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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/56

10:00 a.m., April 4, 1988

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	C. Enoch
	Jiang H.
C. H. Dallara	
	J. Prader
A. Donoso	E. V. Feldman
	A. M. Othman
G. Grosche	
	A. Iljas, Temporary
	L. M. Piantini, Temporary
	D. McCormack
	K. Yao, Temporary
	I. A. Al-Assaf
	L. Filardo
	E. Ayales, Temporary
	M. Fogelholm
H. Ploix	D. Marcel
	G. P. J. Hogeweg
	C.-Y. Lim
G. Salehkhou	
	L. E. N. Fernando
K. Yamazaki	S. Yoshikuni
	S. Rebecchini, Temporary

J. W. Lang, Jr., Acting Secretary
S. B. Woolls, Assistant

Also Present

IBRD: L. Derbez, Latin America and the Caribbean Regional Office. African Department: A. D. Ouattara, Counsellor and Director; E. L. Bornemann, Deputy Director; J. Khallouf, A. B. Petersen, P. L. Parcu. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; E. Brau, S. B. Brown, K. Flug, H. Hino, H. B. Junz. External Relations Department: G. P. Newman. Fiscal Affairs Department: A. Tanzi, Director. Legal Department: W. E. Holder, Deputy General Counsel; R. H. Munzberg, J. V. Surr. Treasurer's Department: F. G. Laske, Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; D. Berthet, J. C. Corr, S. J. Fennell, D. Gupta, P. S. Ross, B. B. Zavoico. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; J. Ferrán, Deputy Director; L. E. DeMilner, M. R. Figuerola, A. S. Linde, I. C. Tandeciarz, A. U. Vasquez. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: P. E. Archibong, W. N. Engert, A. G. A. Faria, A. Ouanes, P. Pétursson, N. Toé, J. E. Zeas. Assistants to Executive Directors: N. Adachi, L. E. R. Alfiler, R. Comotto, E. C. Demaestri, V. J. Fernández, M. Hepp, S. King, V. K. Malhotra, C. Noriega, A. Rieffel, S. Rouai, E. L. Walker, R. Wenzel, D. A. Woodward.

1. ESAF TRUST - LOAN ACCOUNT - BORROWING AGREEMENTS

The Executive Directors considered papers on proposals for borrowing agreements with the loan account of the Enhanced Structural Adjustment Facility Trust and the Caisse Centrale de Coopération Economique of France (EBS/88/62, 3/22/88); the Export-Import Bank of Japan (EBS/88/69, 3/28/88; and Sup. 1, 4/1/88); the Bank of Norway (EBS/88/72, 3/29/88); and the Swiss Confederation (EBS/88/70, 3/28/88).

Mr. Yamazaki thanked the Chairman and the staff for their strenuous efforts in coming up with the detailed and concise borrowing agreements under discussion. His authorities, including the Export-Import Bank of Japan, were willing to accept the proposed agreements.

His authorities were prepared to increase Japan's commitment to SDR 2.5 billion on the condition that other participants would provide sufficient grants to keep the interest rate at the level that was to be determined at the Board's forthcoming meeting, Mr. Yamazaki said.

The Fund had yet to finalize the borrowing agreements for other participants, Mr. Yamazaki noted, and he hoped that the borrowing agreements under discussion, if approved, would serve as a basis for agreements with other participants.

He looked forward to further progress not only in the formalization of Enhanced Structural Adjustment Facility Trust borrowing agreements between the Fund and other participants, but also in the adjustment programs now under way in countries eligible for enhanced structural adjustment facility arrangements.

The Chairman said that the discussion of the proposed borrowing agreements had afforded him the opportunity to express his gratitude to everyone who had been involved in negotiating the first four borrowing agreements with the Enhanced Structural Adjustment Facility Trust; several other similar agreements were in preparation.

Each agreement had been complex and had involved many more technicalities than originally expected, the Chairman continued. In spite of the efforts of the staff in all departments of the Fund and of national authorities to make the process as simple as possible, the agreements were difficult to assemble and settle in every detail. However, all possibilities had been covered in the agreements under discussion, to everyone's best interest, especially the recipient countries.

He hoped that a strong enhanced structural adjustment facility, for the benefit of poor countries, would be put into operation soon, the Chairman concluded. The staff had been working hard to convince members to take the steps necessary to restore sustainable growth. Hopefully, the first arrangement under the enhanced structural adjustment facility could be brought to the Board before the summer of 1988.

Mr. Grosche said that he agreed to the proposed decisions. The enhanced structural adjustment facility was off to a good start, and had an impressive amount of resources available to it. He fully agreed with the Chairman that it was necessary to have good adjustment programs that could be supported under that facility coming to the Board soon.

The staff should be commended for the excellent and speedy work it had undertaken, Mr. Grosche remarked. The authorities of France, Japan, Norway, and Switzerland also deserved commendation. He hoped that the ongoing discussions with his own authorities on the details of the German loan would soon be concluded, although the German contract might differ somewhat from the contracts under discussion. The detailed agreements that were currently being approved should not be regarded as precedents for future contracts.

Mr. Salehkhou said that the Managing Director was to be congratulated for his consistent efforts in securing the proposed borrowing agreements under discussion. He joined him in hoping that the Fund would be approving the agreements pending with other lenders in the near future, so that the enhanced structural adjustment facility could soon become operational.

Furthermore, the staff was to be commended for its hard work and meticulousness in negotiating and finalizing those agreements, Mr. Salehkhou commented. He had no difficulty approving them outright.

Some of the proposed agreements had contained market arrangements for coverage of exchange risks arising from the denomination in SDRs of creditors' loans to the Trust, Mr. Salehkhou observed. Like the staff, he understood that some other major lenders planned to make arrangements for covering that exchange risk through operations in the international currency swap markets. Based on that understanding, during the Board discussion on external contingency mechanisms (EBM/88/50 and EBM/88/51, 3/28/88), he had proposed the extension of coverage to the adverse impact of exchange risk, a proposal which had yet to win the full support of Directors, if a contingency facility was eventually established.

The Executive Board then adopted the following decisions:

a. <u>Caisse Centrale de Coopération Economique of France</u>

Pursuant to Section III, paragraph 2 of the Instrument to Establish the Enhanced Structural Adjustment Facility Trust, the International Monetary Fund, in its capacity as Trustee of that Trust, approves the agreement for borrowing from the Caisse Centrale de Coopération Economique in terms of the draft set out in the attachment to EBS/88/62, and authorizes the Managing Director to take such action as is necessary to conclude and implement the agreement.

Decision No. 8831-(88/56) ESAF, adopted
April 4, 1988

b. Export-Import Bank of Japan

Pursuant to Section III, paragraph 2 of the Instrument to Establish the Enhanced Structural Adjustment Facility Trust, the International Monetary Fund, in its capacity as Trustee of that Trust, approves the agreement for borrowing from the Export-Import Bank of Japan in terms of the draft set out in the attachment to EBS/88/69, and authorizes the Managing Director to take such action as is necessary to conclude and implement the agreement.

Decision No. 8832-(88/56) ESAF, adopted
April 4, 1988

c. Bank of Norway

Pursuant to Section III, paragraph 2 of the Instrument to Establish the Enhanced Structural Adjustment Facility Trust, the International Monetary Fund, in its capacity as Trustee of that Trust, approves the agreement for borrowing from the Bank of Norway in terms of the draft set out in the attachment to EBS/88/72, and authorizes the Managing Director to take such action as is necessary to conclude and implement the agreement.

Decision No. 8833-(88/56) ESAF, adopted
April 4, 1988

d. Swiss Confederation

Borrowing Agreement

Pursuant to Section III, paragraph 2 of the Instrument to Establish the Enhanced Structural Adjustment Facility Trust, the International Monetary Fund, in its capacity as Trustee of that Trust, approves the agreement for borrowing from the Swiss Confederation in terms of the draft set out in Attachment I to EBS/88/70, and authorizes the Managing Director to take such action as is necessary to conclude and implement the agreement.

Decision No. 8834-(88/56) ESAF, adopted
April 4, 1988

Letter to Swiss Authorities

The Managing Director is authorized to send, on behalf of the Fund, the letter to the Swiss authorities set out in Attachment III to EBS/88/70.

Decision No. 8835-(88/56), adopted
April 4, 1988

2. COSTA RICA - 1987 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT, AND EXCHANGE SYSTEM

The Executive Directors considered the staff report for the 1987 Article IV consultation with Costa Rica and the review under the 17-month stand-by arrangement adopted on October 28, 1987 (EBS/88/60, 3/15/88). They also had before them a background paper on recent economic developments in Costa Rica (SM/88/67, 3/22/88).

Mr. Ayales made the following statement:

The Government of Costa Rica is thankful for the valuable work carried out by the staff, and for the fruitful discussions that were held on both the first review under the stand-by arrangement and the 1987 Article IV consultation with Costa Rica during the recent mission to San Jose. The staff papers provide a comprehensive and balanced assessment of recent economic and financial developments in the country, with which my authorities are in broad agreement.

1. Introduction

Economic developments in Costa Rica were last discussed by the Board in late October 1987 in the context of the country's request for a stand-by arrangement with the Fund. At that time, I commented on the economic developments in 1986 and early 1987, underlined the main aspects of the economic program for 1987-88, and informed the Board of the country's external debt situation. I shall, therefore, limit myself to updating information on developments since that Board discussion.

2. Economic background and developments under the 1987 economic program

Following a deep recession and serious balance of payments difficulties in 1981-82, Costa Rica implemented economic and financial policies over the 1983-86 period with highly positive results. Economic stabilization was achieved and there was a resumption of output growth. The combined public sector deficit was reduced from 14.5 percent of GDP in 1982 to 3.5 percent in 1986; the annual rate of domestic inflation feel sharply from 90 percent to about 12 percent during the same period; and, after a sharp decline in 1982, the economy bounced back, expanding by more than 4 percent a year during 1983-86. The fiscal and credit policies that were adopted, together with a flexible stance as regards exchange and interest rates, led to a narrowing of the external current account deficit from 11 percent of GDP in 1983 to slightly more than 4 percent in 1986. However, as a result of adverse external conditions, a substantial decline in official transfers and delays in external debt rescheduling, the country's external position remained weak.

Further improvements in Costa Rica's financial situation were to be achieved in 1987 through a tightening of fiscal and monetary policies within a framework of flexible exchange rate and interest rate policies. To this end, during 1987 the real effective value of the colón was reduced by 17 percent, and the Government adopted a combination of revenue and expenditure measures that brought about a further reduction in the nonfinancial public sector deficit of 1 1/2 percent of GDP. At the same time, the Government continued its policy of bringing domestic prices for basic grains more in line with international levels and adjusting rates of public services to reflect costs, thereby consolidating the financial position of state enterprises.

