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Minutes of Executive Board Meeting 85/136

3:00 p.m., September 10, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. K. Diaby, Temporary
	M. Lundsager, Temporary
	E. L. Walker, Temporary
	G. Ercel, Temporary
	G. Nguyen, Temporary
	T. Alhaimus
	H. Kobayashi, Temporary
	D. Hammann, Temporary
	M. Rasyid, Temporary
	G. D. Hodgson, Temporary
	H. A. Arias
	D. J. Robinson, Temporary
	H. Fugmann
	J. A. K. Munthali, Temporary
F. L. Nebbia	B. Jensen
	E. M. Ainley, Temporary
P. Pérez	G. Ortiz
	A. Steinberg, Temporary
C. R. Rye	
	O. Kabbaj
	A. Vasudevan, Temporary
	N. Coumbis
	Yang W., Temporary

L. Van Houtven, Secretary
V. Wall, Assistant

1. COSTA RICA - 1985 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/85/135, 9/10/85) their consideration of the staff report for the 1985 Article IV consultation with Costa Rica (SM/85/233, 8/7/85; and Cor. 1, 9/9/85). They also had before them a report on recent economic developments in Costa Rica (SM/85/247, 8/28/85).

Mr. Steinberg said that following the financial crisis of the early 1980s, economic development in Costa Rica in recent years had been satisfactory in many respects, particularly when compared with even earlier periods. The 1983 Fund-supported program had been successfully implemented, and the relaxation that had taken place in the second quarter of 1984 had been generally reversed in the second half of that year. Nevertheless, that had not been sufficient to correct the 1984 balance of payments situation, which had turned out to be worse than in 1983.

The Fund-supported program for 1985 aimed at furthering the adjustment process and laying the groundwork for continued economic growth, Mr. Steinberg continued. The program had also helped to secure resources for debt relief. The temporary suspension of the stand-by arrangement was due to Costa Rica's failure to meet the second-quarter arrears target and to complete satisfactorily the review discussions. If the failure to meet the arrears target had been the only problem, a waiver would probably have been approved, especially since the failure was related to delays in disbursement of the structural adjustment loan. After all, the staff had said that "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." Costa Rica could hardly have used any of its $400 million in reserves to discharge its arrears because primarily its reserves were nonliquid medium-term claims on the Central American Clearing House, constituted by obligations of other Central American countries to Costa Rica.

All other performance criteria had been met, almost entirely with substantial margins, which "reflected to a large extent, a tighter monetary stance than called for under the stand-by program," Mr. Steinberg went on. The performance criterion on bank credit to the public sector had also been met with wide margins in the first two quarters of 1985, although fiscal policy had been more expansionary than called for in the program. It made him wonder whether all the ceilings had not been too low, which might have contributed to the authorities' decision to adopt a more accommodating wage policy than originally contemplated.

The uncompleted review, Mr. Steinberg remarked, was the result of disagreement on two issues--exchange rate policy and fiscal policy--unfortunately, the staff report was not clear on either one. For the exchange rate policy the staff had advocated the use of a mechanism to avoid real appreciation while allowing for a smooth and gradual devaluation. Did the authorities take a different position? There had been a weak revenue performance and expenditure overruns caused by higher wages, both of which had undermined the expected reduction in the overall deficit from 3 percent of GDP in 1984 to about 1.7 percent of GDP in 1985. The program limited the combination of fiscal deficit and net losses of the Central Bank to no more than 5.8 percent of GDP in 1985. However, the staff recently projected that the combined deficit for 1985 would be 5.6 percent--below the program goal of 5.8 percent. Therefore could the staff explain the harsh criticism in the text of the staff report?

Wage increases had indeed exceeded the authorities' formula, which made it difficult to reduce expenditures and the budget deficit, Mr. Steinberg noted. More important, wage increases had adversely affected Costa Rica's competitiveness--particularly for nontraditional industrial exports, which had shown disappointing results thus far in 1985--and had supported the need for further exchange rate depreciation. Nevertheless, it was reassuring to find that real wages had not been estimated to increase on average for 1985 in contrast with 1984.

Losses of the Central Bank should be covered by direct transfers from the budget, Mr. Steinberg remarked. In the future, problems could be avoided if liabilities in foreign exchange were matched by assets denominated in the same currency and bearing at least equal interest rates. That practice could be justified because the Central Bank was merely acting as a broker for a domestic borrower, usually from the public sector, that had little creditworthiness abroad.

