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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/125

3:00 p.m., August 5, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	S. M. Hassan, Temporary
	C. Enoch
	Shao Z., Temporary
C. H. Dallara	C. S. Warner
	J. Prader
	M. Hepp, Temporary
	S. K. Fayyad, Temporary
	B. Goos
	D. V. Nhien, Temporary
	J. E. Zeas, Temporary
M. Massé	
	A. R. Ismael, Temporary
Y. A. Nimatallah	
	E. Ayales, Temporary
J. Ovi	
	G. Pineau, Temporary
G. A. Posthumus	G. P. J. Hogeweg
C. R. Rye	
	M. A. Hammoudi, Temporary
	A. Vasudevan, Temporary
	N. Adachi, Temporary
	S. Rebecchini, Temporary

J. W. Lang, Jr., Acting Secretary
L. Collier, Assistant

Also Present

IBRD: L. Derbez, Latin America and the Caribbean Regional Office. Exchange and Trade Relations Department: H. B. Junz, Deputy Director; S. Kanesa-Thasan, K. P. Regling. Legal Department: A. O. Liuksila, J. V. Surr. Secretary's Department: A. Bhagwat. Western Hemisphere Department: S. T. Beza, Director; J. Ferrán, Deputy Director; J. Berengaut, L. E. DeMilner, C. S. Lee, A. S. Linde. Advisors to Executive Directors: W. N. Engert, K.-H. Kleine, M. A. Tareen. Assistants to Executive Directors. H. S. Binay, R. Comotto, F. El Fiky, B. R. Fuleihan, J. Gold, J. Heywood, C. Y. Legg, C. Noriega, M. Pétursson, A. Rieffel, R. Wenzel, D. A. Woodward.

1. COSTA RICA - REVIEW UNDER STAND-BY ARRANGEMENT, AND EXCHANGE SYSTEM

The Executive Directors considered the staff paper on the second review under the stand-by arrangement with Costa Rica approved on October 28, 1987 (EBS/88/133, 7/11/88; Cor. 1, 8/4/88; and Sup. 1, 8/4/88).

Mr. Ayales made the following statement:

> The current stand-by arrangement with Costa Rica has proved to be effective not only as a catalyst for obtaining domestic and external support for the country's endeavors, but also as a conduit for strengthening cooperation between the Fund and the Costa Rican authorities. Both the commitment of the authorities, who have always responded to adverse developments by strengthening the adjustment efforts, as well as the cooperative approach that the staff has taken have contributed to this achievement.
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> It is worth emphasizing that available evidence indicates that performance under the stand-by arrangement is broadly in line with the objectives of the economic program. Economic growth is on track, exports are growing at a faster than expected pace, and the rate of inflation, which was quite rapid during the first quarter, has slowed down considerably to an annual rate of less than 10 percent during the second quarter of 1988; furthermore, an incipient crisis of confidence in the financial sector was surmounted successfully. At the same time, most quantitative performance criteria have been met for end-March 1988, and the end-June criteria are also likely to be satisfied.
>
> Monetary developments have been largely on track. Net domestic assets of the Central Bank increased by only 1.6 percent during the first quarter of 1988, and the net international reserve target was reached with a comfortable margin. As clearly stated in the staff paper, the small deviation in net domestic credit to the nonfinancial public sector--less than 1 percent of the targeted amount--was the outcome of some public institutions investing their surpluses in financial institutions outside the consolidated banking system as defined for the purposes of the program. Despite the authorities' efforts to expand the coverage of the financial sector for analytical purposes, delays in the availability of information for nonbank institutions impose limitations on the currentness of a more comprehensive financial survey.

A crisis of confidence in the financial sector experienced in late 1987 and early 1988 forced the Government to reduce temporarily legal reserve requirements in order to release funds that could be lent to troubled private commercial banks. This crisis seems to have been overcome, and the authorities have renewed their adjustment efforts and have undertaken additional policy measures to keep the economic program on track. Reserve requirements on time deposits in the banking system are being restored, and the authorities also intend to raise the legal reserve requirements on demand deposits. Furthermore, the interest rate on three-month stabilization bonds issued by the Central Bank was raised from 17 percent to 22 percent, the formal agreements with public enterprises to sterilize their surpluses in the Central Bank are being reinforced, and, in general, credit policy is being further tightened. Preliminary data for end-June 1988 show that the reserve target has been reached and total net domestic assets of the Central Bank remain within the program limits.

Financial performance in the public sector has been very satisfactory, despite the step devaluation's impact on prices during the first quarter. A small deviation in cumulative central government expenditures with respect to the program limits for end-March 1988--₡ 422 million, equivalent to less than 1 percent of the targeted amount--which was mainly due to unexpected outlays associated with severe weather conditions on the Atlantic coast, was more than offset by a very strong performance in revenues during the same period. More important, preliminary data for end-June 1988 show that central government expenditures for the first semester as a whole are within the program limits with a comfortable margin. It is important to stress that the central administration deficit for the first semester of 1988 is equivalent to less than one fifth of the deficit recorded for the same period two years ago, and about one third that of last year.

Costa Rica: Central Administration Deficit
Data for the Period January-June of Each Year*

(In millions of colones at current prices)

	1986	1987	1988
Current revenues	17,253	20,816	25,905
(June 88/June 87 growth rate)	(12.7)	(20.6)	(24.4)
Total expenditures	21,371	23,310	26,688
(June 88/June 87 growth rate)	(32.0)	(9.1)	(14.5)
Overall deficit	4,118	2,495	783
External financing	2,617	- 287	- 694
Domestic financing	1,501	2,782	1,477

Source: Tesorería Nacional, Ministry of Finance.
* On a cash basis.

Central Administration current revenues during the first quarter of 1988 rose about 40 percent with respect to the previous year, yielding ₡ 2 billion--over 16 percent--in excess of the amount projected in the program. Although the growth rate in the second quarter fell relative to the first quarter, for the first semester as a whole it is still significantly larger than projected in the program. This extraordinary revenue performance reflects both the effects of the tax package implemented in 1988, and improvements in tax administration. Notwithstanding these positive results for the overall budgetary adjustment, the authorities believe that, to maintain fiscal discipline and to further strengthen public finances, the program's fiscal projections--particularly the ceiling on government expenditures--should be kept unchanged. Furthermore, the authorities are determined to resist spending pressures and to take a conservative position in future wage negotiations with public sector employees. As for the rest of the public sector, preliminary data indicate that the financial results have so far been in line with the program.

Exchange rate management continues to be a key element of the authorities' drive toward economic efficiency. In this connection, following the 6 percent step devaluation in January, the Government has adjusted the exchange rate according to price movements in Costa Rica in relation to its trading partners, so as to maintain the real value of the colón. Though the pace of the crawling peg adjustments during the first few months following the step devaluation was slower than indicated by price movements, the authorities felt this was necessary to quell inflationary fears, especially on the eve of wage negotiations with public sector employees. The additional monetary measures mentioned earlier were intended to make up for the lag in the implementation of exchange rate adjustments. Nevertheless, once the crisis of confidence in the private financial sector was overcome, the authorities accelerated the pace of minidevaluations. Furthermore, the very satisfactory performance of nontraditional exports, as well as the current level of net international reserves in the Central Bank and the weakening of inflationary pressures, indicates that the policies pursued were adequate.

