FOR AGENDA

SM/85/223

CONTAINS CONFIDENTIAL
INFORMATION

August 7, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Costa Rica - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Costa Rica, which is proposed to be brought to the agenda for discussion on Wednesday, September 11, 1985.

Mr. Elson (ext. 8500) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

COSTA RICA

Staff Report for the 1985 Article IV Consultation

Prepared by the Western Hemisphere Department

(In consultation with the Exchange and Trade Relations, the Fiscal Affairs, the Legal and Treasurer's Departments)

Approved by Eduardo Wiesner and Manuel Guitian

August 6, 1985

Contents | Page

Text Tables

Contents

Appendices | Page

I. Introduction

The discussions for the 1985 Article IV consultation with Costa Rica were conducted in San Jose during the period May 20-June 7 and July 10-17, 1985. The representatives of Costa Rica in these discussions included the Ministers of Finance, Agriculture, External Debt Negotiations, and Labor, the Vice-Minister of Economy, the Executive President of the Central Bank and other senior officials of public sector agencies. The staff representatives were R.A. Elson (Head), M. Figuerola (both WHD), A. Gomez-Oliver (INST), M. Kelly (ETR), T. Lehwing (WHD) and R. Orpin (Secretary-WHD). The mission was assisted by I. Tampe, the Fund's resident representative in Costa Rica. Mr. Perez, Executive Director for Costa Rica, participated in the main policy discussions.

The 1984 Article IV consultation discussions were conducted in February-March 1984 and were concluded by the Executive Board on August 1, 1984 (EBM/84/119).

A 13-month stand-by arrangement in an amount of SDR 54 million (59 percent of quota on an annual basis) was approved by the Fund for Costa Rica on March 13, 1985. To date, Costa Rica has made two purchases under that arrangement for a total amount of SDR 24 million. A third purchase would have become available at the end of July 1985, but Costa Rica did not qualify for it because of the nonobservance of the quantitative performance criterion relating to external payments arrears. The midterm review of the stand-by arrangement, which was intended to be completed before August 31, 1985, is a performance criterion for the final two purchases of the stand-by arrangement. That review has not yet been completed because understandings have not been reached in certain policy areas. In addition, the last purchase of the stand-by arrangement is conditional upon the conclusion of rescheduling agreements with foreign creditors or the reaching of appropriate understandings with the Fund in the event such agreements were not concluded.

II. Recent Developments and Performance Under the Present Stand-by Arrangement

1. Developments through 1984

A series of unfavorable developments in Costa Rica's international environment, combined with its failure to adjust domestic policies on a timely basis, led to a major financial crisis in the period 1980-82. Two attempts to reverse the economic deterioration in the context of Fund-supported programs turned out to be unsuccessful. Lax fiscal and monetary policies resulted in substantial external payments deficits, a marked accumulation of arrears, and a rapid depreciation of the internal and external value of the colon. Following a change in administration in mid-1982, an exchange reform and substantial tax and public enterprise tariff adjustments were introduced, paving the way for the approval of a one-year stand-by arrangement in December 1982. This program was carried out with a large measure of success as inflation was reduced sharply, a unified exchange rate was restored, and external debt arrears were reduced substantially.1/

The progress toward economic stabilization achieved in the 1983 program was not continued in 1984, as the stand-by program that was expected to follow the one of 1983 was delayed by over one year. Although negotiations for a new stand-by arrangement were concluded in February-March 1984, a change in the economic team shortly thereafter led to delays in implementing revenue measures central to the adjustment effort and a relaxation in demand management during the first half of the year. During this period the Central Bank started to experience significant foreign exchange shortages, and by mid-1984 its net international reserves had declined sharply, including the accumulation of payments arrears.

After the middle of 1984, a number of measures were introduced to tighten fiscal and monetary management. Revenue measures involving increases in indirect taxes were implemented, which were estimated to yield the equivalent of 1 percent of GDP in the remainder of the year and 2 percent of GDP on a full-year basis. Also, a 50 percent marginal reserve requirement was established on demand deposits, and central bank credit to the banks was frozen for the rest of the year. In October 1984 domestic interest rates were raised by 2 percentage points (the reference rate paid on six-month deposits was increased from 18 percent to 20 percent), and the exchange rate was adjusted in relation to the U.S. dollar by 6 1/2 percent to reverse the real appreciation of the colon experienced since the beginning of the year. On the basis of these measures, the negotiation of a new stand-by program was finalized in October-November 1984; however, its presentation to the Executive Board was delayed because of problems in closing the financing gap that depended on the conclusion of parallel arrangements with the foreign commercial banks and the World Bank.

The economic results for 1984 as a whole were mixed. On the positive side, the rate of inflation remained relatively low (12 percent on an average annual basis), although the 12-month rate of inflation began to accelerate toward the end of the year with the adjustment in the exchange rate mentioned earlier and certain controlled prices, and the sharp growth in aggregate demand during the year. On the strength of a significant increase in exports (following two years of decline) and private investment, domestic output rose by 6 percent in 1984 (Table 1).

1/ Developments under the 1982-83 stand-by arrangement were reviewed in detail in SM/84/156.

Table 1. Costa Rica: Selected Economic Indicators

	1982	1983	1984	1985 Program	1985 Proj.
		(Percentage change)			
Nominal GDP	70.8	29.8	19.8	13.3	12.1
Real GDP	-7.3	2.3	6.3	3.0	-1.1
GDP deflator	84.2	26.7	12.7	10.0	14.8
Consumer prices					
End of period	81.8	10.7	17.4	10.0	11.0
Average	90.1	32.6	11.9	11.0	14.0
Exports (In U.S. dollars)	-13.4	-0.8	10.9	9.9	-3.9
Imports (In U.S. dollars)	-26.3	11.1	10.9	3.0	-5.8
		(As a percent of GDP)			
Gross domestic investment	16.6	21.7	23.1	22.4	23.0
Public 1/	(5.4)	(6.2)	(6.0)	(6.4)	(5.6)
Private 2/	(11.2)	(15.5)	(17.2)	(16.0)	(17.4)
Gross national savings	6.5	11.9	13.6	13.3	14.0
Public 1/	(-2.5)	(4.0)	(5.6)	(6.4)	(6.0)
Private	(9.0)	(7.9)	(8.0)	(6.9)	(8.0)
External savings 3/	10.1	9.8	9.6	9.1	9.0

Sources: Costa Rican authorities; and Fund staff estimates.

1/ Excludes net losses of Central Bank; based on national accounts data which differ from fiscal accounts.
2/ Includes inventory change.
3/ Current account balance of payments deficit (excluding official transfers).

The overall deficit of the nonfinancial public sector was reduced from 3.1 percent of GDP in 1983 to 1.9 percent of GDP in 1984. Together with the Central Bank's operating losses (which arise mainly from large net interest payments abroad), the combined deficit declined from 8.1 percent of GDP in 1983 to 6.6 percent of GDP in 1984. The improvement in the performance of the nonfinancial public sector reflected both a strengthening of the financial position of the Central Administration--because of the tax measures mentioned earlier and a tapering off in the growth of expenditures--and the achievement of approximate equilibrium in the enterprise sector after several years of deficit. The latter result reflected a combination of tariff adjustments for the main public enterprises (in particular the State Electricity Corporation and the Water Authority), as well as a cutback in investment spending. In contrast with previous years, all of the overall deficit of the nonfinancial public sector in 1984 was financed with external resources, although this indicated an increase in external payments arrears; net banking system credit to the public sector declined last year (Table 2).

Despite the correction of fiscal and monetary policies in the second half of 1984, the overall balance of payments result for the year as a whole was weaker than in 1983. Imports grew at the same rate as exports as a result of the expansionary demand policies during the first half of the year and the real effective appreciation of the colon through September. The external current account deficit (excluding official transfers) last year was about the same in relation to GDP as in 1983 (9 1/2 percent),1/ as the restraint exercised by the public sector was offset by the sharp expansion in private sector activity. However, net capital inflows in 1984 were significantly less than in the previous year and insufficient to cover the current payments deficit, mainly as a result of a lower utilization of foreign loans by the public sector than in 1983 and Costa Rica's failure to obtain certain debt relief from bilateral creditors on the basis of a financial arrangement from the Fund as had been planned.

An overall payments deficit of US$110 million is estimated for 1984, compared with a surplus of US$51 million in 1983. All of the deficit last year was accounted for by an increase in payments arrears, as there was an improvement in the net international reserve position of the Central Bank in 1984 (including net repayments to the Fund). Payments arrears rose from US$40 million at the end of 1983 to US$215 million at the end of 1984, mainly on account of delays in debt service payments to official bilateral creditors (Paris Club) and an accumulation of unpaid interest to foreign banks (Table 3).

1/ The current account balance of payments for 1983 and 1984 has been revised since the report on Costa Rica's Stand-by Request (EBS/85/31) was issued, as a result of downward revisions in the series of foreign interest payments.

