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April 27, 1987

To: Members of the Executive Board

From: The Acting Secretary

Subject: Costa Rica - Request for Stand-By Arrangement - Letter of Intent

Attached for consideration by the Executive Directors is a copy of the letter of intent from the Costa Rican authorities requesting a stand-by arrangement equivalent to SDR 50 million for a period of 18 months. The staff paper describing and analyzing the financial program of Costa Rica will be circulated in due course.

Mr. Tandeciarz (ext. 8501) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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San Jose, Costa Rica  
April 25, 1987

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

Dear Mr. Camdessus:

1. During the last four years Costa Rica has made efforts to achieve economic stabilization and to lay the basis for sustained growth after a period of severe external disequilibrium. Progress has been made in strengthening the position of the nonfinancial public sector, improving exchange rate management, and slowing the rate of inflation. In addition, real GDP grew at an average annual rate of more than 3 1/2 percent over this period, gross national savings recovered sharply from the depressed 1982 level, and the coverage of social services was broadened considerably. However, Costa Rica continues to be burdened by a weak external position and by structural rigidities that have affected adversely the performance of output and exports.

2. The Government intends to continue its efforts to overcome the economic difficulties being faced by the country, which have been aggravated recently by a deterioration in the terms of trade. Accordingly, the economic program for 1987 and 1988 includes a major effort to reduce substantially the combined deficit of the nonfinancial public sector and net operating losses of the Central Bank. This action, accompanied by appropriate monetary and exchange rate policies, and by needed reforms in the areas of trade policy, public sector management, and financial intermediation, will facilitate the achievement of the Government's objectives of securing a sustainable reactivation of the economy, lowering the rate of inflation, and strengthening the external position. The Government of Costa Rica would like to count on the continued support of the International Monetary Fund for these efforts, and hereby requests a stand-by arrangement for an 18-month period extending through December 31, 1988, in an amount of SDR 50 million. The major elements of the Government's program, together with operational guidelines for its implementation through the end of 1987, are described below. To assess the progress made in the implementation of the program and to set the performance criteria for the remainder of the arrangement, there will be a midterm review, to take place in conjunction with the 1987 Article IV consultation, that will be completed by December 31, 1987.

3. One of the main objectives of the Government is to increase the level of economic activity within the framework of an export-led growth strategy, which will provide sound investment and employment opportunities while allowing the country to be current with its external obligations. Taking into account Costa Rica's limited access to foreign capital and its already high debt service ratio, most of the financing for the needed investment will have to come from domestic savings.

Therefore, the Government's program aims at increasing public savings, while promoting private savings through appropriate pricing and interest rate policies.

4. The Government's program contemplates a narrowing of the combined deficit of the nonfinancial public sector and net operating losses of the Central Bank from 5.8 percent of GDP in 1986 to 4 percent of GDP in 1987, and to 3 percent of GDP in 1988. Given the limited possibilities of the Central Bank to reduce its losses through discretionary action, the bulk of the proposed adjustment will have to come from improvements in the operations of the nonfinancial public sector. Consequently, a major element of the Government's program is to narrow the nonfinancial public sector deficit from 2 percent of GDP in 1986 to about 2/3 of 1 percent of GDP in 1987, and to achieve equilibrium in 1988 after having transferred sufficient resources to the Central Bank so that the latter's net operating losses do not exceed 3 percent of GDP.

5. To reach the targeted fiscal outcome, the deficit of the Central Administration will be lowered from 3.4 percent of GDP in 1986 to 2.1 percent of GDP in 1987, and to 1.7 percent of GDP in 1988. This adjustment is to be achieved through a combination of revenue measures and expenditure cuts. On the revenue side, the Government has sent to the Legislative Assembly a tax package which is expected to raise additional revenue roughly equivalent to 3/4 of 1 percent of GDP in 1987 and to 1 1/2 percent in 1988. This package calls for increases in direct and indirect taxation, including higher rates of property taxes and a further broadening of the coverage of the sales tax to include professional services and sales of used cars. In addition, the base of the sales tax was broadened at the beginning of 1987 to cover lottery tickets, and steps were taken to improve tax collections through administrative improvements.