As for the external sector accounts, a slightly larger than projected trade deficit--$5 million--for the first quarter of 1988 was more than compensated for by larger than projected private capital inflows, thus resulting in an overall balance of payments surplus that was also higher than projected. Therefore, considering that, on the one hand, lower than expected disbursements on public sector loans are expected to be offset by more debt relief than assumed in the program, basically through the bilateral rescheduling signed with Mexico, and on the other hand, the deviation in the current account was rather small, balance of payments projections for 1988 remain basically unchanged.

The Costa Rican Government firmly believes that to consolidate the gains achieved so far toward the elimination of domestic and external imbalances, it is necessary to come to a lasting agreement with the international financial community. Consequently, it has reiterated its commitment to maintain normal relations with the country's external creditors, as well as its willingness to continue to pursue a negotiated approach.

Following the Board discussion of the first review under the stand-by arrangement last April (EBM/88/56, 4/4/88), the Costa Rican authorities held meetings with the chair of the commercial banks' Steering Committee and with several multilateral organizations. The main purpose of these meetings was to explore ways in which these agencies could cooperate to find a solution to Costa Rica's external debt problem. Those meetings also provided an excellent opportunity to try to understand the reasons behind the apparent indifference--or lack of reaction--toward this case by the commercial banks. In this last regard, the banks' representatives made it clear that most commercial banks believe that a traditional new money scheme is not viable for Costa Rica, given the high interest arrears and widespread, heavy provisioning against loans and, therefore, that an innovative solution is necessary. However, it was also perceived that disagreement among banks persists regarding the specifics of the approach to be developed. Legal, tax, and accounting considerations, as well as corporate strategies, are some of the factors explaining the differences in views among the banks. There was, nevertheless, consensus among the parties represented in those meetings that a renewed effort was indispensable to reach a mutually agreeable solution. It is important to mention that some of the multilateral organizations expressed their willingness to cooperate, within the limitations imposed by their charters, to solve Costa Rica's problem. My authorities have, in fact, already benefited a great deal from very valuable assistance at a technical level from both the Fund and the World Bank.

Following those initial meetings, the Costa Rican authorities and technical staff continued to work very closely with the chair of the Steering Committee, and in consultation with the Fund and the World Bank, to develop a framework of options that was presented to the banks' Steering Committee at a meeting that took place during July 28-29, 1988.

The menu offered to the commercial banks includes not only the restructuring of the outstanding debt and past due interest, with the collateralization of the principal and the establishment of an interest maintenance fund, but also several exit instruments for those banks that may prefer to dispose of their Costa Rican claims at current market valuations. In addition, the possibility of exchanging debt for equity was discussed as a method of debt reduction.

A very important outcome of this last meeting was that for the first time there was recognition among commercial banks of the special circumstances of Costa Rica's case and of the need to work out an arrangement that would satisfy Costa Rica's financing needs for the near and medium term. In view of the complexity of the issues involved, work has been organized to discuss and refine the issues, and a further meeting of the Steering Committee is scheduled for August 16 to work toward a term sheet. This program of work reflects the intention of both the Government and the banks to reach a final understanding in the near future.

As for the negotiations with creditors under the aegis of the Paris Club, the Costa Rican authorities had a preliminary meeting with the chairman, Mr. Trichet, last June 29. During that meeting my authorities took the opportunity to comment on recent economic developments in Costa Rica, and also to request consideration of the rescheduling of the country's debt during the next Paris Club meeting.

In a different sphere, for the first time a World Bank-sponsored Consultative Group Meeting on Costa Rica was held in Paris on June 27-28. The purpose of this meeting was to seek a coordinated effort by donor countries to support Costa Rica's structural adjustment program. It was stressed that the success of the program depends, to a large extent, on the financing of the country's external gap in the coming years. Representatives of the largest industrial countries and multilateral agencies were very supportive of the World Bank's initiative, as well as of Costa Rica's adjustment efforts, and they stated their commitment to continue to support these efforts in the future.

My Costa Rican authorities believe that performance under the stand-by arrangement is highly satisfactory and in line with the objectives of the country's economic program. Temporary events and circumstances might have provoked minor departures from the quantitative performance criteria for end-March 1988, but it seems that the corrective measures implemented since the beginning of the second quarter are already taking hold and are yielding very positive results. As in the past, my authorities remain committed to the path they have chosen and stand ready to take any further measures that may become appropriate to achieve the objectives of the economic program.

The substantial progress achieved during the past few years, which has been made possible--to a large extent--by firm support of the Fund, has resulted in economic stabilization and has laid the basis for sustained growth. Notwithstanding these gains, my authorities remain concerned about the high vulnerability of the country to external developments, particularly in view of the very delicate political situation in the region and the inauspicious external financial environment. Under these circumstances, a harmonious relationship with the international financial community is of the utmost importance, and my authorities believe that firm commitment to the economic program is crucial--and, more important, a means under their control--to achieving that goal. Therefore, the Fund's continued support remains essential at this time, for the signals it gives to the international financial community and for strengthening the internal resolve to continue the adjustment effort, more than for the financial resources provided under the arrangement. It is in this manner that the Fund can best serve its catalytic role.

As stated in the staff report, although the deviations from end-March quantitative performance criteria were minor, my authorities did not request a waiver, with the expectation that the corrective measures implemented since then would result in full compliance with the end-June criteria, as in fact is indicated by the preliminary figures mentioned earlier.

Finally, the escrow account referred to in the staff paper has been opened at the Bank for International Settlements, and payments into this account have begun to be made.

Extending his remarks, Mr. Ayales said that his authorities realized that Costa Rica was a unique case that did not easily conform to the general policies of the Fund. However, they wanted the Directors to know that in the special circumstances facing the country, the existence of a Fund-supported program had played a crucial role in maintaining not only the domestic determination to continue the adjustment effort but also the momentum of the negotiations on the country's external debt. The debt negotiation process had not been completed because the country sought a consensus among all parties concerned. The authorities believed that voluntary participation was essential for a long-lasting, satisfactory solution.

His authorities were fully aware of the implications of the present case, at a time when the strategy for dealing with the external debt situation was being discussed, and they wished to reaffirm their commitment to the cautious use of Fund resources, Mr. Ayales stated. Evidence of that stance was the fact that during the past 13 months, Costa Rica's use of Fund credit had fallen drastically from the equivalent of over 200 percent of quota to about 80 percent.

Directors were aware of the escrow account opened by the authorities with the Bank for International Settlements (BIS), Mr. Ayales remarked. That account should be viewed in the context of a program under which the Costa Rican authorities expected to conclude a financial arrangement with the commercial banks by end-June 1988 on terms compatible with the country's economic constraints, in the sense that external debt service would not obstruct the achievement of the program's objectives.

The account had been devised during the discussions in connection with the present review to assure the Board that Costa Rica would not accumulate more arrears than those envisaged under the program, and his authorities were committed to honoring the agreement reached with the Fund staff and management, Mr. Ayales noted. However, the escrow account would not be a satisfactory solution beyond the end of the current stand-by arrangement period. To make full payments into that account without having resolved its external debt situation, Costa Rica would require a higher level of savings in the public sector--not for investment but for resources for debt service, thus reducing the rate of economic growth and, at best, maintaining per capita income in the near future. It was therefore in the best interests of Costa Rica to reach a lasting solution to its external debt problem.

Mr. Zeas made the following statement:

Four months ago, this Board reviewed Costa Rica's economic performance under the stand-by arrangement. On that occasion we congratulated the authorities for their adjustment efforts. Similarly, we now welcome the authorities' adherence to the comprehensive macroeconomic policies supporting the program. Although the program's growth and employment objectives are modest, the policies needed to achieve them will be difficult to implement. The complete elimination of external arrears will require not only a decline in imports and an increase in exports, but also a satisfactory debt agreement with the commercial banks.

