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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/150

10:00 a.m., October 28, 1987

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

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	P. E. Archibong, Temporary
	Jiang H.
C. H. Dallara	
J. de Groote	J. Prader
	E. Feldman
	M. Hepp, Temporary
M. Finaish	
	B. Goos
J. E. Ismael	
	J. Hospedales
	M. Foot
	M. Fogelholm
	D. McCormack
	C. V. Santos
Y. A. Nimatallah	
G. Ortiz	L. Filardo
H. Ploix	D. Marcel
	G. P. J. Hogeweg
	C.-Y. Lim
	O. Kabbaj
	A. Vasudevan, Temporary
	M. Sugita
	F. Di Mauro, Temporary

L. Van Houtven, Secretary and Counsellor
S. Woolls, Assistant

Also Present

IBRD: L. E. Derbez, Latin America and the Caribbean Regional Office. African Department: G. E. Gondwe, Deputy Director; L. M. Goreux, Deputy Director; E. L. Bornemann, E. A. Calamitsis, R. C. Williams. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; S. J. Anjaria, E. Brau, J. A. Buyse, H. B. Junz, P. J. Quirk. External Relations Department: H. P. Puentes. Fiscal Affairs Department: L. J. Vâzquez-Caro. Legal Department: F. P. Gianviti, General Counsel; H. Elizalde, A. O. Liuksila, R. S. J. Martha. Research Department: P. Wickham. Secretary's Department: C. Brachet, Deputy Secretary. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; J. Ferrân, Deputy Director; L. E. DeMilner, M. R. Figuerola, I. C. Tandeciarz. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: E. Ayales, M. B. Chatah, G. D. Hodgson, A. Ouanes, D. C. Templeman. Assistants to Executive Directors: J. R. N. Almeida, H. S. Binay, S. Guribye, G. K. Hodges, S. King, K.-H. Kleine, T. Morita, C. Noriega, L. M. Piantini, A. Rieffel, V. Rousset, G. Schurr, B. Tamami, R. Wenzel, D. A. Woodward.

1. REPORT BY MANAGING DIRECTOR

The Managing Director said that during his recent visit to New York to attend the meeting of the UN Administrative Committee on Coordination, he had also attended a meeting of the Second Committee of the General Assembly, which dealt with economic affairs, to give an account of the 1987 Annual Meetings. He had been impressed by the interest in the Fund's activities, and especially in coordination among major countries, the debt strategy, and the enhancement of the resources of the structural adjustment facility. He had the strong impression that there was a broader consensus on the need for a cooperative debt strategy in which all the participants must make greater efforts.

In his conversations with Secretary-General Pérez de Cuéllar and other UN officials, the Managing Director went on, he had discerned considerable interest in ways to reduce the social cost of adjustment. He, himself, had stressed the need to consider the cost of a country's failure to make adequate and timely adjustment, and he had mentioned the work of the Fund on adjustment with growth.

While in New York, he had also appeared before the Council for Foreign Relations, where he had agreed to make some extemporaneous remarks on the events of the day. He had mentioned that the international community was being given a strong signal from the financial markets that they had accepted the strategies defined in the Louvre Accord, the Venice Summit Declaration, and in the Interim and Development Committee communiqués, for reducing the huge balance of payments disequilibria without incurring recession and without promoting disorderly movements in the exchange markets. However, everyone realized the great difficulty of that challenge, which could be met only on the basis of very strong, renewed economic policy coordination among major countries and good economic policies in all countries. Those policies included: reduction of the budget deficit in the United States; symmetrical adjustment in all countries; symmetry of adjustment in surplus and deficit countries with different rates of growth and of demand versus output; appropriate channeling of surpluses; appropriate monetary policies; avoiding, to the extent possible, increases in interest rates; resisting protectionism; structural adjustment in all countries, and not only those requesting use of Fund resources; and finally, strengthened coordination. Undoubtedly, everyone would agree on the need for such actions, which would have to be accomplished without delay. In that connection, the present bipartisan initiatives that were being taken in the United States to deal with the budget deficit were welcome.

2. COSTA RICA - REQUEST FOR STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on Costa Rica's request for a stand-by arrangement in an amount equivalent to SDR 50 million (EBS/87/91, 4/27/87; Sup. 1, 10/16/87, and Cor. 1 and Cor. 2, 10/27/87).

The Chairman said that with the agreement of the Costa Rican authorities, a revised proposed decision was being circulated to Directors that excluded the proposal that the Fund should approve the maintenance of an exchange restriction evidenced by external arrears pending agreement with commercial banks on a financing package for Costa Rica. The staff would prepare a paper on the legal considerations arising from the approval of such arrears, in the context of Article VIII, Sections 2(a) and (b), for discussion by the Executive Board within approximately two months.

Mr. Ayales said that he confirmed the Chairman's understanding that the Costa Rican authorities wished the Board to proceed with the consideration of their request for a stand-by arrangement, without a simultaneous request for approval of the exchange restriction in question.

Mr. Goos said that the Chairman's proposal was helpful because his chair had had some problems with the proposed approval of the arrears under Article VIII, owing to the possible legal consequences for other creditors. At the same time, he asked the staff to clarify the situation with respect to the Fund's policies stipulating that, if a country had payments arrears, the Board could approve a program to be supported by use of the Fund's resources only if it had approved those arrears.

Mr. Di Mauro asked whether approval of the stand-by arrangement, without approval of the payments arrears, meant that a financing gap still existed.

The staff representative from the Exchange and Trade Relations Department explained that there would be no financing gap if the Executive Board approved the stand-by arrangement for Costa Rica because of the provision made for the partial payment of interest arrears to the commercial banks for a temporary period. The gap would be financed in part by the accumulation of those arrears through the middle of 1988.

The staff representative from the Legal Department said that approval by the Fund of the exchange restriction of Costa Rica pertaining to its payments arrears must take the form, and for all purposes, of approval under Article VIII, Section 2(a). Nothing in the stand-by arrangement itself could be construed as approval of the restriction in question, although the program suppported by the stand-by arrangement for Costa Rica--and for arrangements for many other countries--did contain a ceiling on the accumulation of arrears during the initial period.

On the policy issues raised by Mr. Goos, Executive Board Decision No. 3153-(70/95), adopted October 26, 1970 stated that the same performance criteria or policies applied to granting financial assistance to members having payments arrears as those applying to the problem of payments restrictions under Article VIII, the staff representative from the Legal Department added. The apparent intention was to permit a judgment to be reached with respect to the approval of the exchange restrictions when a member's request for financial assistance was considered.

Mr. Lim said that it was not clear to him whether the Executive Board, if it adopted the revised draft decision that excluded approval of the exchange restriction, would not in fact be approving the increase in arrears by acknowledging their existence in the program supported by the stand-by arrangement.

The staff representative from the Legal Department responded that approval of the stand-by arrangement did not imply approval of the restrictions under Article VIII, Section 2(a); such approval would require a separate decision. A member that introduced restrictions or maintained restrictions under Article VIII was required to seek the Fund's approval of those restrictions; in the absence of such approval, the restrictions were not legal for purposes of the Articles. Moreover, if the Fund was requested to render an opinion on the member's legal situation under those circumstances, it would have to state that the member's exchange practices were not in all respects consistent with the Articles.

The staff representative from the Exchange and Trade Relations Department observed that if Costa Rica did not observe the performance criterion with respect to payments arrears, its right to purchase under the stand-by arrangement would be interrupted. The temporary increase in payments arrears incorporated in the performance criterion arose from the fact that Costa Rica would make partial payments of interest, of $5 million a month, to the commercial banks as long as negotiations with the banks continued. The program had been drawn up in such a way that the use by Costa Rica of additional resources to finance expenditures not included in the targets would be inconsistent with the program.

Mr. Kafka remarked that if it was a matter of a breach of Article VIII, Section 2--rather than the possible violation of a performance criterion, which could be handled by waiver--the stand-by arrangement could nevertheless be approved. He recalled that there had been instances in the past of stand-by arrangements having been granted to countries maintaining restrictions under Article VIII.

The staff representative from the Legal Department responded that as a matter of law, there was no proposal before the Board to approve Costa Rica's restrictions under Article VIII, Section 2(a), and the member would thus be in continuing violation of that provision of Article VIII. As a matter of practice, there had been cases when the Board had not regarded approval of restrictions as a condition for granting a stand-by arrangement including, for instance, discriminatory restrictions, or other unapproved restrictions that were not considered significant for the purposes of the program. In the case of Costa Rica, a major element of the program was the use of unapproved exchange restrictions for the purpose of financing the program. The Executive Board would thus have to reach a judgment, on policy grounds, as to whether or not to grant the stand-by arrangement. There was no provision in the Articles preventing a member from being granted a stand-by arrangement on the grounds that it was in violation of the Articles, but neither did the approval of the stand-by arrangement imply approval of the restrictions.

Mr. Dallara said that he welcomed the clarification that the stand-by arrangement could be approved legally without legal approval of the restrictions. He asked whether it would be fair to characterize the proposed action as acceptance by the Fund of the arrears without technical or legal approval.