Table 2. Costa Rica: Summary Operations of the Nonfinancial Public Sector

	1982	1983	1984 Actual	1984 Reduced Actual 1/	1985 Program 1/	1985 Proj. 1/
	(In millions of colones)					
Central Administration	-3,258	-4,627	-4,517	-4,517	-2,890	-2,890
Revenue	14,026	21,417	27,012	27,012	33,891	32,812
Expenditure	17,284	26,044	31,529	31,529	36,781	35,702
Current	(15,072)	(20,953)	(26,137)	(26,137)	(29,966)	(29,235)
Capital	(2,212)	(5,091)	(5,392)	(5,392)	(6,815)	(6,467)
Rest of general government	184	2,412	1,707	1,668	1,098	2,337
Revenue	10,782	17,555	21,755	15,176	17,383	19,778
Expenditure	10,598	15,143	20,048	13,508	16,285	17,441
Current	(9,085)	(13,806)	(16,856)	(11,916)	(14,696)	(15,518)
Capital and net lending 2/	(1,513)	(1,337)	(3,192)	(1,592)	(1,589)	(1,923)
Public enterprises	-5,696	-1,737	-32	7	-688	-1,927
Revenue	18,374	29,545	35,324	34,152	36,676	37,458
Expenditure	24,070	31,282	35,356	34,145	37,364	39,386
Current	(20,653)	(26,826)	(31,065)	(30,217)	(31,990)	(34,345)
Capital and net lending	(3,417)	(4,456)	(4,291)	(3,928)	(5,374)	(5,041)
Public sector current account deficit (-)	-2,431	5,020	8,489	7,510	10,580	10,291
General government	-17	2,897	4,527	3,867	6,126	7,456
Public enterprises	-2,414	2,123	3,962	3,643	4,454	2,835
Public sector overall deficit (-)	-8,770	-3,952	-2,842	-2,842	-2,480	-2,480
External (net) 3/	-1,505	-324	-384	-384	4,150 4/	4,465 4/
Domestic	2,697	14,766	159	159)	-1,670	-2,805
Banking system	(1,872)	(13,889)	(-1,122)	(-1,122))		(...)
Other	(825)	(877)	(1,281)	(1,281))		(...)
External arrears	7,578	-13,767	3,067	3,067)		-4,700
Rescheduling	--	3,277	--	--)		5,500
Memorandum items						
Public sector revenue	17,904	34,672	44,883	42,165	50,678	50,815
Public sector expenditure	26,674	38,624	47,725	45,007	53,158	53,295
Current	(20,122)	(29,538)	(36,314)	(34,600)	(40,096)	(40,508)
Capital and net lending	(6,552)	(9,086)	(11,411)	(10,407)	(13,062)	(12,787)
	(Annual percentage change)					
Public sector revenue	71.4	93.7	29.5	30.5	20.7 5/	20.5
Public sector expenditure	44.4	44.8	23.6	24.1	16.1 5/	18.4
Current	(62.1)	(46.8)	(22.9)	(22.3)	(13.6)	(17.1)
Capital and net lending	(8.1)	(38.7)	(25.6)	(30.5)	(25.0)	(22.9)
	(In percent of GDP)					
Public sector deficit	-9.0	-3.1	-1.9	-1.9	-1.5 6/	-1.4
Revenue	18.4	27.4	29.6	27.9	30.6	29.6
Expenditure	27.4	30.5	31.5	29.8	32.1	31.0
Current	(20.7)	(23.4)	(24.0)	(22.9)	(24.2)	(23.6)
Capital	(6.7)	(7.1)	(7.5)	(6.9)	(7.9)	(7.4)
Central Administration deficit	-3.3	-3.7	-3.0	-3.0	-1.7 6/	-1.7
Revenue	14.4	16.9	17.9	17.9	20.5	19.1
Expenditure	17.7	20.6	20.9	20.9	22.2	20.8
Current	(15.4)	(16.6)	(17.3)	(17.3)	(18.1)	(17.0)
Capital	(2.3)	(4.0)	(3.6)	(3.6)	(4.1)	(3.8)
Memorandum items						
Public sector current account deficit (-)	-2.5	4.0	5.6	5.0	6.4 6/	6.0
General government	(--)	(2.3)	(3.0)	(2.6)	(3.7)	(4.3)
State enterprises	(-2.5)	(1.7)	(2.6)	(2.4)	(2.7)	(1.7)
Public sector fixed capital formation	5.4	6.2	6.0	5.1	6.5 6/	5.6

Sources: Ministry of Finance; and Fund staff estimates.

1/ Reduced coverage of public sector operations for purposes of the stand-by arrangement, which includes accounts for the 19 largest decentralized institutions and public enterprises.

2/ Includes differences arising from reporting on an accrual and cash basis, statistical discrepancies, and from the operations of the nonconsolidated public sector.

3/ Includes unpaid amortization.

4/ Includes IBRD/SAL disbursements (US$80 million).

5/ Changes envisaged in the program.

6/ Ratios envisaged in the program.

Table 3. Costa Rica: Balance of Payments

	1982	1983	1984	1985 Program	1985 Proj.
(In millions of U.S. dollars)					
Current account 1/	-246.8	-299.7	-327.1	-300.0	-310.0
Merchandise trade	-25.2	-130.8	-145.4	-98.0	-119.2
Exports, f.o.b.	(869.0)	(862.4)	(955.5)	(1,025.0)2/	(918.0)
Imports, c.i.f.	(-894.2)	(-993.2)	(-1,100.9)	(-1,123.0)	(-1,037.2)
Services (net)	-251.2	-191.8	-205.8	-232.0	-215.5
Nonfactor	(96.0)	(121.9)	(117.6)	(124.0)2/	(114.8)
Factor	(-347.2)	(-313.7)	(-323.4)	(-356.0)	(-330.3)
Direct investment and private interest	/-5.3/	/14.0/	/-9.4/	/-14.0/	/-4.3/
Official interest	/-341.9/	/-327.7/	/-314.0/	/-342.0/	/-326.0/
Paid	[-106.0]	[-275.4]	[-209.9]	[-312.0]	[-302.9]
Unpaid	[-235.9]	[-52.3]	[-104.1]	[-30.0]	[-23.1]
Transfers (private)	29.6	22.9	24.1	30.0	24.7
Capital account 3/	-67.0	350.2	217.4	92.0	415.0
Private and net errors and omissions	16.0	67.5	95.3	47.0	41.6
Public (net inflow)	128.0	219.0	88.9	188.0	138.2
Disbursements	(191.0)	(311.8)	(200.9)	(346.0)	(293.0)
Nonfinancial sector	/91.0/	/121.2/	/97.3/	/218.0/	/204.7/
Financial sector	/100.0/	/190.6/	/103.5/	/128.0/	/88.3/
Amortization (paid)	(-63.0)	(-92.8)	(-112.0)	(-158.0)	(-154.8)
Nonfinancial sector	/-39.0/	/-63.0/	/-62.7/	/-81.0/	/-71.0/
Financial sector	/-24.0/	/-29.8/	/-49.3/	/-77.0/	/-83.8/
Public (net refinancing of current obligations)	-217.3	17.7	-75.7	-238.0	23.1
Rescheduling of principal	(--)	(157.2)	(153.7)	(...)	(251.5)
Refinancing of current interest	(--)	(34.0)	(--)	(...)	(23.1)
Amortization (unpaid)	(-217.3)	(-173.9)	(-229.4)	(-238.0)	(-251.5)
Official transfers	6.3	46.0	108.9	95.0	212.1
SDR allocation counterpart	--	--	--	--	--
Overall balance (deficit -)	-313.8	50.5	-109.7	-208.0	105.0
Financing gap = exceptional financing 4/	--	--	--	268.0	--
Of which: rescheduling of principal	--	--	--	238.0	--
rescheduling of interest	--	--	--	30.0	--
Net international reserves	-313.8	50.5	-109.7	60.0 5/	105.0
Accumulation (+) or reduction (-) of arrears	453.2	-1,070.0	174.2	-245.0	-214.5
Principal	(217.3)	(-722.9)	(62.0)	(-112.0)	(-84.4)
Interest	(235.9)	(-347.1)	(86.2)	(-107.0)	(-104.1)
Imports	(--)	(--)	(26.0)	(-26.0)	(-26.0)
Rescheduling of arrears	--	749.3	--	84.0	79.9
Principal	(--)	(671.9)	(--)	(51.0)	(45.4)
Interest	(--)	(77.4)	(--)	(27.0)	(28.5)
Imports	(--)	(--)	(--)	(6.0)	(6.0)
Conversion of CDs (P+1)	--	51.8	--	--	--
Revolving trade credit facility	--	152.3	49.6	75.0	75.0
Net official reserves (increase -)	-128.8	58.1	-114.1	26.0	-45.4
Net use of Fund resources	(-9.7)	(99.0)	(-36.1)	(21.0)	(21.0)
Other net official reserves	(-119.1)	(-40.9)	(-78.0)	(5.0)	(-66.4)
Valuation adjustment	-10.6	8.0	--	--	--
(As percent of GDP)					
Current account 1/	-10.1	-9.8	-9.6	-9.1	-9.0
Trade balance	-1.0	-4.3	-4.3	-2.1	-3.5
Net factor services	-14.2	-10.2	-9.5	-10.8	-9.6
Other services and private transfers	5.1	4.7	4.2	3.8	4.1
Capital account 3/	-2.7	11.4	6.3	10.9	12.1
Private	0.7	2.2	2.7	1.4	1.2
Public (net inflow)	5.5	8.7	5.8	8.6	10.2
Public (net refinancing)	-8.9	0.5	-2.2	0.9	0.6
GDP (in U.S. dollars)	2,438	3,052	3,408	3,309	3,436

Sources: Central Bank of Costa Rica; and Fund staff estimates.

