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FOR
AGENDA

EBS/88/133
Supplement 1

CONFIDENTIAL

August 4, 1988

To: Members of the Executive Board
From: The Acting Secretary
Subject: Costa Rica - Review Under Stand-By Arrangement

The attached supplement to the review under the stand-by arrangement for Costa Rica has been prepared on the basis of additional information. Proposed decisions appear on page 3.

Mr. Linde (ext. 8500) is available to answer technical or factual questions relating to this paper prior to the Board discussion scheduled for tomorrow, Friday, August 5, 1988.

Att: (1)



INTERNATIONAL MONETARY FUND

COSTA RICA

Review Under Stand-By Arrangement
Supplementary Information

Prepared by the Western Hemisphere Department

(In consultation with the Legal and
Exchange and Trade Relations Departments)

Approved by S. T. Beza and Helen B. Junz

August 4, 1988

Since the staff report on the second review of Costa Rica's stand-by program was issued on July 11, 1988, additional information has become available on Costa Rica's performance with respect to the program targets for June 30. In addition, there have been further developments in the effort to secure the necessary financing arrangements with external creditors. This note discusses these matters and proposes a decision for the second program review.

1. Program performance

Complete and final data on performance with respect to the June 30 program targets are not yet available. Present information suggests that performance has been substantially in observance of the program targets; in particular, it appears that the net international reserves target and the ceilings on net domestic assets of the Central Bank and on central government expenditures were observed. However, the limit on external payments arrears does not seem to have been met. A US\$45 million cash grant was received at the end of June, but for administrative reasons these funds could not be used immediately to reduce payments arrears as targeted; this sum is roughly equivalent to the apparent deviation on the arrears target. Data on banking system credit to the nonfinancial public sector are expected to be available shortly.

In other recent economic developments, the authorities have continued to make crawling peg adjustments to the exchange rate of ₡ 0.35 per U.S. dollar at approximately two-week intervals. In real effective terms, as of June the colon was estimated to have depreciated by 1 1/4 percent relative to December 1987. If the recent pace of depreciation vis-a-vis the U.S. dollar is maintained, it is projected that the depreciation in real effective terms will be close to 5 percent for the twelve months ending in December 1988. After a series of adjustments to administered prices--mainly for public services--at the beginning of 1988, inflation has moderated sharply. Consumer prices rose by 3 3/4 percent during the second quarter of 1988 and wholesale

prices by 2 1/2 percent; these compare with increases during the first quarter of 7 1/2 percent and 8 1/4 percent, respectively. Merchandise imports in the first quarter of 1988 were almost 9 percent above a year earlier, but for the first half the increase subsided to a little over 1 percent. At the same time, exports of goods have performed better than expected, increasing 6 1/2 percent over the first half of 1987.

2. Negotiations on financing arrangements

After several months of informal consultations, the authorities met at the end of July with the commercial bank coordinating committee to discuss an orderly long-term rescheduling of Costa Rican bank debt. In the light of the history of previous rescheduling exercises and current market conditions, it was concluded that a traditional new money package would not be generally acceptable. Instead, the discussion among banks focused on the components of a menu approach. At the meeting the banks agreed to undertake to develop further the specific components of the menu, and to continue the negotiations at a formal meeting of the committee scheduled for August 16, 1988. The communique of the July meeting of the commercial bank coordinating committee is attached as Appendix I.

In consideration of the progress toward concluding a financial arrangement with commercial banks, the Costa Rican authorities have established an escrow account into which they will deposit the full amount of current interest due to commercial banks beginning in July 1988, minus US\$5 million a month which they will continue to pay directly. Costa Rica, therefore, would not be relying further in 1988 on the accumulation of arrears with banks to finance its program. Deposits into the escrow account will continue until a formal financing arrangement with the banks is concluded. The disposition of these funds will be taken into account in the formal financing arrangement.

Given the questions surrounding the status of the negotiations with the commercial banks and the implications for the stand-by arrangement, the Costa Rican authorities have not yet approached the official bilateral creditors of the Paris Club for a debt rescheduling. In light of the latest developments, it is expected that they will request that such a meeting take place in September 1988.

3. Staff recommendation

In view of the progress made toward a financing arrangement with banks and the expectation that agreement on a menu of specific financing alternatives can be reached soon, the staff proposes that the Executive Board complete the second program review, on the understanding that a third program review would take place in October to assess the financing arrangements with both commercial banks and official creditors. Under this proposal, Costa Rica would be able until October 28, 1988 to make the first and second purchases under the stand-by arrangement, subject to observance of the performance criteria as of June 30. In order to

make these purchases, the deviation with regard to the arrears target would need to be waived. Subsequent purchases would be subject to the completion of the third program review, which would assess progress made in reaching agreement with creditors.

Costa Rica engages in a multiple currency practice for certain remittances for study abroad, a practice that has been approved temporarily. The staff proposes an extension of this approval until the completion of the 1989 Article IV consultation with Costa Rica which is expected to take place in May 1989. Approval of the exchange restriction evidenced by external payments arrears is not being requested by Costa Rica or proposed by the staff.

Accordingly, the following draft decisions are proposed for adoption by the Executive Board:

A. Stand-by Arrangement

1. The Fund decides that the second review contemplated in paragraph 4(c) of the stand-by arrangement for Costa Rica (EBS/87/91, Sup. 2, as amended) has been completed, and that Costa Rica may proceed to make purchases, subject to the observance of performance criteria in accordance with paragraph 4 of the stand-by arrangement.

2. During any period after October 28, 1988, Costa Rica will not make purchases under its stand-by arrangement that would increase the Fund's holdings of Costa Rica's currency in the credit tranches beyond 25 percent of quota until the completion of a review with respect to Costa Rica's foreign financing needs for the remaining period of the stand-by arrangement.

B. Exchange System

The approval in Decision No. 8717-(87/150) of Costa Rica's multiple currency practice regarding certain remittances is extended until the earlier of the completion of the 1989 Article IV consultation with Costa Rica or May 30, 1989.

July 29, 1988

To: All Costa Rican Creditor Banks

From: The Costa Rican Commercial Bank Coordinating Committee

1. Representatives of the Government of Costa Rica met with the Costa Rican commercial bank coordinating committee in New York on July 28 and 29. Representatives of the IMF, the World Bank and U.S. AID were also present. Finance Minister Fernando Naranjo briefed the Committee on recent economic developments and on Costa Rica's satisfactory performance under the 1988 Standby Program. Representatives from the IMF, the World Bank and U.S. AID described their respective financial assistance programs and commented favorably on the economic and structural adjustment being achieved.

2. At the meetings, the Government reaffirmed its desire to reach an agreement with its commercial bank creditors for the orderly long-term rescheduling of the Costa Rican commercial bank debt. Discussions between the Government and the bank coordinating committee centered on a number of alternatives designed to address the refinancing of Costa Rica's commercial bank debt and providing for exit instruments for banks that would prefer to dispose of their commercial bank claims on Costa Rica. In addition, the possibility of exchanging debt for equity was discussed as a method of debt reduction.

3. In order to address the various interests of the commercial bank creditors while dealing with Costa Rica's financing requirements, the Government and the bank coordinating committee have reached agreement that a menu approach to dealing with Costa Rica's commercial bank debt is required. The bank coordinating committee also agreed to give serious consideration to the approaches discussed at the meeting. Because of the complexity of the issues, it was agreed that the committee would meet again in mid-August to work towards a term sheet and, in the meantime, the members of the committee will work individually and with the chair in developing the menu of options.

[Banks]