More recently, in October 1986, the Bank approved a US$26 million loan for the Atlantic Agriculture Development Project which aims at expanding agricultural exports. The loan was signed in April 1987 and approved by the Legislative Assembly in February 1988.

The Costa Rican authorities have reached agreement with the World Bank on the principal elements of the next phase of a structural reform program. These include: (i) trade reform policies; (ii) banking reform policies; (iii) management of the public sector and public savings targets; (iv) incentive policies and organizational reforms in the productive sectors to promote exports; and (v) external debt management. The above reform program would be supported by a second World Bank structural adjustment loan which was approved by the Board of Directors in December 1988 and is now before the Costa Rican Legislative Assembly; the overall package is expected to be cofinanced by the Government of Japan. The following tabulation describes Costa Rica's financial relations with the World Bank group.

(In millions of U.S. dollars, as of December 31, 1988)

A. IBRD/IDA/IFC Operations

	Number of Credits	Disbursed to Date	Undisbursed	Total	Repaid
1. IBRD loans	32	486.3	128.6	614.9	199.1
Agriculture	4	29.7	26.0	55.7	20.9
Education	1	6.0	--	6.0	0.9
Export	1	25.2	--	25.2	2.8
Imports	2	6.5	--	6.5	6.5
Industry	3	19.9	--	19.9	11.8
Power	7	126.9	--	126.9	70.5
Technical assistance	1	2.8	0.7	3.5	--
Telecommunications	4	57.9	--	57.9	34.9
Transport	6	107.3	--	107.3	41.0
Water supply	1	24.1	1.9	26.0	9.8
SAL	2	80.0	100.0	180.0	--
2. IDA credit	1	5.5	--	5.5	1.7
Transport	1	5.5	--	5.5	1.7
3. IFC investments	5	8.2	--	8.2	...

B. IBRD Loan Transactions 1/

	1982	1983	1984	1985	1986	1987	1988
Net disbursements	7.5	5.8	17.0	62.4	31.0	-18.0	-27.5
Gross Disbursements	19.7	23.5	36.2	84.1	55.2	13.6	6.6
Pincipal Repayments	-12.2	-17.7	-19.2	-21.7	-24.2	-31.6	34.1

Source: IBRD.

1/ Data are for fiscal years which end on June 30.

Costa Rica--Statistical Issues

1. Outstanding Statistical Issues

a. Real sector

The weights of the wholesale price index (base 1970) and the consumer Price index (base 1975) are outdated. New surveys to reweight and rebase these indices would seem to be appropriate.

b. Government finance

Annual data in IFS are as reported in the Government Finance Statistics Yearbook including the operations of the budgetary central government and Social Security Funds. Monthly and quarterly data in IFS do not include social security transactions.

c. Monetary accounts

The Costa Rican authorities are presently engaged in a program aimed at the modernization of the accounting systems of the Central Bank, deposit money banks (DMBs), and other banking institutions (OBIs). This work is being undertaken within the framework of Bureau of Statistics technical assistance to the Central American Monetary Council (CAMC) and its member countries that is intended to establish common and consistent monetary statistics for CAMC members. Costa Rica has informed the Bureau of Statistics that the new accounting system for the Central Bank would be introduced in April 1989, and that work on the new system for the DMBs and OBIs had started.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Costa Rica in the April 1989 issue of IFS The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Costa Rica, which during the past year have been provided on a timely basis.

Status of IFS Data

		Latest Data in April 1989 IFS
Real Sector	- National Accounts	1987
	- Prices: CPI	December 1988
	home and import goods	January 1989
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	November 1988
	- Financing	November 1988
	- Debt: by currency	September 1988
	by residence of lender	1983
Monetary Accounts	- Monetary Authorities	December 1988
	- Deposit Money Banks	October 1988
	- Other Financial Institutions	Q3 1986
Interest Rates	- Discount Rate	January 1989
	- Bank Lending/Deposit Rates	January 1989
	- Bond Yields	n.a.
External Sector	- Merchandise Trade: values	October 1988
	prices	October 1988
	- Balance of Payments	1987
	- International Reserves	February 1989
	- Exchange Rates	February 1989

Summary of Stand-By Arrangement

1. Principal objectives and targets

a. To promote a higher rate of economic growth, secure a sustainable balance of payments position, and maintain an environment of reasonable price stability. The program for 1989 has been designed to be consistent with a growth of real GDP of 4.3 percent, a reduction of inflation to 12-14 percent from 25 percent during 1988, and a net international reserve gain of US$40 million.

b. To normalize the relationship with external creditors on a lasting basis by reducing debt to commercial lenders, rescheduling bilateral debt, and eliminating arrears that cannot be rescheduled.