1/ Excluding official grants.
2/ The program target for exports is adjusted downward by US$30 million for goods assembled in Costa Rica. Previously this item was included in exports but is now included in services. A corresponding upward adjustment is made to the program number for service receipts.
3/ Including official grants.
4/ Represents working assumptions on amounts to be rescheduled.
5/ Concept used for balance of payments test in stand-by program.

2. The 1985 program

The Government's economic program for 1985 was based on a continuation of the policies which were implemented during the second half of 1984 with a view to containing inflationary pressures and improving domestic savings in order to lay the basis for continued economic growth and a viable external position over the medium term. Accordingly, the program called for a reduction in the combined fiscal deficit and the net losses of the Central Bank to no more than 5.8 percent of GDP in 1985 and a curtailment in the growth of overall bank credit (measured in relation to private sector liabilities outstanding at the beginning of the year) from 19 percent in 1984 to 7 percent in 1985.

Fiscal and monetary restraint were to be complemented by a wage policy which limited semiannual adjustments in private sector minimum wages and public sector wages to no more than the semiannual changes in the cost of a basic basket of essential goods and services. Also, domestic interest rates were to be significantly positive in real terms and the exchange rate was to be adjusted periodically to bring about a modest depreciation of the colon in real effective terms during 1985. On the basis of these policies, the external current account deficit was projected to be limited to no more than 9 percent of GDP in 1985, while the overall balance of payments was to be in surplus and external payments arrears were to be eliminated through a combination of rescheduling and cash payments.1/

The financing of the program depended on the coordinated support of several donors and lenders, contributing gross resources (including debt relief) on the order of US$700 million in 1985. The Fund arrangement closely paralleled complementary programs of U.S. AID (US$190 million) and the World Bank (the latter in the form of a structural adjustment loan of US$80 million). At the same time, debt relief from official creditors (Paris Club) and foreign commercial banks was expected, as well as a new money facility from the banks in an amount of US$75 million.

At the end of June 1985, Costa Rica was in compliance with all the quantitative performance criteria of the stand-by arrangement, with the exception of the limit on external debt arrears (Table 4). As described below, Costa Rica's failure to meet the arrears target for the second quarter of 1985 was related, in part, to delays in the disbursement of the banks' new money facility which is treated as a reserve liability of the Central Bank under the program.

1/ The reduction in arrears projected for 1985 differs from the program target in Table 5 because of downward revisions to the stock of arrears outstanding as of December 1984.

Table 4. Costa Rica: Performance Under Stand-By Arrangement

	March 31, 1985	June 28, 1985
	(In millions of colones)	
Net domestic assets of Central Bank		
Ceiling	18,300	18,500
Actual	16,196 1/	15,879
Margin or excess (-)	2,104	2,621
Net credit to public sector from the banking system		
Ceiling	17,300	17,300
Actual	16,168	15,429
Margin or excess (-)	1,132	1,871
	(In millions of U.S. dollars)	
Net international reserve position (including arrears)		
Target	-175	-165
Actual	-120 2/	-120 3/
Margin or excess (-)	55	45
Stock of external payment arrears		
Limit		
Actual	100	50
Margin or excess (-)	99	106 3/
	1	-56
Foreign indebtedness of the public sector		
Short-term debt outstanding (excluding trade credits)		
Ceiling	3	3
Actual	3	3
Margin or excess (-)	--	--
New commitments with maturities 1-5 years		
Ceiling	25	25
Actual	--	--
Margin or excess (-)	25	25
New commitments with maturities 1-12 years		
Ceiling	50	50
Actual	--	--
Margin or excess (-)	50	50
	(In millions of colones)	
Cumulative central government expenditure commitments 4/		
Limit	7,640	17,710
Actual	7,790	16,991 5/
Margin or excess (-)	-150	791

Source: Central Bank of Costa Rica.

1/ Reported figures were adjusted upwards by ₡ 2,096 million to reflect a float with respect to the payment of arrears at the end of the month.
2/ Reported figures were adjusted downwards by US$42.5 million to reflect a float with respect to the payment of arrears at the end of the month.
3/ Reported arrears figures were adjusted upwards by US$22.2 million to neutralize the effect of revisions to the stock of arrears outstanding in December 1984.
4/ Not a performance criterion.
5/ Preliminary.

With the exception of the target for external payments arrears, Costa Rica had substantial margins with respect to the other quantitative performance criteria through June 1985, which reflected, to a large extent, a tighter monetary stance than called for under the stand-by program. During the first half of 1985, the growth in overall bank credit and bank credit to the private sector was less than envisaged under the program, in part, because of weak demand associated with an economic recession originating in the agricultural sector and, in part, because of limited central bank support to the commercial banks and a slower than projected rate of utilization of the counterpart deposits arising from inflows of U.S. AID grant assistance.1/

The impact of these factors on the net international reserve position of the Central Bank has been reinforced by private capital inflows in the form of dollar-denominated deposits not contemplated in the program. In the latter case, dollar-denominated deposits in the commercial banks rose from the equivalent of US$200 million at the end of 1984 to US$245 million at the end of June 1985. Since most of these deposits carry a legal reserve requirement of 100 percent, these inflows are fully reflected in the balance sheet of the Central Bank and account for a significant share of the decline in the Central Bank's net claims on the rest of the banking system, its net domestic assets and, consequently, its net international reserve position.2/ It appears that these inflows were encouraged by a significant increase in the premium over LIBOR which the Central Bank of Costa Rica paid on these deposits compared with those offered in nearby offshore centers.

During the first half of 1985, fiscal policy was more expansionary than called for in the program, as reflected in the operations of the central administration. Revenues were below the projection for mid-year, in part because of the weaker domestic economy and foreign trade flows than projected in the program, and in part because of a shortfall in revenues at the end of 1984 with respect to the base used in the program. The growth in actual government expenditure for the first half of 1985 was about in line with the annual objective in the program; the program limit for total expenditures (including commitments) was exceeded for the quarter ending March but not for the semester ending

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1/ In the stand-by program, it was assumed that the balance of payments support from U.S. AID would be disbursed in equal amounts as loans and grants, and that a certain share of the local counterpart of this assistance would be used throughout the year to finance central bank rediscounts to private banks or direct assistance to private sector agencies in Costa Rica. It is now projected that all of the assistance will be in the form of grants, and that most of the programmed local expenditure of the counterpart funds will occur in the second half of the year.

2/ The reported margin under the balance of payments test for June 1985 is exactly equivalent to the inflow of dollar-denominated deposits in the first half of the year.

June.[1] The expenditure data for the first half of 1985, however, do not fully reflect the overruns arising from an increase in public sector wages which was more than the agreed indicator in the program ("canasta basica"). The increase in public sector wages for the first half of 1985, which began to be paid out in April 1985, amounted to ₡ 500 per employee per month, or more than double the increase that would have been indicated by movements of prices for the basic basket for the previous semester. Most of the central government deficit in the first half of the year was financed by domestic resources outside the banking system in the form of bonds held by the nonbank private sector and the rest of the public sector.

In the external sector, trade flows have been significantly weaker than assumed in the program. During the first half of 1985, exports were virtually unchanged with respect to the same period of 1984, as higher coffee exports were offset by a decline in banana exports associated with the cessation of operations of a transnational corporation and severe wind damage to banana plantations on the Pacific coast during April. Also, nontraditional exports outside the Central American region showed no growth for the first half of 1985, in marked contrast with the experience of last year. Imports were lower in the first half of 1985, compared to the same period of last year, as a result of the decline in income associated with a downturn in agricultural exports, the exercise of credit restraint and a faster pace of currency depreciation than in the first half of 1984.

During the first few months of 1985, Costa Rica's trade position with the rest of Central America improved much more sharply than it did overall, and thus gave rise to a sharp increase in Costa Rica's nonliquid claims on the rest of Central America. At the end of 1984, the Central Bank of Costa Rica's gross foreign assets in the form of claims on the rest of Central America, most of which are held as medium-term certificates of deposit, amounted to US$317 million; such claims increased by US$42 million during the first half of 1985. On May 20, 1985, the Central Bank established prescription of currency requirements involving payments only in U.S. dollars for all trade with Central America in order to avoid a further increase in such claims.

During the first half of 1985, the colon was adjusted downwards in relation to the U.S. dollar on eight occasions from ₡ 48 per U.S. dollar (selling) at the end of 1984 to ₡ 50.60 (selling) at the end of June 1985, for a cumulative depreciation in local currency terms of 5.4 percent. (During the year ending June 1985, the colon was depreciated by 14 percent.) In the first few months of 1985, the colon tended to appreciate in real effective terms, but then in May and June this tendency was reversed as a result of the depreciation of the

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1/ This limit is not a performance criterion, but excesses over the limit were to trigger consultations between the Costa Rican authorities and the Fund staff on the means to bring actual expenditures within the program target.

