EBS/85/31
Supplement 2

CONFIDENTIAL

March 14, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Costa Rica - Stand-By Arrangement

Attached for the records of the Executive Directors is the text of the stand-by arrangement for Costa Rica agreed at Executive Board Meeting 85/40, 3/13/85.

Att: (1)

<u>Stand-By Arrangement - Costa Rica</u>

Attached hereto is a letter, dated January 11, 1985, from the Executive President of the Central Bank and Minister of Finance of Costa Rica requesting a stand-by arrangement and setting forth the objectives and policies that the Government of Costa Rica intends to pursue. To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For the period from March 13, 1985 to April 12, 1986, Costa Rica will have the right to make purchases from the Fund in an amount equivalent to SDR 54 million, subject to paragraphs 2, 3, 4, 5, and 6 below, without further review by the Fund.

2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 14,000,000 until April 30, 1985, the equivalent of SDR 24,000,000 until July 31, 1985, the equivalent of SDR 34,000,000 until October 31, 1985, and the equivalent of SDR 44,000,000 until January 31, 1986.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Costa Rica's currency in the credit tranches beyond 25 percent of quota, or increase the Fund's holdings of that currency resulting from purchases of supplementary financing or borrowed resources beyond 12.5 percent of quota.

3. Purchases under this stand-by arrangement shall be made from ordinary and borrowed resources in the ratio of 1 to 1, provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Costa Rica will not make purchases under this stand-by arrangement, other than the initial purchase of SDR 14,000,000 that it may request not later than within 15 days of the effective date of this arrangement, that would increase the Fund's holdings of Costa Rica's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of supplementary financing or borrowed resources beyond 12.5 percent of quota:

(a) during any period in which the data at the end of the last reporting period not more than three weeks earlier show that

(i) the limit on the domestic banking system's net credit to the nonfinancial public sector set forth in Table 2 annexed to the attached letter;

(ii) the limit on the net domestic assets of the Central Bank of Costa Rica set forth in Table 3 annexed to the attached letter;

(iii) the target for the net international reserve position of the Central Bank set forth in Table 4 annexed to the attached letter;

(iv) the limit on the outstanding stock of payments arrears set forth in Table 5 annexed to the attached letter is not observed; or

(b) during any period in which the data at the end of the last reporting period not more than seven weeks earlier show that the limit on the amount of new foreign loans contracted or guaranteed by the public sector, and the net short-term foreign indebtedness of the nonfinancial public sector, as set forth in paragraph 10 of the attached letter is not observed; or

(c) during any period after August 31, 1985 if the review contemplated in paragraph 16 of the annexed letter has not been completed or, if further understandings have been reached pursuant to the review, while such understandings are not being observed; or

(d) during any period after January 30, 1986, in which there remain any external payments arrears relating to the rescheduling of external public debt currently under negotiation, until understandings have been reached between the Fund and Costa Rica on the completion of individual rescheduling agreements; or

(e) during the entire period of the stand-by arrangement, if Costa Rica:

(i) imposes or intensifies restrictions on payments and transfers on current international transactions other than as described in paragraph 13 of the attached letter; or

(ii) introduces multiple currency practices; or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII; or

(iv) introduces or intensifies import restrictions for balance of payments reasons.

When Costa Rica is prevented from purchasing under this stand-by arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Costa Rica and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Costa Rica will not make purchases under this stand-by arrangement during any period of the arrangement in which the member has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action in respect of a noncomplying purchase.

6. Costa Rica's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Costa Rica. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 6, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Costa Rica and understandings have been reached regarding the circumstances in which such purchases can be resumed.

7. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Costa Rica, the Fund agrees to provide them at the time of the purchase.

8. The value date of a purchase under this stand-by arrangement involving borrowed resources will be determined in accordance with Rule G-4(b) of the Fund's Rules and Regulations. Costa Rica will consult the Fund on the timing of purchases involving borrowed resources in accordance with Rule G-4(d).

9. Costa Rica shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

10. (a) Costa Rica shall repurchase the outstanding amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Costa Rica's balance of payments and reserve position improves.

(b) Any reductions in Costa Rica's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) The value date of a repurchase in respect of a purchase financed with borrowed resources under this stand-by arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that repurchase will be completed not later than seven years from the date of purchase.