2. Main assumptions

a. The external economic environment would evolve according to the projections contained in the recent World Economic Outlook exercise.

b. The banking system liabilities to the private sector denominated in domestic currency are projected to rise by 17 1/2 percent during 1989.

c. The losses of the Central Bank (accrual basis) will be equivalent to 3 percent of GDP in 1989.

d. Balance of payments support in the form of bilateral official transfers and multilateral financing is expected to be US$150 million in 1989.

3. Principal elements and instruments

a. Fiscal policy

(i) The deficit of the central government is expected to decline from 2.1 percent of GDP in 1988 to 1.7 percent of GDP in 1989. The improvement would come both from higher revenues as the tax reform of late 1987 is fully implemented, as infrastructure investment costs are offset by contributions from banana growers and exporters, and reduced expenditure growth as non-essential investment is postponed and a freeze is maintained on public sector employment.

(ii) In the rest of the nonfinancial public sector the surplus would rise form 1.5 percent of GDP in 1988 to 1.9 percent in 1989 as a result of increases in public utility tariffs and postponement of non-essential investment. There would also be revenue from the sale of assets, as the remaining operations of the state development corporation are privatized.

b. Monetary policy

Although specific ceilings on the growth of credit to the private sector will be continued for another year, the authorities will endeavor to maintain flexibility in credit allocation. Expansion of the net domestic assets of the Central Bank will be limited to 3 percent in 1989 and will be monitored through quarterly targets; this expansion is expected to be consistent with the desired balance of payments results and a deceleration of inflation to the target range. Interest rates will continue to reflect the interplay of market forces.

c. External sector policy

The recent trends in the trade balance suggest the real value of the colon gives Costa Rica a competitive position in world markets. The authorities will as a minimum maintain the end-1988 real effective value of the colon, making such adjustments in the real rate as are required by changes in the structure of import tariffs; periodic adjustments will be made to the nominal exchange rate to take into account any differences between domestic and foreign inflation rates. A schedule for the elimination of external payments arrears has been established and serves as a performance criterion.

d. Structural policies

The authorities will pursue a program of structural reform in order to improve the efficiency of resource allocation and the management of economic policy. These reforms will concentrate on the areas of the structure of tariffs and export incentives in the external sector, reforms to improve the stability and competitiveness of the financial system, and measures to reduce pricing and marketing distortions in the agricultural sector. In addition, the divestiture and privatization plan for the state development corporation will be completed.

e. Other performance criteria

Besides the customary clauses on exchange restrictions and arrears to the Fund, there is to be a midterm review which will assess the progress of the debt reduction operation in addition to program performance.

Costa Rica: Schedule of Purchases During Period of Stand-By Arrangement

Scheduled Availability Date	Amount	Conditions Necessary for Purchase 1/
May --, 1989	SDR 11.25 million	Executive Board approval of program.
After July 31, 1989	SDR 10.25 million	Observance of quantitative performance criteria as of June 30, 1989.
After October 30, 1989	SDR 10.25 million	Observance of quantitative performance criteria as of September 30, 1989 and completion of the mid-term program review.
After January 30, 1990	SDR 10.25 million	Observance of quantitative performance criteria as of December 31, 1989 and any other conditions to be decided upon in the mid-term program review.

1/ Other than generally applicable conditions under the arrangement and nonquantitative performance criteria, including the performance clauses on the exchange and trade system.