Although performance in the fiscal sector was satisfactory, some difficulties were experienced in attempting to tighten the monetary stance in the latter part of 1987. Notwithstanding the efforts made by the Central Bank to absorb commercial bank liquidity, the banks were able to expand lending to the private sector at a rapid pace in the first three quarters of 1987. The scope for credit restraint during the last quarter of 1987 was limited by uncertainties in private financial markets following the failure of several financial companies. Despite the rapid acceleration in the rate of depreciation of the colón, import levels remained high, leading to a widening of the trade deficit, a problem which was compounded by lower than expected inflows of official capital. Furthermore, valuation adjustments in the Central Bank's position with the Fund--stemming from the appreciation of the SDR vis-à-vis the U.S. dollar--as well as data revisions on external payments arrears, substantially contributed to a deviation with respect to the program's net international reserves target. It is important to note, however, that commercial arrears were fully eliminated by the end of 1987.

3. Economic program for 1988

The Costa Rican authorities remain fully committed to continue to work toward the elimination of domestic and external imbalances despite the difficulties encountered in the closing months of 1987. Hence, with a view to restoring the momentum of adjustment, the Government has adopted a set of measures aimed at achieving the objectives set out initially in the program for 1988. A substantial portion of the deviation in the net international reserves experienced at the end of 1987 is also to be reversed.

Since the staff report explains in detail the provisions and objectives of the economic program for 1988, I will only highlight its main elements:

a. External policies

In order to strengthen the country's external position in the context of an export-led growth strategy, a unified and flexible exchange rate system will be maintained. To this end, following an initial step devaluation of 6 percent vis-à-vis the U.S. dollar in mid-January, the exchange rate will be adjusted according to price movements in Costa Rica and its trading partners, to maintain the real effective value of the colón at its new level. Also, import taxes and surcharges on motor vehicles, which constituted the most important single factor in the deterioration of the trade balance in 1987, have been partially restored. In a different sphere, Costa Rica's membership in the GATT is expected to become effective in 1988.

b. Domestic policies

With the purpose of consolidating the improvement in the country's external competitiveness and sustaining the changes in domestic relative prices that are needed to promote a better allocation of available resources, the Government is determined to pursue a tighter monetary policy in the context of a very prudent fiscal stance. Monetary policy aims at slowing down the rate of inflation to about 10 percent by the end of 1988 and partially correcting the underperformance with respect to the 1987 target for international reserves and the deviations that were in prospect for 1988. Partly in response to difficulties encountered by some private financial institutions, the Central Bank resorted to the establishment of ceilings on individual banks to limit the expansion of credit with domestic resources to the private sector in 1988 to no more than 5 percent. Including anticipated external resources for on-lending purposes, total credit expansion to the private sector would be about 10 percent in 1988. This austere credit stance, which is described in fuller detail in the staff report, is being supported by the maintenance of a flexible interest rate policy.

In the fiscal sector, the Government already has put into effect a comprehensive set of measures aimed at ensuring that the combined fiscal deficit in 1988 does not exceed 3 percent of GDP. Achievement of this target will be aided by the tax package approved in November 1987. Furthermore, the adjustment of a wide range of domestic prices and utility rates will bring about a further improvement in the finances of state enterprises, equivalent to 1 percent of GDP. Electricity and water charges, as well as the prices of oil derivatives, have been raised significantly in recent months and will continue to be adjusted periodically. With a view to consolidating the financial position of other state enterprises, the National Grain Marketing Agency, the Port Authority, and the Railroad Company, among others, also adjusted their user charges recently. The resulting larger surplus in the consolidated nonfinancial public sector will partially offset the larger net operating losses of the Central Bank resulting from the real depreciation of the colón. The main component of the Central Bank losses is interest due on external debt.

My authorities believe that the implementation of this economic program will result in a further reduction of domestic and external imbalances: the external current account deficit is expected to narrow by more than 4 percent of GDP in 1988; mainly as a result of a significant improvement in the trade balance; the deficit of the combined public sector will be reduced to 3 percent of GDP, and the nonfinancial public sector will show a surplus of 0.8 percent of GDP; and the country's net official reserve position will improve by $60 million after all external payments arrears have been eliminated, through both refinancing and cash payments.

Notwithstanding the substantial progress achieved so far, my authorities remain concerned about the high degree of vulnerability of Costa Rica's external position to external developments. As presented in the medium-term outlook section of the report, even under an optimistic scenario, at the end of the forecast period the country will continue to require exceptional financing. It is the view of my authorities that additional external assistance beyond that assumed in the scenario would be needed to improve Costa Rica's growth prospects and facilitate the process of structural change. Given the uncertain external environment, the support of the Fund to the country's efforts is crucial at this time to facilitate the reaching of a final agreement with all creditors on the financial package that the program requires. It is in this manner that the catalytic role of the Fund would best be performed.

4. External debt situation

During 1987, the Costa Rican Government continued to make progress in its efforts to improve the country's debt profile. The Government was able to reduce the annual rate of debt accumulation from a peak of almost 8 percent in 1983-85 to 4 percent in 1986, and 1.5 percent in 1987. Concomitantly, the stock of debt as a proportion of GDP declined sharply from its 1982 peak of 121 percent to around 100 percent in 1987.

However, the debt burden continues to be extremely heavy. Indeed, the ratio of contractual interest payments to GDP has fluctuated between 6 and 9 percent in the past three years, while the debt service ratio has remained over 50 percent for several years. Clearly, this debt service constitutes a very serious constraint to the country's efforts to achieve economic stabilization and sustained growth.

The delays in the negotiations with creditors, as well as the limited access to international financial markets in recent years, have contributed significantly to the present level of payment arrears. This situation was addressed by the Board during the discussion of Costa Rica's stand-by arrangement in October 1987. The Fund's support for the country's adjustment efforts has been extremely valuable, both to keep the momentum of adjustment and to foster the cooperation of external creditors.

Following the October 1987 Board meeting, the Costa Rican authorities met with the banks' coordinating committee. At that time, the committee welcomed the progress made by Costa Rica in its negotiations with the Fund, the World Bank, and bilateral creditors. Furthermore, in order to expedite the quantitative analysis of Costa Rica's proposal, the committee appointed an economic subcommittee which met in San José in late January 1988. Based on the findings of this subcommittee, which was the banks' first fresh look at the country's economic program and balance of payments outlook, the steering committee invited the Costa Rican authorities to a meeting in New York in February 1988. On that occasion, the committee expressed appreciation for the work of the economic subcommittee, which had provided the banks with important new elements for the analysis of the Costa Rican situation. In view of this, as well as recent developments in the context of the debt strategy, the committee suggested that discussions continue in March 1988 as agreement had not been reached among the banks on their position with respect to Costa Rica. However, in its communiqué to all of Costa Rica's creditor banks, the committee indicated that significant progress had been achieved.

Following the February 1988 meeting, informal discussions were held with some of the members of the committee during the recent Inter-American Development Bank meetings in Caracas. At that time, the Chairman of the committee requested that a meeting between Costa Rica and the steering committee be held in mid-April 1988. My authorities expect to reach a mutually agreeable solution with the commercial banks at that meeting; however, it is important to note that we are waiting for a response to the rescheduling proposal submitted to the coordinating committee in June 1987. This lack of reaction by the banks has been the major obstacle to reaching a satisfactory solution to the problem of external payments arrears.

The financing of the 1988 economic program also depends on the approval of the second structural adjustment loan from the World Bank and associated cofinancing from the Government of Japan. A letter of development policy has already been submitted to the World Bank and conditions for its discussion by the Board already have been met.

Regarding negotiations with creditors under the aegis of the Paris Club, preliminary conversations were held in Paris and Caracas recently. These meetings were useful both to appraise bilateral creditors of recent economic developments in Costa Rica and to learn about the recent evolution of Paris Club agreements with debtor countries. We have requested a Paris Club meeting to consider the rescheduling of Costa Rica's debt after the Board consideration of the economic program for 1988.

Negotiations with other bilateral creditors are progressing satisfactorily. A debt rescheduling agreement between Costa Rica and Mexico has been recently reached. This arrangement, which was structured on market conditions, contains an important element of debt relief in the form of a sharing of the market discount for Mexican debt, and provides clear evidence that through cooperation and creativity, solutions to the debt problem can and will emerge.

5. Concluding remarks

The impressive adjustment of the Costa Rican economy achieved since 1982 has been made possible, to a large extent, by the firm support of the Fund. This support, however, relies more on the assistance to develop adjustment policies and on the signals given to the international financial community, than on the financial resources provided by the Fund. This fact is borne out by current circumstances in which the country chose not to draw resources that became available upon approval of the stand-by arrangement in October 1987.

My authorities understand that Costa Rica's case has acquired relevance in the ongoing debate of the legal aspects of approval of exchange restrictions by the Fund. In this regard, I would like to stress that Costa Rica fully recognizes its legal and financial obligations to its creditors. The Government's intention in seeking Fund support for its program, without having concluded negotiations with the banks, was to assure the maintenance of adjustment efforts and to break the impasse that had developed in the negotiations with the external financing package, for which the support of the Fund was very important. Under the current circumstances, my Costa Rican authorities believe that the continued support of the Fund to the country's economic program remains crucial to maintain the cooperative environment in which discussions with our creditors are taking place.

Mr. Piantini made the following statement:

In 1987, the authorities undertook a comprehensive economic program to complete the structural reforms begun in 1985 and to foster a path of steady economic growth.

In the fiscal area, the Government increased public sector rates, some consumption taxes, and in November 1987, Congress approved an important tax reform. Subsidies have been eliminated for some agricultural products and reduced for others, making the structure of expenditure more efficient. Privatization of public enterprises continued during 1987, and as a result, the combined deficit of the public sector was below the program target for 1988; the program envisages that the nonfinancial public sector will be in surplus for the first time this decade.

The program is aimed at maintaining external competitiveness. In 1987, the colón depreciated in real effective terms by 17 percent, making a total real effective depreciation of 40 percent since 1980. As a consequence, nontraditional exports to areas outside Central America have almost doubled in the past two years.

A tariff reform geared to reducing effective protection mainly in the industrial sector, thereby lowering the economy's antiexport bias, has been undertaken. Specific tariffs have been replaced by ad valorem tariffs; a number of tax exemptions have been eliminated; maximum tariff rates have been lowered and the Government intends to reduce them further to 40 percent.

Interest rates have been positive since 1984. The current interest rate policy and the relative stability of the exchange rate have led the public to increase the volume of holdings of money and quasi-money by 4 percentage points of GDP in 1987.

The upward trend of real wages was interrupted in 1987 by a modification in the mechanism of wage adjustments, which fostered the competitiveness of the export sector.

Nevertheless, there remain weak areas in the economy; in particular in the financial, monetary, and external sectors.