The staff representative from the Exchange and Trade Relations Department replied that the arrears were being accepted, as a matter of policy, for a limited period until April when a review of the financing arrangements would take place, on the grounds that the Costa Rican authorities and the commercial banks, acting through their steering committee, had agreed that that would be a reasonable way to proceed. If the Board granted the request of the authorities to approve the arrangement for Costa Rica, it would be assisting both the member and the commercial banks, as part of the general debt strategy the Fund had been following, in negotiating a financial package. At the same time, Costa Rica would be assisted in implementing its adjustment program for which financing would otherwise be lacking or blocked.

Mr. Sugita asked how the proposed procedure for treating Costa Rica's payments arrears differed from the Fund's practice in the past with respect to financing gaps.

Mr. Nimatallah inquired whether the precedents for approval of stand-by arrangements for members retaining exchange restrictions had involved both multiple exchange rate practices and payments arrears. In other words, he wished to know what constituted a violation of Article VIII.

The staff representative from the Exchange and Trade Relations Department noted that the Board was called upon to judge the circumstances of the cases laid before it. In doing so, the general principle with respect to the financing of a gap had been that the management, before recommending approval of an arrangement, must be able to give the Board reasonable assurance that the program would be financed. Different degrees of assurance had been noted in different cases, ranging from the securing of a critical mass of financing to agreement in principle on the part of a steering committee of banks to provide financing. In the case under discussion, agreement in principle by the commercial banks' Steering Committee did not yet exist, although all parties, including the committee, believed that it was helpful and reasonable to move ahead, based on an understanding of cooperation. In another instance, the question of the servicing of commercial bank debt had in essence been left aside, by voluntary and cooperative agreement of the parties involved, together with proposals for a buy-back arrangement by the banks of the country's debt.

The staff representative from the Legal Department said that Article VIII stated that "...no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions." If the Fund did not grant its approval of such restrictions, the member was in violation of its obligations under Article VIII, Section 2(a). The decision rested with the Board. However, the Board had adopted no policy stating that there should be no use of the Fund's resources if a member maintained restrictions under Article VIII, as it had for instance with respect to the existence of overdue financial obligations to the Fund. Therefore, it was possible in legal terms for the Fund to grant a stand-by arrangement without simultaneously approving the restrictions subject to Article VIII; nonapproval of the restrictions did however immediately imply a breach of the obligations of Article VIII.

Mr. Hogeweg said that he would be interested in knowing the reason underlying the original proposal to approve Costa Rica's restrictions under Article VIII.

The Chairman noted that the complex legal issues raised by the continued existence of an exchange restriction evidenced by payments arrears would be examined in the paper to be prepared by the staff for later discussion by the Board. The revised proposed decision was intended to facilitate approval of Costa Rica's request for prompt approval of the stand-by arrangement, pending consideration by the Board of those issues.

Mr. Folgelholm asked what were the practical consequences of a breach of Article VIII, Section 2.

The staff representative from the Exchange and Trade Relations Department replied that the practical consequences concerned the certainty of securing financing of the proposed program. A good argument could be made that that question was theoretical in the case of Costa Rica, since the banks represented in the Steering Committee had agreed to the proposed procedure. The assurance of financing for the program until April was thus based on the adherence of the banks, while the negotiations on the package continued, to the cooperative procedure that had been agreed, and on the understanding that there would be no legal challenges. That understanding seemed reasonable in the particular case of Costa Rica, especially as the banks would certainly benefit from receiving partial interest payments that they had not been receiving in the past.

Mr. Ayales made the following statement:

> On behalf of my authorities, I would like to express appreciation to management and staff for their continuous support of Costa Rica's adjustment efforts and for the cooperative manner in which the negotiations for this stand-by arrangement have been conducted.

Following a period of severe economic crisis during the early 1980s, which was precipitated by a series of external shocks and by the political conflict affecting the region, Costa Rica has made strenuous efforts to achieve economic stabilization and to lay the basis for sustained growth. The economic and financial policies implemented by the Government during 1983-85--supported initially by a Fund program--have succeeded in sharply reducing major imbalances. In the fiscal area, the combined deficit of the public sector was reduced to the equivalent of 7.2 percent of GDP in 1985 from 14.5 percent in 1982. The rate of domestic inflation fell dramatically, from 90 percent to 15 percent, over the same period. In the external sector, the introduction of a considerable degree of flexibility in exchange rate management contributed to a more buoyant export performance, especially in new export activities. Also, the rapid growth of real private sector financial assets has been a reflection of more flexible interest rate policies. These developments and policy adaptations served to set the stage for a resumption of economic growth. After a sharp decline in 1982, the economy has been expanding at an annual average rate of almost 4 percent during 1983-85. However, despite these advances, the country's external position remains weak, because the effects of an inauspicious external environment have been compounded by the heavy burden of servicing the external debt.

During recent years, the Costa Rican Government has made efforts to improve the country's debt profile by reducing the rate of accumulation of external indebtedness from an average of 7.7 percent of GDP during 1983-85 to less than 2 percent of GDP in 1986, and by seeking external financing primarily from official and multilateral sources at concessional terms, including longer maturities. It is important to note that the stock of debt as a proportion of GDP has declined sharply from its 1982 peak of 121 percent to about 90 percent in 1986. It is expected that this ratio will continue to decline in the years ahead. However, this improvement in the external debt situation has been achieved at a very heavy cost; the country has transferred abroad more than $600 million since 1982. In terms of per capita income, the result has been stagnation and some decline in the last two years. It is apparent that the burden of adjustment has been borne disproportionately by the country.

On the assumption that the Costa Rican authorities will continue to pursue prudent fiscal and monetary management, flexible exchange and interest rate policies, and implement structural changes to remove over time internal rigidities, the external financing gap for 1987-88 has been estimated at about $200 million. Given the size of the external debt and the external constraints facing the country, my authorities consider that securing additional resources in the form of "new money" on commercial terms to cover this gap is not a desirable option.

Instead, contractual terms and conditions on existing obligations will need to be reviewed and special consideration should be given by creditors to the country's ability to service its foreign obligations.

In October 1986, following six months of negotiations with the Advisory Committee of Costa Rica's bank creditors, the Government presented a proposal for the rescheduling of its outstanding bank obligations. However, the Advisory Committee considered the conditions stipulated in the country's proposal to be unacceptable under the circumstances prevailing at that time. Therefore, they suggested holding follow-up discussions after agreement had been reached with the Fund on the terms of a letter of intent for a stand-by arrangement. After the Fund management approved the letter of intent, it was circulated to Executive Directors on April 27, 1987. The Costa Rican authorities then immediately embarked on the formulation of a new proposal for rescheduling external bank debt.

The new proposal, which was presented to the banks' Advisory Committee on June 1987, rests on two guiding principles: (a) the country's "ability to pay" must be an integral component of any rescheduling arrangement; and (b) the concept of the "menu approach" must be adopted. The first principle is based on the consideration that if the country is to emerge from its debt problem, it must first achieve a satisfactory rate of economic growth that will permit the re-establishment of orderly relations with creditors, without impinging excessively on the welfare of the Costa Rican people. With respect to the second proposition, given the often diverging views of individual banks as determined not only by their current financial situation, but also by their long-term corporate strategies, the proposal includes various options for the payment of interest. These range from the deferral of payments to the acceptance of exit bonds and include, within reasonable limits, the option of swapping equity for debt.

The Advisory Committee, after discussions with the staff of both the Central Bank and the Fund, eventually agreed that the external financing requirement of the program amounted to $200 million. However, there was disagreement among the banks represented on the committee regarding the terms and conditions proposed by Costa Rica to finance this gap. At that point, the banks asked for a postponement of further negotiations until after the Fund/Bank Annual Meetings. This delay, which was totally beyond the control of the Costa Rican authorities--and may have been motivated by fears of setting a precedent--has prevented the country from regularizing its position with other creditors. It also has hampered the flow of external financial assistance, complicated the implementation of domestic financial policies, and created internal political pressures as a result of the apparent lack of external support for the program.

At present, negotiations with the banks are still in progress and are being conducted in an atmosphere of cooperation. My authorities have notified the Advisory Committee of the Government's intention to resume partial interest payments beginning October 1987; the amounts to be paid were determined by the country's ability to service its external obligations and are consistent with the bank financing envisaged in the program. My authorities are of the view that postponing a Fund program until after an agreement with the commercial banks is reached may jeopardize the results already accomplished. Therefore, they request that the proposed stand-by arrangement be submitted to this Board for approval while the negotiations with the banks continue. This will not weaken the Government's commitment, which, as it has always been, is to conclude these negotiations as soon as possible.

A combination of domestic efforts and favorable external developments contributed to a rather satisfactory economic performance in 1986. Although the effect of some relaxation of monetary and fiscal policies in late 1985 was felt in 1986, and may have slightly accelerated the pace of inflation, the economy expanded by some 4 percent, compared with very little growth in 1985.