According to the staff, all the quantitative performance criteria were observed in March, and, according to Mr. Ayales, preliminary figures show that with the exception of external arrears the performance criteria were also met in June. Furthermore, the authorities are making significant progress in the different areas requiring structural reform, such as encouraging competition among banks, eliminating subsidies, adjusting public sector prices, reducing government expenditures in relation to GDP, raising revenues, and further reducing advance import deposits and import tariffs.

The need to combine a reduction of import tariffs with both a reduction of imports and an increase in revenues poses difficult policy problems. The same is true of the need to combine the rather ambitious inflation rate target with the proposed policy of adjusting administered prices. We are also concerned about the serious liquidity constraints that may be imposed on the economy with the sterilization of the surpluses of the oil refinery and of the social security system, equivalent to 2 1/2 percent of GDP. Also, sterilizing the public enterprises' surpluses in the Central Bank rather than expanding their investment may detract from incentives for efficient management.

One cannot expect Costa Rica's debt problem to be solved in the short term by an expansion of exports. First, Costa Rica has already devalued sharply in real terms in the past five years. In fact, the index for the real effective exchange rate shows a depreciation of 30 percent over this period, and according to the staff, this trend continued during the first semester of 1988. Second, Costa Rica faces a number of well-known external obstacles, such as quotas. The staff projects, realistically, an increase in exports in 1988 of $60 million, or 6 percent, while external debt arrears will surpass $300 million and scheduled debt service for 1988 will exceed $690 million, or the equivalent of 53 percent of exports of goods and services. Costa Rica has reiterated, however, its willingness to honor its obligations; clearly this is an example of a country willing, but unable under realistic assumptions, to meet its obligations. Nevertheless, Costa Rica has continued to pay interest to the banks, according to its capacity, of $5 million a month. In addition, the authorities have begun to contribute, to an escrow account, amounts that would guarantee the payment of interest if an agreement is reached with the commercial banks.

Given the large foreign debt of Costa Rica, both the authorities and the banks have recently come to the conclusion that what is needed is a refinancing agreement that would include debt and/or interest reductions and would exclude a new money package.

We understand that the authorities have presented an interesting menu to the commercial banks, including zero-coupon bonds and a debt-equity conversion scheme, that would solve Costa Rica's financing problems in the short and long run. The Steering Committee of about 220 creditor banks has agreed to meet again on August 16 to work on a draft term sheet. This is an encouraging development that may signal a renewed interest on the part of the banks in arriving at an agreement with Costa Rica.

While we encourage the Costa Rican authorities to continue to act expeditiously toward a final debt agreement, we would not like to give the impression to the authorities, or to the financial community, that the Fund and its Board of Directors are pressuring Costa Rica--or any other country--in any way to accept private banks' conditions that may be unfavorable and may strain the financial capacity of the country. The Fund must at least remain neutral and independent in this matter.

In sum, we would like to emphasize that first, Costa Rica is making important adjustment efforts during 1988. Second, the authorities are maintaining a constant dialogue with representatives of the commercial banks, exploring ways to find a satisfactory solution to their debt problem. Third, Costa Rica's indebtedness to the Fund was low--83 percent of quota--at the end of June 1988; in addition, the country is not making use of Fund resources under the present stand-by arrangement, not because it could not use additional liquidity or is prevented from drawing but because, in a very responsible manner, the authorities want to avoid further indebtedness of a medium-term nature. Fourth, Costa Rica has no arrears with the Fund or with any other multilateral creditor. Fifth, the continuation of Fund support at this time would send the appropriate signal to the financial community, promoting both the authorities' and the commercial banks' negotiating efforts. For these reasons, we support the proposed decisions.

Mr. Massé commended the Costa Rican authorities on the successful implementation of measures to correct the slippages that had occurred in the early part of the program. As Mr. Ayales had noted, the program was generally on track at present with regard to meeting both the quantitative performance criteria as well as the broad economic objectives.

His authorities, however, regretted the slow progress of the negotiations with the commercial banks, Mr. Massé continued. Like other members of the Board, he had had high hopes that the completion of the first review would help to bring about an early conclusion to those negotiations. His authorities noted that there had been a significant advance in recent weeks and that there seemed to be cause for guarded optimism that the end was in sight. He urged the Costa Rican authorities to do their utmost to maintain that momentum; further delay could only reduce the credibility of their adjustment effort. In that regard, his authorities were encouraged by the opening of the escrow account, which provided further evidence of Costa Rica's willingness to pursue a cooperative resolution to its debt problem.

He supported the proposed decisions in the hope that the completion of the present review would aid the authorities' efforts to reach agreement with the commercial banks, Mr. Massé said. In addition, he understood that the review would facilitate the passing of the financial legislation that was with Congress at present, and that it would be an important factor in the World Bank's consideration of the second structural adjustment loan. Moreover, the completion of the review should clear the way for the authorities to enter into negotiations to reschedule their debt with Paris Club creditors.

Nevertheless, his authorities would have serious concerns about Costa Rica making any drawings under the program without solid progress on reaching an agreement with the banks on a restructuring package, Mr. Massé noted. He agreed with Mr. Ayales that the continued support of the Fund remained essential for the signal it gave to the international financial community of Costa Rica's adjustment effort and for domestic purposes, such as strengthening the internal resolve to continue that effort. However, as his chair had expressed on other occasions for other countries, he would have serious problems if Fund resources were disbursed to support a program that was not fully financed.

Mrs. Hepp commented that recent developments in Costa Rica showed that the program objectives for the first semester of 1988 had been achieved. Furthermore, the authorities had been taking additional measures to maintain the program on track, reaffirming in that way their commitment to the adjustment program. In that regard, she commended their efforts, which merited the support of the international financial community, and she endorsed the proposed decisions regarding the completion of the second review and the exchange rate system.

The country's performance in the monetary area had been in line with the program, and the targets for the Central Bank's net domestic assets and net international reserves had been met, Mrs. Hepp noted. Important actions had been taken to restore confidence in the financial system. In that regard, the temporary reduction of reserve requirements to alleviate liquidity difficulties of the banks seemed to be appropriate. However, the level of reserve requirements should be restored in steps, as planned, to its previous level, so as to avoid inflationary pressures by tightening monetary conditions. The increase in the interest rate for three-month stabilization bonds was also a step in the right direction to achieve tighter credit conditions and thereby meet the credit targets established under the program.

Given the higher than expected levels of inflation observed during the first quarter, the tightening of credit as well as the maintenance of an adequate level of competitiveness were areas that should receive close attention, Mrs. Hepp observed. She encouraged the authorities to continue the flexible and realistic exchange rate policy so as to maintain the healthy performance of nontraditional exports and to achieve the reserve targets established under the program.

She welcomed the indication by Mr. Ayales that preliminary information for the first semester indicated that central government expenditures were within program limits with a comfortable margin, Mrs. Hepp remarked. Also welcome was the indication that revenue performance had been excellent owing to the implementation of the tax package and improvements in tax administration. She encouraged the authorities to continue that practice, in particular resisting excessive pressures in future wage negotiations.