11. During the period of the stand-by arrangement Costa Rica shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Costa Rica or of representatives of Costa Rica to the Fund. Costa Rica shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Costa Rica in achieving the objectives and policies set forth in the attached letter.

12. In accordance with paragraph 16 of the attached letter, Costa Rica will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Costa Rica has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the government or at the request of the Managing Director, concerning Costa Rica's balance of payments policies.

San Jose, Costa Rica
January 11, 1985

Mr. J. de Larosière
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Larosière:

1. In the last two years, Costa Rica has made great strides in recovering from the economic and financial crisis which was experienced during the period 1980-82. That crisis had its origin in a series of shocks to Costa Rica's external environment which included a substantial decline in the terms of trade associated with a sharp fall in coffee prices and the second round of oil price increases, the world recession and the unprecedentedly high interest rates which accompanied it, and the political and economic upheaval in the Central American region. The failure to adjust domestic economic policies to these developments led to unsustainably large deficits in the public sector and the current account balance of payments, the suspension of debt service payments in mid-1981 and a rapid depreciation of the internal and external value of the colon.

2. During the second half of 1982, the Costa Rican Government set in motion a sequence of adjustment measures which laid the basis for a successful stabilization of the economy during 1983. This program was supported by a one-year stand-by arrangement which was approved by the Fund in December 1982. The main objectives of the program were to regain relative price stability, to strengthen the balance of payments and to restore confidence through the elimination of external debt arrears and the resumption of service payments on external public debt. Substantial increases in public enterprise tariffs and central government taxes were introduced in order to bring about a significant reduction in the overall public sector deficit which had been a major cause of Central Bank credit expansion in the preceding years. At the same time, the exchange markets were reorganized with the objective of achieving a unification of the banking market and free market exchange rates on a gradual basis by the end of 1983. Finally, negotiations were begun with foreign governments and commercial banks on a rescheduling of Costa Rica's external debt arrears and loan repayments falling due in 1983 and 1984.

3. The results of the program in 1983 turned out to be better than expected. As a result of decisive action on the fiscal front and the stabilization of the free market exchange rate, domestic inflationary pressures subsided quickly; the rate of consumer price increases dropped to about 10 percent at the end of 1983, compared with a rate of 82 percent in 1982 and a target of 40 percent in the program. The improvement in the financial position of the rest of the public sector, in particular the Social Security Institute, the National Electricity Company (ICE),

and the State Oil Refinery (RECOPE) was stronger than expected, with the result that the current account balance of the nonfinancial public sector shifted from a deficit of 3 percent of GDP in 1982 to a surplus of 3 1/2 percent of GDP in 1983, while its overall deficit was reduced to the equivalent of around 3 1/2 percent of GDP, compared with one of 9 percent in 1982 and a program target of 4 1/2 percent. In the external sector, the trade account weakened, and consequently the current account deficit increased to around 10 1/2 percent of GDP in 1983, instead of declining to 8 percent as called for in the program. Nevertheless, partly reflecting a reflow of private capital, there was a substantial improvement in the overall balance of payments which led to the formal unification of the exchange markets in mid-November 1983. In addition, as a result of rescheduling agreements with the Paris Club and the foreign commercial banks, virtually all external debt arrears were eliminated at the end of the program.

4. *During 1984-85, the Government of Costa Rica is determined to* consolidate the gains achieved under its stabilization program to date by continuing to strengthen its fiscal performance and balance of payments position so as to provide the basis for a sound economic recovery. Accordingly, the Government has developed a program which is designed to bring about a significant reduction in the current account balance of payments deficit and a replenishment of the foreign reserve position of the Central Bank. In support of this effort, the Government of Costa Rica would like to count on the continued support of the International Monetary Fund, and hereby requests a thirteen month stand-by arrangement in the amount of SDR 54 million. The key elements in the Government's adjustment program in the area of fiscal, monetary, incomes and external sector policies are explained below.

5. As a primary objective of fiscal policy, the Government has the intention of moving the nonfinancial public sector over the next few years towards a position of overall equilibrium. Consistent with this medium-term objective, the Government intends to limit the overall deficit of the nonfinancial public sector in 1985 to no more than 1 1/2 percent of GDP, compared with an estimated 2 1/2 percent in 1984 and 3 1/2 percent of GDP in 1983. The deficit in prospect will be reflected at the level of central government operations, as the rest of the nonfinancial public sector is expected to be in approximate equilibrium. As a result of a number of tax measures introduced during the course of 1984, central government revenues are projected to rise from the equivalent of 17 percent of GDP in 1983 to 20 1/2 percent in 1985. These measures included increases in selective consumption duties, a modification of the corporate income tax and a reduction in import duty exemptions. At the same time, the earmarking of revenues to the rest of the public sector has been reduced and centralized in the budget in 1984 and 1985.