U.S. dollar against other major currencies and a quickening of the pace of depreciation of the colon. During both the first half of 1985 and the year ending June 1985, the colon depreciated in real terms vis-a-vis its major trading partners by an estimated 2 percent.1/

Costa Rica has made some progress to date in securing the financing assumed in the program. On April 16, 1985, the Executive Board of the World Bank approved the structural adjustment loan (SAL) mentioned earlier; however, that loan will not become effective until it has been approved by the Costa Rican Legislative Assembly. On April 22, Costa Rica signed an agreed minute with the Paris Club on the terms for rescheduling its arrears as of December 31, 1984 and debt service falling due in the period January 1, 1985-March 31, 1986.2/ Finally, on May 29, 1985, the Costa Rican authorities signed an agreement with the foreign commercial banks on the rescheduling of principal repayments falling due in 1985 and 1986 and a US$75 million new money facility to be disbursed during 1985. A first disbursement of US$18.75 million was made on June 20, 1985 and the remainder of the new money facility will be disbursed after the SAL becomes effective, as long as Costa Rica also has qualified to make all available purchases under the Fund arrangement as of that date. In the program, it had been assumed that one half of the SAL and the full amount of the banks' new money facility would be disbursed before the end of June 1985.

III. Summary of Policy Discussions

The 1985 Article IV consultation discussions centered to an important extent on the issues relevant to the completion of the mid-term review of Costa Rica's stand-by arrangement. In these discussions, emphasis was focused in particular on exchange rate policy, fiscal policy, fiscal reform and the divestment program of the National Development Corporation (CODESA), as proposed in the letter of intent of the Costa Rican authorities dated January 11, 1985. At the same time, the staff was mindful of the emphasis given in the Summing Up of the 1984 Article IV consultation to the Government's wage policy and its medium-term debt management. The staff was unable to conclude the discussions for the stand-by review because understandings were not fully developed in the area of fiscal and exchange rate policies and details on certain fiscal adjustment measures had not been worked out. Accordingly, it was agreed to continue the discussions on the review at a later date.

1/ Effective exchange rate indices are presented in Appendix V.
2/ The terms of the Agreed Minute of the Paris Club were described in SM/85/137 (5/14/85).

1. Domestic policies

The main issue as regards domestic economic policies was the degree of adjustment to be achieved in 1985 in public sector operations (including the operational losses of the Central Bank) consistent with the desired external current account deficit. In view of the better fiscal outturn for 1984 than estimated at the time the 1985 stand-by program was finalized and downward revisions to the current account deficit of the balance of payments for 1983-84, it was recognized that the degree of adjustment to be achieved under the program in 1985 was now less than envisaged when the program was formulated. As shown in Table 5, the original targets for 1985 would now imply a reduction of about 1 percent of GDP in the combined deficit of the nonfinancial public sector and the Central Bank and a reduction of about 1/2 percent of GDP in the current account deficit of the balance of payments. Notwithstanding the apparent more modest adjustment effort involved in the program targets than anticipated earlier, the authorities believed that the achievement of the original targets would be a significant effort especially in view of the substantially weaker domestic economic and foreign trade conditions now envisaged for 1985, compared with program projections. The achievement of the original program targets, however, requires the implementation of additional measures on which understandings have not yet been reached. In the absence of these measures, as indicated below, the public sector deficit and external current account deficit would exceed the projections for 1985 shown in this report which are consistent with program targets.

a. Fiscal policy

In the light of the results for the first half of the year, discussions in the area of fiscal policy focused heavily on central government operations. Under the program, the overall government deficit was to be reduced from 3 percent of GDP in 1984 to around 1 3/4 percent of GDP in 1985 as a result of the full year's impact of tax increases introduced last year, the carryover of special transfer obligations from the rest of the public sector and a policy of expenditure restraint. In view of the weaker revenue performance to date under the program, the authorities reported that they had taken steps to improve collection procedures for sales taxes and selective consumption duties and had established a tax amnesty in mid-1985 to collect arrears, mainly on income taxes. It was estimated that these efforts could result in an incremental tax yield of roughly ₡ 1.2 billion (0.7 percent of GDP) in the remainder of 1985.

On the expenditure side, the authorities expressed their commitment to stay within the program's expenditure limits, notwithstanding the overruns associated with public sector wage payments. To accomplish this, the Costa Rican representatives pointed to the approval by the Legislative Assembly in mid-July of certain budget cuts on the order of ₡ 643 million and ministerial proposals to reduce actual budget outlays by ₡ 1.2 billion in the remainder of 1985 through underexecution and/or

Table 5. Costa Rica: Overall Deficit of the Nonfinancial Public Sector and Net Losses of the Central Bank

	1982	1983	1984 Est. 1/	1984 Rev.	1985 Program 1/	1985 Proj.
			(In millions of colones)			
Combined deficit 2/	14,270	10,273	11,207	9,878	9,680	9,680
Nonfinancial public sector	8,770	3,952	3,707	2,842	2,480	2,480
Central Bank	5,500	6,321	7,500	7,036	7,200	7,200
			(As a percent of GDP)			
Combined deficit 2/	14.6	8.1	7.6	6.6	5.8	5.6
Nonfinancial public sector	9.0	3.1	2.5	1.9	1.5	1.4
Central Bank	5.6	5.0	5.1	4.7	4.3	4.2
Memorandum item						
External current account deficit	9.7	9.8	12.0	9.6	9.1	9.0
Nominal GDP (In millions of colones)	97,505	126,337	146,049	151,304	165,473	171,777

Sources: Costa Rican authorities; and Fund staff estimates.

1/ As presented in EBS/85/31.
2/ The combined deficit of the nonfinancial public sector and the Central Bank is estimated on an accrual basis as it includes interest payments abroad in arrears.

postponement. The authorities also were intent on drawing up a contingency plan of additional expenditure reductions in the event the tax amnesty did not produce by the end of August the desired yield. It was recognized that a plan of budgetary cuts by means of legislative action or underexecution was the preferred course of action, as an increase in expenditure commitments from the postponement of actual outlays in 1985 would only represent a buildup of arrears and a shift of the fiscal problem into 1986. In any event, the details of the authorities' expenditure plans had not been worked out fully at the time of the consultation discussions.

In the rest of the public sector, the authorities expected an overall surplus similar to that projected in the program. This result, as in the past, would be determined critically by the operations of the main public entities outside the Central Administration, such as the Social Security Institute, the National Grain Marketing Agency (CNP), the National Refinery (RECOPE), the State Electricity Corporation (ICE), and the National Development Corporation (CODESA). As called for in the program, CNP's overall deficit is projected to be about half the result for 1984 (around ₡ 500 million) as a result of increases in the controlled prices of basic grains in January and July 1985 and the withdrawal of CNP from rice support operations which had generated substantial losses in previous years.1/

In the case of RECOPE, the program called for adjustments in domestic fuel prices in line with increases in RECOPE's oil import costs. In fact, no adjustments in domestic fuel prices have been made since mid-1983, despite an increase in RECOPE's local currency cost of oil imports of 11 percent in the last two years, reflecting mainly the depreciation of the colon. The authorities indicated that the question of RECOPE's fuel prices was a very sensitive political issue, especially since 1985 is a pre-election year, and that, in the absence of fuel price increases, RECOPE would be able to cover its oil cost increases through economies in other expenditures. The full details of these offsetting measures were not available at the time of the consultation discussions.

The authorities also reported that the Government's plan to sell a number of CODESA's loss-making enterprises was expected to have significant results beginning late in 1985 as a result of an agreement reached with U.S. AID to use a significant share of the counterpart funds generated by its grant assistance to purchase CODESA's subsidiaries through a private sector trust. The purchases by this trust will be funded by disbursements from the U.S. AID counterpart deposits in the Central Bank which, in turn, will be used to reduce CODESA's outstanding indebtedness with the Central Bank. The mechanism of the trust was designed as a temporary vehicle for the disposition of CODESA's subsidiaries,

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1/ On July 15, 1985, the Executive Board of CNP agreed to refrain from any domestic purchase of rice beyond what was needed to satisfy domestic consumption.

pending secondary sales of the companies to other domestic or foreign investors, or their liquidation in the event no willing buyers were identified. In the light of this divestiture plan, which was not formulated at the time the stand-by program was designed, the authorities have proposed that a provision should be incorporated in the stand-by arrangement whereby the ceilings on bank credit to the public sector would be adjusted downwards by the extent of any transfers to the Central Government or the Central Bank of the proceeds arising from the sale of CODESA subsidiaries.

The importance of fiscal reform also was highlighted in the discussions, and the authorities indicated that a proposal would be submitted by the President of the Republic to the Legislative Assembly before the end of August 1985; this proposal would be based on the recommendations of a commission of ex-Ministers of Finance. Essentially, this reform proposal calls for certain changes in budgetary procedures to eliminate the need for extrabudgetary operations and to establish a unified cash budget for the Central Administration (i.e. free of revenue earmarking and compulsory spending requirements). Because of the constitutional nature of certain of the provisions in the reform bill, the authorities pointed out that a majority vote of two elected legislatures was required, which would imply that the proposed reforms could not enter into effect before the beginning of 1987. In the meantime, the authorities indicated that they intended to make ad hoc adjustments to the revenue earmarking in the annual budget exercises to reduce its incidence over time pending more permanent reforms.

b. Wage policy

The authorities recognized that a weak element in their economic program had been the management of wage adjustments, which had complicated the control of public expenditure and had adverse consequences on the competitiveness of the colon. Although the Government accepted the principle that increases in private sector minimum wages and public sector wages should be increased on a semiannual basis by no more than the increase in the cost of a basic basket of essential goods and services ("canasta basica"), in practice allowances have usually been made in applying that formula for either items not included in the basic basket or expected price changes of essential goods and services not yet reflected in the index. As a result, in the first semester of 1985, the salary award according to the increase in the basic basket for the previous semester should have been ₡ 196 per employee per month; however, an actual award of ₡ 500 was made which included the effects of price adjustments announced in January that might have been expected to affect the determination of salary adjustments for the second semester of 1985.