The nonobservance of the quantitative targets under the program for end-December 1987 originated basically from slippages in the monetary sector. The annual percentage change in net domestic assets was double that projected, and credit to the private sector increased by 24 percent.

The authorities implemented a set of measures to liberalize the financial system, which had accumulated a good deal of liquidity, as reflected in a rise in time deposits. Combined with a reduction of the advance deposit requirement for the purchase of foreign exchange from 50 percent to 10 percent, the result was a rapid increase in credit to the private sector during the first half of 1987. This expansion, along with the reduction in tariffs already undertaken, stimulated the growth of imports, which increased by 19 percent during the same period.

Nonetheless, the rapid action taken by the authorities in freezing public deposits and restoring the credit ceiling helped to constrain the increase during the second half of the year. However, failures in several private financing companies brought about a relaxation of monetary conditions in the last part of 1987.

The monetary authorities have recently adopted a set of measures to handle financial problems, including the creation of a contingency fund, with private resources, to be used in case liquidity problems arise. However, the authorities' most important decision was submitting a bill to Congress that would make monetary instruments more flexible to use. In this respect, changing the level of the legal reserve requirements and open market operations were a better instrument than setting ceilings on credit, which cause discriminatory distortions. On the other hand, to tackle liquidity problems, the use of rediscounts would be preferable to lowering legal reserve requirements, because it dealt directly with the problem and could be less expansive.

On the external side, the current account deficit widened sharply in 1987, owing to a deterioration in the terms of trade and a rise in import volume, which resulted from the credit expansion noted earlier. This deficit was financed by reserves and external arrears, since the public foreign loan disbursements that had been envisaged declined sharply. As noted earlier, credit expansion was brought under control with beneficial effects on the balance of payments, which had also been improved by timely depreciation of the colón.

Costa Rica's experience suggests that structural reforms, such as liberalization in the trade and financial systems, should have been accompanied by sufficient resources to compensate for effects on the current account. In this way, the risk of creating more internal pressure that could interrupt the adjustment process would have been avoided.

With respect to the debt problem, this chair supports the catalytic role of the Fund in mobilizing the necessary financing to enable member countries to successfully implement their adjustment programs. The preservation of the institution's independent stance, however, should at all times be kept in mind.

As Mr. Ayales noted in his opening statement, Costa Rica has continued its negotiations with the banks, and the staff's analysis set forth on page 22 of the supplement to EBS/87/91, continues to be valid in that delays in the negotiations for a financing package with commercial banks appear to have been caused by factors largely extraneous to the specific case of Costa Rica. In this regard, pending resolution of the bank financing problem, the maintenance of external arrears should have been authorized, for a reasonable time, to avoid both unwarranted pressure on Costa Rica and favoring the banks. In the meantime, Costa Rica has fulfilled its obligations to the banks by making partial monthly interest payments in spite of large losses of reserves.

The medium-term outlook shows the excessive burden of external debt service and the weakness in the external position caused by external developments. In this context, the authorities should keep the adjustment process on track to strengthen the country's external stance in the medium term and maintain steady economic growth. The international community should support this comprehensive process of adjustment financially. This chair strongly supports the proposed decision.

Mrs. Ploix made the following statement:

Apart from some indisputable policy shortcomings, a significant factor behind the rather disappointing economic developments in Costa Rica over the past year was the uncertainty surrounding the normalization of the external payments situation. The delayed entry into force of a Fund-supported program reflected this unstable environment and complicated the introduction of adequate policy responses to deteriorating conditions.

The absence of drawings under the stand-by arrangement to date simply confirms that the arrangement was not fully operative. Therefore, she hoped that, with the completion of the first review and the somewhat better prospects for settlement with foreign creditors, the authorities will now adhere to a firmer adjustment path.

Satisfactory control over public finances was secured in 1987. The tax reform, combined with improved efficiency in fiscal administration, yielded noticeable results. However, a lasting difficulty is the split between current and capital expenditures: current account expenditures are still growing at the expense of the capital account, an unsatisfactory development that seems to stem from the continued growth of public service payrolls. Actually, overall employment in the public sector has been rather stable in past years, but as the staff notes, a growing Central Government has offset the decrease in state-owned industries resulting from privatization. Perhaps Mr. Ayales or the staff could comment on the savings that could be expected from a stricter staffing policy in the Central Government, with a view to making room for public investment.

Developments over the past year make it clear that the brunt of the adjustment must fall on monetary policy. The loosening of monetary control, at a time when domestic demand has already been boosted by a sharp increase in coffee revenue, is to be blamed for the surge in inflation and the substantial widening of the external imbalance. The reinstatement of credit ceilings appears necessary to carry out a tighter monetary stance; the present state of the financial system does not seem to be conducive to more indirect monetary regulation.

Important steps have already been undertaken to mop up excess liquidity in the economy by transferring deposits to the Central Bank and floating stabilization bonds, but the cost of these operations for the Central Bank seems rather high. Does this cost explain why the credit targets do not appear over-ambitious for 1988? Nevertheless, the credit expansion programmed for 1988 will not be conducive to a rapid cooling of inflationary pressures. The average rate of inflation will be brought down from 16.8 percent in 1987 to 14.8 percent in 1988, compared with 8.2 percent projected in the program begun in October 1987.

The main cause for concern is still the external sector. The past year's surge in imports is a clear reminder of the very prudent financial policies the authorities should constantly adhere to. Against the background of a heavy debt burden and renewed inflationary pressures, too active an exchange rate policy could complicate the task of the Central Bank, whose operational losses are already substantial. This implies that import regime liberalization must be conducted in a cautious manner. In this connection, the sharp contraction projected for import volume in 1988 seems difficult to attain solely by the foreseen reduction in domestic absorption and the reinstatement of import duties, and any risk of slippage is all the more significant, since the outlook for exports does not seem very encouraging. Mr. Ayales or the staff should comment on this point.

The medium-term outlook for Costa Rica's external position is even less reassuring. The staff assumptions do not appear to be unduly pessimistic; in particular, the annual export growth rate, projected at 8 percent, must imply a rather strong performance in nontraditional exports to make up for the more erratic profile inherent in agricultural exports. In spite of that, however, the external payments situation is expected to remain very tight, with a continuous need for exceptional financing. I wonder about the implications of that need with respect to relations between Costa Rica and the Fund.

For external creditors, the only workable approach consists of restructuring the debt on appropriate terms, which should involve all the relevant components of the menu of options. The picture for arrears is the same as it was in October 1987. The most recent contacts between Costa Rica and the commercial banks' steering committee imply that a settlement is reachable within a reasonable period of time. A rescheduling agreement within the framework of the Paris Club, which is now scheduled for May or June 1988, should be a strong inducement to settle those arrears.

These considerations, combined with the precise phasing out of arrears included in the Fund-supported program, provide the basis for completing the review of the stand-by arrangement. Of course, this position does not prejudge the stance my authorities will take on the forthcoming debate on the legal effects associated with Article VIII of the Fund's Articles of Agreement.

Mr. Donoso said that the case under discussion was important because it was in effect a test of whether the uncertainties and problems normally associated with arrears could be kept under control if the country concerned had the Fund's active support. A conclusion by the Board that a country could make progress under such conditions would prove that, rather than depending on the banks, the Fund could perform independently and even influence banks' behavior.

The considerable improvement in basic macroeconomic policies reflected the authorities' efforts, Mr. Donoso commented. The new system of wage determination, introduced in 1986 to moderate wage increases, seemed to have been successful, although, given the form in which the new scheme operated, its success might have resulted partly from the temporary acceleration in the rate of inflation and the private sector's efforts to restrict wages. The persistent depreciation of the real exchange rate over the past year, coupled with the clear tightening of the overall policy stance, had made the economy competitive. However, since the system for establishing wages in the private sector would induce increases in salaries once the inflation rate subsided, it would be necessary to maintain constant surveillance over wages in the coming period.

The authorities had maintained effective control over public sector finances in the context of the stand-by arrangement, Mr. Donoso continued. In fact, the central administration deficit had declined impressively, by 1.2 percent of GDP in 1987, compared with 1986, despite shortfalls in coffee revenues. The overall surplus of the public enterprises and decentralized public entities had risen to 2 percent of GDP, as planned. The net operating losses of the Central Bank were much lower than expected, although that outcome was not the result of either changes in the level of expenditures, or the effects on the private sector of stringent interest rate conditions.

In the area of monetary management, there had been some problems resulting from the excessive growth of credit to the private sector, Mr. Donoso remarked. Credit control had been made more difficult by ongoing changes in related areas, such as the reduction in deposits required for the purchase of foreign exchange and the various difficulties experienced by financial institutions. The strong corrections that had been made in those areas were welcome.

The adjustment program had been aimed at sustaining GDP growth in 1987 and at increasing the level of employment under the difficult financial conditions, Mr. Donoso recalled. The rate of inflation had increased marginally, but owing mainly to the efforts to devalue the currency in real terms. The larger than expected external current account deficit was attributable to the slippages in credit policy and the impact of tariff reductions and restrictions which seemed to have accounted for the high level of imports.

Overall, Costa Rica had been able to cope with financial uncertainty, introduce positive reforms, and pursue adjustment, Mr. Donoso said. Public sector wages, the exchange rate, and the fiscal position basically had all moved in the desired direction. The increased control of monetary aggregates should consolidate those advances and reduce the rate of inflation, while supporting the improvement in the external accounts sought by the authorities.

The authorities had introduced a "step" devaluation of the colón in mid-January 1988, and further reductions in the public sector deficit were contemplated, Mr. Donoso noted. A key element in the program for 1988 was the tight control of credit. Owing to the weakness of some financial institutions, the authorities were reintroducing credit controls for individual banks. Although the authorities' priorities were understandable, they should eliminate the credit ceilings as soon as possible.

The authorities had introduced a satisfactory crawling peg exchange rate regime to ensure competitiveness, and had embarked on structural reforms, designed in the context of a structural adjustment loan from the World Bank, which should have positive effects on the potential of the country to grow and service its external debt, Mr. Donoso pointed out. Those efforts were evidence of the appropriateness of the authorities' policies, the persistence of their implementation, and their strong commitment, which justified the Fund's support. He approved the proposed decisions.

The performance of the economy had shown that the Fund could act independently of commercial banks and could be of great help to member countries, Mr. Donoso concluded. It was possible for Costa Rica to make progress under the present circumstances. The economy had grown and had sustained a high level of imports while making progress in many policy areas. Problems remained, owing to the high level of debt, but Costa Rica had been able to take advantage of Fund support to the benefit of itself and its creditors, in spite of their reluctance to cooperate. That success justified an optimistic view of the possibilities for strengthening the debt strategy.

