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UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D. C. 20523

COSTA RICA

PROJECT PAPER

ECONOMIC STABILIZATION AND RECOVERY III

AID/LAC/P-173

Project Number: 515-0192

Loan Number: 515-K-043

UNCLASSIFIED

PDAAP 312

CLASSIFICATION:

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

1. PAAD Number: Project No. 0192 - Loan 515-K-043
2. Country: Costa Rica
3. Category: Cash Transfer
4. Date: March 2, 1984
5. To: A/AID, M. Peter McPherson
6. OYB Change Number: N/A
7. From: AA/LAC, Marshall D. Brown
8. OYB Increase: None

   To be taken from: Economic Support Funds (ESF)
9. Approval Requested for Commitment of: $ 35,000,000
10. Appropriation Budget Plan Code: Budget Plan Code
11. Type Funding: [X] Loan [ ] Grant
12. Local Currency Arrangement: [ ] Informal [ ] Formal [ ] None
13. Estimated Delivery Period: FY 1984
14. Transaction Eligibility Date:
15. Commodities Financed: N/A

16. Permitted Source		17. Estimated Source	
U.S. only		U.S.	$35,000,000
Limited F.W.		Industrialized Countries	
Free World		Local	
Cash	$35,000,000	Other	

18. Summary Description

The purposes of the program are to provide balance of payments support to aid stabilization efforts in Costa Rica, and to promote the objectives of USAID/Costa Rica's Caribbean Basin Implementation Plan through encouraging policy and structural changes which help to re-establish dynamic growth in the economy through increased exports. The $35 million loan will consist of B/P support through a cash transfer to the Central Bank of Costa Rica, which, with its own funds, will make available an equivalent amount of dollars for sale to private producers. Imports from the U.S. of raw materials, intermediate goods, construction materials and spare parts in an amount at least equal to the Loan will be required. The local currency equivalent of $15,000,000 of the loan will be used to finance credit to the productive private sector through a special credit line from the Central Bank to the private commercial banks; the equivalent of $20,000,000 of the loan will be used through the same special credit line for similar credit operations conducted through the State Commercial Banks.

The loan will be for 40 years, with a ten year grace period during which interest will be 2% and 3% thereafter. The $35 million program will be subject to the prior actions, Conditions and Covenants specified in Section V.E.1 of this PAAD.

19. Clearances	Date
ARA/ECP:R. Bash (draft)	3/29
LAC/DP: J. Oleson (draft)	3/29
GC/LAC:R. Meighan (draft)	3/30
PPC/PDPR:R. Hullander	4/6/84
AA/PPC: R. Derham	
M/FM:C. Christensen (phone)	4-11-84
LAC/DR:D. B. Johnson	4-6-84
GC:H. Fry	4-9-84

20. Action: [X] APPROVED [ ] DISAPPROVED

Authorized Signature: [signature] Date: April 17, 1984

Title:

AID 1120-1 (5-82)

CLASSIFICATION

Project Development Committee:

PDO:	J. Silver, Chairperson
O/MDIR:	L. Kornfeld, Advisor
PDO:	D. Hagen
PO:	O. Lustig
PO:	M. Sagot
CONT:	F. Latham
LAC/DP:	R. Adler
ROCAP:	J. Heriot

Participation as appropriate from USAID/CR Technical Offices in the development of individual covenants and local currency activities.

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*Bulk Annex — this report may be obtained from LAC/DR bulk files

LIST OF ACRONYMS

ABS	Annual Budget Submission
AID	Agency for International Development
AID/W	Agency for International Development/Washington, D.C.
BANEX	Banco Agro-Industrial y de Exportaciones
BCCR	Banco Central de Costa Rica
CACM	Central American Common Market
CARE	Cooperative for American Relief Everywhere
CATSA	Central Azucarera del Tempisque, S.A.
CBI	Caribbean Basin Initiative
CDSS	Country Development Strategy Statement
CENPRO	Centro de Promoción de Exportaciones
CINDE	Coalición Costarricense de Iniciativas de Desarrollo
CIP	Commodity Import Program
CNP	Consejo Nacional de Producción
CODESA	Corporación Costarricense de Desarrollo
COFISA	Corporación Costarricense de Financiamiento Industrial
CP	Condition Precedent
DA	Development Assistance
DAEC	Development Assistance Executive Committee
ESF	Economic Support Funds
ESR	Economic Stabilization and Recovery
FAA	Foreign Assistance Act of 1961, as amended

FERTICA	Fertilizantes de Centroamérica
FUCODES	Fundación Costarricense de Desarrollo
GDP	Gross Domestic Product
GOCR	Government of Costa Rica
IBRD	International Bank for Reconstruction and Development
IDB	International Development Bank
IESC	International Executive Service Corps
IMF	International Monetary Fund
LAC/DR	Latin American and the Caribbean/Development Resources
LAC/DP	Latin American and the Caribbean/Development Planning
LPSFE	Law for Public Sector Financial Equilibrium
INVU	Instituto Nacional de Vivienda y Urbanismo
PAAD	Program Assistance Approval Document
PL	Public Law
PP	Project Paper
PVO	Private Voluntary Organization
RECOPE	Refinadora Costarricense de Petróleo
ROCAP	Regional Office for Central American and Panama
SNAP	Sistema Nacional de Ahorro y Préstamo
US	United States of America
USAID	United States AID Mission
USAID/CR	Unites States AID Mission to Costa Rica

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PROGRAM ASSISTANCE APPROVAL DOCUMENT

COSTA RICA: ECONOMIC STABILIZATION AND RECOVERY III

I. SUMMARY AND RECOMMENDATION

The Monge administration, which took over in May of 1982, committed to a stabilization program which it has, thus far, successfully carried through. In support of this program, A.I.D. has provided $20 million and $155.735 million in B/P support under two ESF programs for FY's 1982 and 1983, respectively; the IMF provided resources under a 1983 Stand-By Arrangement, and a team is in Costa Rica as of this time to negotiate a Letter of Intent for a 1984 Stand-By.

Despite Costa Rica's success thusfar in achieving short-term stabilization objectives, and significant policy reforms relating to exports investment and public sector deficits, fundamental obstacles to reestablishing long-term dynamic growth persit. These are primarily of a policy and a structural nature. A.I.D.'s goals are to assist Costa Rica to re-establish dynamic economic growth, and to re-orient its economy away from its present import substitution bias, towards one in which the industrial sector contributes to export led growth. Such goals are to be achieved through the objectives of the Mission's CBI Implementation Plan.

The proposed ESR III program both continues the efforts of the previous ESR I and ESR II programs, and establishes new initiatives - some of which will also serve as a basis for future changes required. ESR III involves a shift away from emphases on short term stabilization and the development of an export and investment strategy, and towards conditionality and activities which pertain in particular to improved Policy Formulation and Administrative Reform, Strengthening of the Financial System, and administrative and operational support for Expansion of Exports and Investment. Specific policy reforms leading to structural changes are to be obtained through the GOCR's meeting pre-conditions to obligation of the Agreements and any amendments, and through its adherance to ESR III conditions and covenants.

This PAAD presents the background, objectives, and rationale for a proposed 1984 ESF program totalling $70 million. Two Agreements will be signed under the ESR III program covered by this PAAD, one with the Central Bank of Costa Rica (BCCR), and one with the Central Government. The Agreement with the Central Bank will be for $35 million in loan funds; the one with the Central Government is proposed as a $35 million grant. The Agreement with the Central Bank will be signed first, as soon as all pre-conditions have been met, in order to minimize delay in helping Costa Rica avoid an impending, foreign exchange cash flow crunch.

Both the loan and the grant will be disbursed as cash transfers for balance of payments support. Within CY 1984, the dollar equivalent of the cash transfer will be sold to private producers through the National Banking System to finance the import of raw materials, intermediate goods, construction materials, and spare parts from the United States. The Loan will be made in one disbursement, and the grant in three tranches. Conditionality requirements will be enforced by the sequential nature of the Agreements and any Amendments, and the tranching of disbursements.

Conditionality for the first Agreement has been negotiated and AID/W approval of the $35 million loan is requested at this time. There will be two pre-conditions to A.I.D. authorization and obligation of the first Agreement: submission by the GOCR of a Letter of Intent acceptable to Management of the IMF, and a revision to the Currency Law. This revision would facilitate both making loans in Costa Rica denominated in foreign currency, and access by private banks to foreign financed Central Bank credit operations. A third pre-condition to signing the Agreement has already been complied with --modification of the Free Zones Law. Originally, as proposed in the Concepts Paper, IMF Board approval was to be required for disbursement under the first Agreement. Given the acute cash flow crunch, it is proposed that this C.P. not be included, but that acceptance of the Letter of Intent by IMF Management as a pre-condition suffice to meet our objective. Policy and structural reforms covered by the covenants of the first-Agreement are in the areas of: Credit and Interest Rate Policy; Exchange Rate Policy; Improved Data Relating to External Debt, Foreign Commerce, and other International Transactions and Economic Indicators; Credit Resources for the Private Sector; and Mortgage Financing. Local currency equivalent from the loan will be used to provide credit to the productive private sector through the private commercial banks ($15,000,000), and through the State Commercial Banks ($20,000,000).