The high rate of private investment, 17.4 percent of GDP in 1985, was impressive, but it was unfortunate that the savings rate of the private sector was still only 7-8 percent of GDP, Mr. Steinberg commented. Since that rate had been 14 percent in 1980, the authorities should introduce higher real interest rates as incentives for private savings and thus reduce the country's dependency on foreign borrowing.

He supported the staff position, but felt that the gap between the staff and the authorities was not very wide, Mr. Steinberg said. He urged both parties to conclude the review and put the program back on track soon.

Mr. Robinson stated that Costa Rica had made considerable progress in the previous three years, most notably by a substantial increase in public savings and a sharp reduction in the rate of inflation. Despite that, the picture was not reassuring. Although most of the program targets, with the exception of external arrears, had been met by the end of June, the pace of adjustment was slowing. Further measures, particularly on the fiscal side, were needed if targets were to be met the remainder of 1985. Therefore, it was worrying that details of further measures had not been worked out at the time of the consultations.

He was concerned about the recent slippages in fiscal policy and the substantial increases in public sector wages, Mr. Robinson continued. When the stand-by arrangement had been approved, he had noted that improvements in the nonfinancial sector had been too modest. If central bank losses could not be reduced, they would have to be offset in the remainder of the public sector because they appeared to be due to the cost of fiscal measures. There again, it was disappointing that "additional measures were not fully worked out at the time of the consultations," and he encouraged the authorities to tackle the problem with some urgency.

The medium-term scenario made it clear that the current account would have to be reduced to 5 percent of GDP if the present high ratio of debt to GDP was to be reduced by 1990, Mr. Robinson remarked. Thus, the relatively poor performance of exports in 1985 was of some concern. Over half of Costa Rica's exports had been to the United States and the Central American Common Market, both of which offered limited prospects for growth. In light of that point and of the problems in the banana industry, how was the projection of 10 percent export growth in 1986 to be achieved? Also, could the staff elaborate on the poor performance of exports outside the Central American market after their good performance in 1984? He hoped the forthcoming negotiations would provide a basis on which to complete the midterm review.

The staff representative from the Western Hemisphere Department said that he wanted to make one clarification on the timing of the public sector wage adjustment in 1985. Adjustments in private sector minimum wages and public sector wages usually had been made simultaneously at the beginning of each semester, but that had not been true in 1985. The adjustment of private sector minimum wages had been made in December, but the adjustment of public sector wages had been in February; thus, it had occurred during the 1985 program. As to the effects of the wage adjustments in February and July, it was the staff's view that private sector wages and public sector wages would just about keep pace with inflation if there were no further adjustments. However, by using the mechanism of the basket of goods and services to formulate wages, wage increases were intended to fall below the cost of living index during 1985 in order to correct the trend of past years in which real wages throughout the economy had increased substantially. It was not entirely clear what impact wage adjustments in the public sector would have on the private sector. However, in the past, wages for the economy as a whole had increased at least by as much as the rates for the minimum wage and public sector wages.

The problem for central government operations in the discussions for the midterm review had been to ensure that the overall objectives of the fiscal program would be achieved despite any cost overruns or revenue shortfalls, the staff representative noted. Given the fact that 1985 was a pre-election year--national elections would take place in February 1986--the authorities felt that there had been definite limits on what corrective measures they could implement during 1985, and they had therefore ruled out significant adjustment on the revenue and expenditure fronts that would involve legislative action. However, notwithstanding budget cuts by the Legislative Assembly amounting to

₡ 640 million, the staff estimated that there was a potential expenditure deviation from the program of about ₡ 2 billion (approximately 1 percent of GDP) if action were not taken either to bolster revenues or cut expenditures.