Costa Rica's main problem was its heavy external debt burden, and an innovative approach was required in the country's special circumstances to reach an agreement with the creditors and solve the problem, Mrs. Hepp said. The authorities had been successfully implementing an adjustment program and, by establishing a good track record, they had demonstrated their commitment to that program. Furthermore, an escrow account had been opened at the BIS to deposit the full interest obligations to commercial banks, and payments had already begun to be made. At present, Costa Rica needed the support of the international financial community. The authorities had worked out a program and meetings would be held with commercial banks and the Paris Club in the coming weeks. She hoped that the authorities could soon reach a final understanding with their creditors.

Mr. Prader made the following statement:

> It is clear that we cannot separate our discussion on such a unique case as Costa Rica's from the general policy discussions in the Fund; and at this moment, with the Board under the moral pressure of the issue of overdue financial obligations and of self-criticisms about the causes of the accumulation of arrears to the Fund, it is logical for the Board to be more cautious than at the initial presentation of the program under review.

Yet the Board cannot ignore Costa Rica's specific situation as a small debtor country at the present stage of the debt issue. During the discussion on financing assurances in Fund-supported programs, this chair took the position that in an environment of the banks' growing reluctance to participate in financing for the smaller debtor countries, the Fund cannot afford to let such countries down if they present adjustment programs strong enough to justify a flexible interpretation of the Fund's approval policy. We put this position into practice by joining those who supported Costa Rica during the Article IV consultation and review under the stand-by arrangement in early April (EBM/88/56, 4/4/88), when this Board approved continuation of the stand-by arrangement even though adequate financial assurances from creditor governments and the commercial banks were not yet in hand. The fact that these assurances are still not forthcoming, a matter clearly beyond Costa Rica's control, cannot now be sufficient reason for withdrawing the support promised in April in their absence.

If it was acceptable in October 1987 to approve the stand-by arrangement under those conditions, the only valid reason for changing the Board's attitude now by not approving the midterm review would be Costa Rica's nonobservance of the performance criteria. This position does not imply any lack of concern about the integrity of the Fund's resources to be committed in future drawings by Costa Rica; on the contrary, Costa Rica's record of cooperation with the Fund is good and its willingness to repay the Fund is reassuring.

Also, repudiating our support of Costa Rica now, despite the country's performance under the current stand-by arrangement and its clear intention of honoring its financial obligations, as demonstrated by the establishment of an escrow account at the BIS, would send the wrong signals to the international financial community and would be tantamount to shifting the pressure from the banks to Costa Rica. And as Mr. Ayales made clear, this action would not help his authorities in any way to enforce the objectives of the program which is already in place.

If we withdraw our support now, our action will be interpreted as an indication that countries following the Fund's advice cannot count on continuous assistance from the Fund because this institution tends to back away under the pressure of making decisions in a difficult and uncertain environment. Moreover, it will discourage countries that are now complying with the conditionalities of Fund programs from maintaining their policy commitment and their cooperation with the Fund. Therefore, while we must reach a decision on Costa Rica against the background of the need for a more cautious approval policy for the Fund, we must also bear in mind the repercussions of our decision on other members' behavior. In sum, we have no problem endorsing the views expressed in the staff appraisal.

Except for some policy slippages, which have been explained by the staff, Costa Rica has broadly fulfilled the performance criteria. Perhaps the most hopeful event of the last few months was the increase in capital inflows, which can be regarded both as a sign of the badly needed restoration of business confidence in Costa Rica, and as a clear refutation of capital flight theories that too closely link capital flight with domestic tax ratios and with expectations of future taxation based on the current debt stock. Since the present reinforcement of tax measures is concentrated on improved collection, the apparent reversal of capital flight requires cautious evaluation by the defenders of the tax-flight linkage.

Our main concern rests with the ways and means contemplated by the Government to manage the financial crisis triggered by the bankruptcies of a number of finance companies. We would be more comfortable if the staff would elaborate more fully on this issue as we fear that, under very tight credit conditions, favoring inefficient companies with large-scale bailouts will reduce the ability of more efficient companies to compete and prosper. These concerns underline the need for reform of Costa Rica's financial system--one of the preconditions of the World Bank's structural adjustment loan to Costa Rica that will apparently be determined by the outcome of today's discussion.

Mr. Dallara made the following statement:

Let me begin by offering some comments on recent economic policies and performance. Our general impression is that performance under the program has improved and that in spite of some disappointing deviations with respect to performance targets, the Costa Rican program is on track. The performance deviations were modest and not, in our view, a cause for serious concern.

In particular, we are pleased by the deceleration of inflation in the second quarter of the year. Furthermore, we commend the authorities for their success in dealing with the threat to confidence that emerged in the financial system as a result of the insolvencies of a number of finance companies, as well as for beginning to sterilize the surpluses of the state oil refinery and the social security agency. We also noted the measures taken to tighten credit during the remainder of the year, and we place considerable importance on raising the reserve requirement on demand deposits.

On the fiscal front, while revenues seem to be rising satisfactorily, it is important that the authorities achieve somewhat better control of expenditures during the remainder of the program. In this connection, I would be interested in any additional information the staff or Mr. Ayales might have on the status of wage negotiations, which were reopened within the past weeks.

With respect to the exchange rate, we have some concern that the devaluation earlier this year not be eroded, and we are not sure that the adjustments that are to be contemplated for the remainder of the year will be sufficient. We would welcome any thought that the staff might have on that issue as well. We encourage the authorities to be vigilant and not to allow the exchange rate to become a problem.

On the complex issues surrounding the financing arrangements in this particular case, I recall that on the occasion of the presentation of Costa Rica's request to the Board for a stand-by arrangement in October 1987, the Board was willing to go along with what was at the time recognized by all Directors to be an unusual approach. The Board agreed to approve a stand-by arrangement, not just in principle but outright, in the virtual absence of any financing plan and of arrangements to reduce and/or eliminate arrears during the course of the program.

We recognize that some progress has been made, particularly within recent weeks. Indeed, the logjam that has existed for a little over a year was broken during the discussions that took place recently. We welcome the information that the staff and Mr. Ayales provided on these discussions, and we commend the authorities for the active efforts that they have made to move these financing discussions toward a constructive and satisfactory conclusion.

We also recognize that these efforts have, in part, been hampered by divergent views within the banking community and by the tendency for certain private financial institutions not to give the case of Costa Rica the priority that some, including my own authorities, believe it deserves. The Costa Rican authorities have made a persistent adjustment effort over the course of the past 9-12 months, and this effort is deserving of international financial support.

We also sympathize with the particular problem Costa Rica has faced in evaluating certain approaches that have not been as constructive or as broadly acceptable within the banking community as one might hope. In addition, I commend Fund management and staff for the efforts they have made in recent months to bring the financing package to a satisfactory conclusion.

All of these comments notwithstanding, we are not satisfied that substantial progress has been made toward completion of a term sheet. Last October, and as Mr. Massé pointed out, even more so this spring, the argument was advanced that the continued support of the Fund would catalyze agreement on a financing package. The Fund stand-by arrangement has in a sense facilitated the progress that has been achieved with the banks, but we must all share some sense of disappointment that Costa Rica's program has been in effect for almost a year, while progress on the financing package has been rather modest.

Indeed, when we examine this case in the light of Fund policies on financing assurances in Fund-supported programs, as recently reviewed (EBM/88/16, 2/3/88, and EBM/88/17, 2/5/88), we are not convinced that there is a satisfactory or persuasive basis for deviating from existing policies.