6. The Government intends to limit the expansion of Central Administration expenditures (gasto reconocido) to less than 7 percent in 1987. Moreover, within this limit, outlays of up to ¢ 2.15 billion will only be made to the extent that actual revenues exceed the level of projected revenues in the absence of the new tax measures. The corresponding quarterly limits for 1987 are set out in Table 1. The Government intends to continue with its policy of expenditure restraint in 1988 so as to achieve its fiscal objectives.

7. Control over the public sector wage bill will be facilitated by the implementation of a new system of salary adjustments and by our determination to reduce the size of public sector employment to its 1984 level by the first half of 1989, as agreed last year with the World Bank. During the program period, public sector salary adjustments will aim at maintaining wages constant in real terms, including the effect of merit and seniority increases. The Budgetary Authority will monitor carefully wage adjustments in the state enterprises and will take action to ensure that they are in line with those granted to central government employees. In this regard, the Government will honor all collective

bargaining agreements already signed with the unions representing public sector employees outside the Central Administration; however, no new wage contracts will be negotiated until the Assembly establishes guidelines covering such agreements. As regards public sector employment, although no dismissals can be envisaged at this time, public institutions have been instructed to observe a freeze on new hiring unless offset by reductions elsewhere. In the case of the Central Administration, a redistribution of employment is contemplated in the coming years with a view to meeting growing needs in the areas of education, health, and internal security services. However, the total number of covered positions (including part-time jobs) will not exceed the September 1986 level throughout the period of the program.

8. In the area of social security, the Legislative Assembly has revoked a law enacted in December 1985 that would have allowed all public sector employees to benefit from a privileged retirement system that, until then, had been restricted to a limited number of government employees. The Government is presently reviewing the contributions and benefits granted under this system so as to put it on a sound financial basis and lessen the present inequities which are not in accord with our social justice objectives. In the meantime, the Assembly has approved a cap on the maximum pension that can be granted to any public employee, which will result in some savings on pension payments. In addition, social security contributions for pension funds of central administration employees who choose to remain in special regimes will be adjusted to make them more comparable to those required in the general pension plan of the Social Security Institute.

9. To achieve the desired improvement in the operations of the nonfinancial public sector, the financial position of the state enterprises as a whole will have to remain at least in equilibrium. To this end, electricity and water charges, as well as public transportation fares, have been adjusted in recent months to reflect wage, exchange rate, and other cost movements. These rates will continue to be revised periodically to ensure that they are adequate to cover operating costs, debt servicing, and a share of investment expenditures. In the case of public transportation, the fares established at the beginning of this year will allow for the elimination of most of the subsidies that were being made to the enterprises providing these services. The prices of petroleum products have been maintained at existing levels because the Government decided not to pass on to consumers the decline in world prices that took place in 1986; this decision allowed the state refinery (RECOPE) to transfer part of its windfall profits to the Central Administration.

10. As a result of the price support policy of recent years, together with the policy of passing on to consumers only part of the cost of subsidies granted to agricultural producers, the national grain marketing agency (CNP) has been recording deficits of about 1/2 percent of GDP. The Government is determined to narrow CNP's deficit to 1/4 of 1 percent of GDP by 1988, mainly through a reduction in subsidies for

basic grain production. As part of this process, the support price of beans was reduced by 10 percent in January 1987, and will be lowered by an additional 5 percent in July 1987, while the consumer price will be maintained to lessen the impact of these operations on CNP's finances.

11. The Government also will continue with the process of divestiture of subsidiaries of the state-owned development corporation (CODESA). Since early 1986, several of those subsidiaries have been either sold, closed down, or reallocated within the public sector. It is expected that the remaining subsidiaries, except for two that are affected by a law permitting only a 40 percent share of their ownership to be sold, will be divested by mid-1988; this process could include the restructuring of some of these enterprises as cooperatives.