To compensate in part for the overadjustment of wages in the first semester of 1985, the authorities proposed in July a second semester adjustment which was less than the increase in the basic basket indicator by an amount of ₡ 120. However, at the same time a significant adjustment in public sector teachers' salaries was agreed for 1986; this was estimated to have the same impact on government expenditure (i.e. ₡ 500 million) as each of the general wage adjustments approved in 1985. It is estimated that public sector wages and private sector minimum wages will increase in 1985, on average, at around the same rate projected for consumer prices (i.e. 14 percent).

The authorities considered that one unfortunate byproduct of the basic indicator system of wage adjustments was that it tended to delay necessary adjustments in controlled prices because of concern over the impact of such adjustments on the value of the basic basket. For this reason, they were examining the possibility of establishing a new system in 1986 which would be less sensitive to increases in administered prices and which would link real wage adjustments with productivity increases. They also felt that in Costa Rica's present price environment there was less need for semi-annual adjustments in wages than there was during the high inflation experience of 1982 when the system was established.

c. Monetary policy

The authorities were of the view that their policy of credit restraint was broadly appropriate, especially in view of the somewhat higher rate of inflation experienced to date and the weaker external trade position than assumed in the program. They also felt that the tightening of monetary policy after mid-1984 had been the major factor behind the steady improvement in Costa Rica's net international reserve position. They noted that the growth in imports had been curtailed sharply over the past 12 months, while their tight monetary stance (including the maintenance of positive real interest rates in the financial system) seemed to have produced the return of some Costa Rican capital from abroad.

In the latter connection, the authorities recognized the artificial nature of the incentives which they had allowed to develop in respect of dollar-denominated deposits in the banking system. Since late 1984, the spread over comparable LIBOR rates for these deposits had risen to 3 percentage points, compared with spreads of about 1 percent in the past. In order to dampen the incentive for these inflows, the authorities reduced the spread over LIBOR on these deposits to around 1 percent by the end of July.

In the area of interest rate policy more generally, the authorities recognized that domestic interest rates needed to be significantly positive in real terms, but they wanted interest rates to respond more flexibly to market conditions. As of mid-1985, the basic indicator rate for six-month deposits, to which other rates in the system are pegged, was 20 percent (compared with the 12-month rate of increase of prices of 15 percent); however, since February 1985 the Central Bank has allowed the banks freedom to raise this rate by up to 3 percentage points above 20 percent as long as the entire structure of bank loan and deposit rates was adjusted in similar fashion. Then, in early July, the authorities widened the band of interest rate fluctuations to 3 percentage points above or below the basic rate of 20 percent. The prevailing rate on six-month deposits in the banking system was 21 percent at the time of the consultation discussions (June-July), whereas the interest rate on central bank stabilization bonds and government bonds of similar maturity (i.e. six months) was 22 percent.

An area of concern of the authorities in the monetary sphere was the question of the Central Bank's net operational losses. In recent years, these losses have tended to be on the order of 5 percent of GDP and, as such, they represented a major domestic component of Costa Rica's financial imbalances. These losses arise mainly from the marked imbalance between the Central Bank's interest-earning assets and its interest-paying liabilities, a substantial proportion of which are owed to foreign commercial banks. This foreign indebtedness had been accumulated over the years, largely as a means of financing fiscal operations with central bank credit at subsidized interest rates. The Central Bank also has large liabilities in the form of stabilization bonds which rose sharply in 1982 as a result of an effort of the authorities to offset the expansionary impact of large exchange losses incurred in 1981-82. In addition, most of the interest which the Central Bank pays on dollar-denominated deposits in the banking system gives rise to significant operational losses, as only a small share of these deposits is covered by central bank investments of foreign exchange abroad. Finally, the potential losses of the Central Bank have risen in 1985 because of a commitment to pay interest on the counterpart deposits associated with U.S. AID grants.

In the stand-by program, the authorities undertook to reduce the net losses of the Central Bank by about 1 percentage point of GDP by instituting a mechanism whereby any interest payments by the Central Bank on foreign commercial indebtedness of the public sector assumed by the Central Bank in the 1983 bank rescheduling process would be more than offset by payments in local currency by the public entities in question, and by adjusting the interest rate structure of the Central Bank to increase its interest earnings. In the latter connection, the interest charged to CNP was doubled, while the spread on rediscount operations financed by foreign resources was increased. Notwithstanding these measures, net central bank losses were projected at the time of the consultation discussions to exceed the program target by about ₡ 1 billion (0.6 percent of GDP). The additional measures which the Central Bank might introduce to offset these losses were not fully worked out at the time of the consultation discussions.

Notwithstanding the efforts to reduce the Central Bank's net losses in 1985, the authorities recognized a limit to the extent to which adjustments to the Central Bank's interest rate structure could resolve this problem. For this reason, they foresaw the need to incorporate these losses more directly in the fiscal program in order to bring about a significant reduction in the future. The possibility of a special bond issue to recapitalize the Central Bank or direct transfers from the budget was raised in this connection.

2. External sector policies and the medium-term outlook

The authorities were concerned that certain aspects of the balance of payments outlook for 1985 had changed significantly from the projections of the program. In particular, export prospects this year were significantly worse because of the problems in the banana sector and the payments position of the rest of Central America. In these conditions, they recognized the need to offset the export shortfall by a cutback in imports which, in part, was already being induced by the decline in income generated by the recession in the agricultural sector. At the same time, the authorities expected that net interest obligations would be somewhat less than in the program because of the decline in international interest rates. All in all, the authorities were committed to achieving the same current payments deficit (excluding official transfers) as set in the program (around 9 percent of GDP).

The authorities recognized that a flexible exchange rate policy was critical for the achievement of their balance of payments objectives. In the light of the experience to date with the crawling peg, the staff emphasized the importance of having a mechanism in place which would avoid appreciation of the colon in real effective terms, as had been the case earlier in the year. Doubts also were expressed about whether the existing mechanism of mini-adjustments vis-a-vis the U.S. dollar would be sufficient to bring about the desired rate of depreciation of the colon in real effective terms.

Notwithstanding the temporary problem of Costa Rica's financing arrangements under the program, it appears that for 1985 as a whole, Costa Rica's financing requirements will be satisfied. Total debt relief in 1985 (for current and past due obligations) is estimated at US$355 million, compared with US$352 million assumed in the program. In addition, Costa Rica has been attempting to reschedule a share of three public debt issues which mature in 1985, totalling US$90 million, through a voluntary exchange offer. The proposal of the Costa Rican Government is to convert these public debt bonds or floating rate notes into new obligations of seven years maturity which would bear interest at 1 1/4 points over LIBOR. The exact timing of this exchange offer was not known at the time of the consultation discussions. In the event that total financing for the program exceeded the original targets, the staff emphasized that a portion of that financing should be sterilized in the net international reserve position of the Central Bank in order to ensure that the basic objectives of the program would continue to be attained.

The staff reviewed with the authorities the medium-term outlook for the balance of payments and external debt and concluded that the main conclusions of the exercise carried out in 1984 when the present financial program was framed were still generally valid. In particular, it was agreed that Costa Rica's adjustment effort in 1985 was only a first step in a series of adjustment programs that would be required over the medium term to bring Costa Rica's external current account deficit to a level of around 5 percent of GDP that was judged to be compatible with available financing and an improvement in Costa Rica's external debt position.

The achievement of such an objective would require a significant shift in the trade balance, as well as the continuation of concessional capital inflows to bridge the time required for adjustment efforts to yield their positive effects on production and exports.1/ Such inflows would be assumed to take the form of both loan disbursements from bilateral and multilateral development agencies and debt relief for principal repayments falling due over the next several years. In the latter case, inflows equivalent to 55 to 60 percent of principal repayments falling due over the remainder of the decade would appear to be required (Table 6). Under these assumptions, Costa Rica's debt service payments (after debt relief) would remain in the range of 40 percent of exports of goods and services in 1986-87 and then gradually decline over the rest of the decade. At the same time, Costa Rica's public external debt, which was at a peak of around 105 percent of GDP in the period 1983-85 would taper off to approximately 80 percent of GDP by the end of the decade.

To achieve a satisfactory external position, the Costa Rican authorities recognized that, in addition to prudent financial management, it was necessary to adopt an aggressive export-oriented strategy for the medium term. The main components of this strategy would be the continuation of a flexible exchange rate policy along the lines developed in the current stand-by program and a reform of the national (and regional) trading system which would begin to reorient Costa Rican industrial activity more in the direction of markets outside the Central American region. As a step in this direction, the authorities placed great importance on the series of structural adjustment loans (SALs) which they hoped to negotiate with the World Bank. The first SAL, which was approved by the World Bank shortly after the Fund's approval of the current stand-by arrangement, has as its major focus the implementation of the first significant reform of the Central American common market arrangements in 20 years, as explained below.

IV. World Bank Operations in Costa Rica

World Bank lending to Costa Rica has been focused primarily on developing basic infrastructure (mainly power, telecommunications and highways), with more limited assistance being made available to support development of agriculture and industry. To date Costa Rica has received 28 IBRD loans and one IDA credit totaling US$411.5 million (net of cancellations).2/ An Export Development Loan (US$25.2 million), which established a revolving fund to finance the import requirements of export industries, was approved in 1983 and constituted a first step in the World Bank's support of economic recovery efforts in Costa Rica.