There was a difference of view on the fiscal situation between the staff and the authorities, the staff representative commented. The staff's view was that the authorities had a rather optimistic expectation for the effects of administrative measures they had introduced, such as the tax amnesty. In fact, they were estimating beneficial effects of administration measures at close to 1 percent of GDP. The staff had incorporated into its projections a significant amount of effects from those measures; however, it was felt that those administrative improvements would yield significantly less than 1 percent of GDP. Furthermore, in light of revenue problems and overruns in expenditures, the staff had recommended that the authorities should make further expenditure cuts in 1985. The difference of viewpoint was whether those cuts might eliminate budgetary authorizations for 1985 on a permanent basis or whether there would be a carryover of substantial expenditure authorizations into 1986. The Costa Rican authorities favored adjustments that would allow the expenditure authorization to be carried over into 1986, but the staff was concerned that that would create an undue burden on the prospects for continued adjustment in 1986, especially for the first quarter, which fell within the period of the stand-by arrangement. In the last round of discussions, both parties had attempted to define the maximum amount of effective cuts that could be realized in 1985 in order not to detract from adjustment in 1986.

In the previous stand-by program for 1982-83, the National Petroleum Refinery (RECOPE) had made substantial adjustments in the prices of domestic fuel, and those charges had been an important part of the adjustment, the staff representative said. Since then, there had been no further adjustments to RECOPE's prices, despite a continued increase in its imported costs. Although international fuel prices had declined, RECOPE's imported costs had increased because of the continuing downward adjustment of the exchange rate. One of the understandings incorporated in the present program was a policy of periodic adjustments to fuel prices to keep them in line with increases in the imported costs. However, the authorities had indicated that it would be difficult to implement that policy because of the political implications, and they maintained that the overall financial position of RECOPE could result in a small surplus by means of cost-saving efforts in expenditures. The staff had not insisted on price increases, but the projections had not yet been determined that would ensure that RECOPE would end in a surplus position and also provide the necessary transfers to the Central Government. That issue would be discussed in the forthcoming meetings with the authorities at headquarters.

When the stand-by review discussions were initiated, there was a possibility that the net losses of the Central Bank would exceed the target in the program, the staff representative continued. However, recent discussions had indicated there would not be a problem for two reasons. Earnings of the Central Bank would surpass the program target because of interest payments the authorities had undertaken to collect from Central American countries who had liabilities with the Central Bank. In addition, the U.S. Agency for International Development (AID) had temporarily suspended the requirement for Costa Rica to pay interest on the counterpart deposits of its grant assistance. Also, the authorities planned to reduce gradually the stock of stabilization bonds issued by the Central Bank and offset them by an equivalent increase in reserve requirements to maintain the Central Bank's overall credit position.

During the consultation discussions, the staff had raised the question of a possible waiver for the deviation from the arrears test, the staff representative noted. However, there were two problems in requesting a waiver. Until late August, there had been some uncertainty as to whether the structural adjustment loan would actually be in place. That there was not yet a basis for recommending to the Board a completion of the review was the second criterion against a waiver. Concern had been raised over a number of issues--for example, fiscal policy for the remainder of the program period, and exchange rate management and the achievement of a real depreciation during 1985. In addition, there were certain technical adjustments that had not been worked out, nor had the authorities determined a method to offset excessive wage increases in the first part of the program. However, definite progress had been made to resolve those issues, and the staff was hopeful that the completion of the midterm review could be recommended soon to the Board.

The new money facility from the commercial banks was to be disbursed in two installments provided that adjustment measures in the program were taking place, the staff representative said. Due to delays in negotiations with the banks, the first disbursement under the structural adjustment loan had not been made until June, whereas under the program it had been expected to take place in April. The second disbursement from the commercial banks was linked to the effective date of the structural adjustment loan--namely, late August--as well as the continued compliance with the terms of the stand-by arrangement. The underlying concern was that all the elements of the financing package should be in place and that the program was being successfully implemented. The specific date of August 31 had not been linked to the Fund review. It probably had been fixed by the banks to bring pressure on the authorities to complete arrangements to have the structural adjustment loan in place. The Fund had not been consulted about the date and probably would not have suggested it. In the banks' rescheduling package with Costa Rica in 1983, there had been problems with fixing dates for the possibilities of default, and a waiver had been granted.