6. On the expenditure side, the Government is committed to the pursuit of a policy of restraint in 1985. To this effect, a freeze on government employment was instituted last year and programs were established to accelerate the retirement of older workers and facilitate the shift of public employees to the private sector labor force. Also, transfers to the rest of the public sector are being held below budgeted levels, and only those investment projects will be implemented which can be financed with long-term foreign borrowing, mainly of a concessional nature. As a result, the growth of central government expenditure, in relation to GDP, is estimated to have moderated sharply in 1984 and is to remain unchanged in 1985. The tax and spending patterns outlined above will bring about a reduction in the overall government deficit from 3 1/2 percent of GDP in 1982-83 and an estimated 2 1/2 percent in 1984 to around 1 1/2 percent in 1985. In order to monitor compliance with the fiscal program, the Government has established quarterly limits for cumulative expenditure commitments in 1985, as set out in Table 1, which are consistent with the target for the overall central government deficit mentioned above. In the event that these limits are exceeded, the Government will consult immediately with the Fund staff on the remedial measures needed to bring performance into line with the program.

7. The further strengthening of the public finances in 1985 also will depend on an improvement in the financial position of the rest of the public sector. As in the last program with the Fund, a series of adjustments in local utility rates have been implemented to strengthen the current account position of the main state enterprises. Early in 1984, adjustments in ICE's electricity and telephone rates amounting to, on average, 9 percent and 70 percent, respectively, and an increase of 70 percent in the case of the rates charged by the State Water Authority (ICAA) were introduced. ICE's utility rates were further increased by 12 percent on January 1, 1985. These tariffs will be revised periodically to ensure that they are adequate to cover operating costs and to generate sufficient domestic resources to support the investment program of these enterprises. Also, the prices for basic grain operations of the National Production Council (CNP) are being adjusted in order to reduce its domestic financing requirements to a minimum level. In the case of RECOPE, the prices of its domestic fuel products will be adjusted to reflect increases in the cost of petroleum imports. The improvement in the savings performance of the rest of the public sector in 1984-85 will be reflected in an increase in transfers to the Central Government. The Government has also initiated a process, based on the authorization of the Legislative Assembly, of selling some of the major enterprises controlled by the state-owned development corporation (CODESA). These sales will permit the reorientation of CODESA's future operations and the reduction of its net indebtedness to the Central Bank.

8. In order to further strengthen public sector operations in the future, the Government intends to reduce substantially and permanently the scope of revenue earmarking and compulsory spending. To this effect, a proposal for the constitutional reform of the public finances has been presented to the Legislative Assembly, which will be reviewed by the Special Commission on Fiscal Reform which is to report its recommendations by March 31, 1985. Until a reform bill is approved, the Government does not intend to introduce any new revenue earmarking. Furthermore, the temporary reduction of earmarked taxes in the 1984 budget has been extended and increased in the 1985 budget. The Government's reform proposal, together with a strengthening of the Budgetary Authority, will facilitate the achievement of a better control of public expenditure and will make it possible to continue to reduce the public sector deficit in future years.

9. The programmed financial improvement during 1985 will mean that the nonfinancial public sector will have no recourse to domestic financing for the period of the program, as the overall fiscal deficit will be financed mainly by the use of foreign long-term borrowing, mostly on concessional terms. Consistent with this result, limits on domestic bank financing of the nonfinancial public sector have been established for the period of the stand-by program, as presented in Table 2, which take into account only seasonal financing needs. It is also the intention of the Government not to increase its domestic bond placements outside the domestic banking sector and floating debt (arrears) during the period of the financial program above the levels outstanding as of the end of December 1984, except for seasonal financing needs through domestic bonds placements.