The improved financial performance of state enterprises and the reduction of the Central Bank's net operating losses resulted in a further reduction--by almost 2 percent of GDP--of the combined public sector deficit to 5.8 percent. Not only did the Government continue its policy of reducing subsidies for basic grains, but it also periodically adjusted charges for public services according to wage, exchange rate, and other cost movements. These developments contributed to a reduction in the public sector's net indebtness to the Central Bank and led to improvement in the official net international reserves.

The temporary improvement in the terms of trade and the flexible exchange rate policy pursued by the Central Bank led to a narrowing of the external current account deficit to 5 percent of GDP. Nevertheless, owing to an unexpected sharp decline in net capital inflows--official transfers alone were 50 percent less than planned--and delays in debt rescheduling with commercial banks and bilateral creditors, the overall balance of payments showed a deficit which had to be financed by the accumulation of debt arrears.

Developments in the first semester of 1987 were characterized by: (a) a satisfactory fiscal performance: the deficit of the nonfinancial public sector, the expenditure of the Central Government, and domestic bank financing of the public sector were all below the indicative limits for June 1987; (b) an expansion of the banking system credit to the private sector, which may have been behind the acceleration in the rate of inflation and higher imports; and (c) a dramatic shortfall in disbursements of official loans to less than half the programmed level, which led to a decline in the net international reserve position of the Central Bank beyond the loss contemplated in the program for this period.

In an effort to bring the program back on track, the Government has taken strong remedial actions. With a view to dampening excessive credit expansion to the private sector, the Central Bank increased the discount rate to 30.5 percent and raised the deposit requirements for purchases of foreign exchange to 50 percent. At the same time, in an effort to correct deviations in the current account of the balance of payments, a more active exchange rate policy is being pursued. In addition, the deficit of the nonfinancial public sector is being further reduced (to about one fourth of 1 percent of GDP).

The Government expects that these measures will not only correct the deviations with respect to the indicative targets, but also set the stage for the successful implementation of the adjustment program for the period September 1987-March 1988.

The Government is determined to preserve the economy's recently achieved stability and make adjustments to enable the economy to grow faster in the years ahead. Despite what has already been accomplished, there is great concern that future growth prospects remain severely constrained by the excessive burden of external debt servicing. This preoccupation has led the Government to embark upon an ambitious structural transformation program geared primarily toward the rapid expansion of nontraditional exports. Only by these means will the country be able to improve the standard of living of its people, and honor its external financial obligations.

In order to implement its economic program, the Government has moved forward on a number of major initiatives. In addition to this stand-by arrangement with the Fund, the Government is actively negotiating with the World Bank on the second stage of a structural adjustment program to span through 1989. Furthermore, the country is about to conclude negotiations to become a contracting party to the General Agreement on Tariffs and Trade (GATT). These initiatives are a clear indication of the Government's intention to maintain good relations with the international financial community.

Since the staff paper explains in detail the main provisions and objectives of the Fund program, and makes reference to the program with the World Bank, I will only emphasize their main elements.

In an effort to further improve export performance, especially in nontraditional activities, while reducing the country's dependency on imports, the Government is maintaining a unified and flexible exchange rate system. Periodic adjustments in the value of the colón have resulted in a real effective depreciation of 4 percent in 1986 and about 8 percent during the first eight months of 1987.

It is important to note, however, that even with the expected improvement in the trade balance in 1988, which will halve the deficit with respect to 1986, the official capital account will continue to show net outflows. With official financial assistance remaining at similar levels through 1988, the financial requirements will have to be covered mainly by rescheduling of past and current obligations with bilateral creditors and the accumulation of debt service arrears with commercial banks.

In order to consolidate the improvement in the country's external competitiveness and sustain the changes in domestic relative prices that are needed for resources to be transferred to productive investment and to the external sector, the Government intends to support this exchange rate policy stance with prudent demand management.

With respect to public finances, the Government intends to reduce the combined public sector deficit from 5.8 percent of GDP in 1986 to 3 percent in 1988. This objective will be achieved despite the deficit-raising effect of the deterioration in the terms of trade in 1987. The surplus in the state enterprises will not only offset the small deficit that would be incurred in the central administration in 1988--1.7 percent of GDP--but will also allow a reduction in the Central Bank operating deficit. A combination of revenue and expenditure measures are being implemented to achieve these targets. A tax package was submitted to Congress--equivalent to 1.5 percent of GDP--calling mainly for changes in property and sales taxes. Even though there have been unexpected delays in its approval, the Government is ready to adopt a contingency plan for expenditure cuts, so that the rate of growth of total outlays in nominal terms will be limited to 3 percent in 1987. If the tax package is approved or if actual revenue collections surpass programmed levels by an amount equivalent to the expected yield of the tax package, maximum nominal expenditure expansion--8 percent--would still be much lower than the expected increase in consumer prices. In addition, the Government intends to continue its policy of bringing domestic prices for basic grains in line with their international prices, and is fully committed to consolidating the financial position of state enterprises. To this end, the Government will continue to adjust prices periodically to cover operating costs as a portion of investment.

In the monetary sphere, the Central Bank is already pursuing a very tight credit policy. In order to correct the deviations observed as of June 1987--both in banking system credit to the private sector and in imports--as well as to bring credit expansion within limits consistent with a reduction in the rate of inflation to 7 percent in 1988, from 15 percent in 1986, the Central Bank has taken very restrictive measures, as I mentioned earlier and as was explained in detail in the staff paper. This monetary policy stance is being supported by the maintenance of a flexible interest rate policy, which should contribute to better resource allocation.

The proposed structural adjustment program consists of a set of global and sectoral measures designed to attain a satisfactory and sustainable rate of growth over the medium term. The central feature is the development of an efficient and dynamic export sector capable of generating the foreign exchange required to expand import capacity and meet the country's external financial obligations. The development of such a sector will require raising the productivity of export-oriented and import-competing industries and improving the efficiency of trade-supporting activities.

The program calls for substantial new investment, particularly in the production of tradable goods. Given the country's degree of indebtedness and the paucity of external resources, much of that investment will have to be financed with domestic savings. Accordingly, steps will be taken to increase the pool of domestic resources--both public and private--and to improve the efficiency of their allocation. This will entail further rationalization of current and capital expenditures, an adequate system of prices, taxes and incentives, and major improvements in the process of financial intermediation. In the area of trade policy, one key element will be the reduction of the level of effective protection. Accordingly, both the level and the dispersion of tariffs will be gradually reduced on final as well as intermediate goods and raw materials. Nontariff barriers are few, but those that exist will also be examined with a view to their eventual elimination. On the export side, incentives will be revised with a twofold purpose: first, to have them conform to the prevailing trade regulations in targeted markets and to the commitments attendant to Costa Rica's accession to the GATT; and second, to raise the local value added of exports through further linkages along the processing chain. Measures will also be taken to expedite trade-related administrative procedures, improve information channels to better match market opportunities with potential suppliers, and establish an export insurance scheme. At the same time, steps will be taken to improve the quality of transportation services and facilities and to bring local fuel prices more in line with those prevailing in international markets.

Continued efforts during recent years toward eliminating domestic and external imbalances have accomplished substantial progress. Yet, in order to consolidate these gains, at this stage it is necessary to come to a lasting agreement with the international financial community, so as to lend credibility to the country's economic program. With this aim, Costa Rica has already approached the Paris Club and other bilateral and official creditors in a very serious effort to reach an agreement. The support of the Fund for the country's program would facilitate a final agreement with all creditors, and provide a clear example of the catalytic role of this institution. My authorities attach great importance to a harmonious relationship with their creditors and believe that full commitment to the current economic program is a means to achieving that goal.

Extending his remarks, Mr. Ayales noted that the tax package referred to in the letter of intent was already being discussed by Congress. In addition, as a result of the recent measures taken by the Central Bank, the interest rate had been rising during the past few days, and the Central Bank had already adjusted the rate for stabilization bonds by 5 points.

Mr. Foot said that his authorities wanted to help Costa Rica get the stand-by arrangement under way, but they had serious reservations about how early the Fund's resources had become involved in the financing process and many questions on the Article VIII issue raised by the original decision. He was glad that a way forward had been found in both those respects. However, his authorities did not wish to see any similar cases brought to the Board before a full debate took place on the two issues of the timing of Fund involvement and the legal implications of Article VIII.

The program itself was worthy of overall support, but it raised a number of questions, Mr. Foot said. The fiscal effort had, given congressional resistance to some revenue increases, an inevitably piecemeal air, and he was not sure that the overall fiscal target for 1988 was ambitious enough, or necessarily achievable. On the monetary side, it was not clear to him whether the corrective measures taken to decrease the heavy overrun of credit to the private sector in 1987 would be sufficient.