San Jose, Costa Rica
March 29, 1989

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

1. In the late 1970s and early 1980s, Costa Rica's economy suffered strong external shocks, including a sharp deterioration in its terms of trade. Large disequilibria resulted from the attempt to cushion the shocks, with both the fiscal deficit and external indebtedness growing rapidly. Since then, the country has been making efforts to reduce external and internal imbalances with a view to laying the basis for higher and sustained rates of economic growth. Substantial progress has been achieved in improving the public sector finances, in strengthening the external current account balance, and in addressing longstanding structural rigidities. As a result, economic growth has been revived, and advances in meeting the social needs of the population have been achieved.

2. In the most recent period, the country has sought to continue the correction of internal imbalances while seeking a solution to its extremely heavy debt service obligations. In October 1987 these efforts were supported by a stand-by arrangement with the Fund which was extended in anticipation of the necessary external financing arrangements being concluded during the course of the program. Despite considerable effort, not all of the objectives of that program have been achieved, and negotiations on a longer term solution to the debt problem have not reached a conclusion.

3. The economic performance for 1988 as a whole was mixed. There was a deviation from the program's fiscal target, as the combined deficit of the public sector widened from 3.2 percent of GDP in 1987 to over 3.7 percent in 1988, compared to a programmed reduction to 3 percent. Moreover, shortfalls in external financing necessitated a larger than programmed increase in domestic bank credit to the public sector, and credit to the private sector in real terms fell. Consumer prices rose by 25 percent during 1988 compared with 16 percent the previous year, reflecting, in part, sizeable increases in public utility tariffs and a decline in output of a number of food crops due to hurricane damage.

4. Output growth in 1988 was higher than expected, due primarily to the performance of the external sector. Exports grew by 11 percent in U.S. dollar terms, as nontraditional exports expanded by one fourth. Revenues from tourism also rose by one fourth. Import growth was nearly flat; despite the rapid growth in nominal income, demand for foreign goods was moderated by a drawdown of inventories following a

large buildup in 1987. Even though these developments contributed to a reduction in the current account deficit by the equivalent of 3 1/2 percent of GDP, the improvement was somewhat smaller than expected, as was the increase in net international reserves. Also, anticipated external financing did not materialize and there was a further buildup of external payments arrears.

5. In summary, the path of adjustment has not been a smooth one; however, the Government intends to maintain the course toward greater stabilization. There is a continuing need to deal with the external debt problem, to curb inflationary pressures, and to improve the public finances. In addition, recent successes in the export sector must be nourished if they are to continue, and structural reform efforts must be intensified if resources are to be used more efficiently.

6. The economic program that has been designed for 1989 aims at reducing inflation and consolidating the gains achieved in recent years in the external sector so as to lay the foundation for sustained growth of output and employment opportunities. The program seeks to raise domestic savings, to promote private investment, and to improve the efficiency of resource use. To achieve these objectives, the authorities intend to reduce the combined deficit of the public sector, to maintain an appropriate credit policy, and to pursue flexible interest rate and exchange rate policies. This policy package will be complemented by a continuation of the program of structural reform that is focused on the import tariff schedule, the financial sector, agricultural pricing, and the operations of the public enterprises.

7. Costa Rica's high level of debt service obligations hinders the Government's ability to implement this program. The authorities feel that it is neither desirable nor feasible to rely on new foreign commercial borrowing, and thus they will continue to seek, in a cooperative spirit, an accommodation with external creditors to bring debt service payments to a level consistent with the Government's medium-term macroeconomic objectives. Such an accommodation would allow for the normalization of relations with creditors and reduce uncertainties that stand in the way of an improvement in the investment climate.

8. In support of this program, the Government of Costa Rica hereby requests a stand-by arrangement for a 12-month period extending through April 1990, in the amount of SDR 42 million. The principal elements of the program, including the quantitative performance criteria, are set forth below.

9. The strategy underlying the Government's adjustment program has been oriented toward widening and modernizing the productive base of the economy, with the aim of diversifying exports and competing efficiently with foreign suppliers in the domestic market without reliance on high levels of protection. The success of this strategy will depend not only on the signals and incentives given by appropriate exchange rate and interest rate policies, but also on an adequate supply of credit to the

private sector. For this purpose, the Government intends to implement a fiscal policy that minimizes its use of private savings.