Discussions concerning the second Agreement, to be signed with the Central Government, are underway. The PAAD outlines the policy reforms that will be subsequently negotiated with the GOCR. A PAAD supplement of limited scope, providing specific conditions and covenants for the second Agreement will be transmitted separately by cable, together with a request for authorization of those funds at that time.

To the extent possible, the full conditionality to be included in each Agreement will be negotiated and included at the time that Agreement is originally prepared, with the exception of those items pertaining to activities that would be funded from local currency equivalent that might flow from a supplemental appropriation. Conditionality requirements will be reinforced under this ESF program, both by tranching of disbursements and by the phased nature of the Agreements, wherein the U.S. could delay entering into sequential Agreements if conditionality were not being adhered to.

It is recommended that the Administrator authorize a loan of $35 million dollars to the Central Bank.

II. BACKGROUND

A. Historical Conditions

During a quarter of a century ending approximately in the mid-1970s, Costa Rica appeared to be a model developing country: real growth of GDP averaged well over 6% per year; social security, obligatory workmen's compensation, and similar measures were institutionalized; and social infrastructure (schools, health facilities, water and sewerage installations) and physical infrastructure (roads, electricity and communications facilities) were widely distributed throughout the country. The results were dramatic: adult literacy reached 90%; infant mortality declined sharply to under 20 per thousand; the population growth rate dropped from 3.7% to 2.6%; and open unemployment and underemployment were held to 5% and 6% of the labor force, respectively. Progress in meeting needs for shelter was less spectacular, but satisfactory. Income distribution was quite equitable in comparison to most developing countries.

The private sector operated under a protectionist, import substitution model. Producing for the domestic and Central American markets, the private sector benefited from considerable inflows of external private capital and was allowed a reasonably free hand. Productivity in traditional products, e.g. coffee, was markedly increased. An entrepreneurial/managerial class came into being. This trend was partially offset, particularly in the latter part of this period, by a movement toward creation of state enterprises.

The above achievements were attained in a system of political democracy which continues in full force today. Over time, however, Costa Rica moved somewhat away from a market economy and more towards a state-administered economic model as regards such variables as prices, wages, authorization to operate, and concessions for special interest groups. Social services were expanded but at the cost of heavy internal and external borrowing. Inefficient state enterprises and a significantly increased bureaucracy were created in the process. Public sector employment increased from 6% of the labor force in 1950 to about 20% in 1983. White collar public sector employees, a new segment of the middle class, organized themselves into strong unions and associations which bargained for and secured many fringe benefits and job security concessions. Insufficient attention was given to the fact that the public sector was growing much faster than the output of the private sector upon which it depended for its financial support.

The structural problems inherent in the import substitution economic growth model being followed were not sufficiently appreciated. High levels of effective industrial protection, an overvalued exchange rate, subsidized interest rates, and other incentives to capital investment resulted in an industrial sector with considerable excess capacity, heavy reliance on imported inputs and dependent for expansion on growing domestic and regional (CACM) markets.

In the 1980's, however, the CACM became a contracting and unreliable market. The terms of trade turned against Costa Rica and its partners in the CACM as coffee prices fell sharply from their 1977 high, and the price of petroleum doubled in 1979. Political turbulence in some CACM countries further contracted the demand for Costa Rica's manufactured exports.

In order to maintain the status quo and to compensate for the fall in the value of its exports in what was hoped by some to be a short-term difficulty, the Costa Rican Government engaged in substantial external borrowing, mainly at commercial rates, to cover the growing current account deficits. Net foreign exchange reserves were drawn down to negative levels. Uncontrolled monetary expansion, related to attempts to maintain previous levels of public and private sector consumption, generated inflationary pressures. The results of these policies were a <u>de facto</u> moratorium on the foreign debt, estimated to be about US$3.5 <u>billion</u> at the end of 1982; a drop in GDP of 2.3% in 1981, and of 9.1% in 1982; a doubling of open unemployment and underemployment rates by 1982 to at least 9% and 14%, respectively (and probably higher because of likely statistical quirks); an inflation rate in 1982 of 90%; and a 13% decline in the value of exports in 1982.

By the time the present administration took office in May of 1982, enough elements in the country were sufficiently aware of and concerned with the problems to generate commitment to a stabilization program. This was formalized in December 1982 under a Stand-by Arrangement with the IMF, as described in Section II.C.3, with significant support added via the USAID FY 1982 and FY 1983 ESF programs which are described immediately below.

B. <u>Objectives and Accomplishments of AID's FY 1982 and 1983 Economic Stabilization and Recovery Programs (ESR I and ESR II)</u>.

In FY's 1982 and 1983, AID signed two Assistance Agreements with Costa Rica, both with the Banco Central de Costa Rica (BCCR). The 1982 Agreement provided $20 million, of which $15 million was a loan and $5 million a grant. The 1983 Agreement and its amendments provided $155.735 million, of which $118 million were loans and $37.735 million were grants. All funds have been fully disbursed.

Both programs were based on the need to provide balance of payments support to Costa Rica, and to increase the availability to the productive private sector of both the amount of foreign exchange for sale and local currency credit[1/]. In addition, the FY 1983 program, which included $73.735 million in Caribbean Basin Initiative Funds (C.B.I.), was tied to the objectives of USAID/Costa Rica's CBI Implementation Plan, which encompasses the objectives previously stated, and places high priority on improving private sector performance. It was also tied to the 1983 Stand-by Arrangement with the International Monetary Fund (IMF). Disbursements under the 1983 ESF program (ESR II) were conditioned upon Costa Rica entering into, and remaining in substantial compliance with, the IMF Stand-by then in effect.

In November of 1983, following a revaluation of the "free" bank exchange rate from ¢43.60 to ¢42.60 to the dollar, the Mission opened a dialogue with the Central Bank under Covenant Q of the Agreement which states that the BCCR commits:

> To maintain a policy which does not weaken the competitive position of Costa Rican exports in foreign markets.

Based on data which suggested that the colon was overvalued as of that time, the Mission asked the Central Bank to comment on the relationship between the exchange rate established, and the covenant. At approximately the same time, the IMF suspended disbursements after it determined that Costa Rica was maintaining a tax on foreign remittances which contravened the IMF Stand-by. The AID Agreement also included, as a special provision, the following:

> AID reserves the right to suspend scheduled monthly disbursements in the event that the GOCR is not in substantial compliance with the IMF Agreement as determined by AID.

Given the Special Provision and the Covenant, AID withheld disbursements under its Agreement until corrective action was taken, i.e., a 5% devaluation, and legislative action to remove the tax on remittances.

Significant accomplishments have been attained by Costa Rica in its stabilization efforts, as described in Section II.C. Performance under the Stand-by Arrangement to date has been satisfactory. In addition, significant progress was made on structural problems.

- o A Strategy for Export Promotion and Investment was developed and issued by the GOCR as a statement of policy in the summer

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1/ AID supports, in addition, availability of dollar credit under two DA-funded projects: Private Sector Export Credit (0187), and Private Sector Productivity (0176).

of 1983. The strategy, which was approved by AID, was required as a condition to a portion of the ESR II assistance.

- A draft paper entitled Economic Policy: Strategy and Actions, 1984-1986, has recently been prepared by an interministerial commission - including the Central Bank. This draft, which was included as Annex I to the Concepts Paper, has been approved by the Council of Ministers. The Mission is proposing to require its official publication as a condition prior to obligation of funds under the second Agreement of ESR III.

- A special rediscount line for private banks was established and the equivalent of some $25 million in colones under ESR I and ESR II was channelled through it to the private sector.

- Between December of 1982 and October of 1983, a period covered by ESR I and ESR II plus the 1983 IMF Stand-by Arrangement, credit provided by the National Banking System to the private sector increased 29% in real terms - this is compared to a decrease of 23% in 1982.

With respect to conditions and covenants of the previous ESF Program, ESR II, all conditions were met. All covenants have either been complied with, or progress towards fulfilling these is being made in a manner satisfactory to AID and on an appropriate schedule. The status of compliance with conditions and covenants of ESR II has been reported by cable, SAN JOSE 1691, per ANNEX II.