If there had been no delays in the disbursements of the structural adjustment loan and the banks' new money facility, the statement would have been true that the financing requirement for Costa Rica's program in 1985 was satisfied, the staff representative remarked. Given the two disbursements of the structural adjustment loan and the full disbursement of the new money facility, there had in fact been a possibility of overfinancing. For this reason, the revised projection for the balance of payments for 1985 indicated that there was a possibility that if the program was implemented as intended, the overall balance of payments surplus could be somewhat larger than intended. Prospects for export growth were critically linked with continued adjustments of the colón that would bring about a real depreciation of the currency and the adoption of the regional tariff reform that was currently being negotiated among members of the Central American Common Market, the staff representative continued. Given its weak balance of payments position and large current account position, real currency depreciation, coupled with successful implementation of the regional tariff reform, would reduce what was currently an antiexport bias and would establish clear incentives for redirecting exports outside the region.

In response to a specific question on export prospects, the staff representative from the Western Hemisphere Department said that the shortfalls in the banana industry were temporary and were likely to be reversed late in 1986.

The Deputy Director of the Exchange and Trade Relations Department stated that several points had been made about the possibility of a waiver for Costa Rica. Although delays in the financing had made it more difficult to meet the arrears test, that argument as a basis for a waiver should not be carried too far. Reduction in arrears was an integral part of an adjustment effort, and although a program supported by Fund resources typically assumed that financing flows would take place, it could not assure them. If the financing did not materialize, then additional policy action would be necessary to ensure that the program would remain on track. In this context, inferences from the fact that only one performance criterion had not been observed, while all the others had been met, could not be drawn too far, because, for example, not meeting the arrears test made it easier to observe the other performance criteria. There was no point in separating individual performance criteria if it meant overlooking the overall picture. Those considerations were important because the line of reasoning that arrears had not been reduced because financing was not available could be extended to a more general argument that adjustment was not taking place because financing was not there, which would not be tenable as a general proposition.

The issue of a waiver had been considered, particularly since the expected financing had not materialized, the Deputy Director noted. However, the deviation from the performance criterion had not been small, and, as a result, Costa Rica had not qualified for a waiver on the grounds that its failure to meet the arrears test had only led to a minor departure from the program. To recommend a waiver in the circumstances, strong assurance that the deviation was temporary would have been needed. In that connection, there was a relationship between the requirements for a waiver and those for the completion of the review. If, as the review required, the Board could not be assured that fiscal and exchange rate policies to keep the program on track would be adopted by the authorities, it would be difficult to claim that the deviation in arrears would be transitory. Therefore, recommendation of a waiver without the completion of the review was out of the question.

In a stand-by arrangement, proper formulation of a review clause required that a date be set for its completion, the Deputy Director of the Exchange and Trade Relations Department stated. Such date made quite clear the drawings that would be contingent on the completion of the review; in the case of Costa Rica, the date had been August 31, 1985, by which time it was expected that all the elements required for conducting the review would be in place. In the relationship between Fund programs and capital flows, it had to be recognized that those programs acted as a catalyst typically when policies were in place; but, as a counterpart, when programs were not on track, the other sources of financing could be interrupted.

Mr. Nebbia stated that he was concerned with the general issue of the relationship of the Fund with commercial banks. What bothered him was that the staff had had a free hand in preparing reports for the banks without prior participation by the Executive Directors. In future, reports should at least express the Board's point of view.

The staff's position, Mr. Nebbia continued, was that if the financing package failed to develop as agreed, new adjustment measures would have to be taken. In many cases, the staff had recommended additional adjustment efforts without taking into consideration the special circumstances of the country concerned. What did the staff want from the authorities? Costa Rica was in a pre-election year. Could the staff not understand that there were limits on a government to undertake expenditure cuts or introduce further revenue measures in an election year? The authorities had made the utmost effort to keep the program on track; in fact, they had undertaken adjustment for two years prior to coming to the Fund to request a stand-by arrangement. For the staff to require new adjustment measures would be unjust.

Furthermore, in his view, the staff had been mistaken in some of its assumptions regarding Costa Rica, Mr. Nebbia went on. For example, the staff had suggested there would be some fiscal slippages. In fact, except for arrears, all September targets would be met. In early July the staff had said that the structural adjustment loan would not be in place. However, the staff had been proved incorrect because the structural adjustment loan had been disbursed by August 31. Based on the same incorrect assumption--that the structural adjustment loan would be delayed--the staff had not suggested a waiver to the Board. However, the structural adjustment loan was in place and, as it had turned out, the commercial bank disbursements and the stand-by arrangement were the links in the financing package that had been delayed. At present, the staff was indicating that several midterm review targets would not be met. In light of its track record with Costa Rica, the staff should not, in his view, decide what would develop three months in advance.