10. The program envisages a reduction in the combined deficit of the nonfinancial public sector and net operating losses of the Central Bank to 2.8 percent of GDP in 1989 from 3.7 percent of GDP in 1988. Given the limited scope for the Central Bank to reduce its losses through discretionary actions (as explained below), the reduction in the combined deficit will result from an improvement in the operations of the nonfinancial public sector from a deficit of 0.6 percent of GDP in 1988 to a small surplus in 1989. This will be achieved through a reduction of the deficit of the Central Administration from slightly over 2 percent of GDP in 1988 to 1.7 percent of GDP in 1989, and an increase of the surplus of the rest of the nonfinancial public sector from 1.5 percent of GDP to nearly 2 percent of GDP.

11. The reduction in the deficit of the Central Administration will reflect both improved revenue performance and spending restraint, especially with respect to current expenditure. In November 1987, the Legislative Assembly approved a tax package that included increases in direct and indirect taxes, a broadening of the tax base, and reforms of the tax collection process. In 1988, the first year of the tax reform, the Government faced difficulties in the implementation of some of the measures, including legal challenges to the updated property valuations, administrative bottlenecks (especially with the extension of taxpayers' registry beyond the urban areas), and opposition of vested interests to specific tax provisions. These problems have largely been resolved. In addition, banana exporters and producers have agreed to make in 1989 a contribution to the Government of ₡ 0.7 billion to cover part of the cost of upgrading export infrastructure. As regards expenditure, we intend to continue our policy of restraint which has resulted in the reduction in spending relative to GDP. In 1989, central administration expenditure is to be limited to ₡ 73 billion, an increase of about 19 percent over 1988, which is below the projected rate of growth of nominal GDP. To achieve the spending targets, specific policy actions, including wage restraint, cutbacks in transfers to the rest of the nonfinancial public sector, and reform of export subsidies (CATs) are being implemented. To monitor the implementation of the Government's expenditure policy, quarterly limits have been established which are given in Table 1.

12. The policy of restraining the growth of the wage bill will continue to rely on a freeze in public sector employment that has been in effect since 1985. Some merit and seniority increases will be granted to professionals to retain qualified personnel, and to educational workers according to long-term agreements; apart from this, wage policy will ensure that salary adjustments will not cause the public sector wage bill to rise in real terms. Wage adjustments in the public enterprises will be monitored closely to ensure that they do not exceed those in the Central Administration.

13. In order to reduce the 1989 budgetary cost of the export subsidy scheme of negotiable tax exemption certificates for nontraditional exports (CATs), the maturity period of the certificates (i.e., the waiting period before they can be redeemed) has been extended from 9 months to 12 months.

14. In the rest of the public sector, the Government's overall policy will be to maintain the tariffs and charges of the decentralized agencies and public enterprises at levels that are sufficient to meet the operating and debt servicing costs and a substantial share of their investment expenditure. In line with this policy, the electricity tariffs of ICE--a major public enterprise with large foreign indebtedness--were raised by 37 percent in the period November 1988-February 1989. The telecommunication tariffs of ICE are scheduled to be raised by 20 percent in March 1989. Prices of various grain products sold by the national marketing agency (CNP) were raised in December 1988; wheat prices, which were the most out of line with international prices, were raised by 34 percent. To monitor the financial position of the major public enterprises, indicative quarterly targets have been established for the overall surpluses of the five largest public enterprises and decentralized agencies (the social security agency, CNP, RECOPE, ICE, and the social protection board), which are also set out in Table 1.

15. In the area of social security, the Government will continue its policy of resisting the extension to the whole public sector of a privileged retirement system that now applies to a limited portion of public employees, unless such an extension would be made self-financing through a corresponding increase in employees' contributions. The contribution rates in the different retirement systems will be revised with a view to making them more comparable, based on actuarial studies now underway. These studies also will identify ways to improve the actuarial position of the pension funds.

16. It is the intention of the Government not to increase its floating debt during the period of the program above the level outstanding as of end-1988, except for seasonal factors.