Our concerns in this case have increased as a result of the actions of the authorities to deposit funds in the escrow account. I understand the position taken by Mr. Massé and others that this is a positive sign of goodwill and faith on the part of the Costa Rican authorities. But there is another perspective. The Costa Rican authorities clearly have, at least for the time being, the ability to stabilize their external arrears, and yet they are not doing so. They apparently have the ability to make full interest payments to the banks. If the authorities judge that it is not appropriate or tactically sensible in the circumstances to make these payments, that is their judgment. But is it really appropriate for the Fund, in effect, to sanction partial payment when we believe that full payment is feasible? This is a very difficult question that leaves us more uncomfortable than before.

We are told in the supplement issued by the staff that a waiver of the external arrears targets will be required for purchases based upon September 30 performance criteria. Since the September arrears performance criterion is $30 million, this criterion will be violated in the absence of complete agreement with the commercial banks, and agreement appears unlikely. I would appreciate any clarification from the staff on its intentions with respect to recommending a waiver for this particular performance criterion, if Costa Rica's performance is satisfactory otherwise.

I would certainly be prepared to look for a way to join my colleagues in completing this review. A possible solution is to approve this review in principle. Approval in principle is an option we have at the onset of arrangements. In this case, we could adopt this procedure in the course of the program, thereby indicating broad support for Costa Rica's economic program and yet recognizing that we have not fully safeguarded Fund resources.

I wonder whether Mr. Massé and other Directors who may share our concern about the Fund's exposure in this case might be attracted to a conclusion of this review in principle. If that were agreeable, we would go along. Otherwise, I am afraid that in the circumstances we cannot lend our support to the decision as currently drafted and would have to abstain.

Mr. Ayales commented that it would be somewhat frustrating if, after a good performance under the program and some progress in negotiations on external debt, Costa Rica would not be able to give the banks a decision on whether the country could use Fund resources under the stand-by arrangement, subject to more progress on the financing package than had been achieved to date. Such a proposal would certainly not be in Costa Rica's favor in the negotiating process. His authorities had said that it would be difficult to accept a position where the completion of the review would hinge on a subjective assessment by management or the Board that progress had been made. The onus for achieving that progress should be placed on the banks rather than on Costa Rica, which had always been willing to conclude negotiations.

Mr. Massé noted that while he had been "somewhat reluctant" to endorse the proposed decision and had referred to "serious problems," he had concluded that outright approval--not approval in principle--was warranted. He had not mentioned that disbursements should not be made under the stand-by arrangement so as to avoid any appearance of prejudice in favor of either the banks or Costa Rica in the ongoing negotiations. He would have serious problems if Fund resources were disbursed under a program that was not fully financed, but he would not oppose the disbursements.

He had found it preferable to go along with completion of the second review because basically Costa Rica had been fulfilling its part of the agreement, Mr. Massé remarked. The Board should avoid creating a precedent that could present problems in subsequent cases.

Mr. Prader observed that if Costa Rica were not allowed to draw on Fund resources, such an outcome would seem to constitute a change in the terms of a contract during the period of the agreement.

Mr. Dallara said that he had not put forth a proposal so much as an idea that captured the substantive position that embodied his concerns. His authorities were uncomfortable with the present situation, and he thought that his suggestion might allow him to support a decision that under present circumstances he could not.

In many respects, he shared the frustration expressed by Mr. Ayales, as his authorities had tried to play a constructive role in facilitating discussions between Costa Rica and its creditor banks, many of which were U.S. banks with diverse views and agendas, Mr. Dallara continued. No one felt comfortable about giving the commercial banks greater leverage, but he was not sure that there was a difference between his suggestion and the typical requirement of the Board that a satisfactory financing package be agreed between creditors and debtors. As in any negotiation, there were differences of views between Costa Rica and the banks that had to be sorted out. The present negotiations were more complex than usual, and it was understandable that the authorities were frustrated with the lack of speed with which the banks had dealt with the problem, but his authorities did not have the impression that the banks were simply being uncooperative.

In every case, the Fund had a standard policy of being assured of adequate protection for its resources and of a workable program, undertaken by the debtor, Mr. Dallara commented. But it was illusory to suggest that a program would succeed because domestic policies were sound in spite of the absence of a satisfactory external financing environment.

The Deputy Director of the Exchange and Trade Relations Department pointed out that Costa Rica had not requested a waiver for the breach of the performance criterion related to the level of arrears. Consequently, upon conclusion of the present review, it would not be eligible to make a purchase on the basis of compliance with the end-June performance criteria. Thus, no drawing could take place before the review planned in connection with the purchase that would become available upon compliance with the end-September performance criteria. At that time, there should be sufficient information available about financing assurances.

The Acting Chairman noted that one aspect of the present case that had had an influence on the staff and management's approach since its inception was the fact that the authorities had made every effort over time to implement their economic policies. The authorities had not been anxious to draw under the program but had found that having the program in place provided a firm anchor for them in their dealings with their political counterparts in the Government. That was the main way in which the program had been used. For example, when the stand-by arrangement had been approved, the authorities had been concerned that the program might be drifting off track and they had not drawn. Similarly, when the March performance criteria had been missed by a minor amount, the authorities had not requested a waiver, which would have been the normal procedure. That background was the reason for the confidence of management and staff that Fund resources in the present case were protected.

Mr. Enoch commented that Costa Rica's performance under its stand-by arrangement since the previous review had been broadly satisfactory. While two performance criteria for end-March had been missed, the shortfalls had been relatively small. In the case of the criterion for net domestic credit to the nonfinancial sector, the problem appeared to have been essentially a technical one, related to the investment of surplus funds in financial institutions that were excluded from the program definition for practical reasons. However, the incompleteness of the program definition raised some questions about the effectiveness of that criterion.

He noted the concerns expressed by the staff regarding the adequacy of existing credit policies to achieve targets for the remainder of the program period, Mr. Enoch continued. Clearly, action had been required to bolster the financial system following the solvency problems encountered by some finance companies earlier in 1988, and the authorities appeared to have responded to the situation effectively. However, it was important that credit policies should be brought back on track so that the objectives of the program could be fulfilled, particularly in view of the overrun of inflation during the first quarter of the year. While there appeared to be a substantial improvement in that respect during the second quarter, appropriate credit policies would be important to maintain that improvement.

On the external side, it was somewhat worrying that the target for net international reserves had been met in part as a result of what appeared to have been a temporary improvement in exports, arising from changes in the timing of shipments, Mr. Enoch remarked. If the external objectives of the program were to be met, a more lasting improvement on the trade balance would be needed. In that context, the authorities' intention to accelerate the rate of exchange rate depreciation was commendable.

The improvements in the medium-term outlook compared with the previous review were welcome, particularly the significant reduction in projected financing gaps, Mr. Enoch said. However, those gaps remained substantial, and the continuation of large trade and current account deficits and the slow reduction of the debt/GDP ratio from its high level remained a cause of concern. Concessional debt relief would help to reduce the current account deficit and the debt burden, but greater improvement in the trade balance would seem necessary to secure medium-term viability.

The main concern about the present review related to financing assurances, Mr. Enoch observed. As he had said in previous discussions, his authorities attached considerable importance to that matter, and they believed that programs or reviews should not normally be approved unless prospective financing gaps were filled. Because of those considerations, he had been unhappy about the program since its approval.

At the present stage, however, his authorities were prepared to treat Costa Rica as a special case, Mr. Enoch stated. The quality of its program was high, performance under the program had been broadly satisfactory, delays in securing financing had been largely--although not entirely--attributable to the commercial banks' reluctance to negotiate, and significant progress was being made toward bringing those negotiations to a successful conclusion. Furthermore, the authorities had demonstrated a commendably responsible attitude to the use of Fund resources by refraining from making purchases under the program thus far. He hoped that they would continue to show such restraint, and he was reassured by the staff's comments in that connection. In the light of those factors, he could support the completion of the present review on an exceptional basis, despite the absence of full financing assurances. It was far from clear that there were other cases where all those various factors would play a part; and he was thus far from sure that there were other cases where such exceptional treatment could be undertaken; therefore, the case would not set a precedent.