C. Current Economic Situation, Structural Problems and Prospects

The following is based on the report contained in Annex III prepared by Robert Adler, LAC/DP, and Julian Heriot, ROCAP.

1. Economic Trends of Recent Years

--Economic growth stopped in 1980 and Gross Domestic Product declined by 2.3 percent in 1981 and 9.1 percent in 1982. The present estimate for 1983, with growth of 0.8 percent, suggests only a bottoming out of recession. The present official forecast for 1984 growth, 2.3 percent, is far from indicative of full-blown recovery and is still less than population growth.

--Based upon national accounting estimates for 1983, on a per capita basis, 1983 GDP was 88 percent of the 1977 level, and consumption was 81 percent and investment 42 percent of the 1977 levels. Private consumption per capita in 1983 was 79 percent of the 1977 level.

--The fundamental constraint on economic growth relates to the balance of payments. Current account deficits amounting to $ 1.0 billion in 1979-1981 were financed by foreign loans, but with the sharp rise in debt service payments, particularly after 1980, the strong net inflow of external credits could no longer be maintained. Finally, in 1981 the GOCR suspended external debt service, essentially to maintain a reasonable level of imports.

--Inflation reached high rates in 1981 and 1982; for example, on an average annual basis the wholesale price index registered a 65 percent increase in 1981, and a 108 percent increase in 1982. The high rate of inflation of these years is partially explained by accelerated expansion of domestic credit, which registered nominal rates of growth increasing from 35 percent in 1978 to 105 percent in 1982. Lower rates of inflation up to 1981 are explained by orthodox theory, which suggests that excessive growth of domestic credit will enlarge imports and the balance of payments deficit until foreign exchange reserves and external creditworthiness are exhausted. Substantial balance of payments support inflows in 1983 (approximately $270 million) and exchange rate stability served to increase imports by $100 million and reduce inflation to 26% in that year. In addition, domestic credit expansion was 33.5% in 1983, which was postulated on an expected rate of inflation in excess of 30%.

--The rate of open unemployment was 8.9 percent in 1983, i.e. a relatively low rate given the decline in output. However, the growth of the employed labor force was only 1.2 percent in 1983, suggesting a deteriorating employment situation. Real wages declined strongly in 1981 and 1982 and, after some recovery in 1983, are about 60 percent of the 1979 level.

--Arrearage on external debt service, which accumulated to over one billion dollars by the end of 1982, was a major element in Costa Rica's balance of payments after 1979. Costa Rica's balance of payments crisis and suspension of external debt service in 1981 was caused by the rapid increase in external debt, a sharp increase in interest payments on that debt, declining export prices, loss of Central American export markets, and (up to 1982) by imports increased by domestically-generated demand pressures. By the end of 1983, after commercial bank and Paris Club rescheduling agreements, Costa Rica was again current on contractual external payments.

--Costa Rica's trade deficit decreased from $527 million in 1980 to $28 million in 1982 and $143 million in 1983. Related to this improvement, import volume (referring to imports of goods and non-factor services per national accounts) declined by about 50 percent from 1980 to 1983, and the projected 1984 import volume is only 56 percent of the 1980 volume. This is also confirmed by the balance of payment accounts which indicate that the value of 1983 commodity imports was only 65 percent of the 1980 nominal dollar value, also implying a 1983 import volume about 50 percent of that of 1980. In contrast, the volume of 1983 exports of commodities and non-factor services (from national accounts) was nearly the same as in 1980. Thus, the economy has achieved a very substantial economy in imports as related to exports. Reduction of domestic demand through monetary restraint and reduction of the fiscal deficit underlie this achievement.

--However, the reduction in real imports is also related to very low investment. In 1982/83 investment was only 43 percent of the level of 1979-80, and if continued for long this will impair the achievement of both structural adjustment and future economic growth. Even though financial savings, in particular quasi-money, have increased in 1983 (as a stock, from 32.6 percent in 1982 to 38.1 percent of GDP in 1983), with the recessed economy, incomes are down and logically profits must also be down. More importantly, the expected rate of return on real investment is undoubtedly low. The tax exempt government bonds and high real rate of return deposit media are obviously preferred by savers over more risky productive investments.

2. Structural Problems

--For Costa Rica, with a small open economy, export growth is the lifeline to higher standards of living. The structure of trade arrangements encourages production for the small domestic and regional market rather than for markets outside the region. Slow growth in the regional market must be assumed under the best of circumstances.

--The Common External Tariff imparts a high degree of effective protection to final consumer goods industries and very low protection to intermediate and capital goods industries. Consequently, consumer goods industries avoid the competition that would help them be price competitive in third markets, and intermediate and capital goods producers are deprived of incentives for investment.

--The colon is overvalued. It has been adjusted on the side of overvaluation rather than on meeting competitive prices in third markets for non-traditional exports. Using the IMF/IBRD purchasing power parity methodology and a 1974 data base, in mid-1983 the colon was found to be 6% overvalued when the trading partner factor was limited to the U.S., and 16% overvalued when other high income markets for non-traditional exports were included. However, the recent unification of the "free" bank and inter-bank exchange rates and the reduction in the percentage of export proceeds that must be liquidated at the official rate effectively devalued the colon by 8%.

--There are little or no Central Government current account savings.

--Current account savings in the public sector enterprises are due mainly to surpluses generated by the state-owned petroleum company, RECOPE, and not to a rate and tariff structure throughout the state enterprises that would produce savings in all the companies. The absence of public sector savings generally has meant that the government has had to resort to excessive domestic and foreign borrowing to finance public sector investment.

--Some current account improvements through revenue increasing changes and expenditure reduction measures were enacted in the "Law for Public Sector Financial Equilibrium" (LPSFE) passed in February, 1984.1/ These include a 10% income tax surcharge; transfers from state enterprises to the Central government, and reductions in government expenditures. A 10% to 25% sales tax on gasoline is under discussion. These stop gap measures do not reflect a durable restructuring of the public sector finances.

--Credit quotas and differential interest rates, which favor some economic sectors (or people) over others, make financial intermediation in the National Banking System inefficient. The BCCR's subsidies have demonstrably failed to meet the aims of the program. In one typical institution, 1.6% of the loans accounted for more than 45% of the credit. These inefficiencies reduce the flexibility of the system to channel adequate credit to new and more productive sectors of the economy. The GOCR has taken measures recently which improve this situation somewhat.

--The private banking sector, which could provide a healthy degree of competition to the state banks, suffers from unequal access to financial resources. Private banks cannot accept demand and savings deposits from the domestic private sector, and direct re-discount facilities from the Central Bank are not available to them.

--Antiquated management practices and over-regulation in general generate high costs for borrowers and savers in the financial intermediation process.

3. The 1983 Economic Program

--By the time the present (Monge) administration took office in May 1982, most segments of Costa Rican society were sufficiently alarmed to make possible the imposition of the discipline of a stabilization program, which was formalized in a Stand-by Arrangement

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1/ The Law has not yet been published in the official Gazette, and the reference here and in later sections of this document to its provisions derive from what we are informed is a final draft.

with the IMF in December, 1982. In July of 1982, the GOCR also resumed partial payments on external debt service arrears, and said payments amounted to over $40 million in 1982.

--The IMF's one year Stand-by was approved on December 20, 1982 (and amended on April 26, 1983). This program, which provided approximately $100 million (SDR 92.5 million), was designed to reduce inflationary pressures, to promote orderly exchange markets, and to facilitate resumption of public sector debt service. Furthermore, the agreement was widely regarded as a necessary element in the GOCR-commercial bank debt rescheduling, and a pre-condition to the Paris Club bilateral debt rescheduling.

--On January 10, 1983 the GOCR signed a debt rescheduling agreement under the aegis of the Paris Club with ten creditor countries which rescheduled principal and interest falling due between July 1, 1982 and December 31, 1983 mainly to a five year period beginning September 1987. On April 22, 1983, the GOCR signed a memorandum of understanding with foreign commercial banks, covering all principal in arrears and falling due in 1984. These payments are rescheduled to a period beginning with 1987, and ending with 1992. In addition, the agreement includes a revolving credit fund in favor of Costa Rica, but of self liquidating and diminishing character, composed of fifty percent of interest payable and due in 1983.

--The substantial infusion of IMF and U.S. ESF assistance provided essential support to the 1983 balance of payments and was crucial to GOCR efforts to bring about exchange rate stability and to reduce the rate of inflation. By the end of 1983 the consumer and wholesale price indices were increasing at annual rates of 10.7 and 5.9 percent, respectively. In addition, the five colon spread that had existed between the inter-bank and "free" market exchange rates was eliminated during the course of 1983.