17. The losses of the Central Bank largely reflect the assumption of public sector external debt by the Central Bank and the subsequent depreciation of the colon. As such, there is limited scope for reducing these losses except through a negotiated arrangement to reduce external indebtedness. Until such an arrangement has been put in place, it is projected that the losses of the Central Bank will be equivalent to about 3 percent of GDP in 1989, the same as in 1988.

18. Monetary policy for 1989 has been designed to be consistent with a reduction in the rate of inflation to about 12-14 percent. In order to reach the objective for net international reserves, and assuming no change in the velocity of money, the rate of expansion of the net domestic assets of the Central Bank will be limited to about 3 1/2 percent. Quarterly ceilings have been established for the net

domestic assets of the Central Bank, which are set out in Table 2. The improved performance of the nonfinancial public sector will permit a reduction in its outstanding internal indebtedness. Quarterly limits on the domestic financing of the nonfinancial public sector that take account of seasonal factors and the expected foreign financing are set out in Table 3.

19. The credit program allows for an increase in bank credit to the private sector of 13 1/2 percent during 1989. In early 1988, ceilings on credit to the private sector by individual banks were reintroduced in the aftermath of a crisis in the nonbank financial sector. Although such problems have been largely overcome, for reasons of prudence the system of ceilings will be kept in place for the time being, but an effort will be made to maintain flexibility in the management of the credit program.

20. The evolution of interest rates in recent years has reflected the Government's policy to let rates be determined by the interplay of market forces; this policy has contributed to an increase in the holdings of real financial assets by the private sector. The Government will continue to pursue a flexible interest rate policy to maintain the attractiveness of saving in domestic currency. At present, most interest rates in the banking system are positive with respect to current inflation and will be maintained as such during the program period.

21. In line with the objective of fostering export-led growth, the Government intends to continue its flexible exchange rate policy which seeks to maintain the country's competitive position through periodic adjustments of the value of the colon in the light of relative price and balance of payments developments. It is the Government's intention not to allow a rise in the value of the colon in real terms with respect to the level of December, 1988. Flexible exchange rate management will be particularly important in the period ahead as the recent and prospective import tariff reductions may require a real depreciation of the colon. Attention also will be paid to the relation between the exchange rate and wage policy. To reduce potential inflationary pressures arising from private sector wage adjustments, the Government will seek to emphasize the central role of changes in labor productivity for determining wage settlements.

22. The external current account deficit is expected to decline by 1/2 percent of GDP from 1988 to 1989, on the assumption that the terms of trade will be largely unchanged. Exports are expected to continue to expand at last year's pace, while imports are expected to rise about in line with the growth of dollar-denominated GDP, now that the inventory situation has returned to normal. After taking into account projected capital inflows and debt relief from official and commercial creditors, net international reserves of the Central Bank are targeted to increase by US$40 million in 1989. Quarterly targets for net international reserves that reflect seasonal factors as well as the expected timing of foreign disbursements and exceptional financing are set out in

Table 4. The present policy of not granting exchange guarantees on external obligations will be maintained.

23. After taking into account official debt rescheduling and balance of payments support from official and multilateral sources, Costa Rica is faced with a financing gap equivalent to more than 2 percent of GDP over the medium term. Reliance on adjustment policies alone to close this gap would impede the recovery of investment and constrain economic growth. The Government has entered into negotiations for a debt reduction package with commercial banks. We have proposed a two-stage scheme, with a debt buyback in the first stage and a menu of options regarding the treatment of the remaining debt in the second stage. We envisage it would be possible to buy back about one half the outstanding debt with commercial banks by early October, 1989. During the period of these negotiations, Costa Rica will make partial interest payments to commercial banks of at least US$11 million a quarter. Upon Executive Board approval of the arrangement, the Government will request a rescheduling of arrears (including previously rescheduled debt) and current maturities from the Paris Club creditors. Arrears other than those which creditors have expressed a willingness to consider refinancing will be reduced according to a schedule that takes into account the projected flow of foreign exchange and that is set out in Table 5. No additional arrears will be incurred during the period of the arrangement (except for those subject to negotiations with commercial banks) and all arrears would be eliminated by the end of the arrangement.