Mr. Yoshikuni said that he fully agreed with the staff that a sharp tightening of credit to the private sector was essential, as was paying due attention to the situation in the private financial sector. In that regard, he recognized the difficulties in following an extremely narrow path between the need to tighten credit policy and the need to prevent further problems in the financial market. Nonetheless, failure to follow such a path would exacerbate the balance of payments situation and undermine public confidence in the economy.

Along with credit control, the appropriate implementation of exchange rate policy should play a central role in restoring a viable external position, Mr. Yoshikuni recommended. The authorities were to be commended for the recent devaluation measures, and they should continue those efforts in the period ahead. As long as the authorities pursued those policies, Costa Rica's economy would move in the right direction. However, he attached great importance to the negotiations with commercial banks, in spite of the extraordinary procedural treatment the Executive Board had accepted when it approved the stand-by arrangement in October 1987. The authorities should renew their determination to deal with that matter and with the commercial banks' coordinating committee. Mr. Ayales and the staff should comment further on the status of those negotiations.

Concerning the proposed decision on the review of the stand-by arrangement, he generally supported the cooperative attitude of the staff and the authorities, Mr. Yoshikuni commented. In particular, he appreciated the staff's prudence in not proposing the approval of exchange restrictions evidenced by arrears, pending the Board's forthcoming discussion on the legal aspects of that issue. However, he had strong reservations about the procedural points concerning the timing of the approval for the review of the stand-by arrangement, since, as he had previously mentioned, the negotiations with commercial banks had been delayed and were far from being complete. Under those circumstances, he could go along with the decision only if the majority of Directors supported it. As to the approval of exchange restrictions, he had no difficulty in agreeing with the proposed decision.

Mr. Prader said that the case of Costa Rica had been the starting point and a catalyst for a number of important discussions on the role of the Fund in the debt strategy, in particular the consequences for the approval of programs of the emergence of arrears. In other words, the ramifications of the case under discussion, involving a small debtor country, went far beyond the country's size in the world economy and the approval of just another stand-by arrangement. The situation in Costa Rica remained unchanged with respect to the absence of any financing agreement with the banks. Thus, in the context of the Fund's deliberations on the debt situation and its role, it might be useful to refer to some of the issues which had first surfaced or which had been highlighted by the case under discussion.

During the Board discussion on financing assurances in Fund-supported programs (EBM/88/17, 2/5/88), his chair had argued that in an environment of increasing reluctance by the banks to take part in financing for smaller debtor countries, the Fund could not afford to let such countries down, if they presented adjustment programs strong enough to justify a flexible interpretation of the Fund's program approval policy, Mr. Prader recalled. While for a number of reasons, many Board members had been reluctant to translate such changes in the policy environment directly into revisions of the Fund's guidelines for approval of programs--instead they preferred to make decisions on a case-by-case basis--it was clear that the emergence of a number of such case-by-case changes in the application of approval policies would eventually give rise to the perception of a new trend in the Fund's approach. To outside observers and financial markets, the challenges to the Fund's approval policies posed by the shift in the banks' attitude toward debtor countries would be visible, even if the guidelines remained completely unaltered.

The view on criteria for outright approval for stand-by arrangements in certain cases, that had been put forward in EBS/87/266 and discussed in the Board on February 3 and 5, 1988, was sound and appropriate; it had been confirmed by its application to the present decision-making process, Mr. Prader remarked. Those criteria were not only perfectly suited to Costa Rica's situation prior to the program's approval, but also to its present situation at the first review under the stand-by arrangement.

According to the information available in EBS/88/60, the failure to reach agreement with the banks had been outside of the country's control, Mr. Prader noted. On balance, the country's adjustment record--disregarding the slippages in the balance of payments and credit performance--was positive; therefore, the country could be expected to stick to the program. In addition, the strength of the adjustment program provided evidence of the country's ultimate willingness to repay the Fund.

In light of those criteria, and the assurances given in Mr. Ayales's opening statement that a mutually agreeable solution vis-à-vis the banks could be expected by mid-April 1988, his authorities could support the proposed decision, Mr. Prader suggested, especially since the performance targets for March 1988 had been met and the authorities seemed to show strong determination to renew their efforts to offset the deviations the adjustment path had taken since the beginning of 1988.

As far as the sizable balance of payments target slippages were concerned, to some extent they might have been considered a consequence of a specific design in orientation of adjustment policies toward the opening of economies, Mr. Prader observed. The reduction or abolition of tariffs and duties on imports was a regular feature of programs supported by international organizations. Quite often, however, that policy gave rise to a flood of imports at difficult stages of the adjustment and placed the efforts of the authorities in an unfavorable light. He understood that in the case under discussion, negotiations with the World Bank on the reduction of tariffs and duties on imports, which had antedated the Fund-supported adjustment program, had been responsible for a large part of the import overhang. In a sense, that exemplified not only the inconsistency of adjustment policies aimed at the opening of economies, but also the still inadequate coordination between the World Bank and the Fund on the programs they supported.

The steps undertaken by the authorities to cut imports by devaluing the currency and introducing tax measures on imports of consumer goods were evidence of the political will of the authorities to keep the program on track and to compensate for the deterioration in the balance of payments, Mr. Prader noted. If implemented, the measures would result in a substantial improvement in the current account.

Signs of a consistent approach to combating the major shortfalls that had occurred in the program were welcome, Mr. Prader commented. The authorities had announced a tightening of monetary policy, in particular the target on the increase in monetary reserves and the ceilings on lending to the private banks.

In view of the particularly difficult situation of the country, he could support an extension of the approval of the remaining multiple currency practices, Mr. Prader went on. Apparently, Costa Rica's efforts to normalize its relations with creditors had been frustrated by factors outside of its control, an issue which went back to those raised at the beginning of his statement.

He wondered why so far there had been no financing agreement with the banks, Mr. Prader asked. He asked for that clarification especially in light of the remark made by Mr. Dallara during the Board's discussion on the role of the Fund in the debt situation (EBM/88/55, 3/31/88), that the reluctance of the banks to come up with financing was due to slippages in policy implementation.

Mr. Fernando made the following statement:

Costa Rica's circumstances warrant a larger and more timely role by external creditors, especially private creditors. Interest obligations alone in 1988 are estimated to be 7 percent of GDP, and 26 percent of exports. Debt service is estimated at about 50 percent of GDP. These are telling figures of an overload of debt. Recent growth performance, inadequate even to maintain real per capita income, has not strengthened the authorities' hand in addressing the debt issue in a credible and sustained manner. The environment for sustained and appropriate adjustment can be vastly enhanced if a measure of stability and reduced uncertainty is achieved in dealing with the debt issue. A multiyear restructuring package can provide this essential respite. Besides, the authorities should not be overcome by negotiation fatigue at a time when sustained adjustment and implementation will be significantly influenced by their ability to maintain focus on the adjustment program.

The authorities' substantial correction of the fiscal imbalance is commendable, but the program is off track in many respects, and the authorities are well aware of the need for a good track record to instill creditor confidence in their policies and in their resolve to implement needed corrections. While adverse exogenous developments have all too familiarly complicated the adjustment task of many countries, I am somewhat concerned that a favorable development--the boom prices for coffee--has been allowed to cause slippages in the program's implementation. Given the low level of reserves, the coffee price boom presented a welcome opportunity to conserve this windfall gain. The mechanisms for conserving temporary upswings in commodity prices are too well known to warrant repetition. However, this conservation should be practiced at the income generation level by excluding those extra profits before the income multiplier has time to work. The authorities' attempt to conserve at the expenditure level, through import tariffs, has many shortcomings; it is too late and complicates the trade strategy.

The most significant shortcoming undermining the adjustment effort is that monetary policy was not sufficiently coordinated with fiscal policy to play a mutually supportive role. There are many signs of a lack of confidence in the domestic currency, and despite some good actions, many structural rigidities continue to hamper the financial system. The market is segmented, and many features of monetary policy, especially interest rate policy, seem to maintain this segmentation rather than working toward uniformity. The lending policies of financial institutions have been too loose and perceptions about the real cost of credit are not clear. The complexity of the system has also hampered direct intervention on the part of the authorities to curb and allocate credit to arrest excessive monetary expansion. The authorities should move on a comprehensive front to reform and restructure the financial system so that the interest rate will play the primary role in credit developments. A sustained domestic savings effort, which is an essential objective of adjustment, requires a consistent interest rate policy as the primary incentive. Meanwhile, the authorities' actions to improve the regulatory framework and the Central Bank's authority to monitor and discipline financial institutions are welcome.

I support the proposed decisions. On the question of the multiple currency practice under which remittances for study abroad are allowed at a special exchange rate, I wonder why a more transparent method of assistance cannot be employed. For instance, an explicit subsidy could be tailored on a needs basis and its cost would be clear. The special window in the exchange system, while not apparently less cumbersome in an administrative sense than a fiscally administered scheme, can lead to mismanagement.

Mr. Grosche said that although several performance criteria had been met, the implementation of the program had been rather disappointing. Certain developments which had been visible at the beginning of 1987 and again at the time of the program's approval in October 1987 had resulted in serious slippages. Consequently, the program objectives for 1988 had had to be revised. The attainment of a viable balance of payments position had once again been postponed to the distant future.

The decline in the fiscal deficit, as envisaged under the program, Mr. Grosche commented, was welcome as was the fact that tax administration and collection had been improved. The improved tax administration should ensure the effective implementation of the November 1987 tax package.

On the expenditure side, there had been a rise in current expenditure after two years of decline, Mr. Grosche noted. Part of that increase was due to unexpectedly high interest payments, but it also appeared that the new wage formula had contributed to the increase. Since that formula linked wage increases to inflation, it could become a propelling factor for expenditures if inflation could not be reduced as envisaged. In that context, the staff assessment should have addressed the question of whether the wage formula could be considered appropriate under the circumstances.

The further increase in the overall surplus of the public enterprises in 1987 was welcome, Mr. Grosche commented. Nonetheless, the authorities' should proceed with the intended legislative action to align wage increases in the public enterprise sector with those of the General Government.

Serious concerns had arisen with regard to monetary policy, Mr. Grosche continued. While he recognized the authorities' commitment to stem the credit expansion and the subsequent surge in imports, he had received the impression that development had been largely self-inflicted. As the staff had rightly noted, the authorities' lifting of credit ceilings for individual banks, while at the same time liberalizing imports, should have been complemented by appropriate exchange rate actions.

He was not advocating the reintroduction or the maintenance of import restrictions, Mr. Grosche went on. On the contrary, the authorities should continue import liberalization policies. However, the less than satisfactory developments in the external accounts could improve somewhat as a result of the export led growth strategy followed by the authorities, a strategy supported by the World Bank. Given the uncertainties and the long gestation period of such a policy, there remained a need to contain import growth as much as possible.