10. As mentioned above, the Government intends to finance the operations of the public sector in the future mainly with the proceeds of foreign long-term concessional borrowing. In view of the rescheduling in 1983 of substantial arrears on foreign commercial debt service and of repayments of principal falling due during 1983 and 1984, the Government intends to limit its recourse to foreign commercial borrowing in the future to minimal amounts. Much of the present debt servicing difficulties has arisen from inappropriate external borrowing policies in the past, particularly the heavy utilization of short-term loans. In accordance with the Government's policy of improving the external debt profile over the medium term, the contracting by the public sector (including public financial institutions) of new foreign loans with maturities of over one year up to and including twelve years will be limited to US$50 million during the period of the program. Within this overall ceiling, new commitments with maturities of over one year and up to and including five years will be limited to US$25 million. This ceiling will also apply to officially guaranteed private sector loans and suppliers' credits, but will exclude any new loans directly related to the refinancing or rescheduling of existing external public debt, and credits under the Mexico-Venezuela oil facility. The Government also intends not to increase its recourse to short-term foreign borrowing; accordingly, during the program period, the net short-term foreign commercial indebtedness of the nonfinancial public sector, excluding normal trade credits, will not increase over the balance outstanding at the end of September 1984 (US$3 million).

11. The reduction in the domestic financing requirements of the non-financial public sector, together with the Central Bank's policies of credit control, will ensure that the rate of overall bank credit expansion is consistent with the Government's price and balance of payments objectives. The projected increase in domestic bank credit in the program is intended to ensure that sufficient financial resources are available to support the continued, gradual reactivation of private sector production and investment. In this connection, the interest rate policy of the Government is intended to achieve a balance between the need to provide adequate incentives to the growth of financial savings and the need to avoid hampering the productive efforts of the country. The authorities intend to maintain a flexible interest rate policy whereby the basic rate on six-month deposits, to which most rates in the system are related, will be adjusted from time to time to reflect the domestic rate of inflation, movements in interest rates abroad, the demand for private sector credit and the growth of domestic financial savings. At present, most interest rates in the banking system are positive in real terms and will be maintained as such during the program period. At the same time, the structure of Central Bank lending rates has been revised and subsidized credit operations are being reduced in order to lower the losses of the Central Bank. It is also the Government's policy not to increase the existing nominal tax rate of 5 percent on interest earnings. Consistent with the credit needs of the private and public sectors and the objective of increasing the net foreign reserve position of the Central Bank, ceilings have been established for the net domestic assets of the Central Bank over the program period, as set out in Table 3.

12. The Government is determined to ensure that the burden of economic adjustment is distributed equitably. This will be done in a manner consistent with the conviction of the authorities that in the present circumstances and for the foreseeable future, market forces should be the main determinant of prices, and that administrative controls and subsidies should be limited to a minimum number of basic consumer products, mainly benefitting low-income groups. Wage policy will be geared to reducing inflationary pressures, while minimizing the effects of price increases on low-income groups. Therefore, during 1985, public sector salaries and private sector minimum wages will be adjusted in absolute amounts in accordance with the increased cost of a basic basket of goods and services ("canasta basica").

13. In the external sector, the Government intends to pursue a flexible exchange rate policy whereby the value of the colon will be adjusted from time to time to reflect developments in the balance of payments and price changes in the domestic market and among its trading partners abroad. Consistent with this stance, the authorities also intend to avoid the accumulation of any arrears in the future for payments and transfers for current international transactions, including external debt

service payments, except in the case of arrears that may materialize on external public debt currently under negotiation for rescheduling with foreign commercial banks and bilateral creditors. In order to test compliance with this objective, the Government has established quarterly targets for the net international reserves of the Central Bank, as set out in Table 4, which incorporate seasonal factors and are defined to include payments arrears. The existing arrears, other than those related to rescheduling agreements under negotiation, will be eliminated before the end of 1985 according to the schedule set out in Table 5. Any arrears that may arise in respect of external public debt presently under negotiation with foreign banks and bilateral creditors in 1985 will be matched by an equivalent increase in the net official international reserves of the Central Bank for the amount not assumed to be rescheduled. To monitor the emergence of any arrears in the future, other than those on public sector debt service, the authorities are now requiring that all applications for foreign exchange purchases be backed by a counterpart deposit in local currency equivalent to 100 percent of the amount requested. It is also the firm intention of the Government to continue its policy of not issuing exchange guarantees on external obligations which could give rise to losses for the Central Bank.