1/ The medium-term scenario presented in Table 6 implies a real export growth of 6 to 7 percent a year. Alternatively, a medium-term projection without resort to exceptional financing would imply a reduction in the current account deficit to 1 percent of GDP by the end of the decade and real export growth of 10 to 11 percent a year.

2/ Costa Rica's financial relations with the World Bank Group are summarized in Appendix II.

Table 6. Costa Rica: Medium-Term Outlook

					Proj.			
	1983	1984	1985	1986	1987	1988	1989	1990
			(In millions of U.S. dollars)					
Current account	-299.7	-327.1	-310.0	-258.0	-210	-213	-229	-246
Trade balance	-130.8	-145.4	-119.2	-53.2	-4	1	-4	-10
Exports, f.o.b.	(862.4)	(955.5)	(918.0)	(1,010.0)	(1,130)	(1,256)	(1,392)	(1,537)
Imports, c.i.f.	(-993.2)	(-1,100.9)	(-1,037.2)	(-1,063.2)	(-1,134)	(-1,255)	(-1,396)	(-1,547)
Factor payments	-313.7	-323.4	-330.3	-349.0	-356	-372	-390	-408
Interest (official)	(-327.7)	(-314.0)	(-326.0)	(-344.4)	(-346)	(-352)	(-360)	(-368)
Other	(14.0)	(-9.4)	(-4.3)	(-4.6)	(-10)	(-20)	(-30)	(-40)
Other services and private transfers	144.8	141.8	139.5	144.2	150	158	165	172
Capital account	350.2	217.4	415.0	338.0	289	298	321	344
Private	67.5	95.3	41.6	73.0	76	83	132	140
Public	219.0	88.9	138.2	31.0	-237	-62	-85	-64
Disbursements	(311.8)	(200.9)	(293.0)	(263.0)	(348)	(353)	(305)	(300)
Amortization paid	(-92.8)	(-112.0)	(-154.8)	(-232.0)	(-585)	(-415)	(-390)	(-364)
Official transfers	46.0	108.9	212.1	172.0	120	65	65	60
Refinancing of current obligations	17.7	-75.7	23.1	5.8	--	--	--	--
Rescheduling of principal	(226.1)	(154.2)	(251.5)	(129.3)				
Refinancing of interest	(34.4)	(--)	(23.1)	(5.8)				
Amortization unpaid	(-242.8)	(-299.9)	(-251.5)	(-129.3)				
Financial gap = exceptional financing	--	--	--	56.2	330	212	209	208
Overall balance	50.5	-109.7	105.0	80.0	79	85	92	98
IMF, net	99.0	-36.1	21.0	-29.1	-51	-43	-35	-27
Other net international reserves (increase -)	-149.5	145.8	-126.0	-50.9	-28	-42	-57	-71
Debt service	420.5	426.0	480.8	576.4	931	767	750	732
Amortization paid	92.8	112.0	154.8	232.0	585	415	390	364
Interest	327.7	314.0	326.0	344.4	346	352	360	368
Of which: IMF charges	(13.0)	(12.0)	(14.5)	(15.2)	(12)	(9)	(6)	(3)
Outstanding public debt	3,393.0	3,455.0	3,575.0	3,633.0	3,675	3,774	3,863	3,981
As percent of GDP	111.2	101.4	104.1	98.7	92.8	88.1	83.0	78.6
			(As percent of GDP)					
Exports	28.2	28.0	26.7	27.4	28.5	29.3	29.9	30.4
Imports	32.4	32.3	30.2	28.9	28.6	29.3	30.0	30.6
Trade balance	-4.3	-4.3	-3.5	-1.4	-0.1	--	-0.1	-0.2
Current account	-9.8	-9.6	-9.0	-7.0	-5.3	-5.0	-4.9	-4.9
Capital account	11.4	6.3	12.1	9.2	7.3	6.9	6.9	6.8
Overall balance	1.7	-3.2	3.1	2.0	2.0	2.0	2.0	2.0
			(Annual growth in percent)					
GDP (in U.S. dollars)	25.2	11.6	0.9	7.1	7.6	8.2	8.7	8.7
Real GDP				(3.0)	(3.5)	(3.5)	(4.0)	(4.0)
External inflation				(4.0)	(4.0)	(4.5)	(4.5)	(4.5)
SDR (in U.S. dollars)				--	2.5	2.5	2.5	2.5
LIBOR (in percent)			9.5	9.0	8.0	8.0	8.0	8.0
			(As percent of exports of goods and services)					
Debt service								
Excluding IMF	58.6	56.0	57.5	51.0	62.9	47.4	42.5	37.9
Including IMF	60.8	58.7	60.5	55.0	67.2	50.7	44.8	39.5
Debt service after debt relief								
Excluding IMF	34.4	32.5	35.4	41.0	40.3	34.1	30.6	27.1
Including IMF	36.7	35.2	38.4	45.0	44.6	37.4	32.9	28.7

Sources: IBRD/Debt Reporting Service; Costa Rican authorities; and Fund staff estimates.

On April 16, 1985, the Executive Board of the World Bank approved what is expected to be the first in a series of structural adjustment loans (SAL), together with a technical assistance loan of US$3.5 million, to continue support of Costa Rica's economic recovery and adjustment effort. The first SAL in an amount of US$80 million, which is intended to be disbursed in two tranches during 1985, supports a structural adjustment program focused on export-led growth, with particular emphasis on expanding exports to markets outside the Central American Common Market (CACM). The initial objective of the program is to introduce changes in the balance of incentives in favor of exports through a reduction in effective tariff protection via a reform of the common external tariff (CET) of the CACM. In addition, the SAL program envisages a strengthening and reform of the nationalized banking system with a view to improving credit allocation and financial savings; an improvement of public sector expenditure control through a reform of revenue earmarking and compulsory spending requirements; and the promotion of agricultural and manufacturing industrial growth through the introduction of more appropriate pricing and incentive policies.

To achieve the objective of reducing tariff protection, Costa Rica agreed with the rest of the CACM on a reform of the regional incentive and tariff regime, which was embodied in a protocol signed in Guatemala in December 1984. This agreement calls for, in addition to the negotiation of a new CET, (1) the conversion of all specific duty rates to an ad valorem basis; (2) the conversion of the NAUCA tariff classification to the Brussels nomenclature; (3) the elimination of all regional tariff exemptions and investment incentives, as well as the special surcharges of the San Jose protocol; and (4) the creation of a new Central American Council for Tariffs and Customs which would have authority to establish and modify import tariffs without the need for legislative action by member countries.

The reformed regional tariff, which is to be put into place no later than October 1, 1985, will have the following characteristics: (1) goods produced outside the CACM (noncompeting imports) including essential final consumer goods, raw materials, intermediate and capital goods will have tariff levels of 5 and 10 percent (at present, these items have tariff levels in the range of zero to 80 percent); nonessential final consumer goods and inputs used in the production of these goods will carry a 10 percent tariff rate; (2) goods produced within the CACM (competing imports) including raw materials, intermediate and capital goods will bear duty rates ranging from 10 to 30 percent, instead of from zero to 60 percent, as at present; in the case of final consumer goods, tariff levels of 40 to 220 percent will be reduced to a range of 35 to 70 percent.

In the SAL program, Costa Rica has agreed to go beyond the regional guidelines on tariff reform just described in order to reduce further its effective protection. In particular, all intermediate goods and raw materials, including those produced outside the CACM (noncompeting goods), will be subject to a 10 percent tariff, initially to be established by means of surcharges. Also, all capital goods will be subject to a duty of 20 percent.

V. Staff Appraisal

In recent years Costa Rica has made significant progress in recovering from its economic and financial crisis of 1980-82. Under a stabilization program in 1982-83, which was supported by a stand-by arrangement from the Fund, Costa Rica reduced substantially domestic inflation and external debt arrears and re-established a unified exchange system virtually free of exchange restrictions.

During the first half of 1984, however, there were slippages in economic performance which delayed the formalization of a new arrangement from the Fund. These slippages were reversed during the second half of the year, with the result that for the year as a whole domestic financial imbalances were contained. The external current account position of Costa Rica did not improve in 1984, as the restraint exercised by the public sector was more than offset by a surge in demand by the private sector which left the current account deficit virtually unchanged in relation to GDP with respect to the previous year. Also, the overall balance of payments registered a deficit (compared with a surplus in 1983), reflecting a lower utilization of official capital, which was financed mainly by an accumulation of debt arrears.

The measures of fiscal adjustment and monetary restraint which were implemented during the second half of 1984 laid the basis for the approval of a stand-by arrangement from the Fund in March 1985. The economic program supported by that arrangement called for a further reduction in the overall fiscal deficit and net losses of the Central Bank and a cutback in the pace of overall credit expansion, together with a policy of interest rate and exchange rate flexibility, to bring about an improvement in Costa Rica's external position (including the elimination of payments arrears). The achievement of the external objectives of the program also depended, to an important extent, on the coordinated support of the foreign commercial banks, bilateral creditors, and the World Bank.