Apart from proper exchange rate policies and tight credit policies, some improvement in the current account could result from the switch from traditional products to new and faster growing markets, Mr. Grosche stated.

He supported the economic program for 1988, but there was no room for further slippages, Mr. Grosche added. His authorities were concerned about the medium-term scenario's results, which had demonstrated that even if the program objectives were met, the current account deficit in 1992 would be reduced by only one percentage point from the 1988 level. Consequently, Costa Rica was likely to face a continued need for external financing, and given the excessive external debt, the authorities would have to make every effort not only to reach, but also to outperform the program objectives.

Notwithstanding his general support for the economic program, he shared the doubt expressed by other speakers about the appropriateness of the completion of the program review, given the fact that the financing gap for 1988 had not been closed, Mr. Grosche commented. In October 1987, his chair had accepted outright approval of the stand-by arrangement on an exceptional basis, with the expectation that that arrangement would help to expedite Costa Rica's negotiations with the banks. However, almost half a year later, the arrangement with the banks was still not in place, although he understood that progress had been achieved, and that, according to Mr. Ayales's opening remarks, an arrangement with the banks could be reached in mid-April 1988.

He welcomed Costa Rica's intention to reduce its external payments arrears by cash payments, which should contribute to a normalization of its relations with creditors, Mr. Grosche concluded. Against that background, there were strong indications that the financing gap would soon be closed, and he could go along with the proposed conclusion of the program review on an exceptional basis. He had no problem with the suggested approval of exchange restrictions.

Mr. Yao said that the staff report had highlighted the difficult economic and financial situation that beset Costa Rica. The difficulty of the situation appeared to be all the more constraining given the fact that the program targets could not be met and the performance criteria were not observed, despite the commendable adjustment efforts made by the authorities.

Faced with an unfavorable economic environment that made the restoration of sustainable growth elusive, the authorities' willingness to pursue the adjustment process was commendable, Mr. Yao commented. Consequently, he welcomed the far-reaching structural policies that had been implemented, namely, the adjustable exchange rate policy and the price increase in the public enterprise sector aimed at improving the financial situation. The authorities' decision to adopt a more restrictive monetary and credit policy was a step in the right direction.

The authorities' willingness to take additional corrective measures if warranted was a sufficient safeguard against future slippages, Mr. Yao observed. The successful implementation of those measures hinged on a favorable economic environment. Therefore, the international financial community should support Costa Rica's adjustment efforts. He welcomed the staff's flexibility in monitoring the program, and supported the proposed decision.

Mr. Dallara made the following statement:

The decision we must make at the end of today's Board discussion is a particularly difficult one owing to a combination of circumstances. First, there was some serious policy slippage, particularly in the area of monetary policy, that we were not fully aware of when we approved the Costa Rican stand-by arrangement in October 1987. Second, there appears to be a strong possibility, according to the staff's analysis, that Costa Rica will not achieve balance of payments viability within the next five years. Third, although they began negotiations with commercial banks almost a year ago, the Costa Rican authorities have not yet received a counterproposal from the banks for a financing package consistent with their economic program.

Before turning to the issue of the financing package, I would like to make some brief comments on Costa Rica's economic program.

To begin with, we share the disappointment of the staff and other Directors regarding the excessive credit expansion in the private sector that occurred in 1987. Under the circumstances, the authorities were acting appropriately when they did not make the drawing that was available immediately after the Board's approval of the stand-by arrangement in the fall of 1987. By the same token, we welcome the measures taken by the authorities in late 1987 and early 1988 to put their program back on track. In this light, we concur with the staff recommendations to reduce the amount of financing available under this program by SDR 10 million, to reset the timing of the second review, to link the first drawing to observance of the March 31, 1988 performance criteria, and to insist that a substantial amount of the shortfall with regard to the target for net international reserves in 1987 be made up in 1988.

Before turning to particular policy areas, I would also like to comment on the program design. In light of the structural problems which continue to beset the economy, some greater attention to structural reforms would be appropriate. If there is a follow-on program supported by the Fund, we hope that key areas of structural policy change receive greater attention. In particular, while I welcome the fact that the World Bank is working with the authorities on financial sector reform, trade liberalization, and parastatal reform, some of these areas--especially financial sector reform--are critical to the correction of Costa Rica's external payments problem. Financial sector problems, for example, contributed importantly to the excess credit expansion during the past year, which triggered a sharp increase in imports. I would have thought that financial sector reform was important enough to justify establishing some performance targets in this sector, at least for formulating and beginning to implement a clear program of financial sector reform. In any case, a follow-on program should address the problems in this sector in a comprehensive fashion. It would have been desirable to schedule a third review in October 1988 in light of the extension and retiming of this program.

As to fiscal policy, the thrust of revenue and expenditure measures has been broadly appropriate. It is worth stressing, however, that expenditure controls and wage restraint will be critical to the success of the program.

Many Directors have already voiced concerns about monetary policy, so I will just ask two questions. I wonder if the staff or Mr. Ayales could comment on the criteria used to set the credit ceilings that have been reintroduced for individual banks. Also, I would be interested in further staff comment on the measures taken in late January 1987 to reduce the legal reserve requirement on time deposits of at least six months from 10 percent to 6 percent. I welcome the assurances of the authorities that the potential expansionary impact of these measures would be fully taken care of within the context of the contemplated ceilings, but recent experience suggests that this could be difficult.

With respect to external policy, I have only two comments. The authorities' active approach to exchange rate policy is commendable, and will continue to be important to the success of the program. As to the medium term outlook, we have noted the staff view that medium-term payments viability may be very difficult to achieve, even with a solid performance by the authorities and reasonably optimistic assumptions. On the other hand, if Costa Rica achieves the objectives of the 1988 program and maintains the momentum of adjustment in 1989, we wonder whether the prospects for payments viability might not be somewhat better than the staff seems to suggest. Any further comments from the staff or Mr. Ayales on this point would be welcome.

Given the exceptional circumstances Costa Rica was facing in the fall of 1987, we agreed to support the activation of the stand-by arrangement in spite of the absence of any agreement on a commercial bank financing package. Regrettably, the agreement anticipated in October 1987 has not materialized. We recognize that there are a number of complex factors that lie behind this lack of progress, and we acknowledge that substantial responsibility for the lack of progress lies with the banking community. Nevertheless, we note that meetings are scheduled in the near future between the authorities and the banks. Indeed, Mr. Ayales suggests that there is a real prospect of reaching an agreement during these upcoming discussions. I wish that we were as confident as Mr. Ayales that an agreement will emerge that quickly; unfortunately, we are not. I would recall our position in the Board in October 1987 when we made it very clear that we considered the approach taken to be exceptional and temporary. We stressed that it was critical that the authorities and the creditors intensify their efforts to ensure that by April 30, 1988, or the completion of the second review of the stand-by arrangement, whichever was earlier, a more definitive financing arrangement would be in place.

Basically, our views have not changed. We believe that progress toward a more definitive financing arrangement should be achieved before Fund resources are disbursed. We recognize that it is not feasible to have a financing arrangement actually in place by April 30, 1988, but we are very concerned about the implications for Costa Rica, and the potentially broader implications for the debt strategy, if the Fund were to re-endorse this program with no clearer sign of progress on the financing front.

Two courses of action suggest themselves. Costa Rica will not be able to make its first drawing under this program until its observance of the March 31, 1988 performance criteria has been assured--which would, if I understand it correctly, be some time in early May 1988. Therefore, one potentially appropriate course of action would be to come back and complete this review in early May, in light not only of the observance of the performance criteria, but also of the progress made between the authorities and the banking community in their April 1988 discussions.

Another course of action, which I could support, would be to make any disbursements available following the completion of this review contingent on progress between the authorities and the banking community toward developing a financing package to support Costa Rica's economic program. I would not suggest that this be made dependent on complete agreement, however, but simply on sufficient progress being achieved.

Under either approach, it would be appropriate for management to express the serious concerns of the Board on the lack of progress by banks in supporting Costa Rica's efforts, and to consider ways management might facilitate further progress in order that Costa Rica's adjustment efforts might receive the support of the international financial community they merit.

Mr. Ayales said that Costa Rica had gained access to the stand-by arrangement in October 1987 within the context of a set of rules, and it had managed its domestic policies accordingly. Therefore, changing that agreement without advance notice would not only be unprecedented, but also unproductive, and harmful to his authorities. The negotiations with the banks were progressing within the time frame originally contemplated under the program, namely, to reach some agreement by April 1988 and a conclusion by end-June 1988. A change in the rules would not improve the environment in which negotiations were taking place or further support the authorities' efforts.

On the contrary, the apparent lack of external support for the country's efforts would make the situation more difficult both domestically and internationally, Mr. Ayales commented. Costa Rica was experiencing strong political pressure following the step devaluation and the tightening of credit and wage policies. It would be particularly difficult to explain those changes to pressure groups within the country, which had been skeptical about going into an agreement with the Fund from the beginning. It would be dangerous to send the wrong signal to those groups at the present time.

Externally, the authorities would have to modify their strategy in the negotiations with the banks if the banks perceived faltering support by the Fund, Mr. Ayales explained. Although that was not the intention behind Mr. Dallara's proposal, a change in the agreement could be perceived by external creditors as diminished support by the Fund.

The present review of the economic program for 1988 was the first, and although some objectives had been modified somewhat, the overall program which had received Board approval in October 1987 had not significantly changed, Mr. Ayales pointed out. Costa Rica had not misused the Fund's support and that support had been important in the progress achieved with the banks.

The authorities hoped that some agreement with the banks would be reached by the end of April 1988, but there were some elements beyond their control, Mr. Ayales continued. They hoped that the support of the Fund and the World Bank would help accelerate the pace of negotiations with the banks.

Mr. Dallara said that he appreciated the concerns expressed by Mr. Ayales, particularly with respect to the possibility that either of the proposed changes in the approach could be misinterpreted as a withdrawal of Fund support. Perhaps, to alleviate such misinterpretation, the Fund could complete the program review in principle, and thereby clearly endorse Costa Rica's economic program, but without formally concluding the review leading to a disbursement of Fund resources.

It seemed that there was potential room for an approval in principle, since the envisaged disbursement was not to take place for a month anyway, Mr. Dallara went on. Even if the Board were to approve the review of the stand-by arrangement outright, it would have to wait a few weeks for the end-March 1988 performance criteria to be observed. He appreciated the potential risks involved in sending a negative signal to the banks. However, it was obvious that in the case under discussion, the Fund's catalytic role had not worked well. The Fund had given clear evidence of its support for the policies of Costa Rica in the hope of speeding the process of financing negotiations, but clearly not much had been accomplished in that regard. There was a legitimate question as to whether it was possible for the Fund to be as catalytic as it would like to be in the case under discussion. The further the Fund proceeded with the program and made disbursements without any real progress on the side of the banks, the more worrisome the situation would become, and that would not really be supportive of Costa Rica.