The external position was programmed to remain weak, and any slippage in fiscal or monetary policy could have a rapid and serious effect on both the need for and the voluntary supply of external finance, Mr. Foot added. Past exchange rate policy had been helpful, and the authorities should keep in mind the possible value of a further depreciation. If the policies in the program were fully implemented and the external environment was as favorable as assumed, Costa Rica would be better placed by the end of 1988. However, he would urge the authorities to reduce the combined deficit to even less than 3 percent of GDP in 1988, and to be ready to respond quickly to adverse external circumstances.

Mr. Dallara made the following statement:

I support the strategy embodied in the new program, consisting of a further reduction in the combined fiscal deficit; an active foreign exchange rate policy; renewed credit restraint; and important structural reforms, which are primarily to be supported by a second structural adjustment loan from the World Bank. These structural reforms appear to encompass trade policy, banking sector reform, management of the private sector, reforms in the productive sectors to promote exports, and external debt management.

I hope the Fund will look at the key aspects of these reforms during the period ahead to consider which aspects, such as banking sector and trade policy reform, should be more clearly incorporated into the design of the program supported by the stand-by arrangement with the Fund. An important part of this adjustment effort, obviously, is the effort to reduce the combined fiscal deficit. I join the staff in stressing the importance of implementing the policies necessary to reduce arrears. I welcome the contingency spending arrangements, which provide protection against possible erosion of the deficit reduction effort if certain revenues fail to come on stream. Contingency arrangements have been used in other cases, and I believe that they are a constructive way of enabling the Fund to lend its support to a country in spite of uncertainties about a government's capacity--not its desire--to completely follow through on every aspect of its fiscal reform.

In the monetary area, net repayments of credit to the public sector for the fourth consecutive year should facilitate control over total credit expansion. However, it is clear that the authorities have had to move twice during this past year to slow excessive credit expansion in the economy. The existence of positive real interest rates on deposits and on most loans should be helpful in containing credit and mobilizing savings, as should the pending financial market reforms.

I encourage the authorities to continue the renewed effort to restrain credit policy, because a relaxation on this front could undermine the strengthening of the payments position and, indeed, the entire adjustment effort. I share the staff's concern about the efforts to provide special arrangements for certain sectors, such as the agricultural sector. The weaker than expected payments position earlier this year has, of course, been a cause for concern. The staff has correctly identified not only the policy measures important to correcting the payments deficit, but also the broader structural reform effort and exchange rate policy. In fact, there has been a fairly steady real effective depreciation of the colón since 1983, except for 1984, and nontraditional exports are picking up. However, the exchange rate had appreciated in real effective terms by more than 37 percent in 1982. In addition, I wonder whether the staff views Costa Rica's external competitive position as more or less adequate in current circumstances.

The medium-term payments outlook is not a particularly strong one. However, I believe that full and complete implementation of this program and the additional reforms embodied in the World Bank program can move the authorities toward a sustainable position. I underscore the need to consider, during the course of 1988, ways in which this effort could be intensified, in light of the fragility of the external situation.

Regarding the unusual financing of this program, I have serious reservations about the application of this approach in a broad number of cases. However, in the particular and rather unusual circumstances in this case, which critically include the cooperative, although unusual, understanding reached between Costa Rica and its external creditors, and which explicitly acknowledge the temporary nature of the current approach to financing the package, we do consider the approach developed by the Costa Rican authorities with their creditors and with the assistance of the Fund management and staff to be an appropriate one. I underscore, however, that my authorities consider this a temporary approach, and that it is essential that the authorities and the creditors intensify their efforts during the months ahead to ensure that, by April 30, 1988, or the completion of the second review, whichever is earlier, a more definitive financing arrangement will be in place. It is also essential that the banking community, as well as Costa Rica, understand that this is an individual case, and that the case-by-case approach must prevail, so others in similar circumstances receive the appropriate support. In this connection, I also support the modification of the decision, which enables us to provide essential support to Costa Rica, while giving us the time to reflect more deeply on the rather fundamental questions raised in the exercise of the Fund's authority under its Articles.

Mr. Archibong made the following statement:

Judging from the main economic indicators, the performance of the economy has been encouraging, despite some unfavorable exogenous developments. Significant growth in output, deceleration in the rate of inflation, and decline in the combined public sector deficit are largely reflections of the authorities' prudence in fiscal and monetary management and in flexible exchange and interest rate policies. Some strenuous efforts have been made to stabilize the economy and put it on the path of sustained growth. However, as the staff paper and Mr. Ayales noted, not much has been achieved in that connection; domestic and external imbalances persist, and are compounded by the heavy external debt-servicing burden.

In light of the policy measures embodied in the authorities' economic program for 1987-88, there is a possible solution to the structural problems that the economy faces. A viable and dynamic export sector could be developed which would--among other things--generate the much needed foreign exchange to expand import capacity and meet the country's external financial obligations. Moreover, the envisaged substantial new investment would stimulate both employment and the production of tradable goods. Particularly in the area of structural reforms, I welcome the role which the World Bank has played, and hope for a speedy conclusion of the ongoing negotiations for disbursements under the second phase of the structural adjustment loans (SAL-11).

However, projections indicate that exceptional financing will be required over the medium term for Costa Rica to meet its obligations. Although the financing gap could be covered in part by a rescheduling of principal obligations to the commercial banks and bilateral creditors, without an arrangement supported by the Fund, the authorities will encounter difficulties in the rescheduling process. Apparently, the catalytic role of the Fund is needed to speed up the negotiations and ensure success.

As for the determination of the Costa Rican authorities and their commitment to full implementation of the program, their track record and their letter of intent would appear to provide some assurance. I believe that the external, domestic, and structural policies that the authorities intend to implement are adequate and the program merits our support.

I, therefore, endorse the proposed decisions as amended today.

Mr. Kafka made the following statement:

The Costa Rican authorities have reacted with courage and competence to the unexpected difficulties they have had to confront in the current year. Fiscal performance has been better than estimated in the original letter of intent. Credit to the private sector and net domestic assets of the Central Bank have been larger than envisaged, but the authorities have recently taken strong measures to correct these deviations. Nontraditional exports have been doing extremely well, but the burden of adjustment borne by the country has been heavy.

The international commercial banks, so far, have not been helpful. The process of negotiation has been going on since March 1986: a proposal by Costa Rica was presented to the banks in October 1986, and a letter of intent was presented to the Fund in April 1987; a second proposal to the banks was presented in June, and still a clear decision from the banks has not become available. These delays have prevented the regularization of the debt with official creditors, and have gravely hampered Costa Rica's ability to obtain additional external assistance and thus, its ability to implement the economic program. This chair warmly supports the authorities' request that the "Executive Board approve the stand-by arrangement while negotiations with commercial banks are still in progress, even though this would be a departure from current practices, and would require approval of a further accumulation of arrears on a temporary basis." My authorities fully endorse the staff recommendation that the Executive Board approve the stand-by arrangement, to become effective immediately. My authorities could also approve the original proposed decision on the exchange restrictions evidenced by existing external payments arrears and by the external arrears that will remain pending rescheduling agreements until April 30, 1988, or the completion of the second program review, whichever is earlier. To do anything else would be an abdication of the Fund's responsibility.

The adjustment program is well designed. The medium-term policies continue to focus on the recovery of savings from their depressed levels; important progress has already been reached in this and in other respects. I am happy to see that the 1988 fiscal outcome is heavily dependent on a reduction of the central government deficit, as it should be, since this is an area in which the authorities have direct control. Several structural reforms have been planned and privatization policies are well under way. The medium-term outlook is for improvement, but causes some concern. A more forthcoming attitude from the international creditors, to clarify the financing outlook for the late medium term, would be helpful to Costa Rica and in the creditors' own intelligent interest.

Mr. McCormack made the following statement:

The proposed stand-by arrangement for Costa Rica has a number of unusual features and raises very difficult issues for the Board. Because negotiations with the commercial banks have not yet been completed, the Fund program is not fully financed. Moreover, the program involves an increase, albeit temporary, in commercial bank arrears. My authorities believe that, as a general rule, programs supported by the Fund should be fully financed. Pending completion of negotiations with the banks, the Fund should generally give approval in principle.

There are a number of distinguishing features in the case of Costa Rica which suggest that a mechanical application of the approval-in-principle formula would not be appropriate. There has been a protracted delay in negotiations with commercial banks; this delay has been, to some degree, outside of the authorities' control. In the interim period, what is to all intents and purposes, a shadow program has been in existence. This program exemplifies the authorities' good faith and determination to pursue adjustment policies. Good faith is similarly exhibited in the authorities' willingness to make partial interest payments of some $5 million a month to their commercial bank creditors.

My authorities note that the Coordinating Committee for the banks apparently concurs with the proposed stand-by arrangement and that the banks have indicated their intention to expedite negotiations to the maximum extent possible. Therefore, by approving the proposed arrangement, the Fund is not putting its weight behind either creditor or debtor, but rather is acting in a way that is regarded by both parties as mutually beneficial.