To date, Costa Rica has complied with all the performance criteria except the one relating to external arrears. Costa Rica's failure to meet the arrears test was related to some extent to delays in the disbursement of certain foreign loans assumed in the program. Notwithstanding Costa Rica's compliance with the other performance criteria, policy implementation under the program has been mixed. Important weaknesses in program implementation have emerged in the area of wage policy and control over government expenditures, and the staff believes that economic performance in the rest of the year could deviate significantly from program objectives in the absence of corrective policy action.

The program called for adjustments to private sector minimum wages and public sector wages strictly in accordance with the absolute increase in the cost of a basket of essential goods and services, but the Government has exceeded that norm with the two adjustments granted this year.

In addition, the large adjustment to teachers' salaries agreed for 1986 means that a substantial burden of public sector wage payments will be carried over to next year.

The continuing problem of excessive wage adjustments has created a problem for the containment of government expenditures which is particularly critical for the success of the present stand-by program. In the staff's view, the expenditure overruns incurred this year need to be compensated by cuts in other expenditure programs and not by delays or postponements in expenditures until next year. The problem of expenditure control is made more difficult by the rigidity of expenditure commitments arising from the complex system of revenue earmarking and compulsory spending existing in Costa Rica. For this reason, the staff welcomes the intention of the authorities to start the formal process of fiscal reform involving, among other things, a dismantling of this system. In the interim, it is imperative that ad hoc procedures be developed to enhance the Government's control over expenditures.

An additional aspect of the fiscal problem that needs to be addressed more forcefully in the future is the question of the net losses of the Central Bank. These losses far exceed the imbalances in the public sector, and to a large extent represent a shift of the fiscal burden to the Central Bank. Monetary measures alone will not be sufficient to deal with this problem and the objectives for fiscal policy should take into account the resources needed to cover or offset these losses.

The lack of effective control over wages has led to a significant increase in real wages in Costa Rica in recent years not justified by productivity gains and therefore poses a threat to Costa Rica's external competitiveness. For this reason, the staff attaches particular emphasis to the flexibility of exchange rate management and the need to maintain a realistic value for the colon. This question is all the more important viewed against the perspective of the balance of payments adjustment effort required of Costa Rica over the medium term. The staff believes that significant fiscal adjustment needs to be accompanied by a real effective depreciation of the colon to bring about a manageable current account position for Costa Rica. The achievement of that objective also will require structural reform of the trade regime, and the staff supports the program of tariff reduction which Costa Rica is initiating in the regional context.

Looking to the immediate future, the staff would urge the authorities to implement the requisite adjustment measures which are not yet in place as soon as possible to ensure that, as a minimum, the original objectives of the financial program supported by the existing Fund arrangement will be attained. For this reason, it is not possible to complete the review under the stand-by arrangement at this time. One of the objectives of the stand-by program was the elimination of Costa Rica's exchange restriction in the form of payments arrears before the end of 1985. In the absence of assurances that this objective can be achieved, no approval of Costa Rica's exchange restriction is being recommended at this time.

It is proposed that the next Article IV consultation with Costa Rica take place on the regular 12-month cycle.

Costa Rica - Fund Relations
(As of July 31, 1985)

(Amounts in millions of SDRs, unless otherwise indicated)

I. Membership Status

(a) Date of membership: January 8, 1946
(b) Status: Article VIII

(A) Financial Relations

II. General Department

		Millions of SDRs	Percent of Quota
(a)	Quota: SDR 84.1 million.		
(b)	Total Fund holdings of colones:	256.3	304.7
(c)	Fund credit: Total	172.2	204.7
	Of which: Credit Tranche	(58.4)	(69.4)
	CFF	(33.7)	(40.1)
	EAR	(57.9)	(68.8)
	Extended facility	(11.3)	(13.4)
	Supplementary facility	(11.0)	(13.1)
(d)	Reserve tranche position:	--	--
(e)	Current operation budget:	--	--
(f)	Lending to the Fund:	--	--

III. Current Stand-by Arrangement and Special Facilities

Type of Arrangement	Amount: SDR Million	Amount: Percent of Quota	Duration	Amount Drawn (SDR million)	Status
(a) Current stand-by arrangement:					
SBA	54.00	64.2	Mar.13, 1985-Apr.12, 1986	24.0	Temporarily suspended pending completion of review
(b) Previous stand-by and extended arrangements:					
SBA	92.25	150.0	Dec. 1982-Dec. 1983	92.25	Expired
EFF	276.75	450.0	June 1981-May 1984	22.5	Cancelled Dec. 1982
SBA	60.50	147.6	Mar. 1980-Feb. 1982	15.4	Cancelled June 1981
SBA	11.60	36.2	July 1976-July 1977	--	Expired

(c) Special facilities--
Compensatory financing:

Date of Approval	Amount Drawn SDR Million	Percent of Quota
Sept. 1983	18.60	30.2
June 1981	30.10	48.9

IV. SDR Department

	Millions of SDRs	Percent of Allocation
(a) Net cumulative allocation:	23.7	100.0
(b) Holdings:	0.13	0.53
(c) Current designation plan:	--	--

V. Administered Accounts None.

VI. Overdue Obligations to the Fund None.

(B) Nonfinancial Relations

VII. Exchange rate arrangement: The representative exchange rate for the Costa Rican colon is the unified banking rate which is presently quoted at ₡ 51.35 (selling) per U.S. dollar. All transactions take place at this rate with the exception of the equivalent of 1/5 of 1 percent of export proceeds which are surrendered at the official rate of ₡ 20.00 per U.S. dollar, however, this does not give rise to a multiple currency practice under Article VIII, Section 3.

VIII. Last Article IV consultation: February-March 1984, completed by the Executive Board on August 1, 1984 (EBM/84/119), after a 12-month cycle. At present, Costa Rica's exchange restrictions are approved by the Fund, except for that described in footnote 1 on p. 19 of EBS/85/31.

IX. Technical Assistance:

(a) CBD	None
(b) Fiscal	A FAD panel expert was assigned to the Ministry of Finance from August 1980 to December 1983, providing assistance principally in the area of budgetary procedures.
(c) Bureau of Statistics	Technical assistance missions to improve the reporting of monetary data were fielded in December 1984 and June 1985. In January 1985 a technical assistance mission on balance of payments accounting visited Costa Rica.

X. Resident Representative/Advisor: Mr. Ignacio Tampe has been the Fund's Resident Representative in San Jose since March 1984.

Costa Rica: Financial Relations With the World Bank Group
as of May 31, 1985 (net of cancellations)

(In millions of U.S. dollars)

	Number of Credits	Disbursed to Date	Undisbursed	Total	Repaid
	A. IBRD/IDA/IFC Operations 1/				
1. IBRD loans	28	356.1	49.9	406.0	109.0
Agriculture	3	29.7	0.2	29.9	11.0
Education	1	6.0	--	6.0	0.3
Export	1	20.0	5.2	25.2	--
Industry	3	18.6	1.3	19.9	7.0
Power	7	123.3	4.0	127.3	45.1
Telecommunications	4	57.9	--	57.9	16.5
Transport	6	92.1	15.2	107.3	22.6
Water supply	1	2.0	24.0	26.0	1.9
Program loan	2	6.5	--	6.5	4.6
2. IFC investments	5	6.7	--	6.7	...

B. IBRD Loan Disbursements

	Actual 1980	Actual 1981	Actual 1982	Actual 1983	Actual 1984	Proj. 1985
Net disbursements	22.7	13.7	7.5	5.8	17.0	83.9
Disbursements	29.4	22.3	19.7	23.5	36.2	108.9 2/
Repayments	-6.7	-8.6	-12.2	-17.7	-19.2	-25.0

Sources: IBRD.

1/ Excludes US$80 million Structural Adjustment Loan (SAL) and US$3.5 million Technical Assistance Loan (TAL) which although approved by the Board are not yet effective.

2/ Includes Structural Adjustment Loan (SAL).

Costa Rica--Basic Data

Area and population	
Area	50,900 sq. kilometers
Population (1984)	2.5 million
Annual rate of population increase (1979-84)	2.5 percent
Unemployment rate (1984)	6 percent
GDP (1984)	SDR 3,324 million
	US$3,407 million
	₡ 151,304 million
GDP per capita (1984)	SDR 1,330

Origin of GDP	1981	1982	1983	1984
		(percent)		
Agriculture and fishing	23	25	21	21
Manufacturing	19	20	22	22
Construction	5	3	3	4
Utilities	2	2	4	4
Commerce	18	22	20	20
Other	33	28	30	29
Ratios to GDP				
Exports of goods and nonfactor services	44	47	37	36
Imports of goods and nonfactor services	50	44	38	37
Current account of the balance of payments (including official transfers)	-16	-10	-8	-6
Central government revenues	13	14	17	18
Central government expenditures	18	18	21	21
Central government savings	-2	-1	--	1
Central government overall surplus or deficit (-)	-5	-3	-4	-3
External public and government-guaranteed debt (end of year) 1/	102	121	111	101
Gross national savings	7	6	12	14
Gross domestic investment	22	17	22	23
Money and quasi-money (end of year) 2/	36	35	38	38
Annual changes in selected economic indicators				
Real GDP per capita	-4.8	-9.8	-0.2	3.8
Real GDP	-2.3	-7.3	2.3	6.3
GDP at current prices	37.9	70.8	29.8	19.8
Domestic expenditures (at current prices)	30.1	61.5	33.0	19.8
Investment	(16.2)	(26.8)	(69.3)	(28.0)
Consumption	(34.5)	(70.9)	(25.7)	(17.6)
GDP deflator	41.1	84.2	26.7	12.7
Consumer prices (annual averages)	37.1	90.1	32.6	11.9
Central government revenues	47.2	81.6	52.7	26.1
Central government expenditures	24.8	60.4	50.7	21.1
Money and quasi-money 3/	27.3	50.1	30.3	11.2
Money	(46.7)	(59.9)	(32.5)	(14.4)
Quasi-money	(14.6)	(43.9)	(28.7)	(9.0)
Net domestic assets 4/	62.9	105.3	38.2	28.7
Credit to public sector (net) 4/	(9.1)	(8.7)	(0.9) 5/	(-2.4)
Credit to private sector 4/	(6.4)	(17.9)	(22.8)	(9.0)
Merchandise exports (f.o.b., in U.S. dollars)	0.2	-13.4	-0.8	10.9
Merchandise imports (c.i.f., in U.S. dollars)	-20.6	-26.3	11.1	10.9