24. The objective of external debt management will be to improve the terms and maturity structure of external debt. To this end, the Government intends to rely on long-term development credits for financing public sector investment and to minimize recourse to borrowing on commercial terms. New foreign loans contracted or guaranteed by the public sector (including public enterprises and financial institutions) with maturities of over one year and up to and including 12 years, will be limited to US$60 million in calendar year 1989. Within this ceiling, new commitments or guarantees of loans with maturities of over one year and up to and including five years will be limited to US$30 million. These ceilings exclude any loans contracted with official creditors for the purpose of financing a buyback of commercial bank debt, as well as rescheduling of current and past obligations with Paris Club creditors. In the event that debt relief granted by the Paris Club creditors turns out to be greater than the amount assumed under the program, the target for net international reserves will be raised by the amount of the additional debt relief. In addition, the stock of external short-term debt of the public sector at end-1989 shall not exceed its level at end-1988.

25. Consistent with its medium-term objective of higher growth of output and employment, the Government also is committed to continuing its implementation of structural reforms to support the demand management policies of its program. Many of these reforms are being supported with financial and technical assistance from multilateral and bilateral

agencies. These reforms are concentrated in four main areas: reform of the import tariff system and incentives in the external sector; reform of the financial sector; restructuring of the pricing, marketing, and subsidy policies in the agricultural sector; and privatization and rationalization of public sector enterprises.

26. In the external sector, these reforms are aimed at fostering export-led growth and diversification by reducing the level and dispersion of effective protection and by reducing the fiscal costs and distortionary effects of the present export incentive scheme. Since 1986, Costa Rica has been lowering the average import tariff rate and its dispersion, and the Government is committed to further semiannual reductions in tariff rates to achieve a maximum rate of 40 percent by the end of 1990. Within this framework tariffs on raw and intermediate materials and capital goods will be reduced below 20 percent. The present scheme of issuing negotiable tax exemption certificates to encourage nontraditional exports (CATs) will be reformed by June 30, 1989 by structuring the eligibility criteria according to value-added, regional, and employment criteria. The new system of investment and production incentives will be consistent with the obligations of GATT membership. In addition, the advance foreign exchange deposit requirement will be reduced from 50 percent at the end of 1988 to a maximum of 10 percent by the end of 1989.

27. In the financial sector, the reforms are aimed at improving the quality of the state banks' loan portfolio, strengthening the supervision and control of financial intermediaries, and increasing competition in the banking sector. In the fall of 1988, a comprehensive package of legal reforms was approved to address these goals, in part by providing a more reasonable valuation of banks' loan portfolios and allowing for penalty interest rates on overdue loans. As noted, the instability that occurred in the nonbank financial sector in 1987-88 has been overcome, and the recent legislation strengthens the authority of the Superintendency of Banks and extends its control over nonbank intermediaries. This program and the new legal framework should promote financial modernization and innovation and contribute to greater competition and a narrowing of interest rate spreads, which should give additional incentives to investment.

28. The structural reforms in the agricultural sector are geared to reducing pricing and marketing distortions, mainly those arising from the monopoly position of CNP in the importation of wheat. It shall be a general policy to avoid subsidies to producers or consumers. Although some qualitative import restrictions will be kept in place until 1990, trade by private parties is being introduced in a move toward more efficient use of limited resources. To assist in this effort, agricultural credit policy has been designed so as to direct resources toward newer, more efficient crop production.

29. The program of divestiture of subsidiaries of the state-owned development corporation (CODESA) is expected to be completed by the end

of 1989. Since 1986, 15 enterprises have been liquidated, 3 enterprises have been absorbed by other public sector entities, CODESA's minority interest in 6 enterprises has been divested, and the process of divesting to the private sector 40 percent ownership in 2 strategic public sector enterprises has commenced. In addition, a program to improve the management of the public finances is being supported by the World Bank. This program will involve measures to promote cost effectiveness, rationalization of the public investment program, a reduction of earmarking of revenues for specific uses, and limitations on the growth of current expenditure.