--The GOCR complied with the performance tests of the IMF agreement. The quantitative tests in this agreement were no net decline in international reserves (adjusted for certain arrearage liquidation), a limit on Central Bank expansion of credit to the economy, and on banking system credit to the non-financial public sector. The larger-than-anticipated reduction in inflation has impacted on the economy via increased real demand through a 15% increase in real wages and increased real credit.

--The public sector deficit, which had increased from 6.7 percent of GDP in 1977 to a high of 13.7 percent in 1981 was reduced to 9.5 percent in 1982. A conservative estimate for 1983 is 5.0 percent. The reduction of the deficit can be attributed in part to expenditure cuts that began in 1982, but in even larger measure to increases in the charges of the state-owned petroleum refinery and electric company. Private purchases of government securities were a major source of financing of the public sector deficit in 1983.

4. Outlook for 1984

--The major negative for 1984 has been failure of IMF-GOCR to reach agreement on a new Stand-by early in the year. This problem arose because the public sector's 1984 budget had a projected deficit of ¢15 billion. Wage increases for the public sector, many of which were approved in the 1983 budget but deferred for payment until 1984, constituted about 10% of this deficit. In total, the deficit was judged to be about triple the amount compatible with continued stabilization. To face this problem, the IMF suspended negotiations for a new Stand-by until the GOCR had obtained legislative approval for stop gap measures to reduce this deficit. The laws in question have now been approved and the projected deficit reduced to ¢5 billion. An IMF team is now negotiating a Letter of Intent.

--Our review of Central Bank projections of Costa Rica's 1984 balance of payments indicates a gap of $267 million to be financed with IMF, US ESF, and PL 480 Title I resources. Under pessimistic assumptions, e.g. IMF resources of about $50 million, US ESF resources at only $70 million, Title I resources at $28 million, the unfinanced gap would be in excesss of $100 million. A more optimistic assumption, such as, an additional $60 million of ESF and $50 million of IMF resources, would suggest adequate financing for the additional imports which accrue to mild economic recovery, projected at $90 million in nominal dollar value, and which are equivalent to about four percent in volume.

--In spite of the fact that domestic demand growth in 1983, and growth for 1984 along the lines of the official projection (2.8 percent), cannot be considered as excessive, the GOCR confronts very limited options to reduce its 1984 B/P gap. It can either cut imports by carrying out a mix of actions such as tightening credit, stepping up devaluation, and imposing new taxes on imports; or it can default on its commerial bank rescheduling agreement. However, cutting imports would result in aborting the moderate recovery now under way, would be unpopular, and politically untenable. Defaulting on the commercial bank payments would undo the present IMF negotiation and undoubtedly bring greater foreign exchange losses than gains, particularly if a period as long as one year is considered. The only acceptable courses of action are those which will bring in sufficient foreign exchange to close the B/P gap and, to the extent possible, generate new exports.

--Not having an IMF program yet in place is a negative in terms of making predictions for 1984, and this is mainly due to the lack of quantitative performance targets, i.e. the ceiling for credit to the public sector and the floor for the net international reserve position. The present Central Bank credit program allows for an over-all nominal increase of credit to the private sector of 15.7 percent (and it also assumes a 13 percent inflation rate for 1984), and we suspect that only minor changes in this projection will result from current IMF negotiations. In regard to the balance of payments, even though we doubt that any substantial changes will result from the current IMF-GOCR negotiations, an important question concerns IMF-Central Bank agreement on a target $50 million increase of net Central Bank liquid foreign exchange holdings, which is included in the $267 million gap cited above. We also do not know how the IMF-GOCR negotiation will come out in regard to closing the gap.

--Under present conservative estimates however, the Central Bank will exhaust its liquid Foreign Exchange Reserves in early March. Payments on rescheduled commercial debt in March and April ($47.7 million) are particularly high, and if these payments are not made, we expect the hard earned stabilization process to begin to unravel. (For further details, see SAN JOSE 01445 (1984), Classified.)

III. U.S. INTERESTS, ESF ASSISTANCE OBJECTIVES, AND STRATEGY

A. U.S. Interests

As historically the most successful democracy in Latin America, Costa Rica has unique credibility and influence as a spokesman in regional and international fora. Costa Rican support is a critical factor in developing broad-based domestic and international support for U.S. Central American policy. Both because of our shared values, and to preserve Costa Rica as a model of democratic development for the region, a primary U.S. interest and objective is the preservation of Costa Rican democracy. Recent economic failure has called into question, for the first time in forty years, the ability of the democratic system to respond to the legitimate aspirations of the Costa Rican people. U.S. policy must therefore seek to achieve economic recovery in order to forestall Marxist-Leninist challenges. It is U.S. policy to assist Costa Rica to move towards a more market oriented economy.

To attain economic recovery, Costa Rica must move away from the protectionist, import-substitution economic model towards export-led growth. If Costa Rica can move forward economically, it may encourage some of the other Latin American countries which have adhered to the same economic model, and are now also suffering economic problems, to make similar shifts in policy and operations.

B. Overall ESF Assistance Objectives in Costa Rica

The proposed ESR III program supports the goals and objectives established for U.S. Economic Support Fund assistance to Costa Rica, and thus continues the efforts of the previous ESR I and ESR II programs. These goals and objectives, which were articulated in the Mission's Caribbean Basin Initiative Implementation Plan for Costa Rica and in its CDSS Supplement are as follow:

--To help re-establish dynamic growth in the Costa Rican economy;

--To assist in re-orientation of the economy from its present import substitution bias, to one in which the industrial sector contributes to export led growth.

Such goals are to be achieved through the following routes:

--Economic Stabilization and Recovery - To relieve Costa Rica's economic crisis by improving its balance of payments situation by: alleviating the shortages of imported goods required for production; increasing credit available to the productive private sector; and restoring international confidence in Costa Rica and its currency. The program is coordinated with, and supports the economic stabilization and recovery aims of the IMF.

--Strengthening of the Financial System - To encourage the further development of private banks and other private financial entities in Costa Rica, in order to expand and improve services to the productive private sector beyond those currently available through the nationalized banking system.

--Expansion of Exports and Investment - Costa Rica will need to export at a higher level, and on a more diversified basis, if it is to recover its former standard of living and reinitiate long term, dynamic economic growth. The aim of this objective is to increase exports, particularly non-traditional products for non-traditional markets, and to increase foreign and domestic investment in enterprises which engage in such production.

--Improved Public-Private Sector Coordination - To develop improved means of collaboration between the public and private sectors in order to contain the current crisis, stabilize the economy, and establish a basis for long term economic growth thru export and investment.

--Improved Policy Formulation and Administrative Reform - To establish the attitudes, laws, procedures, and practices which facilitate exports and investments and a more stable and diversified economy. Among the policies which the Mission sees as most desirable are a commitment to a greater role for the private sector in the economy, an exchange rate regime favorable to exports, the reduction of export quotas and controls, decreased incentives for import substitution industries, a broader commitment to free markets in general in order to foster more efficient resource allocation, and monetary and fiscal policies designed to foster greater internal capital formation.

C. <u>Strategy for the ESR III Program</u>

The previous two ESR programs, together with IMF support and the commitment of the GOCR have, as described in Sections II. B. and C. above, made considerable strides towards stabilization, and re-establishment of international confidence in Costa Rica. A strategy has been approved for increasing exports and investment, and some incentives to promote these have been adopted -- particularly for non-traditional exports. On the basis of this and other progress, the specific objectives of ESR III involve a marked shift away from emphases on short-term stabilization and the development of an export and investment strategy, and towards conditionality and activities which pertain in particular to Improved Policy Formulation and Administrative Reform, Strengthening of the Financial System, and administrative and operational support for Expansion of Exports and Investment.

The Mission strategy is to address as many of the policy and structural reforms required to achieve the overall long-term objectives of the ESR Program, as is feasible in the context of the 1984

Agreements. This involves both continuing efforts begun under previous Agreements, and seeing that initial steps (sometimes only a study) are taken in 1984 towards changes that will be fully realized in later years. There are several reasons for this approach as opposed to singling out a small number of reforms where the analysis is more advanced and where conditionality can be more specific. First, it allows a broader range of conditionality relating to policy and structural reforms to be tackled. The alternative approach is too limiting. Specifically, structural reform and policy change need to be viewed as a process over time, rather than as the achievement of a few changes at any one point in time, even if they are important changes. Secondly, all macro-economic policy factors interact in achieving export led growth. Finally, in a different vein, there is a political factor: 1986 is an election year in Costa Rica. Therefore, delay in initiating movement towards needed reforms beyond 1984 could result in these being postponed and not reconsidered until 1987, after the election, inauguration, and settling in of the new administration.