12. The improved performance of the nonfinancial public sector will allow for a reduction in its net indebtedness with the domestic banking system both in 1987 and 1988. In line with this expectation, quarterly limits on net banking system credit to the nonfinancial public sector have been established that take into account seasonal needs and expected external financing (Table 2). These ceilings also include a gradual reduction of public sector arrears to the Central Bank, related to the assumption of foreign loans by this institution in the context of external debt reschedulings. It is also the intention of the Government not to increase its floating debt (net of the arrears just mentioned) during the period of the program above the level outstanding as of end-December 1986, except for seasonal needs.

13. The Government believes that reductions in the scope of revenue earmarking and compulsory spending, enforcement of tax laws regarding evasion and delinquent accounts, and improvements in public expenditure determination and control are essential reforms needed to improve fiscal performance. However, political considerations necessitate that changes in this area be made gradually. The Executive Branch has already submitted to the Legislative Assembly proposals aimed at rationalizing the income tax structure and at modifying existing tax procedures so as to enhance tax collection. In addition, by the time of the midterm review, it will introduce modifications to a proposal (that is already being considered by the Assembly) to earmark 10 percent of central administration revenues for the municipalities. These modifications will be directed to authorize the transfer of certain functions and programs that are presently being carried out by the Central Administration to the municipalities, but with the proviso that the amount of revenue to be earmarked should not exceed the current cost of the functions and programs that are to be transferred. Further earmarking is not envisaged during the period of the program.

14. The Government's economic program contemplates a reduction in the net operating losses of the Central Bank (on a commitment basis) from 3.8 percent of GDP in 1986 to 3.4 percent in 1987, and to 3 percent in 1988, including the transfers of resources from the Central Administration mentioned above in paragraph 4. These reductions also

reflect, among other things, lower interest payments on counterpart deposits, as well as capital gains arising from the conversion of external debt into domestic debt. The Central Bank intends to lower these losses further by not passing on to the nonfinancial public sector any reduction in interest rates that the country may obtain as a result of the renegotiation of external debt with foreign commercial banks, and by using government bonds for open market operations. By the time of the midterm review, the Central Bank will have implemented the necessary adjustments in its accounting procedures to be able to monitor the evolution of these losses on a monthly basis.

15. Monetary policy will aim at reducing domestic inflation to about 10 percent during 1987 and to about 7 percent in 1988, and achieving a level of freely usable international reserves of the Central Bank equivalent to five weeks of imports by the end of the program period. Consistent with these objectives and an expected slowing of the growth of private sector financial savings in the banking system, the rate of expansion of the net domestic assets of the Central Bank (excluding the counterpart of external debt arrears) will be limited to about 12 percent in 1987. Accordingly, quarterly ceilings have been established for the net domestic assets of the Central Bank as set out in Table 3. These ceilings take into account seasonal factors, as well as the expected use of counterpart deposits by the U.S. AID, the evolution of the central bank losses on a cash basis, and the scheduled disbursement of foreign assistance. Banking system credit to the private sector has been projected to expand by about 13 percent in 1987. To this end, and also to compensate for the effect of the reduction in the counterpart deposits required to monitor external arrears (mentioned below in paragraph 20), legal reserve requirements on sight deposits have been recently increased from 32 percent to 35 percent.

16. The Government intends to pursue a flexible interest rate policy to maintain the attractiveness of saving in domestic currency. At present, most interest rates in the banking system are positive in real terms and will be maintained as such during the program period. The preferential interest rates for loans to the agricultural sector that were announced recently will cover only a very small fraction of credit to the private sector, and will become positive in real terms during the program period as our objective of curbing domestic inflation is being achieved.

17. The existing spread between deposit and lending rates in the financial system is a cause of concern. This spread, which results from the high operating costs of the state banks that dominate the financial system, is hampering the productive efforts of the economy and constitutes an impediment to sound investment. The Government is conducting several studies, one of them in collaboration with the World Bank, with a view to improving the operational efficiency of the state banks and, thereby, reducing the costs of financial intermediation. In the meantime, the Central Bank has issued regulations requiring the establishment of reserves for certain nonperforming loans and has submitted to

the Legislative Assembly a proposal to strengthen the authority of the Superintendency of Banks. By the end of 1987, the Executive Branch will propose to the Assembly additional legislation aimed at imposing penalty charges on interest in arrears, and increasing control over nonbank financial intermediaries. Within the context of this reform, the recent rescheduling of obligations of the agricultural sector with domestic banks could be seen as the only practical way to improve the loan portfolio of state banks. Moreover, the Government has decided that, in the future, refinancing of domestic arrears will only be made on a case by case basis.