With respect to the manner in which the review had been handled, he welcomed, in particular, the contribution made by the staff in projecting the financing and the innovation of the recent informal meeting on Costa Rica that allowed prompt consideration of the present case, Mr. Enoch remarked. Nevertheless, he would not want there to be an expectation that an informal meeting was a method for obtaining exceptional treatment for a country.

He particularly welcomed the suggestion that had arisen during the informal meeting to undertake a retrospective analysis of the issues raised by the present program, Mr. Enoch said. Some of the issues would of course arise during the Board's forthcoming discussion of the debt strategy, but a retrospective look, not only at Costa Rica but at the few other cases where programs had been approved involving similar issues--for example, Ecuador--would be particularly useful. The key question was whether the Fund continued to play a catalytic role. When the programs of both Costa Rica and Ecuador had been introduced, it had been argued that the Fund should approve them, despite the absence of full financing assurances, because doing so would stimulate the banks' participation. At present, the Board was much less positive. The effect in the case of Costa Rica had been neutral, while in the case of Ecuador the effect had been negative in that it had reduced the incentives for the banks to reach agreement and negotiations had fallen through. Perhaps the retrospective survey could help to find an alternative way to make progress in such difficult cases in the future. For example, the solution might be an "empty" stand-by arrangement, which would have been appropriate in the case of Costa Rica.

Mr. Pineau observed that even if Costa Rica had been able to remain approximately in compliance with the program targets, progress would apparently be slow and difficult to consolidate. Moreover, the lengthy negotiation process with commercial banks raised questions about the commitment of the Fund's resources in the absence of satisfactory financing assurances.

As regards the implementation of the program, some headway had been made in the second quarter compared with the first quarter of 1988, when several performance criteria had not been met, Mr. Pineau continued. The performance seemed to imply that the authorities had regained better control of economic developments. The situation was still precarious, however, as the underlying trends pointed to a relaxation of financial discipline. The most disturbing feature was the upsurge in inflation. It was already clear that the initial objective for 1988 would not be met, reflecting a persistent inability of the authorities to stabilize the financial sector. The excess liquidity that had emerged largely in connection with the financial system's structural weakness was to be blamed for that situation. In particular, the authorities had been very slow to react to increasing liquidity pressures. He wondered whether they were currently contemplating the floating of new stabilization funds. Moreover, he wondered what steps could be taken that would secure tighter regulatory control of the largest commercial banks, which had found ways to circumvent reserve requirements. In light of recent developments, he would appreciate confirmation from the staff that the performance criterion set for bank credit to the public sector was likely to be fulfilled.

The acceleration of price rises could also have a detrimental impact on the fiscal position, Mr. Pineau noted. Over the recent period, the authorities had been able to maintain a reasonable degree of financial discipline in the public sector. A good revenue performance--largely attributable to the 1987 tax reform--had been helpful in that regard, but control over expenditure appeared more questionable in view of the recent reopening of wage negotiations. The risks associated with the full indexation of wages at a time of mounting inflationary pressures were obvious. The authorities would therefore have to be ready to resist excessive wage claims, which would have a serious destabilizing impact on the whole adjustment process.

With regard to Costa Rica's drawing on Fund resources, his authorities could go along with the proposed decisions, Mr. Pineau stated. Their attitude was based mainly on two considerations. First, the fact that Costa Rica would resume full payment of interest due to commercial banks seemed to indicate that the negotiations were entering a new phase. The establishment of an escrow account appeared appropriate as a temporary solution, and only to the extent that it could help speed up the negotiation process. Second, additional drawings would be dependent upon completion of the third review.

Even if they could support the proposed decisions, his authorities had some concerns about Costa Rica's actual willingness to reach a workable agreement with its creditors, Mr. Pineau remarked. A substantial buildup of arrears had been taking place at a time when negotiations had not been proceeding as expeditiously as feasible. In that matter, responsibility was often shared by the two parties, but prompt elimination of those arrears would greatly contribute to stopping the deterioration of Costa Rica's creditworthiness.

His authorities continued to believe strongly that a rescheduling agreement with official creditors under the auspices of the Paris Club would help the country in its discussions with the commercial banks, Mr. Pineau said. He would appreciate Mr. Ayales's confirmation that a

Paris Club meeting would take place in September, as indicated in the staff paper. That meeting would be another indication of the authorities' readiness to normalize their relations with external creditors.

Mr. Goos recalled that during the informal meeting two days previously, he had argued in favor of postponing the review under Costa Rica's stand-by arrangement out of concern about the safety of the Fund's resources and because of fundamental reservations concerning the Fund's approval policy and the Fund's role in the cooperative debt strategy. However, after hearing the arguments presented in favor of completing the pending review, he was able to support the proposed decisions. Nonetheless, he wished to make it clear that his support was based on a number of critical assurances that had been given at the informal meeting.

The first of those assurances related to the fact that on present indications it could be expected with a reasonable degree of certainty that the remaining financing gaps discussed in the staff's medium-term outlook would eventually be filled so that the Fund's resources would not be exposed to undue repayment risks, Mr. Goos continued. In that regard, he understood that at the end of the arrangement there would in practice be no balance of payments gap. During the previous discussion, it had been stated that arrears had reached their maximum level and no further accumulation would take place. If the Fund disbursed under such a situation there would de facto be no risk for the Fund's resources. In sum, at the moment, the balance of payments gap was closed by the existing arrears; and the balance of payments gaps in the medium term would be filled on the basis of present indications for future aid inflows, either bilateral or multilateral.

The second assurance to which he attached great importance was that the Board's approval of the proposed decision, before finalization of the rescheduling package, or even agreement on a term sheet, would not hamper the ongoing negotiations between Costa Rica and the commercial banks, Mr. Goos stated. On the contrary, he had understood that, given the momentum that had developed in the process, final agreement would be reached in the not too distant future. In that regard, he was somewhat worried by Mr. Dallara's statement, which indicated that agreement might not be reached for some time.

The accumulation of current interest obligations in an escrow account was the cause of some uneasiness, similar to Mr. Dallara's concerns, Mr. Goos said. While the escrow arrangement was preferable to the outright accumulation of arrears, it implied continued nonpayment to the banks. He was therefore concerned that completion of the second review could indicate sanction of an arrangement that might be inconsistent with the cooperative approach. He asked the staff to comment on the matter.

More generally, he attached the utmost importance to the continued adherence to established Fund principles concerning financing assurances and cooperation within the financial community, Mr. Goos remarked. As agreed by the Board, deviations from those principles must remain the exception and must be strictly limited to extraordinary cases. He considered that the case before the Board was one where the criterion of exceptionality had been largely met.

He was reassured by Costa Rica's recent performance under the program, Mr. Goos concluded. That performance was highly commendable and instrumental in alleviating his authorities' initial concerns. However the overall situation remained fragile, as indicated notably by the recent acceleration in inflation, the emerging wage pressures, and above all, the remaining external financing gaps in the years ahead. The filling of those gaps would undoubtedly require further substantial efforts to generate the necessary domestic savings. It therefore appeared that the more difficult part of adjustment might still lie ahead and, accordingly, would require the continued strong commitment of the authorities. He endorsed the staff appraisal and supported the proposed decisions.