Mr. Ayales said that he disagreed that no progress had been achieved. The current situation regarding the negotiations with the banks was completely different from that of October or November 1987. In any case, withdrawing Fund support or reducing it to an agreement in principle would not help the Costa Rican authorities, who had strongly opposed such an agreement. Changing Costa Rica's position vis-à-vis the Fund or Fund support might negatively affect the country's position in its negotiations. Although the authorities had encountered some problems in the implementation of domestic policies, those problems were being overcome, and on the whole, progress had been good; the economy had become stable and was growing. Although the authorities were being extremely prudent in their negotiations with the banks, they were making progress. The banks had recently informed the authorities that they were ready to make a counterproposal. Therefore, it was extremely crucial for the Fund to stand by Costa Rica, as it had in October 1987, until the negotiations were completed.

Mr. Enoch made the following statement:

> The staff appraisal contains an excellent review of performance under the program supported under the stand-by arrangement, and of the program for 1988, including the main areas of concern and further actions required for success. I have little to add to the staff's comments, or to those of other Directors--in particular Mr. Grosche--and I will therefore concentrate on the issue of financing.
>
> I recall the serious concerns expressed by this and other chairs when the stand-by arrangement was originally approved in October 1987, and in particular the preference expressed by a number of Directors for approval in principle. The Board's decision to approve the program outright was exceptional, made on the understanding that agreement between the authorities and their commercial bank creditors was expected by April 1988. However, it appears that there has so far been no substantive progress in negotiations with the banks since then.
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> Since October 1987, the Board has had the opportunity to discuss the general issue of financing assurances in Fund-supported programs (EBM/88/17, 2/5/88), and a number of Directors have expressed serious concerns about the approval of unfinanced programs. The Board concluded that the Fund should make disbursements into an unfilled financing gap only under very exceptional circumstances. At that meeting, I suggested a number of necessary conditions for such an approach: there should be a strong

adjustment program; it should be clear that any delay in disbursement would be seriously damaging to the country's adjustment effort; the country concerned should have a good track record of cooperation with the Fund; the required new commercial bank finance should not represent a significant proportion of the overall financing package; and the amount of Fund resources involved should not be large relative to the size of the country's quota. My authorities still maintain this position.

Two of these criteria are not satisfied in the case under discussion. The new money required from the commercial banks represents a substantial proportion of the overall financing package. The overall financing gap is extremely large at 12 percent of GDP--although this includes the clearance of arrears accumulated in 1987--and the authorities' confidence that the assumed financing will be forthcoming from the commercial banks and the Paris Club may prove to be misplaced. Incidentally, there have recently been some press reports indicating that the Mexican authorities are considering providing debt relief to certain countries in Central America, and Costa Rica is expected to be an early beneficiary. The staff should provide information on this proposal and on its potential impact on Costa Rica's financing gap.

The second criterion for exceptional treatment which does not appear to be met is that delays in Fund disbursement could seriously jeopardize the borrowing member's adjustment effort. It is by no means clear that this is the case for Costa Rica, particularly in view of the authorities' intention not to make immediate use of Fund resources, but to wait until a track record has been established. This forbearance on the part of the authorities is welcome, and represents a mature and responsible attitude toward the use of Fund resources. However, it does suggest that immediate disbursement is not crucial to the adjustment effort. The fact that no drawings have yet been made under the stand-by arrangement would also appear to cast some doubt on the need for outright approval in October 1987. In addition, it casts doubt on the argument that Fund disbursement into arrears acts as a catalyst to other creditors to complete their financing arrangements. The amount of Fund resources involved in the first disbursement under the stand-by arrangement is small, and the program has been improved significantly since the original approval. Despite some lapses in 1987 and some concerns about the prospects for 1988, I would have no difficulty in supporting the program if there were no financing gap. However, the question of financing assurances is an issue of fundamental importance to my authorities. Programs should not proceed and disbursements should not be made until full financing is assured, except under very exceptional circumstances. The same considerations which apply to the initial approval of a program apply equally in program reviews.

I do recognize a number of mitigating factors. I was impressed by Mr. Ayales's opening statement, by Costa Rica's willingness so far not to make any drawings, and by the fact that this program predates the Board's discussion of financing assurances. The Board has yet to discuss the legal aspects of approval or nonapproval of arrears accumulation under Article VIII. However, I hope that, in giving signals to members' authorities, the Fund will not be so concerned about giving false signals about a program that it will fail to maintain its requirements on seeking appropriate financing assurances.

I note that no approval of Costa Rica's arrears is proposed. I would be interested in the Legal Department's comments on whether disbursement to a member with unapproved exchange restrictions is contrary to Article V, Section 3(b).

Mr. Salehkhou made the following statement:

This discussion on Costa Rica's 1987 Article IV consultation and first review under the stand-by arrangement clearly extends beyond normal consultations and reviews because of the complexities it has involved in connection with the country's relationship with commercial creditors. These complexities have led to the staff's preparation of a paper on the legal effects of approval or nonapproval of exchange restrictions by the Fund, which is to be discussed by the Board in the near future. I would, therefore, refrain from addressing technical details of these highly complicated legal issues at this stage and try to address only a few related issues of general interest to the membership.

In his opening statement, Mr. Ayales largely attributed Costa Rica's economic achievements since 1982 to the firm support the country has received from the Fund not so much by way of financial support, but rather by assistance in the development of adjustment policies and by the positive signals the Fund has sent to the international financial community. It follows, logically, that in the absence of the Fund's moral and legal support, Costa Rica's adjustment efforts would probably have failed. This is the clearest indication of the important role the Fund can and does play not only through its so-called "catalytic role," but also in providing the membership and especially borrowing members with the necessary legal protection in an increasingly hostile external environment dominated by impatient commercial and at times official creditors.

There are clearly two sides to any financial conflict: the debtor and the creditor. As far as the debtor is concerned, it has been the consistent position of this chair that any legitimate financial claim should be honored in full and on a uniform and timely basis. Stated differently: as long as a debtor is not generally recognized as "recalcitrant," every effort should be made to facilitate its meeting payments, including an extension of time and various types of relief. The creditor should remain understanding of the extent and severity of the problems the debtor may be facing during hard times and be willing to cooperate fully and sympathetically with the debtor in helping it to prosper and grow, and thus be able to meet its payments obligations. It has been precisely this lack of understanding and cooperation that has led to the gradual worsening of the debt situation, and no end appears to be in sight.

As far as the Fund and its catalytic role, especially in the present uncertain external environment, are concerned, debtor members like Costa Rica justifiably consider the Fund's role to be crucial in facilitating the reaching of equitable agreements with creditors, and thus in moving toward the restoration of normal debtor-creditor relations. As I have said during various discussions on debt-related issues, this catalytic role of the Fund has at times been misinterpreted and wrongly implemented to the detriment of debtor members.

In a series of meetings, Costa Rican authorities have tried to reach agreement with commercial creditors. However, for reasons purely beyond their control, namely, reluctance by, and lack of consensus among, commercial creditors, no response has yet come from the banks on the authorities' rescheduling proposal, which was submitted to the coordinating committee of the banks nearly a year ago. While negotiations with bilateral creditors are progressing satisfactorily, lack of any positive reaction by commercial creditors has impeded a satisfactory solution to the problem of external payments arrears. This is in sharp contrast with the agreement reached between Costa Rica and Mexico in which a better understanding and a more cooperative attitude prevailed.

Accordingly, I conclude that the commercial banks are indeed responsible for the existence of these arrears. In that context, I am surprised and frankly find it somewhat odd that the authorities have not requested--and the staff has not proposed--the approval of the exchange restriction that is evidenced by these external payments arrears. I wonder whether, and to what extent, the authorities might have been persuaded to refrain from making such a request, and, if so, whether by the banks or the Fund. The lack of approval of restrictions by the Fund clearly encourages Costa Rica's commercial creditors to take their time in giving any favorable consideration to the country's rescheduling proposal and is likely to force the country further into accepting more unfavorable financing terms. I agree with Mr. Ayales that any action by the Fund in penalizing Costa Rica for its inability to reach agreement with commercial creditors would be unjustified, counterproductive, and would prove damaging to the Fund's credibility as a cooperative international institution. Costa Rica's continuing partial payment of interest to the banks, despite the banks' irresponsible behavior, is a clear indication of the country's good faith toward its commercial creditors. It remains to be seen whether the banks will eventually reciprocate. The authorities have presented a program aimed at strengthening the country's external position and improving the general economic performance. The staff has rightly observed that, for the program to be successfully implemented, the authorities' efforts need to be complemented by external cooperation; otherwise, it is not likely that the country will be in a position to meet the economic goals envisaged, let alone to maintain orderly debt servicing.

Mr. Lim said that he welcomed the first review of the stand-by arrangement and noted that progress had been made in the fiscal area, which was considered to be an essential element of the program.

While there had been slippages in the implementation of credit policy and the balance of payments outcome, Mr. Lim commented, the authorities had already taken steps to address that problem with the step devaluation of the colón, and they were contemplating further fiscal tightening.

The authorities' reaffirmation of their commitment to re-establish normal relationships with external creditors was welcome, Mr. Lim remarked. The continuing partial payment of interest to commercial banks was essential in demonstrating their commitment and could help maintain an environment that was conducive to a cooperative solution to the debt problem.

In light of the difficulties the authorities were facing, the support of the Fund was essential for successful progress in negotiations with the international banking community, Mr. Lim concluded. He supported the proposed decision.

Mr. Fogelholm said that despite some slippages in the monetary field, overall program implementation during the past year had been commendable. The corrective measures undertaken by the authorities and their commitment to keep the program on track was encouraging. He was in broad agreement with the staff appraisal.

In October 1987, his authorities had given outright approval for the stand-by arrangement with Costa Rica on an exceptional basis, owing to the special circumstances prevailing at that time, Mr. Fogelholm recalled. That situation had not changed: the financial assurances had not been met, and the authorities were in the midst of negotiations with the banks. Like other speakers, he was somewhat disappointed that the catalytic role of the Fund had not been as successful as expected. Like Mr. Dallara, he wondered what had gone wrong. In addition, he wanted to know why negotiations with the banks had not progressed. It seemed as though Costa Rica was trapped in an awkward situation, not through its own fault, but for reasons beyond its control.

Mr. Ayales said that it was ironic that Costa Rica had been trapped in the present situation with respect to the banks. However, the current Board discussion was for the first review of the stand-by arrangement, and thus, should focus on the economic program for 1988. Financial assurances were not supposed to be discussed until the second review of the stand-by arrangement, which was scheduled for end-June 1988. He understood, of course, that the timing of the Board discussion was bad and that the legal aspects of the approval of exchange restrictions were still unresolved, but the present discussion should nevertheless be focused more on the objectives of the first review, which were, strictly speaking, the features of the program for 1988.