18. Because of the importance of fostering export growth, the Government intends to continue its flexible exchange rate policy. Accordingly, the value of the colon will be adjusted from time to time to reflect developments in the balance of payments and inflation differentials between Costa Rica and its trading partners, with a view to improving the country's competitive position. Although the effect of this policy will offset only part of the impact on the external current account of the sharp drop in coffee prices in 1987, it will contribute to a narrowing of the current account deficit of the balance of payments in the years ahead. As a guideline to exchange trade policy, quarterly targets for the net international reserves of the Central Bank have been established through the end of 1987, as shown in Table 4. These targets incorporate seasonal factors, the anticipated schedule of disbursements of foreign assistance, and the expected rescheduling of existing debt. It is the firm intention of the Government to continue its policy of not granting exchange guarantees on external obligations which could give rise to losses for the Central Bank.

19. In the area of trade policy, the Government has been working closely with the World Bank on a program to reduce effective tariff protection and to review the existing structure of incentives and other institutional arrangements that may be hindering the expansion of exports. In 1986, under a structural adjustment program, a new tariff regime became effective, which reduced tariffs on regionally produced consumer goods, eliminated surcharges on final consumer goods, and imposed surcharges on inputs and capital goods. The Government is determined to take further steps to reduce effective protection as part of its program of structural reforms. To support the Government's trade promotion objectives, administrative procedures have been simplified and a system to improve the handling of commodities by customs will be in place before the end of 1987. Moreover, the administration of export incentives will be modernized by establishing procedures to improve the effectiveness of these incentives, and the coordination among the various agencies involved in export promotion.

20. As part of its external sector policies, during the period of the program the Government of Costa Rica does not intend to impose or intensify restrictions on payments and transfers for current international transactions, introduce any multiple currency practices, conclude any bilateral payments agreement that is inconsistent with Article VIII



of the Articles of Agreement, or introduce any new, or intensify any existing, restrictions on imports for balance of payments reasons.

21. Given the magnitude of the country's external debt, it would be unrealistic to expect that adjustment policies alone would make it possible for Costa Rica to be current with its external debt service by the end of the program period; external support in the form of additional resources and rescheduling of outstanding debt will be needed throughout the remainder of the decade. Thus, to ensure that the required foreign assistance can be obtained, we have established a schedule for the elimination of arrears--except for those subject to bilateral negotiation--that takes into account the expected cash flow of foreign exchange, as set out in Table 5. The Government also will request through the Paris Club a rescheduling of its debt with official creditors, and it is determined not to incur new arrears once negotiations with commercial banks and Paris Club creditors are concluded. To monitor the emergence of any external arrears in the future, other than those just mentioned, we will require that all applications for foreign exchange purchases be backed by a counterpart deposit in local currency equivalent to 10 percent of the amount requested.

22. To improve the maturity structure of the external debt, the Government intends to rely on long-term development credits for financing public sector investment and to reduce to minimal amounts its recourse to foreign commercial borrowing. To this end, the contracting by the public sector (including public financial institutions) of new foreign loans with maturities of over 1 year up to and including 12 years will be limited to US\$60 million during the period of the program. Within this overall ceiling, new commitments with maturities of over 1 year up to and including 5 years will be limited to US\$30 million. These ceilings will also apply to officially guaranteed private sector loans and suppliers' credits, but will exclude any new loans directly related to the refinancing or rescheduling of existing external public debt with commercial banks and Paris Club creditors, and credits under the Mexico-Venezuela oil facility. The Government also intends not to resort to short-term foreign borrowing during the program period, except for normal trade credits.

23. The Government of Costa Rica believes that the policies set forth in this letter are adequate to achieve the objectives of its program, but will take any further measures that may become appropriate for this purpose. The Government will consult with the Fund on the adoption of any measure that may be required in accordance with the Fund's policies on such consultations.