Mr. Rye said that as with other speakers, the proposal posed a dilemma for him. On the one hand, it was of the utmost importance that financing should be assured before Fund resources were disbursed, and on the other hand, the Fund should take appropriate opportunities to distance itself from the commercial banks, particularly in program financing. He did not want to see the banks conditioning the use of the Fund's resources, as stated by Mr. Ayales; the Fund owed a duty to its members but owed none to the commercial banks. Mr. Ayales had also justly stated that Costa Rica presented a unique case that did not readily fit into the framework of the normal policies of the Fund.

In the past, he had indicated that Costa Rica's program was a good one and that delays in negotiating external financing were largely, if not entirely, beyond Costa Rica's control, Mr. Rye continued. During the April 1988 review, he had emphasized that support from the Fund was essential for progress in negotiations with the international banking community. Notwithstanding the fact that the hopes held then had not yet been fulfilled, those points continued to hold.

The staff report presented a generally encouraging, although certainly short of perfect, picture of progress under the stand-by arrangement, Mr. Rye remarked. The continuing difficulties with the commercial banks were a serious matter, and the reasons for the banks' reticence in coming to the negotiating table were not entirely clear--although recent activity might indicate some progress. However, there was no evidence to suggest that the Costa Rican authorities had been dragging their feet. Moreover, their undertaking to pay the balance of commercial bank interest due each month into an escrow account was an important step indicative of their good faith. That action largely removed the concern regarding the buildup in arrears. He considered it a straightforward negotiating element, and he did not share the interpretation given by Mr. Dallara and Mr. Goos of that step.

More generally, Costa Rica was cooperating with the Fund, and he did not believe that that constructive attitude--a key element of which was restraint in the use of the Fund's resources--should be rebuffed, Mr. Rye stated. He would therefore not wish to see an interruption of the program, and he could support the proposed decisions.

Finally, he endorsed Mr. Enoch's proposal for a "retrospective look" at the present program and others that raised important issues concerning Fund-commercial bank relationships, Mr. Rye concluded.

Mr. Vasudevan made the following statement:

> The additional information provided yesterday for the second review under Costa Rica's stand-by arrangement shows that the performance under the arrangement has been satisfactory. Mr. Ayales attributes this performance to the support that the Fund gave to the authorities in their actions toward stabilization. As Mr. Prader has indicated, at this stage of the arrangement it is necessary for the Fund to give continued support, which would be a signal to the international community to make the needed contributions to Costa Rica's ongoing adjustment efforts.
>
> We commend the authorities for successfully overcoming the crisis of confidence in the financial sector that occurred in late 1987 and early 1988, and for taking measures to tighten credit policy through the restoration or increase of reserve requirements and the raising of interest rates on three-month central bank stabilization bonds. This should have the desired effect on prices, the increase in which seems to have moderated sharply in the second quarter. The meeting of the program limits on central government expenditures for end-June 1988 by a comfortable margin and the extraordinary revenue performance so far indicate that the fiscal position will show the requisite improvement. We welcome Mr. Ayales's statement that the authorities will resist spending pressures and take a conservative position on future wage negotiations with public sector employees.
>
> In regard to the exchange rate and trade, the supplement shows that there has been considerable real depreciation of the exchange rate and that the export performance has been improving. The present level of net international reserves also indicates the adequacy of the policies that are being pursued in this area.
>
> With regard to the external debt situation, the establishment of an escrow account for deposits of current interest due to banks from July 1988, with an adjustment of $5 million a month, is an indication of the authorities' willingness to pursue an approach of negotiation with its creditors. We

welcome the fact that, after a long delay, discussions were held on long-term rescheduling of Costa Rican bank debt between the bank coordinating committee and the authorities. A menu approach has been offered, and while the menu provides opportunities to address the debt problem more effectively than the position obtaining now, the terms that Costa Rica would ultimately receive are important since they would have considerable impact on the future potential of the economy.

It is this consideration, we hope, that will permeate the meeting with the Steering Committee on August 16. We also hope that the authorities will soon approach the Paris Club creditors for debt rescheduling, which in our view plays an important role in the present circumstances. The present review will help the process of negotiations. We would not like banks to have greater leverage in future negotiations with the authorities. Finally, we support the draft decisions.

Mr. Ovi observed that the inflationary effects of the economic measures implemented by Costa Rica at the onset of the program had been somewhat underestimated. The price effects of the depreciation of the currency seemed to have led to pressures for wage adjustments that could have potential adverse consequences for the public sector finances in particular. Commercial bank credit expansion had been, at least temporarily, somewhat in excess of the set limit, with consequent pressure for an increase in imports. Also, there was some concern about credit policy for the rest of the year; the authorities had acted by raising the interest rate on shorter-term stabilization bonds, and they were considering increasing reserve requirements on demand deposits. He would appreciate an assessment by the staff of the adequacy of those measures.

On the basis of economic developments under the program and the authorities' commitment to maintaining decisive economic adjustment, he concurred with the staff that the 1988 program justified continued support, Mr. Ovi said. As to the financing of the program, he remained concerned about the lack of financing assurances from banks and he therefore saw problems in completing the second review. However, he recognized the difficult and special situation leading to the present course of action, and having approved the stand-by arrangement and completed the first review, it seemed inconsistent to stop the program at the present stage. Moreover, three aspects that reflected strength rather than weakness might convey a positive gesture to the banking community, thereby promoting agreement in the near future: first, the Fund's approval of the second review would indicate confidence in the economic policies being pursued and acknowledgment that performance under the program had been satisfactory; second, the program was unchanged in all major respects except the implementation of the financing arrangement; and third, the opening of an escrow account by the authorities indicated the country's commitment to servicing its external debt in accordance with the program.

He had one slight reservation about the introduction of a third review, although it was fully consistent with the underlying principles of the Fund, Mr. Ovi remarked. He was uncertain how that review would be handled if agreement with the banks had not been reached at that time. The Board should avoid undue complications. Also, he did not think the time was appropriate to put forth a proposal to approve the decision in principle, as suggested by Mr. Dallara. Rather, considering Costa Rica a truly exceptional case, he could go along with the proposed decisions. He had taken note of the Acting Chairman's remarks concerning the safeguarding of Fund resources.

Mr. Adachi said that he welcomed the further progress in adjustment efforts made by Costa Rica since April. The performance under the program had been broadly satisfactory. However, it was obvious that much remained to be done. Although the rate of inflation was slowing down, it was undoubtedly the main source of concern. Nonetheless, he would not dwell on any specific action to be taken, since on previous occasions his chair had stated the measures to be developed.

His authorities had serious concerns about the present review of the stand-by arrangement not because of the performance record but because of the unsatisfactory status of the negotiations between Costa Rica and the commercial banks, Mr. Adachi continued. Like others, he hesitated to go along with the proposed decision. Therefore, he had a great deal of sympathy for Mr. Dallara's suggestion to complete the review in principle. However, taking into consideration the fact that the request for a waiver had not been made, and with the understanding that drawings would not be made until the next review, he could support the proposed decision, although, like Mr. Enoch, he believed that the case should not be considered a precedent for the future.

He attached great importance to the normalization of Costa Rica's relationship with commercial banks, Mr. Adachi stated. In that respect, the setting up of the escrow account could be seen as an encouraging sign, although he sympathized with Mr. Dallara and Mr. Goos in their concerns. In sum, he urged the Costa Rican authorities to make every effort to reach agreement with the commercial banks.