Costa Rica was the only case in his two months on the Board in which a country's financing package had been disrupted because money from the Fund had not been in place, Mr. Nebbia said. Considering the efforts made by the authorities and that a number of the staff's assumptions had proved to be incorrect, the Board should review the staff's judgment of Costa Rica's performance.

The Deputy Director of the Exchange and Trade Relations Department replied that the point of his earlier remarks had been only that delays in financing made adjustment more difficult. He had not been trying to link adjustment only to the reduction in arrears and certainly had not wanted to be understood as saying that adjustment should take place at any cost. However, neither could it be said that the absence of financing obviated the need for adjustment. In fact, when financing was not available, that was probably the time when adjustment was most needed. The reason adjustment was more difficult when external savings were not forthcoming was that performance could only be ensured by funds generated from inside the country. Whether or not that could be done involved not only an assessment of how much domestic saving could be raised but also an evaluation of whether proper pricing prevailed in the economy. Those were issues, in turn, which required the completion of the review.

There had been a number of cases in which delayed reviews had affected the pace of disbursements under a financing package, the Deputy Director stated. There seemed to be no reason for the Board to depart from its usual procedures in the case of Costa Rica on this count. In order for Costa Rica to be granted a waiver, a technical recommendation to this effect would have to be put to the Board. However, despite the financing delays and the adjustment measures that had been taken, the fact was that the deviation from the program was not minor. In the absence of policy understandings, the staff could not assure the Board that the deviation was temporary, which, as he had already noted, was the other technical basis for a waiver.

The staff representative from the Western Hemisphere Department said that the current status of the program was as follows: Costa Rica's purchase rights under the arrangement were temporarily suspended because as of August 31, the country had only been eligible to make purchases if the midterm review had been completed. Currently, the intention was to complete the review. However, the review was intended to give assurances that not only would the September targets be met, but also that the fundamental macroeconomic objectives of the program for calendar 1985 would be attained. The staff's duty was to recommend to the Board completion of the review only if it had been satisfied that those fundamental macroeconomic objectives had been met--namely, an improvement in its external debt situation and an improvement in the current account balance of payments. The staff was also guided by two other issues. Given Costa Rica's extremely difficult balance of payments situation, it was critically important that the targets set in the current program be considered minimum achievements and that, to the extent possible, the authorities should go beyond them. In addition, there was concern about fiscal operations: too much emphasis in the past had been placed on revenue policy and not enough on the expenditure side. That particular problem had been considered important in the discussions. In concluding, he said that the projections included in the report were based on a consensus between the staff and the authorities, and that those projections represented what both parties hoped to achieve.

Once the review had been completed Costa Rica's purchase rights would be reinstated, the staff representative from the Western Hemisphere Department said. Costa Rica would then request a meeting of the Committee of banks and formally request an extension of the deadline for the second disbursement of the new money facility. However, under the procedures of the refinancing, a change in the availability date of the new money facility required all the banks to vote.

The Acting Chairman said that he would make a comment from the perspective of management because the decision not to move ahead with the completion of the review had not been taken lightly. There had been long and extensive discussions in the previous year between the authorities of Costa Rica and the staff and management, and his comment would reflect a number of those discussions and what had been emphasized in them.

In the course of the discussions with the President of the Central Bank and the Finance Minister, which had taken place in February toward the end of the negotiations with the staff, great emphasis had been placed on the importance of continued fiscal adjustment, the Acting Chairman continued. In that connection, it was important that the authorities should pursue a wage policy consistent with the fiscal policy outlined in the program; that meant a policy of wage restraint, which in the past had posed a serious problem. There had been specific commitments by the authorities to achieve those fiscal objectives and on that basis a decision had been made for the Fund to support Costa Rica's program.

Also, the importance of maintaining a flexible exchange rate had been emphasized in light of the difficult external circumstances. There was also a financing aspect in the background, the Acting Chairman noted. The negotiations between the commercial banks and Costa Rica had been long and difficult, going well back into the previous year. The assessment of the commercial banks was that looking to the future, Costa Rica needed to emphasize structural adjustment. Whereas impressive adjustments in fiscal policy had been made over the previous two years, the longer-term prospects for achieving sustainable domestic growth and servicing its external debt would depend also on external adjustment. Therefore, the commercial banks attached great importance to the relationship between Costa Rica and the World Bank because they felt that structural adjustment loans would facilitate that adjustment. It was on that basis that the commercial banks had supported Costa Rica with new financing during the course of 1985, linking their own disbursements as much to performance under the Fund program as under the arrangement with the World Bank.