Sincerely yours,

/s/  
Fernando Naranjo Villalobos  
Minister of Finance

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

Table 1. Costa Rica: Limits for Cumulative Central  
Government Expenditure 1/

(Cumulative amounts in millions of colones)

Periods	Limits
January 1, 1987 - June 30, 1987	24,000
January 1, 1987 - September 30, 1987	35,200 <u>2/</u>
January 1, 1987 - December 31, 1987	47,400 <u>3/</u>

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

2/ This limit shall be increased by any amount that actual revenues exceed projected revenues in the absence of the new revenue measures (¢ 29,170 million). The maximum increment to this expenditure limit is ¢ 755 million.

3/ This limit shall be increased by any amount that actual revenues exceed projected revenues in the absence of the new revenue measures (¢ 41,820 million). The maximum increment to this expenditure limit is ¢ 2,155 million.

Table 2. Costa Rica: Ceilings on Domestic Banking System's  
Net Credit to the Nonfinancial Public Sector 1/

(Outstanding balances in millions of colones)

Periods	Ceilings
March 31, 1987 - June 29, 1987	42,700
June 30, 1987 - September 29, 1987	41,900
September 30, 1987 - December 30, 1987	42,300
December 31, 1987	40,500

1/ Defined to include any net credit extended by the Banco Internacional to the nonfinancial public sector. For this purpose, the nonfinancial public sector includes the central government, decentralized agencies, and state enterprises. These ceilings exclude foreign loans from the Canadian International Development Agency (CIDA) to the nonfinancial Public sector channeled through the Central Bank. These ceilings will be reduced by the amount of counterpart funds from the IBRD structural adjustment loan (SAL) used by the Central Administration, the amount of any transfers of the Central Bank to the Central Administration, and any reduction in CODESA's indebtedness with the Central Bank arising from the sale of CODESA's subsidiaries. These ceilings will also exclude credit arising from additional assumption of external debt of the nonfinancial public sector by the Central Bank during the program period. If the timing of the rescheduling or the negotiated terms differ from those assumed in the ceilings on net credit from the domestic banking system to the nonfinancial public sector, these ceilings will be revised by subsequent understandings.

Table 3. Costa Rica: Ceilings on the Net Domestic  
Assets of the Central Bank 1/

(Outstanding balances in millions of colones)

Periods	Ceilings
March 31, 1987 - June 29, 1987	26,310
June 30, 1987 - September 29, 1987	25,990
September 30, 1987 - December 30, 1987	18,050
December 31, 1987	19,890

1/ Defined as the difference between currency issue and net international reserves of the Central Bank. These ceilings assume a rescheduling of Costa Rica's external public debt in 1987 on terms similar to those negotiated during 1985. If the timing of the rescheduling or the negotiated terms differ from those assumed in the net domestic assets ceilings, these ceilings will be revised by subsequent understandings.

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

(Outstanding balances in millions of U.S. dollars)

Periods	Targets
March 31, 1987 - June 29, 1987	-170
June 30, 1987 - September 29, 1987	-170
September 30, 1987 - December 30, 1987	-35
December 31, 1987	-10

1/ Defined as the difference between the Central Bank's gross foreign assets and short-term foreign liabilities including its net position with the Fund. Also included are any arrears on commercial payments and external debt service. These targets assume a rescheduling of Costa Rica's external public debt in 1987 on terms similar to those negotiated during 1985. If the timing of the rescheduling or the negotiated terms differ from those assumed in the reserve targets, these targets will be revised by subsequent understandings.

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

(In millions of U.S. dollars)

Periods	Limits
March 31, 1987 - June 29, 1987	175
June 30, 1987 - September 29, 1987	175
September 30, 1987 - December 30, 1987	75
December 31, 1987	50

1/ Defined as the stock of arrears on medium- and long-term external public debt (excluding amounts assumed to be rescheduled) plus the outstanding balance of deposits for foreign exchange requests held by the Central Bank of Costa Rica in excess of 15 working days. These limits assume a rescheduling of Costa Rica's external public debt in 1987 on terms similar to those negotiated during 1985. If the timing of the rescheduling or the negotiated terms differ from those assumed for the limits on payments arrears, these limits will be revised by subsequent understandings.