The present request is somewhat exceptional. For the Board to deny its approval, or to defer approval further, would be neither in the interest of Costa Rica nor the banks. Presumably, the most fundamental reason for approving the program is that delay would risk undermining Costa Rican commitment to the program. There may be a perception that Costa Rica's adjustment efforts were being made without the support that could reasonably be expected from the Fund and other multilateral agencies. In this connection, delay on the Fund's part could jeopardize agreement in the Paris Club and the conclusion of lending decisions by the World Bank. Given all of these circumstances, and the acknowledged need for the Fund to demonstrate flexibility in the overall debt strategy, the present proposal is in the best interest of all the parties involved. Clearly, the particular circumstances of Costa Rica will not be readily replicated. However, my authorities stress that other similar cases coming before the Board would have to be decided on their own merits.

On the legal issues raised by Costa Rica's request, it would seem appropriate for the Legal Department to prepare for the Board's consideration a paper setting out the issues together with a thorough analysis of their implications for the Fund's normal operating procedures. My authorities do not wish to hold up Costa Rica's application further, pending the preparation and consideration of this document, and therefore, approve the modified decision.

On the substance of the program, I wish to emphasize a few points. In the first half of 1987, there were significant slippages from the program, particularly in relation to central bank credit to the private sector. I note the corrective measures which have been taken by the Central Bank to alleviate these slippages, but stress the importance of the authorities' pursuing a strong credit policy, and underpinning it with a flexible interest rate strategy. I also note that there is no scope in Costa Rica's circumstances for the sort of interest rate subsidization associated with recent debt moratoriums extended to the agricultural sector. Costa Rica's medium-term balance of payments prospects require a strong export-oriented policy. The exchange rate policy will need to be pursued flexibly and supported by appropriate demand-management policies. My authorities strongly endorse the necessity for far-reaching structural reforms in Costa Rica to reduce the rigidities that are detrimental to economic growth prospects for the medium term.

Mr. Goos made the following statement:

I have little to add to the staff's analysis and recommendations regarding economic developments and policies. Costa Rica's efforts to resolve its economic and financial problems in close cooperation with the international community, as Mr. Ayales stressed in his opening statement, are welcome, and I certainly agree that this effort warrants the Fund's support.

The program before us points in the right direction in that it emphasizes domestic financial restraint, external competitiveness, and overall economic efficiency. However, some questions arise in regard to the strength and place of the external adjustment effort and the prospects for the realization of the program's objectives.

As to the external adjustment, it is noteworthy that the current account deficit in terms of GDP is expected to remain almost as large in 1988 as it was in 1986, and that it could turn out to be even higher if additional financing became available. At the same time, Costa Rica is likely to face continued need for exceptional external financing throughout the medium-term projection period. Those projections advise against an increase in imports beyond the program targets. And this advice is underlined by the fact that the current account projection for 1988 rests in large measure on a continued strong expansion in nontraditional exports--which of course has still to materialize.

It is difficult to assess the feasibility of the program's objectives in the absence of agreed specific policy measures for the remainder of the adjustment period. While the reasons for this lack of specificity are understandable, the prospects of the program are also somewhat clouded by the substantial slippages that occurred in the indicative targets earlier in 1987. However, the authorities have repeatedly taken strong corrective measures to keep the program on track, including the most welcome adoption of a contingency plan to protect the fiscal position. Those efforts attest to the authorities' commitment to meet the original program objective for the two-year period 1987-88. With this in mind, I support the request before us on the merits of the prospects for adjustment.

However, like other speakers, I have considerable doubts about the appropriateness of granting an outright approval and of approving the external payments arrears in accordance with Article VIII.

I appreciate the reasons for the proposed course of action. It is indeed difficult to accept that the extent and pace of the normalization of external creditor/debtor relations is being dictated by one creditor group, though I am not sure to what extent Costa Rica itself might have contributed to the delays in reaching an agreement with the banks.

The proposed outright approval of the program would constitute substantial deviation from the established principles of Fund policy, which prescribe that at the time of program approval, the balance of payments has to be fully financed or--in case there is a financing gap--that there is reasonable assurance that that gap will be closed in the foreseeable future. Obviously, those requirements have not been met in the case before us.

It could be argued that the evolving nature of the debt strategy and its case-by-case approach would justify or even warrant a flexible interpretation of our guidelines for program approval. However, I strongly feel that the scope for such flexibility is limited by the Fund's role as a catalyst for external assistance and the need to secure the repayment of its own resources. It is difficult to see how the Fund should be able to carry out those responsibilities without insisting on the closing of balance of payments gaps prior to program approval. It should also be noted that Costa Rica will resume at least partial interest payments to the commercial banks without any corresponding commitment on their part to make contributions, and the Fund, by approving the program, would at least facilitate those payments to the banks. It is therefore a little surprising that the banks expressed their agreement with the arrangement which provides little incentive to the banks to expedite an agreement with Costa Rica.

The crucial question of course is what would happen if there were no such agreement by April 1988. Would the Fund then interrupt the program? In that event, what would the consequences be? In view of these unsettled, fundamental issues regarding Fund policy and in view of the risk of creating an undesirable precedent for future cases, the "approval in principle" would be the most advisable course of action.

I acknowledge that such a course of action would be of little immediate help either to Costa Rica or to the resolution of the fundamental issue arising for the Fund's current debt strategy. The Board should hold a discussion of the policy issues involved and then reconsider Costa Rica's request without delay in the light of that discussion's outcome. If this proposal was not acceptable to the Board and if the consensus is to grant an "outright approval," I could go along with such an approval, provided that it was on a clearly exceptional basis. Moreover, if a bank agreement is not in place by April 1988, disbursements under the program must be interrupted until an appropriate solution is found.

Mr. Ayales commented that approval in principle would not be very helpful to Costa Rica at the present time, for reasons that had already been mentioned. The most important reason was the absence of what was a basic consideration for the Board--to facilitate by approval in principle the conclusion of a financing package. The postponements in Costa Rica's negotiations with the banks were completely beyond the control of the Government. In addition, further delay in the approval of the Fund-supported program could increase the political pressures that might already be affecting the implementation of the program, because of the apparent lack of external support.

Mr. Vasudevan made the following statement:

We attach considerable importance to the Costa Rican request for a stand-by arrangement, which is interesting and challenging in that it requires considerable ingenuity on the part of the staff, the authorities, and the Executive Board to help Costa Rica resolve its main problem of external adjustment while ensuring enduring growth. The Fund staff and management have shown their willingness to rise to the occasion. The authorities have continued to show their commitment to the adjustment program and have taken corrective measures when the indicative targets were missed. This commitment is viewed by the authorities as a means of achieving "a harmonious relationship" with all of their creditors. It is the Board's turn to give full and fair consideration to this case, and respond in a manner that is flexible and helpful to the member country.

Fortunately for Costa Rica, the economic program for 1987-88 is reasonably satisfactory. The 1986 economic performance, in particular, has been good, except for the absence of debt relief and the sharp decline in net capital inflows including official transfers. The difficulties of implementing the program during the first half of 1987 were not serious, and the authorities took strong, corrective actions which provided what the staff called "a reasonable assurance that the original program objectives for the two-year period 1987-88 will be achieved." Apparently, there has been a strong private sector demand for bank credit, and the corrective measures taken impinged on the cost as well as the potential creation of credit. At the same time, the authorities provided sufficient incentives for private financial savings by maintaining a flexible interest rate policy.

Both the staff paper and Mr. Ayales's statement describe the fiscal, exchange rate, and structural policy areas in which actions either have already been taken, or are intended. I will, therefore, limit myself to making a few observations on some of these measures. In the fiscal policy area, I hope that the tax package will ultimately be given legislative approval. If this approval is not obtained, the contingency expenditure measures that have been developed would help realize the objective of reducing the public sector deficit. However, in that event, some of the expenditure cuts could have an impact on investment programs and on the development of important sectors, such as agriculture and housing. It would be unfortunate if investment outlays, which would have a favorable effect on growth over the medium term, were cut for the sake of observing the deficit target. I wonder whether the Fund cannot be somewhat flexible and agree to some critical minimum for investments in sectors of importance. We think that the real effective depreciation of the colón and the structural measures that are being taken to promote the production of tradable goods, exports, and trade liberalization will help achieve the program's major objectives. Despite the strong economic policy framework implied in the program, my authorities note that full financing for the program has not been ensured. The external financing requirement is about $200 million. This gap could have been financed had there been no protracted delay in agreement between the authorities and the commercial banks. These delays have had two results: first, they have prevented Costa Rica from regularizing its position with other creditors; second, they have hampered the flow of external financial assistance. The undesirable features of the present situation, however, could be avoided if the Fund supports this program.

Negotiations are currently being conducted between the authorities and the banks in an atmosphere of cooperation. The authorities intend to make partial interest rate payments to banks beginning this month, according to the cash flow plans under the program. In addition, the authorities propose to review the program toward the end of April 1988 to assess the adequacy of the external financing in connection with the package to be negotiated with the banks. The proposed agreement indicates that there are no substantial uncertainties regarding the financing of the program over the proposed time frame. In Costa Rica's exceptional circumstances, a stand-by arrangement would help the member to reach agreement with its bank creditors; further delays in reactive agreement would have the potential to disrupt the capital inflows and the implementation of the program. For these reasons, I support the proposed decision as amended.