The legislative measures that were necessary to open the way for the structural adjustment loan with the World Bank were to have been finalized early in 1985, if not late in 1984, the Acting Chairman stated. The consequences of this slow process had surfaced in August, in part because of the lags in the implementation of the World Bank legislation, which had delayed the structural adjustment loan and which, in turn, had delayed the disbursement of the banks' loans. It was not a rigid mechanical cross-conditionality that was driving the process but a sense on the part of the commercial banks that structural adjustment was important. The problem of arrears had come about partly because of the delays in providing the financing which had been arranged to help implement the structural policies that were viewed as important to Costa Rica's long-term prospects. Consequently, the persistence of arrears when the financing had not been there reflected that important policy adjustments were not being made in the structural areas. The arrears issue was more than just a technical matter and in the circumstances it could not have been easily waived.

In addition, there had been the additional issue of the midterm review, the Acting Chairman said, regarding which there had been serious slippages on the fiscal side--especially on wage policy--and on exchange rate management. Consequently, the staff and management had been reluctant to proceed with the midterm review until those issues had been resolved.

He had met with and had discussions with the President of the Central Bank several weeks earlier during the Board's recess, the Acting Chairman added. At that time, he had underscored the importance of making the adjustments promptly and of not creating a more difficult fiscal burden for 1986 by putting off the adjustment from one year to the next, when it would be even more difficult and would require a larger fiscal adjustment. The President of the Central Bank had returned home and discussed with his authorities the measures that might be taken to redress some of the fiscal slippages that had taken place, and it was hoped that in a few days, further discussions would be held to see how the Fund program could be put back on track and the medium-term review concluded.

He hoped and believed that completion of the review would reactivate the commercial bank flows, the Acting Chairman concluded. After all, the commercial banks had gone through a long negotiation, and had committed resources on the assumption that progress would be made.

Mr. Pérez said that some Directors had expressed disappointment concerning the recent evolution of the Costa Rican economy. When a first step in the adjustment process had been concluded, it became increasingly difficult to maintain momentum, since the Government's room for maneuvering logically narrowed. That fact was demonstrated in all cases analyzed by the Board during 1985. Therefore, any examination of a more recent stage in the adjustment process of a country should be framed in the context of the adjustment period as a whole. In that sense, he did not think that Costa Rica's determination to continue its adjustment process had wavered. On the contrary, the current modest achievement vis-à-vis previous years should not be considered as slippages but as the result of a sharp deterioration of the economic growth prospects in relation to those previously envisaged. Despite the more adverse circumstances, the Costa Rican Government had made every effort to keep the program on track and, actually, all quantitative performance criteria had been met by the end of June, except for the limit on external debt arrears. The Costa Rican Government was confident that all quantitative performance criteria would be met by end-September.

There was no disagreement between his authorities and the staff on substantive points regarding exchange rate policy, Mr. Pérez continued. The mechanism was a basket of currencies, taking into account the volume of trade with its main trading partners, and the final target was to reach a 2 percent depreciation of the colón. The latest available information at the end of May showed that that depreciation had been achieved and that the authorities would maintain that differential during the remainder of the program. There was a small difference between the authorities and the staff on the weights assigned to the different currencies that comprised the basket utilized to judge the evolution of the real exchange rate. However, they expected to reach an agreement in the following few days.

Regarding the adjustment of oil prices, there were two different points of view within Costa Rica's public sector: the National Petroleum Refinery (RECOPE), of course, had requested an increase in oil prices, but the Minister of Finance, whose view was shared by the rest of the authorities, had argued against an increase for the time being. The Minister of Finance was of the opinion that a part of the expenditure program that RECOPE was carrying out was not efficient enough. He thought that, as a first step, RECOPE had either to sharply reduce or eliminate its inefficient expenditure program altogether. The second step would be to authorize an increase in prices. Such an increase in oil prices might lead to the postponement of the necessary cut in expenditure. In addition, no increase in oil prices in the international market had taken place, at least during the previous two years; on the contrary, a steady decline in oil prices had taken place and was expected to continue. Therefore, the Government's view remained that the necessary surplus in RECOPE should be achieved by further reducing expenditures rather than by increasing prices, at least for the time being.