Central government finances	1981	1982	1983	1984
	(millions of colones)			
Revenues	7,770	14,026	21,417	27,012
Expenditures	10,769	17,284	26,044	31,529
Current account surplus or deficit (-)	-893	-1,046	464	875
Overall surplus or deficit (-)	-2,999	-3,258	-4,627	-4,517
External financing (net) 6/	1,441	1,002	2,341	1,691
Internal financing (net)	1,558	2,256	2,286	2,826

Balance of payments	1981	1982	1983	1984
	(millions of U.S. dollars)			
Merchandise exports, f.o.b.	1,003	869	862	956
Merchandise imports, c.i.f.	-1,213	-894	-993	-1,101
Investment income (net)	-319	-347	-314	-323
Other services and transfers (net)	105	132	191	250
Balance on current and transfer accounts (including official transfers)	-424	-240	-254	-218
Official capital (net)	20	-89	237	13
Private capital and errors and omissions (net)	-71	16	68	95
SDR allocations	5	--	--	--
Overall balance (deficit -)	-470	-314	51	-110
Change in net official international reserves (increase -) 7/	111	-139	218	-64
Arrears, net (accumulation +)	359	453	-269 8/	174

International reserve position	Dec. 31 1981	1982	1983	1984
	(millions of SDRs)			
Central Bank (gross)	126	221	293	429
Central Bank (net) 9/	-731	-1,065	-127 10/	-176 10/
Rest of banking system (net)	10	12	-1	5

1/ Includes IMF, but excludes short-term debt.

2/ Ratio of two-year average of liabilities to the private sector, including liabilities to nonbank financial intermediaries, to GDP.

3/ Liabilities to private sector.

4/ Measured in terms of the liabilities to the private sector at the beginning of the period.

5/ Excludes credit growth arising from the 1983 debt rescheduling.

6/ Includes accumulation of arrears on interest and/or principal.

7/ Includes revolving trade credit facility.

8/ Reduction in arrears, net of rescheduling.

9/ Includes payments arrears of SDR 564 (1981), SDR 1,006 (1982), SDR 38 (1983), and SDR 147 (1984), respectively.

10/ Excludes rescheduled arrears.

Costa Rica: Statistical Issues

1. Outstanding statistical issues

a. Prices

The weighting pattern of the CPI (base 1975) is somewhat outdated.

b. Government finance

Data published in the 1984 GFS Yearbook are available through 1982 and cover the budgetary cental government and the social security funds. However, there is a need to compile data on the extrabudgetary units (decentralized agencies), and to improve the data on financing and debt.

c. Money and banking

The primary objective of the current technical assistance program to Costa Rica is to revise the financial institutions' accounts and to improve the reporting of data to the Fund which are at present very uncurrent. During the first visit, in December 1984, the sources of information used in deriving the Central Bank's monetary accounts were reviewed and discussed with the authorities. Serious problems were encountered regarding the accounting procedures and valuation adjustments which need to be solved before consistent and accurate monetary data are obtained. A second follow-up visit was made in June 1985, and a report on this mission will be sent shortly.

However, until the necessary accounting improvements can be made, it is planned to update the IFS country page, beginning with the September 1985 issue, using the data derived from various tables which the Bank sends monthly to the Central American Monetary Council. These tables (which include data for the Central Bank through May 1985 and, for the commercial banks, and for the rest of the banking system through April 1985), together with additional data, will be used to generate the monetary data for the IFS and for the production of the WHD's analytical tables.

d. Balance of payments

There was a technical assistance mission on balance of payments in January 1985. A report on the work of the mission was sent to the authorities in May 1985.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Costa Rica in the July 1985 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Costa Rica, which during the past year have been provided on a timely basis, although data on money and banking are very uncurrent.

Status of IFS Data

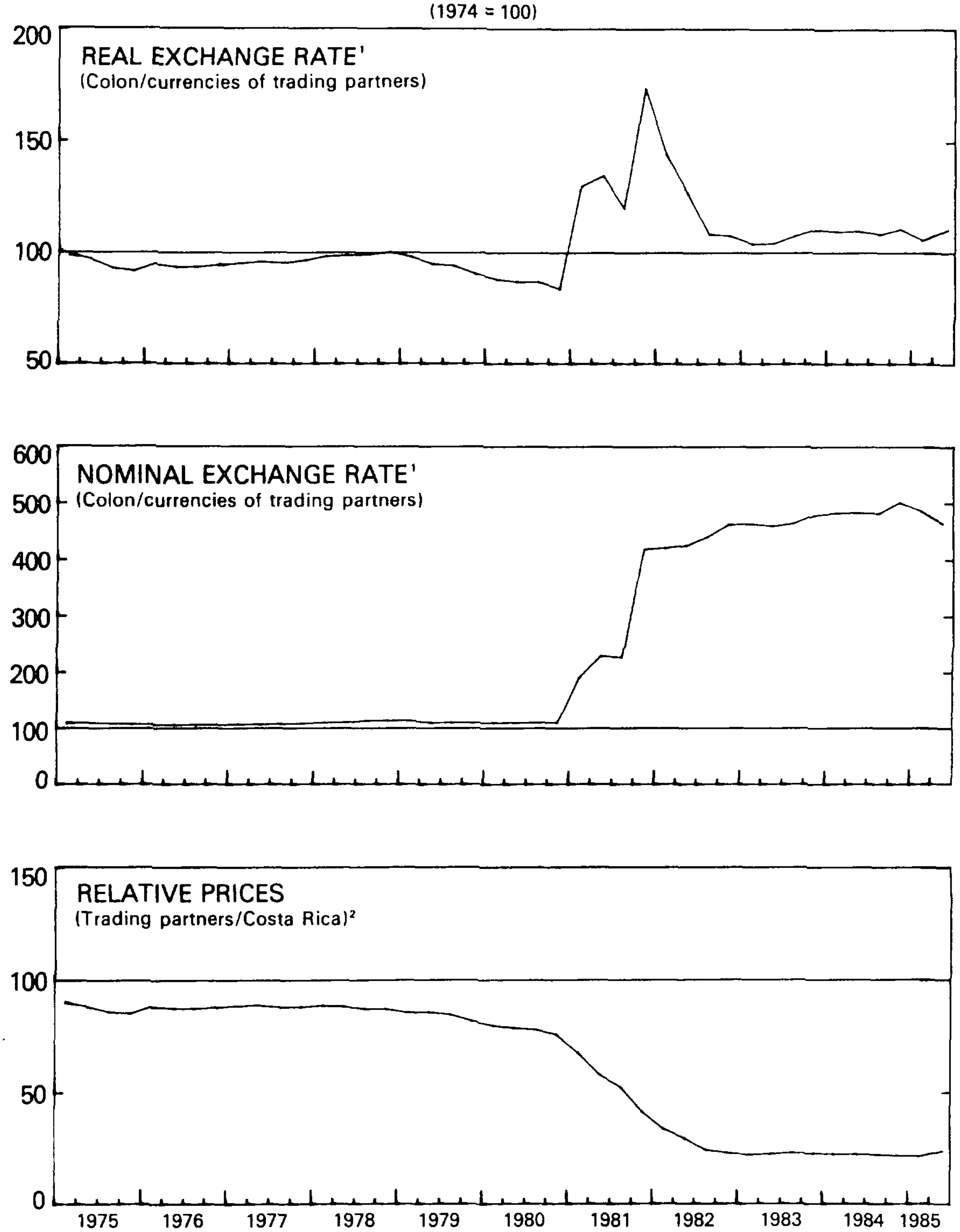
		Latest Data in July 1985 IFS
Real Sector	- National Accounts	1982
	- Prices	February 1985
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	December 1984
	- Financing	December 1984
	- Debt	December 1984
Monetary Accounts	- Monetary Authorities	November 1981
	- Deposit Money Banks	November 1981
	- Other Financial Institutions	November 1981
External Sector	- Merchandise Trade: Value	March 1985
	Prices	March 1985
	- Balance of Payments	1983
	- International Reserves	April 1985
	- Exchange Rates	May 1985

CHART 1

COSTA RICA

EFFECTIVE EXCHANGE RATE

(1974 = 100)



Sources: IMF, *International Financial Statistics;* and Fund staff estimates.

[1]An increase (decrease) in the index indicates a depreciation (appreciation) of the colon.

[2]Wholesale price index for Costa Rica and consumer price index for trading partners.