An additional aspect of the Mission strategy is to assure compliance with conditionality both by tranching disbursements, as described in Section IV.C.2, and by using the sequential nature of the Agreements and Amendments thereto to also make funds available for transfer dependent upon progress/compliance with conditionality requirements.

Signing of the first Agreement with the Central Bank is contingent upon satisfaction of a number of pre-conditions as described in Section IV.E.1.a below. Signing of the second Agreement with the Central Government of Costa Rica will be contingent both upon satisfaction of a pre-condition described in Section IV.E.2.a, and upon compliance as of that time with the conditionality contained in the first Agreement. The same considerations will be applied to any Amendments which might result from a supplemental appropriation.

IV. PROGRAM DESCRIPTION AND RATIONALE

A. Program Components

The components of the proposed program are as follows:

1. A $35 million dollar loan for balance of payments support will be executed between AID and the BCCR. The disbursement mechanism to be employed will be a cash transfer. The local currency equivalent of the cash transfer will be used as follows:

- $35 million to a special credit line for the productive private sector, of which $15.0 million will be for use by the private commercial banks and $20.0 million for the state commercial banks.

Authorization for this loan component is requested in this PAAD.

2. A $35 million dollar grant for balance of payments support will be executed between AID and the Central Government of Costa Rica. The disbursement mechanism to be employed will be a cash transfer to the Central Bank on a tranched basis. The uses of the local currency equivalent of the grant will be developed with the Central Government along the lines described in Section IV.E.2 below, and will be detailed, along with conditionality requirements for the grant, in a cable supplement to this PAAD. Authorization of the Grant will be requested at that time.

B. Rationale for Loan-Grant Composition

A loan-grant split of 50/50 is proposed in this PAAD, $35 million loan and $35 million grant. There are three reasons for proposing that a portion of the assistance be provided as a grant. First, as Tables I and II below indicate, Costa Rica's present and future debt service burden is already an onerous one, and it is clear that despite the 1983 debt rescheduling and Costa Rica's austerity measures, further rescheduling will be required in the near future. Thus, the Mission feels that the maximum grant financing that AID can provide is required to support stabilization and recovery objectives, and U.S. interests in Costa Rica.

TABLE I

COSTA RICA
OFFICIAL DEBT SERVICING 1983-84

	Estimated 1983	Projected 1984
Interest	$375.9 m	$347.4 m
Amortization*	67.9 m	125.6 m
	$443.8 m	$473.0 m

*Includes Central Bank in addition to Central Govt. at Pub. Enterprises.

TABLE II

COSTA RICAN DEBT

	Estimated 1983	Projected 1984
Commodity Exports, FOB	850.7	899.1
Exports of Non-Factor Services	249.0	267.1
Total Exports of Goods & Non-Factor Services	1099.7	1166.2
Debt Service as a % of Commodity Exports	52.2%	52.6%
Debt Service as a % of Commodity plus Non-Factor Service Exports	40.4%	40.6%

A further rationale for providing a portion of the assistance in the form of a grant is to avoid the second Agreement, which would be signed with the Central Government, having to be ratified by the Costa Rican Legislative Assembly. The Concepts Paper explains that while loan obligations of the Central Bank are not subject to such ratification, those of other government agencies are.

Furthermore, aside from time delays in effecting the cash transfer that the legislative process would bring about, it would be politically unwise to submit the type of conditionality required to legislative debate and action as a package. It could generate much unfavorable publicity--at odds with our national interest, and might well result in a refusal to ratify the Agreement. Inasmuch as many of the structural reforms and activities to be carried out under ESR III are not within the mandate of the Central Bank, there is no option but to sign the Agreement with the Central Government. Finally, grant funding will allow for maximum flexibility with regard to local currency uses, especially transfers to private sector entities.

C. U.S. Dollar Resources

1. Purpose and Terms of Dollar Resources

A total of $70 million dollars, $35 million in grant and $35 million in loan funds, will be provided to the Central Bank in the form of cash transfers covered under two separate Assistance Agreements as described in Section IV.A. above. The first Agreement, which will be signed with the Central Bank, will contain covenants to cover the use of all dollars obtained under the ESR III program, including also those provided under the Second Agreement to be signed with the Central Government, and under any Amendments to either Agreement.

It is proposed that the loan portion of the transaction be made on A.I.D.'s most concessional terms, i.e., a forty year loan with a 10 year grace period, 2% interest during the grace period, and 3% thereafter.

Dollar resources and reporting on these are covered by the proposed Covenants as detailed in Section IV.E.1 below. In sum, the Central Bank will make an amount of dollars equivalent to that disbursed under the cash transfers, available for sale through the commercial banks to private enterprises in Costa Rica. Imports of raw materials, intermediate goods, construction materials and spare parts from the United States for an equivalent amount will be required and monitored. Reports on sales of dollars will be made within three months following each disbursement and on purchases of imports at appropriate intervals. Procedures for ex-post facto price checking on these and other imports will be developed and put in place.

Costa Rica's private sector can easily absorb $70 million for the specified purposes, within the time frame provided. This amount represents approximately 25 percent of Costa Rica's imports for these types of commodities.

2. Disbursement of U.S. Dollar Resources

a. Schedule for Disbursements

As in the ESR II program, the Mission proposes to tranche disbursements both to provide a basis for enforcing conditionality, and to maintain an even flow of foreign exchange into Costa Rica. The first disbursement will be made under the first Agreement with the Central Bank; that Agreement will provide for that disbursement only. The second through fourth disbursements will be made under the subsequent Agreement with the Central Government, which will provide only for those three disbursements. Tranching between the disbursement under the first Agreement and the first disbursement under the second Agreement will be a function of the time lag between the two Agreements. Tranching of the three disbursements under the second Agreement will be carried out in the same manner as for ESR II, wherein disbursements will be made at monthly intervals and may not exceed the schedule except as AID may otherwise agree in writing.

The proposed disbursement schedule is as follows:

(millions of U.S. dollars)

Disbursement	Loan	Grant	Total
First Agreement	$35		$35
Second Agreement			
First		$15	15
Second		10	10
Third		10	10
	$35	$35	$70

AID found in implementing ESR II, that variations in the schedule were sometimes required due to the need to "make up" missed disbursements when these were witheld or prior conditions not met on schedule, and also to allow greater flexibility to AID and the Central Bank in managing the flow of foreign exchange resources given seasonal variations and timing of inflows from other donors such as the IMF. Thus, the Bank may not need to request a disbursement for over a month, but may then need two disbursements in close succession, or together. (Note that although the second Agreement will be signed with the Central Government, it will provide that requests for disbursements under this Agreement be made by the Central Bank.)

Given this situation, authorization to vary the disbursement schedule as required to assure good management and regular availability of foreign exchange resources, was granted to the Mission (See Annex VII); The Mission proposes to include, in both the

Authorization for the second Agreement and the Agreement itself, a schedule for monthly disbursements, but with the provision that allows this to be varied by the Mission.

b. Disbursement Procedures

Dollar disbursements will be made in the same manner for the loan and grant portion of the program. Disbursements will be made into a BCCR account, in accordance with its instructions. It is anticipated that electronic transfer of funds to a U.S. Bank will be employed. However, other mechanisms may also be employed if it appears there is any possibility of an embargo of said account by BCCR creditors.

c. Justification for Cash Transfer

Use of a cash transfer as opposed to a CIP is proposed for the ESR III program for several reasons. First, the setting up and the operation of a CIP would limit the quick disbursement capability which is required to move foreign exchange into the Costa Rican economy to meet the balance of payments and cash flow needs as described in Section II.C above. Second, the data indicates that in 1982 and 1983 there was an increasing positive net flow of private capital into Costa Rica, rather than capital flight out of the country, and, hence, the indirect benefits of a CIP in limiting capital flight are not needed.

With respect to the data, net private capital inflows to Costa Rica for 1980-1983 were as follow:

1980	-$240 million
1981	-$ 55 million
1982	+$ 69 million
1983	+$137 million

The trend towards a reflow of private capital to Costa Rica corresponds to the stabilization of the economy, and the improvements in the exchange and interest rate structures.

Since Costa Rica is using the AID funds to compensate for foreign exchange inflows lost as a result of factors leading to the current economic crisis, and since it normally trades with the U.S. in excess of the dollar amount to be provided under ESR III (even assuming there were to be a supplemental appropriation), there is nothing to be gained over the current situation by using a CIP. Imports from the U.S. in 1980 of raw materials and intermediate goods alone were, as previously mentioned, equivalent to $251 million. During 1983, imports from the United States of raw materials, intermediate goods, construction materials and spare parts were well in excess of the $155.735 million provided to Costa Rica by AID under ESR II. The total of imports from the U.S., including these eligible items, amounted to $398.3 million during 1983.