Mr. Di Mauro made the following statement:

The program to be supported by the stand-by arrangement is in line with the thrust of recent successful adjustment efforts and deserves our support, as it contains an adequate set of policies to manage the resurgence and persistence of some domestic and external imbalances. However, because the approval of the stand-by arrangement in the presence of external arrears represents a major departure from the Fund's established practices, I feel some uneasiness about the proposed decision.

The stance of monetary and fiscal policies has been appropriately strengthened in view of the evident overheating of the economy. The flexible management of interest rates, the increase in reserve requirements, and the containment of fiscal imbalances are certainly appropriate steps to contain the pressure on the external accounts and dampen inflationary pressures.

However, the effectiveness of the fiscal measures is a cause for some concern. Because the Central Administration's fiscal expenditures have increased in the past fiscal years at sustained and increasing rates--12.4 percent in 1985 and 29 percent in 1986, compared with a growth in revenues of about 18 percent in the same years--a question arises as to whether the contingency mechanism envisaged by the authorities to contain expenditures by 3 percent in nominal terms can realistically be achieved. In particular, further information should be provided on the way the mechanism will actually be applied in the presence of presumably built-in indexation mechanisms, and on whether it will be included in the total budget or in a single expenditure category. In the latter case, I wonder how it could be compatible with the public sector wage agreement, which calls for the maintenance of constant real wages--which at current inflation rates would imply a nominal increase of at least 15 percent. Because the tax reform has not started yet and the terms of trade are affecting the budget negatively, a scrupulous expenditure control is needed to ensure the macroeconomic consistency of the program. The staff should comment on this issue.

In this respect and in the the presence of rising inflationary pressures, a policy of real exchange rate depreciation should be managed with caution to avoid the dangerous resurgence of a vicious circle of inflation and devaluation.

On the issue of Fund intervention in Costa Rica, I fully share Mr. Goos's well-articulated concerns. The outright approval of the stand-by arrangement in the face of external arrears is a departure from established Fund practice. This departure, even if it is required for alleviating the debt problem, has far-reaching legal implications. Other countries in similar circumstances might expect the same treatment. Moreover, such a departure might leave some scope for an unjustified delay in reaching agreement with commercial lenders.

In light of these concerns, the first preference of this chair would be to adhere to the established practice of the Fund, and consequently, to approve the stand-by arrangement in principle, pending the conclusion of the agreement with commercial lenders. However, if the majority of the Board is in favor of an outright approval of the modified proposed decision, I would not stand in the way of this and would go along with the majority, provided two conditions were met:

First, the maintenance of exchange restrictions should not be extended beyond April 30, 1988, and the authorities should work constructively to avoid the emergence of a similar situation. Second, no other similar case should be considered by the Board before it has discussed the legal implications of the present approval in principle.

Mrs. Ploix said that since the beginning of the 1980s, Costa Rica had maintained close relations with the Fund, as was reflected in the implementation of successive stand-by arrangements. The cooperative stance of the authorities should be considered in examining Costa Rica's request for a new stand-by arrangement.

The staff paper had made it clear that the fiscal position was broadly satisfactory. A significant degree of stringency had been applied since 1986, with a steady decline in the overall public sector deficit. Furthermore, the seriousness of the authorities' commitment for the future was evidenced by the formulation of a contingency plan, which was to be activated in case of slippages in the enforcement of the tax reform. The relatively sound position of state-owned industries was also noteworthy. On a related matter, she asked whether the structural measures designed to enhance the country's nontraditional export capacity rested primarily on private initiative or on the public sector enterprises. She agreed with previous speakers that structural reforms were needed.

The situation in the monetary field appeared less reassuring, Mrs. Ploix continued. During the first half of 1987, an upsurge of inflation was experienced mainly owing to lax monetary control over domestic credit expansion. Since then, corrective measures had been taken, but this experience could have pointed to some significant rigidities which hindered the efficacy of the Central Bank's operations. More specifically, the high cost of financial intermediation left little room for the authorities to make active use of interest rates.

Like other Directors, Mrs. Ploix considered that the external sector was a sensitive element of the program. However, considering the lengthy process of negotiations with the commercial banks, and the detrimental effect on domestic adjustment efforts, a workable solution had to be found, and her authorities agreed with the proposed decision as amended. The first review, which would be devoted to setting new targets for 1988, would provide a good opportunity for the staff to present a thorough status report on the negotiations with commercial banks. Her authorities were also ready to consider a thorough review of the potential legal implications of the current exchange restrictions included in the program.

Mr. Hogeweg made the following statement:

> Costa Rica's request for a stand-by arrangement has been submitted to the Board for approval prior to the conclusion of its rescheduling negotiations with the commercial banks. The Coordinating Committee of creditor banks has indicated that it is prepared, on the basis of Costa Rica's intention to proceed with the policy program to be supported by the Fund and the World Bank, to expedite negotiations to the extent possible. However, the staff has indicated that there are differences of opinion among the banks, and there is no certainty what the outcome of the negotiations will be. Costa Rica's request for a stand-by arrangement should be judged on the merits of the adjustment efforts contained in the program.
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> The implementation of the program contained in the April letter of intent has experienced some slippages, especially in the area of monetary policy. These slippages have led to a modification of the original, envisaged performance criteria. I note, however, that the additional measures being adopted by the authorities, in the staff's opinion, provide a reasonable assurance that the original objectives of the program through 1988 will be achieved. Those original policy objectives still leave much to be done. In time, however, those policies should lead to a better economic performance and a reduction in Costa Rica's dependence on external assistance. In this connection, I note the emphasis in the June proposal to the commercial banks on Costa Rica's "ability to pay," on the necessity of growth, and on not impinging excessively on the welfare of the Costa Rican people. From the medium-term scenarios, I gather that the external position of Costa Rica is extremely vulnerable to developments in interest rates, and coffee and oil prices. Even under an optimistic scenario, Costa Rica will need substantial debt relief. I am prepared to support the envisaged stand-by

arrangement, particularly because of the importance of external support for policies which have been frustrated for so long by delays in negotiations with the banks.

One important aspect of this request is that it is submitted for approval before agreement between Costa Rica and the banks has been reached, and while the outcome of the negotiations is highly uncertain. Approval of a stand-by arrangement without a rescheduling agreement with the commercial banks may be desirable in some cases. This is so when such approval would allow the Fund to better assist the member in the implementation of an adjustment program. Another example is when the Fund would want to avoid taking sides in negotiations between a member and the banks. Approval of a stand-by arrangement without a rescheduling agreement may also be desirable when it enables the Fund to avoid weakening its conditionality in the face of pressure arising from the need to reach an agreement with the banks. Perhaps the staff could elaborate, in light of the considerations I have just mentioned, on the precise nature of the delays in the negotiations between Costa Rica and the banks.

I welcome the amendment of the decision on payments restrictions, although, at least in theory, it seems to weaken the certainty of financing for the program. In addition, I especially welcome an opportunity to discuss the legal aspects of the original draft decision in the near future.

Finally, let me reiterate that the case-by-case approach is at the heart of the current debt strategy. In this strategy each case is judged on its own merits. The creation of a precedent is inconsistent with the debt strategy as it stands.

Mr. Finaish asked how the case-by-case strategy could be considered consistent with the principle of uniform treatment of members. That principle did not necessarily stipulate that members should be treated identically when circumstances were not the same. At the same time, however, if the circumstances involved in different cases were similar, or the same, members should be treated equally. Therefore, if the Board approved Costa Rica's request, it could not say that it was a special case, and that it was not setting a precedent, or at least not without explicitly or implicitly suggesting that it was not taking the right decision. The staff should explain the link between the case-by-case strategy and the principle of uniform treatment, especially as Costa Rica was not the first case that the Board would have approved, on the condition that it was not establishing a precedent. It was difficult to take that approach and be fair to other members.

Mr. Nimatallah said that he understood the special nature of the cases to which Mr. Finaish had referred to mean special cases under the debt strategy. Certainly, in the Fund's normal operations, the principle of uniform treatment still existed, and must continue to be respected. He agreed with Mr. Finaish that the Board could not say that the Fund's rules on uniform treatment would be ignored if other cases arose that were similar to those that the Board had previously branded as special.

Mr. Kafka said that it was his understanding that the case-by-case approach did not excuse the Fund from proceeding with uniform treatment, properly understood, which meant that similar cases--none were ever totally identical--would have to be treated similarly.

The Chairman remarked first that equal treatment of members was mandated by the Fund's Articles; second, precedents mattered, but never if the decision proved to be the wrong one; and, third, case by case meant that as no two cases were truly the same, the Board had to feel free to address each case on its merits. However, the Board had to recognize that there was an apparent contradiction between equality of treatment according to the Articles, and the flexibility involved in assessing specific cases. When the Board discussed the debt strategy in general, it could explore the issue in greater depth.