The staff representative from the Western Hemisphere Department said that during the financial crisis that had surfaced toward the end of 1987, when a number of financial companies had become insolvent, the monetary authorities had basically allowed the companies to go bankrupt and no bailout measures had been taken. Some liquidity had been injected into the system in general to prevent any spreading of the problem, but no support had been given to those financial companies, one of which had been rather large.

On Costa Rica's exchange rate policy, at the current pace of biweekly devaluations, the originally programmed 6 percent real effective depreciation would not be achieved until the end of 1988, the staff representative commented. Nevertheless, it appeared that the export performance in general was on track or slightly better than expected. Nontraditional exports were, for the third consecutive year, performing well, increasing at a rate of about 20 percent during the current year. As a group, those exports would surpass coffee exports by the end of 1988 in U.S. dollar value. Although there had been a spurt in import growth at the beginning of the year, for the first half of 1988 as a whole, imports were only 1 percent higher than in the same period of 1987, and imports in the second quarter of 1988 were 5 percent below those in the same quarter of 1987. Thus, merchandise trade was performing as planned. Some inflows of private capital had occurred in the early months of the year, and the increase in interest rates should help that trend to continue. The target for net international reserves appeared to have been met. Therefore, although it would have been preferable, given the probability of higher than programmed price increases, to maintain a more active exchange rate policy, it seemed that overall, on present trends, the policy was adequate; nevertheless, the situation bore watching.

An increase in wages had been granted recently as a result of negotiations held in July, the staff representative reported. The increase in July together with the earlier increase granted in January would push wages by 14 percent for the year as a whole, or about 2 percentage points below the expected rate of inflation which, for the year as a whole, would be about 16 percent--well in excess of the programmed target.

Two components were necessary to determine whether the ceiling on bank credit to the nonfinancial public sector would be met, the staff representative said. One--bank credit--was available, but the other--the placement of government bonds with the nonbank private sector--was not yet available because, while the Government knew the size of its outstanding bonded debt it could not tell, except with a lag, who the bondholders were. It appeared that the ceiling might be breached by a small amount.

The financing gap for 1988 was closed in the sense that interest arrears to commercial banks in June had reached $200 million, which was the size of the gap, the staff representative noted. Of course, the stock of arrears would have to fall to zero by the end of the fourth quarter, provided that the program was financed following agreement with the commercial banks. For the years to 1992, the period of the midterm projection, the gaps that appeared would be covered mainly by rescheduling of bank principal as well as by Paris Club reschedulings. A gap of $35-40 million a year remained that arose from the assumption in the projections that aid levels would decline sharply, a development that may not arise; moreover, only those disbursements from multilateral and bilateral agencies that were in the pipeline were included, although it was likely that there would be new loans approved in the years ahead that would help to finance the gap. No new bank financing was assumed for the years to 1992.

The staff considered that the measures that had been put into effect in recent months to maintain the program on track were yielding the desired results, the staff representative from the Western Hemisphere

Department remarked. While inflation for the year as a whole would be higher than programmed because of the first quarter price jump, the trend of the past three months had been toward a decline. Similarly, import growth was decelerating.

The staff representative from the Exchange and Trade Relations Department said that speakers had wondered whether Costa Rica's establishment of an escrow account had been consistent with the cooperative debt strategy. There was no doubt that the Costa Rican authorities had tried to demonstrate their belief in the cooperative approach and their desire to stay within the negotiated framework. Both the banks and the authorities agreed that the banks would eventually accept their share in filling the financing gap, but because both sides considered that a conventional new money package would not be appropriate and because they wanted a menu-based package that would better accommodate their preferences, negotiations had been lengthy. The establishment of an escrow account was a temporary compromise measure, and admittedly views on the measure remained a matter of judgment. Nevertheless, the establishment of the account for the full payment of interest due to banks demonstrated the authorities' ability to handle their debt service payments.

Mr. Dallara inquired whether it was the staff's expectation that arrears to the commercial banks would continue to grow during the period ahead in the absence of an immediate comprehensive agreement on commercial bank financing. If so, he wondered whether a waiver of the current arrears test would be required.

The staff representative from the Western Hemisphere Department said that arrears to the commercial banks would grow by the amount of the deposits in the escrow account, which would be credited with the difference between contractual interest and the $5 million that would be paid to the commercial banks. A waiver would not be required if an agreement was reached with the commercial banks before the end of the third quarter. The purpose of the third review was basically to determine whether the program was financed. If by that time arrangements with the commercial banks were not concluded, the Board would have to consider whether the third and fourth purchases subject, first, to concluding the third review, and second, to observance of the September and December performance criteria, would be approved.

Mr. Dallara remarked that unfortunately the staff's comments tended to crystallize his concerns; it seemed that the Board was being asked to accept, if not formally approve, the growth of arrears in a situation where the country obviously had the resources to avoid rising arrears. It was difficult to reconcile that practice with the policies for Fund-supported programs.

Mr. Goos commented that it would be appropriate to give further consideration to the question of the escrow account on another occasion. In the present situation, Costa Rica's accumulation of interest payments in the account might be a welcome indication, and he recognized the exceptional nature of the case. But he could envisage other situations in which a country, for other reasons, refused to make interest payments directly to the banks and placed the money in a separate account. In general, he would have concerns about the Fund agreeing to that procedure because it represented an accumulation of arrears and might result from a country's desire to place pressure on the banks. In approving such a procedure, the Fund might possibly jeopardize its role in the cooperative debt strategy.

Mr. Ayales said that the resources that were deposited in the escrow account constituted the difference between the contractual amount of full interest and the amount--$5 million--that Costa Rica was paying to the banks, according to a negotiated arrangement with those banks. The country was not refusing to pay the banks. The escrow account had been set up because of the emergence of a gap during the extension of the program period.

Mr. Goos stressed that he had referred to the escrow account procedure as a general problem but not necessarily one that arose in the case of Costa Rica, where the procedure could be justified; he had merely wished to point out that in other cases it might be more difficult to do so.

Mr. Ayales pointed out that his authorities held an extremely cautious position on the use of Fund resources. Following the positive outcome of the present review, the authorities would be able to concentrate on the regularization of Costa Rica's relations with creditors in the Paris Club, which had already been approached to consider Costa Rica's case at its next meeting, and with the commercial banks, with which Costa Rica was striving to reach final agreement soon.

The Executive Board then took with one abstention the following decision on the review under the 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.

Decision No. 8950-(88/125), adopted
August 5, 1988

The Executive Board then took the following decision on the exchange system:

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

Decision No. 8951-(88/125), adopted
August 5, 1988

2. HAITI - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE K-1 - POSTPONEMENT

Without discussion, the Executive Directors agreed to postpone consideration of the report and complaint of the Managing Director under Rule K-1 with respect to Haiti's overdue financial obligations to the Fund (EBS/88/134, 7/11/88; and Sup. 1, 7/15/88) to August 24, 1988, as the Board would not be meeting on the previously scheduled date of August 22, 1988.

The Executive Board took the following decision:

Paragraph 1 of Decision No. 8921-(88/107), adopted July 18, 1988, shall be amended to read:

The complaint of the Managing Director under Rule K-1 dated July 15, 1988 on Haiti in EBS/88/134 (7/11/88) and Supplement 1 (7/15/88) is noted. It shall be placed on the agenda of the Executive Board for August 24, 1988.

Decision No. 8952-(88/125), adopted
August 5, 1988

APPROVED: February 21, 1989

LEO VAN HOUTVEN
Secretary