D. Local Currency Resources

A description of activities to be funded from the local currency equivalent of the loan, and the amounts, objectives and rationale for each of these is combined with the discussion of conditionality in Section E below. To the extent that areas for local currency supported activities under the Grant can be described at this time, they are also contained in Section E.

E. Program Conditionality and Rationale

As indicated earlier, the ESR III Program will be implemented through two Agreements - a Loan-funded agreement with the BCCR and a Grant funded agreement with the Central Government. The situation with regard to each Agreement is dealt with separately.

1. Agreement with the Central Bank of Costa Rica (BCCR)

a. Prior Actions to Obligation

Submission of a Letter of Intent acceptable to IMF Management, and legislative approval of an Amendment to the Currency Law designed to facilitate dollar denominated lending by all credit institutions will be required. The purpose of requiring the submission of the Letter of Intent is to give Costa Rica the signal that the U.S. will not move forward with the ESR III program without establishment of the necessary discipline and measures for continued stabilization that are the purview of the IMF.

The requirement related to the Currency Law Amendment is predicated on the belief that no substantial economic recovery can proceed without a change to this law in order to permit credit to be effectively denominated in dollars or other hard currencies as required to support export-import transactions. At present, the Currency Law, as interpreted by the Costa Rican courts, allows many debts denominated in foreign currency to be repaid in Costa Rican currency -- but at the official rate of 20 colones to the dollar rather than the bank rate, which is twice as high. Thus, some debtors have, and would continue to liquidate loans at much less than the lenders' cost of repaying their foreign creditors. The law as currently constituted is responsible for holding up dollar disbursement on two DA-funded projects designed to make dollar credit available to exporters (COFISA (0187) and BANEX (0176)).

A third prior action had been contemplated, i.e. approval of a revision of the Banking Law submitted last year in satisfaction of an ESR II covenant, which was designed to permit direct private bank access to Central Bank credit operations. Soundings taken by the Executive

Branch with members of the Legislative Assembly and with party leaders indicate that an unacceptably high political cost would be entailed in pushing through this measure. The BCCR proposes to withdraw the proposed amendment to the Banking Law, and simultaneously to include in the amendment to the Currency Law, a provision which would enable direct access by private banks to BCCR credit where the origin of the funds is external. The Executive believes that this somewhat more limited reform will be acceptable to the Legislative Assembly.

A substantial portion of BCCR credit to the commercial banks derives at present from external sources, and is likely to continue to do so for the near and medium term. Also, an informal check with the private banking community indicates that the proposed change would satisfy their aspirations. The Mission recommends that AID accept implementation of this compromise in satisfaction of the precondition to obligation.

Progress towards meeting the above pre-conditions was reported in classified cable SAN JOSE 01445, dated February 24, 1984, and will be updated as required.

Another pre-condition was proposed in the Concepts Paper, i.e., an amendment of the Free Zones Law. This action has been completed. The amended Law now permits establishment of free zone areas in the Meseta Central where most of the country's productive infrastructure is located, and provides needed clarity on rules governing the use of free zones. It also betters incentives for enterprises wishing to locate in free zones.

b. Conditions Precedent to Disbursement

In the ESF Concepts Paper and related AID/W guidance cable, provision was made for formal IMF Board approval of the 1984 Standby Agreement as a Condition Precedent to initial disbursement. In view of the foreign exchange liquidity crisis referred to earlier, the Mission recommends that this requirement be dispensed with, and that only the prior action, as defined above, be required.

c. Covenants - Including Local Currency Activities

All items put forward in the ESF Concepts Paper as topics for discussion with the BCCR have been successfully negotiated and approved by the Board of Governors of the BCCR, except as specifically noted. The draft covenants, with comments on each one, are as follow:

1. The BCCR will undertake the following measures as regards credit and interest rate policy:

a. During 1984, the activities subject to credit control will be: rice (planting and marketing), coffee harvesting, sugar marketing, macadamia, purchase of a sugar refinery (Ingenio Atirro), the program of assistance to enterprises, and the special programs for the development and diversification of the agriculture and livestock sector (amongst others, those proposed by SEPSA and SEPSEI. It is understood that the commercial banks may freely transfer resources amongst the different items of a given activity (livestock, industry, pre-exports, fishing, and other activities) but only for items which are detailed in the credit program for 1984 approved by the BCCR in Article 12 of its session No. 3898-83, held on December 22, 1983.

Comment: The above text corresponds textually to a decision already taken by the Governing Board of the BCCR. It is not as clear as might be desirable. In fact, as of this writing, there is some controversy at staff level in the BCCR as to the exact intentions of the Board of Governors. This is especially true of the "special programs" subject to credit control. The two entities mentioned in this connection (SEPSA, the Agriculture Sector Planning body, and SEPSEI, a parallel body for the industrial sector) have been authorized --although not in writing-- to propose indicative or illustrative credit levels on a product-by-product basis directly to the commercial banks. There has been no formal definition of what is, or is not eligible for inclusion in these "special programs", let alone establishment of criteria for same.

The meaning of "credit control" is also the subject of uncertainty at the BCCR staff level. It probably is intended to mean that the identified operations are to be tracked and an attempt made to ensure that they are executed in conformity to the National Credit Program. There is also debate about whether the last sentence dealing with transfer of resources amongst different items of a given activity, applies to the "special programs".

What has happened here is that the BCCR in its initial, December 22, 1983 decision, approved a simple set of six credit allocation categories as these were presented in the Concepts Paper. In January, 1984 opposition to this departure from historical practice began to develop in the substantive ministries and amongst special interest groups, e.g. product specific producer associations. The Board of Governor's amendment of the original approval, which is the text of the proposed covenant, is an attempt to satisfy the complaining entities in a face saving fashion, without giving away very much in the way of substance. The result is a somewhat fuzzy product. Nevertheless, it does represent a significant improvement in reducing controls over the allocation of credit. In 1983, there were over 100 credit ceilings established on a product by product basis. Whatever the lack of clarity in the present regulation may be, the number of items on which ceilings are established is now down to six. The purpose of including this BCCR Board of Governor's decision as a covenant is to prevent further backsliding by the BCCR when the additional pressures from special interest groups come into play. The Mission will monitor compliance in accordance with our own interpretation of the covenant and act accordingly.

b. The BCCR will develop, together with CODESA (the State owned holding company/development bank) and its subsidiary companies, a consolidated credit program to finance their operations during 1984. Said credit program will establish an overall limit on financing by the National Banking System to CODESA and its subsidiary companies. Except for funds for the Free Zone Corporation, the approved credit program will be limited to requirements for operational credit; neither will it provide for any direct Central Bank of Costa Rica credit to CODESA or its subsidiaries,

c. The National Banking System (NBS) will not authorize credit to the National Production Council (CNP) when such credit is designed to cover losses incurred by provision of subsidies during 1984. An exception is made as regards financing needed by the CNP to cover losses incurred in rice exports from the 1983/84 harvest. For the above purpose, subsidies are defined as the difference between the CNP's cost of acquisition of the product, plus transport, handling, and related administrative expenses and the price at which it sells the commodities.

Comment: The PL 480 Title I Agreement requires the CNP to maintain a balanced budget. It was successful in doing so in 1983, but will run a large deficit in 1984 unless it either decreases support prices, raises its selling prices, or undertakes a combination of the two. This covenant is designed to strengthen the hand of the BCCR in dealing with the problem, since the CNP law requires the BCCR to provide unlimited credit at 2% to the CNP for "price stabilization" purposes.

d. The basic passive rate will continue to be positive in real terms during 1984. For purposes of this Agreement, the "basic passive rate" is the interest rate which is fixed by the BCCR for resources captured from the public in the form of 6 month certificates of deposit.

Comment: In the past, the Board of Governors of the BCCR maintained that they could (at least in theory) arbitrarily establish a "basic passive rate", to which all other interest rates, margins, etc. relate, without it necessarily having any relation to the cost to the banks of capturing resources, or levels of inflation. This covenant does away with this fallacy. The criteria established under covenant (i) below, and the quarterly reporting on this provided for in covenant (k) below, will constitute a mechanism for monitoring compliance with the provisions of covenant (d).

e. When a general revision of interest rates is undertaken during 1984, the BCCR will modify the general credit regulations dealing with interest rates then in force, so that (with the exception of livestock breeding) the interest rate for Category C.2 operations (All Other Agricultural and Livestock Activities) is fixed at a level higher than the basic passive rate.