14. During the period of the program, the Government of Costa Rica does not intend to introduce or intensify restrictions on payments and transfers for current international transactions, introduce any multiple currency practices, conclude any bilateral payments agreement which is inconsistent with Article VIII of the Articles of Agreement, or introduce any new or intensify any existing restriction on imports for balance of payments reasons.

15. As part of its external sector policies, the Government also intends to restructure its external tariff and system of export incentives with a view to reorienting domestic production towards export promotion and diversification. To this effect, the Government has recently revised the system of export incentives and has enacted legislation which will shift promotion efforts toward sectors with a high component of domestic value added. The authorities also intend to revise the customs tariff on July 1, 1985 by substituting the Brussels nomenclature for the existing NAUCA classification and by replacing specific duty rates with ad valorem ones. In addition, the Government intends to change the tariff structure, in the context of a structural adjustment loan (SAL) with the World Bank, with a view to reducing the dispersion of tariff rates and the effective level of protection in accordance with its export promotion goals.

16. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of the program, but will take any further measures that may become appropriate for this purpose. The Government will consult with the Fund on the adoption of any measure that may be appropriate, in accordance with the policies of the Fund on such consultation. Progress made in the implementation of the program, especially in the area of exchange rate and fiscal policies, CODESA's divestment program and fiscal reform, will be reviewed with the Fund before August 31, 1985.

Sincerely yours,

/s/
Porfirio Morera Batres
Minister of Finance

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

ATTACHMENT

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

(Cumulative amounts in millions of colones)

Periods	Limits
Jan. 1, 1985 - Mar. 31, 1985	7,640
Jan. 1, 1985 - June 30, 1985	17,710
Jan. 1, 1985 - Sept. 30, 1985	28,685
Jan. 1, 1985 - Dec. 31, 1985	40,741

1/ Defined as the sum of budgetary expenditures (gastos comprometidos y reconocidos) plus pending commitments (compromisos pendientes) plus extrabudgetary expenditure of the Central Government.

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

(Outstanding balances in millions of colones)

Periods	Ceilings
Jan. 1, 1985 - Mar. 31, 1985	17,300
Apr. 1, 1985 - June 30, 1985	17,300
July 1, 1985 - Sept. 30, 1985	17,100
Oct. 1, 1985 - Dec. 31, 1985	17,100
Jan. 1, 1986 - Mar. 31, 1986	17,300

1/ Defined as the difference between the banking system's gross credit to the nonfinancial public sector and the latter's deposits in the banking system. For this purpose, the nonfinancial public sector includes the Central Government, decentralized agencies and state enterprises. These ceilings exclude foreign loans from the Canadian International Development Agency (CIDA) to the nonfinancial public sector channeled through the Central Bank (up to US$4 million). Also, these ceilings will be reduced by the amount of counterpart funds from the IBRD structural adjustment loan (SAL) used by the Central Government.

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

(Outstanding balances in millions of colones)

Periods	Ceilings
Jan. 1, 1985 - Mar. 31, 1985	18,300
Apr. 1, 1985 - June 30, 1985	18,500
July 1, 1985 - Sept. 30, 1985	19,000
Oct. 1, 1985 - Dec. 31, 1985	19,750
Jan. 1, 1986 - Mar. 31, 1986	18,300

1/ Defined as the difference between the currency issue and the net international reserves of the Central Bank.

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

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

Periods	Targets
Jan. 1, 1985 - Mar. 31, 1985	-175
Apr. 1, 1985 - June 30, 1985	-165
July 1, 1985 - Sept. 30, 1985	-170
Oct. 1, 1985 - Dec. 31, 1985	-140
Jan. 1, 1986 - Mar. 31, 1986	-115

1/ Defined as the difference between the Central Bank's gross foreign assets and short-term foreign liabilities including its net position with the Fund. Also included are any arrears on commercial payments and external debt service.

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

(In millions of U.S. dollars)

Periods	Limits
Jan. 1, 1985 - Mar. 31, 1985	100
Apr. 1, 1985 - June 30, 1985	50
July 1, 1985 - Sept. 30, 1985	25
Oct. 1, 1985 - Dec. 31, 1985	--
Jan. 1, 1986 - Mar. 31, 1986	--

1/ Defined as the stock of arrears on medium- and long-term external public debt (excluding amounts assumed to be rescheduled in 1985) plus the outstanding balance of deposits for foreign exchange requests held by the Central Bank of Costa Rica in excess of 15 days.