30. The Government of Costa Rica 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 measure that may be required in accordance with the Fund's policies on such consultations. A review of the program with the Fund to assess policy implementation and progress toward concluding financing arrangements will be completed by November 1989; at the time of this review the Government will present its plans for dealing with the servicing of the remaining bank debt.

Sincerely,

/s/
Fernando Naranjo Villalobos
Minister of Finance

/s/
Eduardo Lizano Fait
Executive President
Central Bank of Costa Rica

Table 1

I. Costa Rica: *Limits for Cumulative Central Government Expenditures* 1/

(In millions of colones)

Periods	Limits
Cumulative change from December 31, 1988	
March 31, 1989 2/	19,200
June 30, 1989	37,900 3/
September 30, 1989	54,800 4/
December 31, 1989	73,000 5/

II. *Indicative Targets for the Combined Overall* Financial Surplus of Selected Public Enterprises and Decentralized Agencies 6/

(In millions of colones)

Periods	Targets
Cumulative change from December 31, 1988	
March 31, 1989 2/	1,300
June 30, 1989	4,000
September 30, 1989	6,700
December 31, 1989	7,900

1/ Defined as the sum of budgetary expenditures (gasto reconocido) plus pending commitments (compromisos pendientes) plus extrabudgetary expenditure of the Central Government plus current interest payments in arrears.

2/ Indicative target.

3/ This limit shall be increased by any amount that actual revenues exceed projected revenues (31,000 million colones), up to a maximum amount of 750 million colones.

4/ This limit shall be increased by any amount that actual revenues exceed projected revenues (46,800 million colones), up to a maximum amount of 1,200 million colones.

5/ This limit shall be increased by any amount that actual revenues exceed projected revenues (65,500 million colones), up to a maximum amount of 1,500 million colones.

6/ These entities comprise the social security system (CCSS), national refining company (RECOPE), the electricity company (ICE), the national marketing agency (CNP), and the social protection board JPSSJ).

Table 4. Costa Rica: Targets for the Stock of the Net International Reserves of the Central Bank 1/

(In millions of U.S. dollars; end of period)

Periods	Stock Outstanding 2/
December 31, 1988 (actual)	-67
March 31, 1989 3/	-51
June 30, 1989	-77
September 30, 1989	-64
December 31, 1989 4/	-27

1/ Defined as the difference between the Central Bank's gross foreign assets and short-term foreign liabilities, including its net position with the Fund. This definition excludes the increase in foreign currency deposits since December 1986 as well as any resources contributed for the purpose of a debt buyback. Short-term liabilities include the revolving credit and the new money from the 1983 and 1985 commercial bank reschedulings; any reductions in these liabilities because of debt conversion operations shall not count against the target. The definition also includes any arrears on commercial payments and external debt service that are to be settled in cash. These targets take into account an expected debt rescheduling with Paris Club creditors in 1989. The targets will be revised upward by any amount of debt relief granted by Paris Club creditors in excess of program assumptions. The targets also will be revised upward by any shortfall in interest payments to commercial banks from the minimum amount of US$11 million a quarter during 1989.

2/ Excludes interest arrears to commercial banks of US$248 million as of December 31, 1988, assumed to be settled in conjunction with the debt reduction package.

3/ Indicative target.

4/ This target will be adjusted downward by up to the equivalent of 20 percent of access under this stand-by arrangement to the extent that Costa Rica's net international reserves are used to buy back commercial bank debt.

Table 5. Costa Rica: Limits for the Stock of External Payments Arrears 1/

(In millions of U.S. dollars)

Periods	Limits 2/
December 31, 1988 (actual)	131
March 31, 1989 3/	131
June 30, 1989	100
September 30, 1989	72
December 31, 1989	44

1/ Defined as the stock of arrears on medium- and long-term external public debt (excluding those which creditors have expressed a willingness to consider refinancing), plus the outstanding balance of deposits for foreign exchange requests held by the Central Bank of Costa Rica in excess of 15 working days.

2/ Excludes interest arrears to commercial banks of US$248 million as of December 31, 1988, assumed to be settled in conjunction with the debt reduction package.

3/ Indicative target.