Comment: Under present regulations, credit provided under the category, "All Other Agricultural and Livestock Activities", is at the basic passive rate, currently 18%, and is thus subsidized. In 1983, the stock of credit under this category amounted to approximately 7 billion colones, almost one third of total credit. The livestock breeding component amounted to 2.3 billion colones. The intent of the covenant is to reduce this major element of subsidized credit.

f. Except as a consequence of item "e" above, during 1984, no more than two interest rates superior to the basic passive rate will be used by the commercial banks.

Comment: The present interest rate structure provides for a higher rate for commerce and personal credit than for agriculture and industry. We are prepared to accept this, but wish to avoid any proliferation of rates.

g. The National Banking System will only provide credit at interest rates lower than the basic passive rate for the following activities: small farmers, small industry and artesanal enterprises, rural women and rural youth promotion programs, restructuring of small farmer debt, personal credit to banking system employees, and Perez Zeledón earthquake renewal. The net outstanding balance for such operations as of December 31, 1984 shall not exceed 16% of total credit in 1984.

Comment: The net outstanding amount of credit as of the 31st of December, 1983 for these highly subsidized programs (from 6 to 12%) was 3.5 billion colones, i.e., 16% of total credit. It increased sharply in 1983 over 1982 as a percent of total credit. The covenant is designed to avoid further increases of this type in subsidized credit.

h. The loans referred to in article "g" above will be financed in at least 50% from resources other than those captured from the public by the Commercial Banks.

Comment: In 1983, the BCCR financed through its rediscount lines approximately 20% of the subsidized credit; the balance was financed by the commercial banks, the theory being that the funding comes from demand deposits and savings deposits on which the banks pay little or no interest. The intent of the covenant is give the Central Bank an incentive to hold down the amount of subsidized credit.

i. During 1984, the interest rates, both passive and active, will be revised - as often as necessary - to reflect, amongst other factors, the actual and anticipated level of domestic prices, international interest rates, and the relationship between the supply and demand for credit.

Comment: This covenant is designed to establish a framework for periodic reports (see item IX below) which can be used as a basis for continuing policy dialogue.

j. As soon as the results of the analysis being undertaken by the Commission for the Evaluation of the National Banking System are available, the Central Bank will prepare a program designed to reduce the cost of credit to the final users through measures concerned with the operational costs and profit margins of the banks and related measures and requirements that unnecessarily increase the cost of credit.

Comment: We are informed that the Commission referred to above is expected to finalize its report this summer. The purpose of the covenant is to commit the BCCR to translate all or some of the Commission's findings into an action program.

k. For purposes of this Agreement, it is agreed that the provisions of items la, le, lf, lg, and lh refer only to credit operations financed from domestic sources, and that the provisions of items lb and lc relate to all credit operations whether domestically or externally financed.

Comment: This definitional item is included to avoid potential disputes on interpretation in the future. The need for such an article has been discussed with the BCCR, but not the exact text.

II. During 1984, the Central Bank will undertake the following measures concerning exchange rate policy:

a. Maintain a unified exchange rate.

b. Review the exchange rate on a continuing basis in accordance with, amongst others, the following factors: relation between domestic prices (actual and anticipated) and prices in the principal countries with which Costa Rica has commercial relations, the status of the current account transactions in the balance of payments, service of the foreign debt and non-compensatory net capital inflows.

Comment: This covenant is designed to establish a framework for periodic reporting (see item IX below) upon which a continuing policy dialogue can be undertaken.

III. The Central Bank will prepare a plan of action designed to improve the quality, timeliness and use of economic information, especially that related to external debt, foreign commerce and other international transactions and indicators of economic activity. This plan should be finalized not later than June 30, 1984.

Comment: Envisioned here are activities such as training for the originators of raw data, better forms for same, training of Central Bank staff, development of suitable computer software, technical assistance in determination of information priorities, etc.

IV. To prepare by June 30, 1984, a plan of action designed to monitor on an ex post facto basis import and export transactions with a view to identifying overinvoicing of imports and underinvoicing of exports, and to take appropriate sanctions against firms indulging in these practices; that the plan of action will include steps to be taken to develop and to progressively strengthen a price checking unit, the preparation of registers of prevailing market prices for major imports and exports, organizational arrangements for ex post facto auditing, investigation, and punitive action, training and other technical assistance requirements and personal requirements;

V. The Central Bank will increase the resources made available to the productive private sector through the private commercial banks under the special credit line established pursuant to A.I.D. Loan 515-K-037 and 515-K-040 in a local currency amount equivalent to fifteen million dollars (US$15 million). The Central Bank will revise the regulations in effect for this rediscount line so as to permit the recuperation of funds disbursed by the State commercial banks as of December 31, 1984 to be relent by those banks, and will make available new resources to be used by State Commercial Banks in a local currency amount equivalent to $20.0 million.

Comment: The U.S. $15.0 million equivalent in new funds for the private banks will enable them to reach a level of approximately U.S.$27.0 million in new loans during 1984. Several of them will have to increase their capital in order to take advantage of the resources under the rediscount facility. The statement about revision of the new regulation dealing with use of reflows relates to a provision that all reflows under the rediscount line must go to the private banks. The provision was introduced when we anticipated a liquidity problem in rediscount availability for the private banks. This is no longer the case.

VI. The Central Bank will support the creation of a Central Secondary Mortgage Bank, whose Board of Directors will have a majority from the private sector. Among the functions of the new bank, importance will be placed on financing secondary mortgages and rediscounting credit operations for housing construction undertaken by savings and loan associations, members of the National Banking System, labor unions, asociaciones solidaristas*, and INVU (The National Housing Agency). Among the attributions of the bank, will be legal authority to capture funds through the emission of investment and other market instruments.

Once the housing bank is created, the Central Bank and AID will agree on the terms and conditions of a seed capital loan by the BCCR.

Comment: This covenant implements a resolution of a recent National Housing Conference. It is intended to provide an incentive to those groups interested in developing the financial market for housing. It will be noted that the amount of the seed capital loan is not specified. It is probable that no funding will be required until 1985. The amount can then be fixed in light of the status of the institutional initiative and the macroeconomic situation.

VII. To provide during 1984, foreign exchange resources to the National Banking System and other authorized agents for purchase by private enterprises, the total amount of which shall be not less than the amount of all cash transfers received by Costa Rica from the United States Government during 1984 under the Economic Stabilization and Recovery Program III, and to report to USAID/Costa Rica, by March 31, 1985 that such transactions were accomplished.

Comment: This covenant is designed to cover reporting commitments on all ESF assistance provided in 1984.

VIII. To make available through its own funds and during CY 1984 a dollar amount equivalent to that disbursed as cash transfers to Costa Rica under the Economic Stabilization and Recovery Program III for the importation from the United States of raw materials, intermediate goods, construction materials and spare parts needed by private enterprises in Costa Rica.

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*Asociaciones solidaristas are legal entities created by labor and management of an individual enterprise to which both contribute agreed upon amounts, with the proceeds used for social purposes determined by the asociación.

IX. Not later than July 1, 1984 the Central Bank will prepare a report on the execution of the national credit program for the years 1982 and 1983 in which the actual operations will be compared to the planned targets and differences analyzed. Similar evaluations will be undertaken relating to the 1984 credit program.

X. The Central Bank will provide to AID copies of the documents that are produced pursuant to items I.b., I.j., III. and IX above, as well as copies of all reports to the IMF, as these are issued, in accordance with the stabilization program. The reports related to items I.i. and II.b. will be provided to AID at least quarterly. The report on status of operations indicated in Article IV will be provided monthly. As regards Covenants VII and VIII, reports on the status of operations will be provided within three months and six months, respectively, following each disbursement.