The Government had presented to Congress a law, which had been approved, revoking most of the system of revenue earmarking and compulsory spending at present existing in Costa Rica, Mr. Pérez stated. At the same time, the law stipulated that all expenditure and revenue programs not included in the budget at present would be added to it. That measure did not involve a reduction of expenditure itself, but it allowed the Government to implement a better system to control both public revenues and expenditures. The law would be in effect by the end of 1986, while Congress carried out the necessary constitutional reforms.

On the question of savings resulting from the substitution of open market operations for reserve requirements for purposes of monetary control, the Government estimated that ₡ 130 million would be saved through interest rate differentials during the rest of the year.

He was not going to delve into the waiver question because Mr. Nebbia had mentioned most of his concerns. There was still the possibility of re-establishing the financing package, Mr. Pérez said in closing, and he sincerely hoped that an agreement could be reached between his authorities and the staff during discussions in the following few days.

The Acting Chairman made the following summing up:

Directors commended Costa Rica for the significant progress achieved since 1982 in lowering the rate of inflation, reducing the overall fiscal deficit, and liberalizing the exchange system.

In this connection, they made reference to Costa Rica's satisfactory performance under a stand-by arrangement in 1982-83 and welcomed the Government's decision to enter into a new arrangement that was approved by the Fund in March 1985. It was noted that Costa Rica had complied with the program's quantitative performance criteria during the first half of 1985, except the one relating to external arrears.

However, Directors expressed concern that slippages in the area of fiscal and wage policies that occurred in the first half of 1985 could jeopardize the achievement of the overall objectives of the current stand-by arrangement. In the fiscal area, Directors underscored the need for tighter control over government expenditures as a means to achieve the program objectives and urged the authorities to introduce the necessary cuts in budget outlays to ensure that this year's fiscal targets would be attained.

In noting the impact of adverse trends in economic activity on revenue receipts, Directors welcomed the additional measures that were taken to improve tax collections, including the collection of tax arrears. Some Directors believed that further revenue measures might be needed, but it was also noted that the ratio of current tax to GNP was already quite high and hat this added strength to the need for cuts in budgetary outlays.

Directors emphasized the importance of moderating public sector wage increases, which exceeded the guidelines that had been agreed on under the program. Directors noted that the system of revenue earmarking and compulsory spending made it difficult to contain government expenditures and welcomed recent steps taken by the authorities to accelerate the process of fiscal reform. They also encouraged the authorities to take further measures to improve the financial position of state enterprises. Some Directors expressed regret at the failure to raise energy prices further.

Directors observed that the significant tightening of monetary policy since mid-1984 had been an important factor in improving Costa Rica's net international reserve position during the first half of 1985. Directors encouraged the authorities to deal more forcefully with the problem of central bank losses by assigning fiscal resources to offset these losses in the future, particularly since the perception was that the losses had their origins in what were essentially fiscal operations.

The *critical importance of a flexible exchange rate policy* was highlighted in view of the need to maintain export competitiveness, especially given the recent slippages in wage policy and export performance, and to facilitate an improvement in Costa Rica's external position over the medium term.

Directors pointed out that Costa Rica's weak balance of payments position, related to its large external indebtedness, would require an adjustment effort sustained over several years. In this regard, Directors emphasized the important role for collaboration between the Fund and the World Bank in promoting necessary structural reforms--including, for example, those in the area of the foreign trade regime and public financial management.

Directors welcomed the recent first tranche disbursement of a World Bank structural adjustment loan, which had followed the completion of the requisite legislative steps in Costa Rica, and the prospect for early introduction of the tariff reform, which is an important aspect of the structural adjustment loan.

In conclusion, the Directors urged the authorities to implement promptly the measures required to assure that the objective of the existing program would be obtained and expressed the hope that Costa Rica would soon be in a position to complete the midterm review of the current arrangement. The hope was also expressed that the balance of payments financing package for Costa Rica would be maintained.

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

APPROVED: May 21, 1986

LEO VAN HOUTVEN
Secretary