Mr. Hogeweg made the following statement:

The problem in Costa Rica's program seems to be monetary policy, and consequently, the balance of payments. At the root of the slippages in monetary policy are the difficulties in the private financial markets and the shortfalls in disbursement of foreign loans, which implied a higher recourse to domestic financing, although fiscal policy was broadly on track. Owing to the slippages and consequent delays in purchases, total access under the stand-by arrangement will be reduced from 50 million to 40 million, and will be subject to a satisfactory track record.

The authorities are implementing measures to achieve the program objectives for 1988 and to correct part of the balance of payments deviations. As to monetary policy, the authorities have reinstated credit ceilings as the main instrument of monetary policy. This recourse to their traditional instrument stems from fear that high interest rates on nonbank assets would exacerbate the troubles in the financial sector. This argument can give only a temporary justification. The disadvantage of ceilings is of course their administrative character and the consequent rigidities. Also, the ceilings may be difficult to administer if too large discrepancies arise between bank reserves and outstanding credits. Moreover, support of financial institutions may lead to a higher rate of monetary expansion. The authorities should try to return to market-based approaches as soon as feasible.

On exchange rate policy, Costa Rica shows that devaluations contribute lastingly to a better competitive position and balance of payments outcome only if they are accompanied by appropriate domestic demand management policies. The exchange rate action and the welcome reductions on import duties and consumption taxes on imported goods seem to have been less than optimal. I hope the authorities will be able to adhere to their intention of frequent adjustments to maintain the real exchange rate after the mid-January 1987 devaluation. With adequate monetary policies, these adjustments may grow smaller over time.

The October 1987 Board discussion of the Costa Rican program gave rise to extensive debate on the legal effects of approval or nonapproval of exchange restrictions. Therefore, it is justified that pending Board discussion of those issues, no approval of the restrictions, as evidenced by payment arrears is proposed. I hope that the mid-April 1988 meeting between the authorities and commercial banks mentioned in Mr. Ayales's opening statement will produce mutually agreeable results, which are highly necessary, not only to fill the financing gap, but also in view of Costa Rica's vulnerable medium-term outlook. The case under discussion demonstrates that long delays in negotiations with the banks can be harmful for the adjustment effort.

In October 1987, the Board approved the program supported by the stand-by arrangement on an exceptional basis. On this occasion, there is a prospect of agreement with the banks, but no assurance of it. Like others, my authorities are concerned about committing Fund resources when financing gaps persist, but I take Mr. Ayales's point that the financing package is a subject to be discussed at the second review of the stand-by arrangement, the first review being focussed on the 1988 program. I agree with his argument that it would not be helpful at this stage to alter the Fund's approach. This stance stems from the way the Fund has structured program reviews in the past and in no way prejudges what this chair will say on the occasion of the second review of the arrangement or at the forthcoming discussion on the legal aspects of approval of exchange restrictions. The prospects for agreement with the commercial banks and subsequently the Paris Club should be the basis on which to endorse the proposed decision.

Mr. Donoso said that he would have great difficulty in accepting any proposal to delay the completion of the review under the stand-by arrangement until after April 30, 1988 or to complete it only in principle, thus precluding any disbursements pending a financing agreement with the banks. From the Board's discussion in October 1987, when the stand-by arrangement was approved, he had received the impression that the Fund would continue to support Costa Rica as long as there was a reasonable economic program in place. Given the difficult measures the authorities had introduced to open up the economy, it would be surprising and unfair to withhold that support. In addition, changing that policy would be dangerous in terms of the Fund's overall strategy, because it would indicate to the banks that having an appropriate economic program was not a sufficient criterion to warrant Fund support, but rather that the banks would have to finance a program as well. Such a change in the Fund's policy would clearly weaken its catalytic role. In the past, the Fund had shown that when banks had unjustifiably refused to finance a program, the Fund would give financial support to the country anyway. For that reason, the Fund could expect countries to repay the Fund even when they were in a financially difficult situation. That practice could not be maintained if the Fund were to declare that it would not finance programs unless the banks did so as well.

He would be very worried if the Fund's hesitancy to continue the stand-by arrangement with Costa Rica were in any way related to the fact that the country was not one of those members whose policies had significant effects on the international economic and financial system, Mr. Donoso concluded. The Board had held lengthy discussions on financing assurances and on when financing assurances should become a requirement during the course of a stand-by arrangement. The present practices of the Fund should apply to large and small debtors equally.

Mr. Dallara said that the Fund would not necessarily be changing its signals to the financial community with respect to Costa Rica by bringing up the issue of financing assurances during the current review of the stand-by arrangement. Although it was normally during the second review of stand-by arrangements that an assessment was made on the adequacy of external financing arrangements, the case under discussion was somewhat exceptional in that the initial expectation had clearly been that the second review would be completed by end-April 1988. The slippage in scheduling had been due, in part, to the credit difficulties that had emerged in Costa Rica in late 1987, delaying the first review of the stand-by arrangement, which was originally expected to take place by end-January 1988. Moreover, in October 1987, when the Board had approved the stand-by arrangement, it had made it clear that that approval was in a sense temporary, in that it would have difficulty proceeding beyond April 30, 1988 if improvements had not been made with respect to financing assurances.

The staff representative from the Western Hemisphere Department said that a more appropriate view of the growth of capital and current expenditures could be gained by looking at the total nonfinancial fiscal sector. Capital expenditures had increased from 3.6 percent of GDP in 1987 to 3.9 percent in 1988, while the Central Government's current expenditures were expected to grow in line with the rate of inflation for the two-year period 1987-88. Another useful indicator was nonfinancial public sector savings, as measured by the deficit in the public sector current account which had in fact recorded a surplus of 4.5 percent of GDP in 1986, which was expected to increase to 7.2 percent in 1988.

With respect to whether the credit program was too ambitious in terms of the limited expansion of credit to the private sector, if the two years 1987 and 1988 were examined together, credit would expand at a pace similar to that of nominal GDP. Following the 22 percent increase in credit to the private sector in 1987, a 10 percent increase in 1988 would seem to be adequate for 1988. The authorities' measures to reintroduce credit ceilings and to reduce the reserve requirements on time deposits were related to the uncertainty about private financial institutions following the bankruptcy of several unregulated institutions. That problem had become more serious at the end of January 1987, when one regulated institution had faced extreme difficulties. The authorities had either to use interest rates, legal reserve requirements, and other instruments to fulfill the requirements of the program, or go back to more familiar instruments such as the reintroduction of credit ceilings, which had recently been eliminated. The authorities considered that by increasing interest rates on stabilization bonds or on the deposits of state banks, which dominated the system, they would only add pressure to the unregulated financial sector by attracting more resources to the official institutions.

The reduction in reserve requirements on time deposits was related to the same problem, the staff representative commented, but it was only temporary. In addition, the reserve requirement for time deposits would be raised again after July 1988, and by October 1988, it would be back to the original level. The resources derived from the lowering of the reserve requirement had been designated to support the operations of the private financial institutions, and could not be used for any other purpose.

The question of whether the wage formula could be considered appropriate under the present circumstances should be viewed in a longer-run perspective, the staff representative commented. At the end of 1986, real wages were the same as those that had prevailed before the recession began in 1981-82. Thus, it would appear that increases in productivity throughout the 1981-87 period had not yet been incorporated into wages. Therefore, there could still be some room, at least in the short run, to have consistency between the maintenance of real wages and a depreciation in the real effective exchange rate.

There was a relationship between real effective depreciation and nominal tariffs, which sometimes caused problems, the staff representative observed. However, in the case under discussion, there was no inconsistency between changes in nominal tariffs and exchange rate movements, particularly since mid-1985. Most of the reductions in import tariffs began in January 1986 and, over the past two years, the real effective exchange rate had depreciated by about 40 percent.

It was always difficult to know beforehand how large a depreciation would be needed to compensate for a reduction in the level of nominal tariffs, the staff representative explained. That had been particularly true in Costa Rica's case, because not enough information was available about the composition of tariffs or the real effects of protectionism on the economy. Despite those limitations, the authorities seemed to have been moving in the right direction, and the exchange rate movements had been consistent, particularly in light of the fact that in the last quarter of 1987 the colón had depreciated at an annual rate of about 30 percent, and there had been a step devaluation of 6 percent in January 1988.

As to whether the staff's projection for exports could have been overly optimistic, and whether it was possible to achieve balance of payments viability sooner than was currently expected, the staff representative continued, the staff was taking a middle-of-the-road view in its expectations for the balance of payments. It would be difficult to attain balance of payments viability in the short term, owing to the difficulties involved in bringing about a consensus among the political parties in Costa Rica on needed economic reforms. Furthermore, 1989 was to be an election year, which might make it even more difficult than usual to strengthen the adjustment effort.

As to the coordination of Fund and World Bank efforts, particularly with respect to import liberalization and the exchange rate, the staff had been in constant contact with the World Bank staff regarding the program in Costa Rica. Staff members of the two organizations had had meetings before and after every mission to Costa Rica, and they had had overlapping missions to discuss current economic problems. In fact, the reason that the level of capital expenditures was not emphasized in the staff report was because the World Bank was conducting a review of the investment program in Costa Rica. The World Bank was also studying the financial sector, because it was going to be one of the main sectors considered in the second structural adjustment loan currently under negotiation between the Bank and Costa Rica.

The staff representative from the Exchange and Trade Relations Department said that the Fund's catalytic role in Costa Rica was complicated by the slippage in the scheduling for the proposed program, as described on page 37 of EBS/88/60. The original design of the stand-by arrangement had foreseen that the first review--which was to focus on the program for 1988--would be concluded by end-January 1988. The second review, which was to consider the completion of financing arrangements, was expected to be completed by end-April 1988.

The slippage in scheduling had occurred because Costa Rica had been unable to implement certain measures and the performance criteria for end-December 1987 had not been observed, the staff representative explained. Therefore, the current issue was whether importance should be placed on the expectation that the review of the financing requirement should be completed by end-April 1988, or on adhering to the intention to consider the review of financing at the time of the second program review, which had been delayed for two months, and was now expected to be completed by end-June 1988.

Some Directors had asked why a financing agreement between the authorities and the banks had not yet been reached, the staff representative from the Exchange and Trade Relations Department noted. The reason was in part that the banks were finding it difficult to respond to Costa Rica's original proposal for a financial package, and the unprecedented degree of concessionality requested. Although it was certainly the prerogative of the authorities to ask for the favorable terms, the inevitable outcome was that reaching an agreement became more difficult.