Mr. Finaish said that he agreed that each case should be considered on its own merits and circumstances, but if the circumstances and merits recurred, the same, or similar, treatment should be repeated. Of course, wrong decisions should not be repeated, but should be recognized as such. Members must feel that they were being treated equally.

Mr. Lim said that the case before the Board was a difficult one. Costa Rica had shown a willingness to adopt significant adjustment measures, including those taken in September 1987 in an effort to correct its economic difficulties, and meet the objectives set out in the program to be supported by a stand-by arrangement. His authorities endorsed the objectives of the program and, in particular, supported the exchange rate and fiscal policy objectives, including the provision for contingency expenditure measures in the event of possible revenue shortfalls.

In normal circumstances, the program was one that his authorities would readily support, Mr. Lim added. However, the Board was being asked to go beyond the special case of granting approval in principle--where agreement on the financing package was expected to follow shortly--to approve the stand-by arrangement when agreement with the commercial banks was still a considerable way off. Nevertheless, there were good reasons for the recommendation that the stand-by arrangement be approved. Costa Rica had negotiated the adjustment program with the Fund as long ago as April 1987, and had made a firm commitment to the policies envisaged in it. The negotiations with the commercial banks had been delayed for reasons, that, the Board was told, were at least partly beyond the control of the authorities.

For some time his authorities had argued that the debt strategy must be carried out flexibly, on a case-by-case basis, Mr. Lim noted. Costa Rica's request for a stand-by arrangement appeared to be one in which the

Fund could diverge from the usual procedure, and if the majority of the Board supported the modified decision, his authorities would also agree to it, but on the clear understanding that it was a special case.

Mr. Fogelholm observed that Costa Rica was facing acute domestic and external imbalances as well as many structural problems. In order to address those problems, the authorities had developed an economic program which had subsequently been strengthened and a number of corrective measures had been undertaken. The program was, however, still fragile, and it was clear that it did not allow for any slippages. The authorities should reduce the deficit further and, if possible, adopt more stringent measures in the fiscal area. His authorities were pleased to note that the Costa Rican commitment to the program seemed strong, as was indicated by the contingency plans they had worked out in case the proposed tax package was not approved by Congress.

It was quite obvious that Costa Rica needed the program to be supported by the requested stand-by arrangement, Mr. Fogelholm said. The arrangement would allow Costa Rica to regularize its position with other creditors, obtain external assistance, and gradually improve its external situation. It would be unreasonable to expect Costa Rica to wait any longer to implement the program because the banks could not agree among themselves. He, therefore, supported the proposed decision.

However, his authorities were somewhat concerned about the legal implications of the decision, Mr. Fogelholm added. Therefore, they also supported the proposal that the Board should take up the legal issues involved before any other similar cases were brought to the Board. His authorities were also uneasy about the fact that Costa Rica would be in violation of Article VIII. They believed that the case of Costa Rica and other similar cases involving violations of the Fund's Articles, should be dealt with by the Board on an appropriate occasion.

Mr. Sugita said that his authorities were eager to help Costa Rica, and had no difficulty in supporting the proposed program. However, they regretted that the proposed handling of Costa Rica's case would involve a deviation from the Fund's established practice of approving requests for stand-by arrangements only after the necessary financing negotiations have been completed. Ideally, there should have been general discussions regarding the timing of Fund approval of programs in relation to financing negotiations and the legal implications involved before Costa Rica or any other specific case, had been brought to the Board's agenda. Therefore, it was with considerable reluctance that his authorities agreed to the proposed decision. In addition, he was concerned about the manner in which the legal issues had been handled. The modification of the proposed decision had not been explained sufficiently, and issues that affected third parties--including commercial banks--should be examined extensively in the staff paper. Moreover, proposals involving such issues should not have been put before the Board and considered hastily.

Mr. Nimatallah said that the attempt to help Costa Rica brought to mind a similar case, that of Nigeria, which in 1984 had sought the Board's approval of a stand-by arrangement at a time when it was holding protracted negotiations with the banks. Some Directors had insisted on obtaining the critical mass of the financing package as a condition for outright approval, even though only a small amount was unaccounted for. But after strong appeals by others for flexibility, the Board had finally agreed to approve Nigeria's request. He was pleased to note that the Board was taking a flexible approach in the Costa Rican case.

In the first sentence of its appraisal, Mr. Nimatallah noted, the staff stated that "Costa Rica experienced a deep recession and serious balance of payments difficulties in the early 1980s as a result of adverse external factors and shortcomings in domestic policies." He had hoped that Costa Rica would adjust to those circumstances, which were beyond its control, and adopt appropriate policies. In fact, Costa Rica had been cooperating with the Fund; it had had several stand-by arrangements and one extended arrangement. But he would have liked Costa Rica to adhere more closely to its adjustment programs, particularly the one approved in 1985. In that year, there had been two favorable factors: the increase in coffee prices, and the large decrease in oil prices. He had hoped that Costa Rica, like other countries, would take advantage of those factors to continue with its program and with policies to reduce its deficits, and persevere with the effort to tackle problems it had faced since the beginning of the 1980s. Unfortunately, however, the Costa Rican authorities had relaxed instead of continuing, or even strengthening, their adjustment effort.

If there were any slippages in the program to be supported by the new stand-by arrangements, several unfavorable consequences would ensue for Costa Rica, particularly in its relations with the banks, Mr. Nimatallah continued. He understood that the banks wanted Costa Rica to show more continuity and resolve in facing its problems. Any slippages on the fiscal front or in the flexible exchange rate policy might thus be harmful to Costa Rica. The authorities should therefore be careful in the way in which they carried out their commitment to continued adjustment.

The absence of an agreement between the Costa Rican authorities and the banks by 1988--and he foresaw the possibility of further delay in certain areas--might jeopardize the Fund's good relations with all parties, including the banks, Mr. Nimatallah commented. The banks were anxious for the Fund to continue to play its catalytic role, which was very important in obtaining financing for members. Therefore, the Fund must emphasize that agreement between the banks and Costa Rica was in everybody's interest, including the Fund's.

Costa Rica could not afford to live beyond its means, Mr. Nimatallah stated, particularly because of its debt and limited resources. However, he had been encouraged to approve the proposed program because nontraditional exports were expected to do well in 1988. He hoped that the authorities would stand ready to undertake further adjustment and prevent any possible disruption in the program in case of unexpected fluctuations in exports. The need for the authorities to maintain the momentum of their efforts was the main reason for his support of the program, as indeed it had been for his support of Nigeria's request in 1984.

The Chairman noted that Mr. Nimatallah was right to stress the need to preserve the catalytic role of the Fund, and the quality of its relations with the banks. The Fund must have continuous, good relations with the Coordinating Committee of Costa Rica's creditor banks, which had been informed of the Fund's intention to support Costa Rica's program. For their part, the banks had indicated their preparedness to expedite negotiations on the financing package for Costa Rica to the extent possible, in recognition of the consistency of the Fund's action with the cooperative, case-by-case approach under the debt strategy. He hoped that the agreement between the banks and Costa Rica, which was to be reached by the end of April 1988, would permit the elimination of Costa Rica's external arrears by mid-1988. If the Board helped to accomplish that goal, it would not necessarily set a precedent as such, but it would contribute to the quality of the Fund's relations with the banking community.

Mr. Nimatallah said that his concern was that in case there would be no agreement by April, and a clear conflict arose between Costa Rica and the banks, the Fund might appear to be taking a one-sided position. He wanted to preserve the neutrality of the Fund's relationship vis-à-vis the banks and its members.

The Chairman responded that management and staff had been careful not to take sides in the negotiations between Costa Rica and its commercial bank creditors. The program the Board was discussing did not assume financing on concessional terms, although it was Costa Rica's prerogative to seek the most advantageous terms possible from the banks. The Fund had simply urged both parties to conclude the negotiations on time.

Mr. Prader said that his authorities had a number of serious reservations about the approval of the stand-by arrangement, in particular because of the legal implications. Costa Rica's difficult economic and financial situation was the only reason his authorities could support the proposed decision as amended.

Mr. Kabbaj stated that he agreed that the Fund should exercise flexibility and judgment in respecting the criterion of equality of treatment of members. At the same time, the Board should not ignore the real problem that underlay the legal and procedural discussions, namely, that of the relationship between the banks and the debtor countries. He did not question the good intentions of those Directors who wanted the Fund to stay neutral. Unfortunately, he had first-hand knowledge of the unequal relationship of the banks and countries in such negotiations. Countries were not in a position to exert the same kind of pressures as the banks, and by withholding programs, the Fund added to that pressure, perhaps without realizing it. Banks were given an opportunity to force countries to accept what were sometimes unreasonable terms, or to wait, perhaps for months, for the negotiations to begin or for the relevant documents to be distributed. He could cite two recent examples of such pressure on Morocco, which after satisfactory negotiations, and the signing of the term sheets, had nevertheless had to wait five months to receive the first draft agreement. Apparently, the banks had been preoccupied with reaching agreements with other, larger countries. Under such circumstances, approval in principle was of little use; the country's program would soon be off track. The second example had occurred that week. One small bank, which held $100,000 of Morocco's outstanding credit, was holding up an agreement to renegotiate more than $2.5 billion by not signing the papers. The Board might take such lack of agreement as a signal that the country had not finalized its agreements with the banks. Such negotiating problems placed countries in a very difficult position.

The Fund should not withhold approval, or approve arrangements in principle, Mr. Kabbaj concluded. Arrangements should be approved outright whenever possible. Of course, the Board had to make a finding that the country was negotiating with its creditors, but it should not use the procedure of approval in principle unless the country had shown that it was taking an unreasonable attitude in its negotiations with the banks. Furthermore, if the Board was going to follow the procedure of approval in principle, it should make a firm distinction between agreements that involved reschedulings only and agreements that included new money packages. If new money was involved, the banks had to be more careful and the Fund also should be more careful in assuring that the financing was secured. The Fund should not be involved in negotiating financial terms where it was a matter of rescheduling only.

The staff representative from the Western Hemisphere Department observed that the question of the adequacy of the exchange rate level had perhaps arisen because there was no longer a column for 1981 in Table 2 in Supplement 1 to EBS/87/91 on selected economic and financial indicators. In that year, the real effective depreciation of the colón was about 110 percent.

The adjustment in the external account between 1986 and 1988 would not be a significant one, with the deficit declining from 5.1 percent of GDP to 5 percent, the staff representative added. However, it was necessary to take into account the improvement in the terms of trade effect in respect to coffee and oil prices, which was equivalent to about 2 percent of GDP. The underlying trend was therefore one of a substantial adjustment, particularly in light of the reversal in coffee prices envisaged under the program.

As for the fiscal effort, the combined deficit of the nonfinancial public sector would be halved, from 5.8 percent of GDP in 1986 to about 3 percent of GDP in 1988, the staff representative commented. The reduction was significant, particularly in light of the changes in the terms of trade, which had a serious impact on revenue collection and on costs that were reflected in the fiscal accounts, the petroleum refinery being part of the nonfinancial public sector. In discussing the fiscal aspects of the program, the staff had always stressed the need to focus on cutting current expenditures. In addition, as Directors had noted, the effect on development and growth had to be taken into account. There was little room to cut wages and interest payments, and most of the adjustment had been made in transfers to the public sector and capital expenditures. It was important to note that the cuts in the public investment program had not been made across the board. In that respect, the staff had been guided by the review of the investment program, which was being made on a continuing basis. The review had revealed a substantial investment in social infrastructure--including, for example, telephones and electrification--that had brought public services in those areas up to the highest standards in the region. Another World Bank mission would be visiting Costa Rica shortly, and one of the subjects for discussion would be by precisely how much and in which specific sectors the adjustments in investment could be made.

Following a total increase of public expenditures in 1986 of 28 percent, the staff considered that it was feasible to slow down the rate of increase to about 3-8 percent, the staff representative commented. It should be borne in mind that the fiscal package did not involve only expenditure cuts, but revenue enhancing measures, either through legislative tax proposals or administrative improvements in tax collection.

A variety of measures were being introduced to expand exports, the staff representative said, the main one of course being the very active exchange rate policy. Much was being done, including in the context of the second structural adjustment loan from the World Bank, to correct what had been called Costa Rica's antiexport bias. The process of reducing effective protectionism had begun early in 1986, and further progress had been made recently with a reduction of duties on almost all imports and of some surcharges. Efforts were being made to provide incentives to investors in the export sector by simplifying export contracts, offering favorable opportunities to participate in the debt conversion scheme, and improving the physical facilities for the storage and handling of commodities in the ports, as well as by putting exporters in touch with the main centers of demand for Costa Rican commodities.

The second review of the program, to be held by April 30, 1988, would focus on the adequacy of the financing for the remainder of the program period, the staff representative stated. Meetings between the Costa Rican authorities and the commercial banks would resume in New York on the following day. As for the nature of the delay in the negotiations, the banks had not accepted a concessional proposal which the authorities had put forward in mid-1986. Several months later, the discussions had resumed, but several problems had emerged, including a request by the banks that Costa Rica negotiate a program with the Fund before formal meetings were held. The letter of intent had been circulated to the Executive Board in April (EBS/87/91, 4/27/87), and the negotiations with the banks had once more been resumed in June 1987. Several difficulties had emerged at that stage. The banks considered that the contributions that they were to make, which would increase their exposure by 10 percent during the period 1986-88, were excessive; there were also differences of view among the banks on the modalities of the package. Apparently, the banks were concerned with setting a precedent. However, the authorities had then presented a second, less concessional proposal to the banks. Nevertheless, owing to the difficulties that the banks themselves had in reaching a unified position, the banks had informed the authorities that they would resume negotiations only after the Annual Meetings of the Fund and the World Bank.

As for the effect of the program on the authorities' policy of maintaining constant real wages, the staff representative from the Western Hemisphere Department said that although real wages had been on an increasing trend in recent years, the authorities were maintaining their effort to keep them constant. If they succeeded, real wages in 1987 and 1988 might be somewhat below the level they had reached in 1979/80 before the recession.

Mr. Nimatallah remarked that his concern had been based on the possibility of hidden indexation in the program, which in his judgment was the most effective accelerator of inflation.

The staff representative from the Exchange and Trade Relations Department said that he wanted to stress how important it was for Costa Rica and the banks to reach agreement by April 1988. The first review under the stand-by arrangement scheduled for January 1988 would give the Board an opportunity to review the status of the financing package. Each disbursement under the arrangement until mid-1988 would depend on the completion of a review by the Board. But an agreement by April 1988 was also of importance to the commercial banks. Costa Rica was a debtor country that was obviously cooperating with its creditors, and it would be politic for the banks to exert their utmost efforts to reciprocate.

Mr. Ayales said that his authorities remained fully committed to their economic program, as they had been since the current Administration took office 18 months previously. In fact, the economic policy of the Administration had been framed along the lines of a shadow Fund-supported program. There had been slippages in the early part of 1987, but most of them were due to difficulties stemming from an apparent lack of external support for the economic program. Strenuous efforts had been made in different areas. The current fiscal situation was healthy, the deficit as a proportion of GDP having been reduced from 15 percent to 3 percent within four to five years, an important accomplishment. As Mr. Nimatallah had observed, one weak point was wage policy, which had had to cope with the rigidities introduced under previous wage agreements among various parties. The present Government was trying to introduce flexibility into the wage determination process, and had made a beginning in that direction by stopping the rising trend of real wages, which should show a small reduction in 1987.

In addition to the increase in interest rates, a clear indication that the authorities' monetary measures were taking hold was the decline in the rate of expansion in the monetary base, Mr. Ayales observed. That rate had fallen from an average 40 percent in 1986 to about 15 percent in the first semester of 1987; for the third quarter, the average monthly rate of monetary expansion was about 5 percent or 5 1/2 percent. Monetary policy had also been supported by very flexible exchange rate and interest rate policies. The real depreciation of about 15 percent of the colón expected for 1987 would be the main element in the Government's export promotion scheme.

The negotiations with the banks were being resumed, Mr. Ayales said, with the expectation that the banks would be more cooperative. The authorities understood that more than Costa Rica's financing package was at stake, but they were nevertheless trying to finalize the negotiations in order to regularize their situation with external creditors.

The Chairman said that he had taken note of the wish expressed by Directors to avoid the need to take up other cases similar to that of Costa Rica before the Board had had an opportunity to discuss the general paper to be prepared by the staff on the legal and policy issues raised by arrears that constituted a payments restriction under Article VIII. The paper would be issued for discussion within the next few months. Meanwhile, every effort would be made to avoid bringing similar cases to the Board although he would count on Executive Directors' understanding should it become necessary to take up other cases.

The Executive Board then took the following decisions:

Stand By-Arrangement

1. The Government of Costa Rica has requested a stand-by arrangement for the period from October 28, 1987 through March 31, 1989 in an amount equivalent to SDR 50 million.

2. The Fund approves the stand-by arrangement set forth in EBS/87/91, Supplement 3.

3. The Fund waives the limitation in Article V, Section 3(b)(iii) of the Articles of Agreement.

Decision No. 8716-(87/150), adopted
October 28, 1987

Exchange System

Costa Rica engages in a multiple currency practice for certain remittances. The Fund grants approval for the retention of the remaining multiple currency practice until the earlier of the completion of the second review under the stand-by arrangement, or April 30, 1988.

Decision No. 8717-(87/150), adopted
October 28, 1987

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/87/149 (10/26/87) and EBM/87/150 (10/28/87).

3. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/87/231 (10/26/87) and by Advisors to Executive Directors as set forth in EBAP/87/228 (10/23/87) is approved.

APPROVED: May 19, 1988

LEO VAN HOUTVEN
Secretary