The staff representative from the Legal Department said that a question had been raised as to whether adoption of the proposed decision while Costa Rica maintained unapproved exchange restrictions would be consistent with Article V, Section 3(b)(i). Although an unapproved exchange restriction--such as that evidenced by external payments arrears--was inconsistent with Article VIII, Section 2(a), did not mean that a member imposing such a restriction would be automatically barred from using the Fund's resources under Article V, Section 3(b)(i). Under that provision, a member's entitlement to purchases from the Fund was subject to the condition that "the member's use of the general resources of the Fund would be in accordance with the provisions of this Agreement and the policies adopted under them." The requirement in the provision was that the member's use of the Fund's general resources be consistent with the Articles, rather than that the member had been meeting all of its obligations under the Articles. It was explained on pages 12-22 of the staff paper on the legal effects of approval or nonapproval of exchange restrictions by the Fund (EBS/88/13, 1/28/88), that a measure inconsistent with Article VIII was relevant to a decision under Article V, Section 3(b)(i), and the use of the Fund's general resources could be approved while an unapproved restriction persists. Appendix I to EBS/88/13 gave a list of arrangements approved by the Fund, during the period 1984-87, for members with unapproved restrictions. In any event, those matters would be taken up at a subsequent Board meeting.

Mr. Dallara said that the United States wished to abstain on the proposed decision until after the Board's discussion on the legal aspects of approval or nonapproval of exchange restrictions took place.

Mr. Enoch said that the United Kingdom wished to associate itself with the U.S. position. He stressed that his authorities gave the highest priority to the issue of financing assurances.

Mr. Salehkhou asked whether there had been any formal rejection of the Costa Rican proposal by the banks or whether there had been any counter proposal from the banks. It was his understanding that the banks had not responded at all.

Mr. Ayales said that the comments made by the staff with respect to monetary policy were particularly noteworthy. Although such psychological factors were difficult to measure, he believed that the uncertainties which had occurred in private financial markets in late 1987 were brought about primarily by the Government's efforts to tighten credit and reduce liquidity within the framework of a rapidly growing private financial sector. As a consequence of the Government's policy of financial liberalization during the previous two to three years, the private financial sector had grown more rapidly than desired. The Government's measures to slow the rapid expansion had affected some private financial companies and many had gone bankrupt.

The authorities had been using traditional instruments of monetary control, primarily reserve requirements, owing to legal limitations, Mr. Ayales remarked. Open market operations had been overused and interest rates were extremely high in real terms, so the authorities had resorted to the implementation of credit ceilings without really considering whether that was the best possible option. To some extent, the Government had been forced into making that choice, partly because it had exhausted the other instruments of monetary control, and partly owing to domestic political pressure. The monetary program for 1988 was designed for a growing economy. The credit ceilings on individual banks would limit the expansion of credit to the private sector financed with domestic resources to 5 percent, which was not an exceedingly tight monetary stance. The Government was trying to overcome some legal limitations inherited from previous regimes and to rationalize wage policy. Real salaries in 1986 were at the same level as in 1980; and in 1987, the average real salary had remained constant or had even decreased by 1 or 2 percentage points. The authorities were certainly aware of the problems in the current account expenditure of the Central Government. With the help of the World Bank they were trying to implement policies aimed at structural reform, and some progress had been made in that direction.

Perhaps one of the reasons Costa Rica was having so much difficulty in its negotiations with creditors was that the authorities were acutely aware of the economic problems they faced, Mr. Ayales suggested. The authorities were extremely worried about the debt indicators being so high; thus, they feared making any mistakes which could jeopardize the progress achieved so far. The authorities had submitted a proposal for a financing package to the banks in June 1987, and they had met with the banks in October 1987, January 1988, and February 1988; the banks still had not given any official response to that proposal. In mid-March 1987, the steering committee of the banks had indicated that the banks were having difficulty agreeing among themselves, but they had neither accepted nor rejected the proposal.

The authorities agreed that financial assurances were important, Mr. Ayales declared. In fact, they were extremely concerned about financing the economic program for 1988. However, obtaining the necessary financing package had to be done carefully; putting pressure on the wrong side at the present critical juncture was not going to help. The authorities were not suggesting any change in the stand-by arrangement. They considered that by end-June 1988, the financing negotiations with the bank would be concluded, but the decisive support of the Fund for Costa Rica during those final meetings would be crucial.

Mr. Fogelholm said that there were no clear answers in the case under discussion. Noting Mr. Ayales's statements and the fact that the negotiations with creditors were at an extremely sensitive stage, the Fund should give the benefit of the doubt to the authorities and try not to give any misleading signals to the financial community. Therefore, he joined the majority in approving the proposed decisions.

The Chairman made the following summing up:

Executive Directors were in general agreement with the appraisal in the staff report. They noted the progress made by the authorities in recent years in strengthening the finances of the public sector and improving exchange and interest rate management. Nevertheless, the external position remained weak and a heavy debt burden was an obstacle to more rapid growth in the medium term. Thus, they considered that there was a need to consolidate the adjustment effort and intensify the process of structural reform.

Directors observed that the adjustment program undertaken for 1987-88 suffered some setbacks in the first year. Although the program guidelines for fiscal and exchange rate policies had been effectively implemented, there had been slippages in credit policy toward the private sector, imports had been much higher than projected, and net international reserves fell short of the program target.

With respect to the program for 1988, Directors were encouraged by the passage of the Government's tax package in November 1987. Nevertheless, efforts to improve tax administration and restrain the growth of expenditures, including a stricter staffing policy in the public sector, would be needed. As to the losses of the Central Bank, Directors felt it was important to establish arrangements that would result in a more transparent picture of the public finances.

In view of the slippages that occurred in 1987, Directors urged the authorities to take all the steps needed to ensure implementation of the policy of credit restraint that had been designed for 1988. While recognizing that instability in the private financial sector had consequences for the application of credit policy, they stressed the need to enforce the credit ceilings for individual banks that had been established. They also encouraged the authorities to allow more interest rate flexibility.

Directors welcomed the active use of exchange rate policy by the authorities to maintain Costa Rica's competitiveness in foreign markets and to compensate for changes in the tax structure that affected the relative prices of imported goods.

Even though there had been a sizable real depreciation of the colón in recent years, Directors emphasized the need for the authorities to follow balance of payments developments very closely to be able to adapt credit and exchange rate policies to changing circumstances.

Progress in negotiating a new structural adjustment loan with the World Bank was noted. With respect to structural reforms, speakers attached importance to the establishment of a stable policy framework for the development of exports, the elimination of distortions stemming from pricing policies, and particularly, the strengthening of the financial system.

Directors drew attention to the challenge posed to economic management in the period ahead by the magnitude of Costa Rica's debt problem. The successful implementation of a growth-oriented adjustment program would require exceptional external financing over the medium term and the continuation of aid inflows. Directors therefore attached importance to the normalization of financial relations between Costa Rica and its external creditors, including an orderly settlement of arrears. Directors noted that only limited progress had been made so far in the negotiations with commercial banks and Paris Club creditors, and stressed that further progress was urgently required. They expressed the strong hope that the completion of the first program review would help to bring about an early conclusion to those negotiations.

It is expected that the next Article IV consultation with Costa Rica be held on the standard 12-month cycle.

After a further brief discussion the Executive Board approved the following decisions:

Review Under Stand-By Arrangement

1. Costa Rica has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Costa Rica (EBS/87/91, Sup. 2) and paragraph 2 of the supplementary letter dated October 9, 1987 from the Minister of Finance and the Executive President of the Central Bank of Costa Rica, in order to review the implementation of the measures described in that letter and the letter of April 25, 1987, and to establish performance criteria for 1988.

2. The letter dated March 14, 1988, from the Minister of Finance and the Executive President of the Central Bank of Costa Rica, shall be annexed to the stand-by arrangement for Costa Rica, and the letters dated April 25, 1987 and October 9, 1987 shall be read as modified and supplemented by the letter dated March 14, 1988.

3. Paragraph 1 of the stand-by arrangement is amended to read: "For the period from October 28, 1987 through March 31, 1989, Costa Rica will have the right to make purchases from the

Fund in an amount equivalent to SDR 40 million, subject to paragraphs 2, 3, 4, 5, and 6 below, without further review by the Fund."

4. Paragraph 2(a) of the stand-by arrangement is amended to read: "Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 10 million until July 29, 1988, the equivalent of SDR 20 million until October 31, 1988, and the equivalent of SDR 30 million until January 31, 1989."

5. Accordingly, Costa Rica will not make purchases that would increase the Fund's holdings of Costa Rica's currency in the credit tranches beyond 25 percent of quota during any period in which:

(i) the limit on central administration expenditures described in paragraph 11 and Table 1 of the letter of March 14, 1988; or

(ii) the ceiling on net banking system credit to the nonfinancial public sector described in Table 1 of the letter of March 14, 1988; or

(iii) the ceiling on the net domestic assets of the Central Bank described in paragraph 7 and Table 1 of the letter of March 14, 1988; or

(iv) the target for the net international reserves of the Central Bank described in paragraph 7 and Table 1 of the letter of March 14, 1988; or

(v) the limit on the stock of external payments arrears described in Table 1 of the letter of March 14, 1988;

are not observed.

6. Paragraph 4(c) of the stand-by arrangement is amended to read:

"during any period after July 28, 1988 until the second review referred to in paragraph 2 of the attached supplement to the letter of intent has been completed and understandings have been reached on any necessary changes in performance criteria, or after such performance criteria have been changed, while the revised performance criteria are not being observed; or"

7. The Fund decides that the review contemplated in paragraph 4(b) of the stand-by arrangement 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.

Decision No. 8836-(88/56), adopted
April 4, 1988

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 second review under the stand-by arrangement or June 30, 1988, whichever is earlier.

Decision No. 8837-(88/56), adopted
April 4, 1988

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/55 (3/31/88) and EBM/88/56 (4/4/88).

3. PEOPLE'S REPUBLIC OF CHINA - TECHNICAL ASSISTANCE

In response to a request from the People's Bank of China for technical assistance in the area of data processing, the Executive Board approves the proposal set forth in EBD/88/94 (3/28/88).

Adopted April 1, 1988

4. TANZANIA - TECHNICAL ASSISTANCE

In response to a request from the Tanzanian authorities for technical assistance in surveying the country's tax system, the Executive Board approves the proposal set forth in EBD/88/95 (3/29/88).

Adopted April 1, 1988

5. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 87/127 through 87/129 are approved. (EBD/88/90, 3/25/88)

Adopted March 31, 1988

b. The minutes of Executive Board Meetings 87/130 through 87/133 are approved. (EBD/88/93, 3/28/88)

Adopted April 1, 1988

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/80 (3/30/88) and by an Advisor to Executive Director as set forth in EBAP/88/68, Supplement 1 (3/31/88) is approved.

APPROVED: November 28, 1988

LEO VAN HOUTVEN
Secretary