2. Agreement with the Central Government of Costa Rica (GOCR)

As was agreed at the DAEC review of the ESF Concepts Paper, this Agreement will be for a grant of $35 million. We have deliberately avoided entering into detailed negotiations until after the IMF Agreement is concluded. We have, however, had preliminary discussions with pertinent officials on policy matters which do not have implications for local currency use. These will be reflected below, as will be a series of important structural reform actions dealt with in the ESF Concepts Paper, and incorporated into the recently passed Law for Public Sector Financial Equilibrium (LPSFE) and other legislation and Executive Branch determinations.

a. Prior Actions to Obligation

At the time of the DAEC review of the ESF Concepts Paper, we were advised by GOCR officials that they expected to formally issue their document on "Economic Policy: Strategy and Actions 1984-1986" by mid-February. This has not yet happened. We are informed repeatedly that the Cabinet has approved the substance of the paper, but that certain embellishment for public consumption purposes has not been finished. In all fairness, it should also be noted that the GOCR has had several, considerably more urgent matters to deal with in the past two months. Nevertheless, we attach considerable importance to the formal issuance of the document for two reasons: one is to be able to use it explicitly in developing the conditionality of the grant Agreement; and secondly, because a change in the membership of the GOCR economic team is imminent. It is important that there be an agreed upon, formal policy line to which the new incumbents should relate. Thus we propose to advise the GOCR that a pre-condition to signing the grant Agreement will be formal approval and public issuance of the document referred to above.

b. Conditions Precedent to Disbursement

None are presently contemplated, but may conceivably be developed with regard to the release of local currency by the BCCR (which will receive the dollars) for specific activities.

c. Conditionality

Six areas for policy and structural reform were identified in the ESF Concepts Paper. Recent developments and the status of discussions with regard to each (except Financial Intermediation, which is dealt with in the preceding section) follow:

i. Tax Reform

A bill was introduced to the Costa Rican Legislative Assembly which aims to strengthen the ability of the Tax Bureau to effect collections. Conversations with GOCR officials have revealed that the proposed legislation is stuck in committee in the Legislative Assembly, and is considered very controversial. Preliminary analysis of the proposed law reveals that, while it would help considerably, it could be improved. Given these developments, we consider it prudent to give the IRS team working with the Government some time to work out changes in the draft law with their counterparts, and to develop a legislative strategy with them. Later on, in relation to an Ammendment related to a supplemental appropriation, or possibly in next year's ESF negotiations, we may propose passage of this legislation as a prior action to obligation.

There are several developments to report concerning elimination and/or reform of taxes affecting exports. First, the recently approved LPSFE and Free Zone Law significantly reduce or eliminate taxes on extra-regional exports; secondly, as Annex III of this paper shows, further reduction and rationalization of export taxes should probably be related to, and offset by, changes in the import duty structure, especially non-renewal, at the end of 1984, of the Industrial Investment Contract with its import duty exemptions. This approach appears to coincide with the thinking in some sectors of the Government.

Finally, it should be noted that because of the local currency implications, we have not specifically discussed this topic with the GOCR. Our present assessment is that it may be desirable to leave this matter pending until later in the year, or until next year, when there is more clarity on the reforms in the external tariff that must be decided this year.

ii. Other Actions with Fiscal Policy Implications

Here again there have been several recent developments. The LPSFE includes provision for the creation of a commission to develop recommendations for restructuring the management of public finance; for Executive Branch evaluation of a series of decentralized agencies with the view, inter alia, of eliminating or consolidating programs; and for limiting Central Government recourse to bank credit and to shifting funds. The Law also eliminates unfilled positions, freezes new hires, develops other controls on central government employment levels and provides retirement incentives.

In addition to the LPSFE, there has been a determination by the Attorney General and the Controller General that the Ministry of Public Works (MOPT) can create cooperatives or similar entities amongst its work force and turn over to them machinery on sale or lease terms.

We have explored, in preliminary fashion, GOCR interest in taking advantage of these legal developments and devising action programs to implement the new authorities. Such programs might include financing on-the-job training costs of public sector employees who wish to take advantage of early retirement provisions of the Law; needed financing for moving the MOPT divestiture of functions from a concept to a reality; and development of parallel programs for other public sector entities. Initial reaction is very favorable.

The LPSFE also opens the door to some extent as concerns divestiture by CODESA of its subsidiaries. With the exception of FERTICA (the fertilizer company) and Cementos del Pacîfico, where only 40% of the shares can be sold; and CATSA (the sugar refinery) and Cementos del Valle, which can only be converted to cooperatives, the Executive Branch is authorized to sell its subsidiaries on an open bid basis, without need for legislative approval. We propose to explore the desirability of a covenant under which the GOCR would be committed to developing an action plan for using the new legal authority.

iv. Customs Tariff Policy

We have reviewed, with the pertinent GOCR officials, the criteria they are using in the negotiations with other countries in the region regarding the Common External Tariff, and their timetable for action which provides for finishing talks by July, having proposals ready for consideration by the GOCR in August, and submitting appropriate legislative proposals to the Legislative Assembly in September. We see no utility in discussing a covenant to the Assistance Agreement on this topic at this time.

v. Export and Investment Promotion

The LPSFE contains a series of provisions relating to this topic, including new tax incentives and tax credits, and the creation of a National Investment Council empowered to approve export contracts and fulfill other functions. The recently approved Anmendment to the Free Zone Law provides the necessary flexibility to the Executive Branch to move ahead with this development. After careful examination of these new institutional and policy reform measures, we have come to the conclusion that there is little more in terms of establishing a suitable framework for investment and export that can be identified as needing action this year. The task now will be to utilize effectively the new and broadened authorities and incentives. Thus no covenant seems appropriate.

vi. Other topics

In addition to the subjects dealt with above, we have identified and discussed with the GOCR two other areas for structural reform which do not involve local currency use. The response to developing and negotiating covenants on the following two matters has been initially positive. They are:

i. Measures to increase exports of beef and sugar by a series of actions, including gradual reduction in export quotas.

ii. Improvement in the Rent Control Law and in the Savings and Loan Law.

d. Potential Local Currency Uses

As indicated earlier, this topic has not yet been discussed with the GOCR, except very tentatively in connection with item V.D.2.c.ii above. The possible uses which we propose to explore with the GOCR, after substantive agreement has been reached between them and the IMF, are listed below. It should be noted that the GOCR may propose additional items.

i. Reduction in Port Charges

Thirty three percent of the anticipated 1984 receipts by the Atlantic Port Authority, amounting to the equivalent of US$6 million, are to be transferred to the Central Government. (This is the "normal" transfer and is additional to the one time, special transfer of 125 million colones required under the recently enacted LPSFE). In order to make exports more competitive, we would be prepared to consider offsetting a one-third reduction in port changes by a transfer of US$6 million equivalent to the Central Government.

ii. Primary School Textbooks

It is believed that use of new primary school textbooks would be a desirable development. It may be possible to make arrangements whereby private sector, non-profit institutions (e.g., the National Economic Development Association (ANFE) and/or the Costa

Rican Institute for Management (INCOSEM) would participate in producing such books and making them available to the Ministry of Education.

iii. Counterpart for IDB Loans

Approximately US$9.7 million equivalent from PL 480 generations is presently programmed for meeting counterpart requirements of IDB loans during CY 1984. There is a possibility that an additional US$2 million equivalent for loans dealing with rural roads, animal health, and rural electrification could be utilized during 1984. These additional requirements might be financed from ESF or from a supplemental PL 480 Title I authorization.

iv. Infrastructure:Water and Sewerage Facilities and Road Maintenance

One of the elements of the economic reactivation/employment generation strategy is to get the housing construction sector moving again. A major constraint is the inadequacy of water and sewerage facilities in areas suitable for housing development. We propose to explore the possibility of using ESF local currency equivalent to overcome this constraint. In this connection, we would also examine the needs for maintenance of the existing systems. There is also a problem with protecting the countries current investment in roads.

v. Development of Free Zones and Industrial Parks

Now that the Free Zone Law has been enacted, it may prove desirable to provide financing for termination of the Puntarenas and Moin installations and for development of a free zone facility on the Central Plateau, near the airport.

vi. Offsets for Export Taxes

As was indicated earlier, our present reading of the situation is that there is probably no need for such action at this time. Nevertheless, we do not wish to rule out this possibility until we have explored the issue more thoroughly.

vii. Private Sector Credit Through Non-Bank Institutions

There are indications that some of the private sector Financieras, especially COFISA, may be in a position to use additional credit resources. These institutions are not eligible for using the BCCR Special Credit line. We proposed to explore this situation and accord the problem a high priority.

/

COUNTRY CHECKLIST

A. GENERAL CRITERIA FOR COUNTRY ELIGIBILITY

1. FAA SEC. 481. Has it been determined that the government of the recipient country has failed to take adequate steps to prevent narcotic drugs and other controlled substances (as defined by the Comprehensive Drug Abuse Prevention and Control Act of 1970) produced or processed, in whole or in part, in such country, or transported through such country, from being sold illegally within the jurisdiction of such country to U.S. Government personnel or their dependents, or from entering the U.S. unlawfully?

No.

2. FAA Sec. 620(c). If assistance is to a government, is the government liable as debtor or unconditional guarantor on any debt to a U.S. citizen for goods or services furnished or ordered where (a) such citizen has exhausted available legal remedies and (b) the debt is not denied or contested by such government?

No.

3. FAA Sec. 620.(e)(1). If assistance is to a government, has it (including government agencies or subdivisions) taken any action which has the effect of nationalizing, expropiating, or otherwise seizing ownership or control of property of U.S. citizens or entities beneficially owned by them without taking steps to discharge its obligations toward such citizens or entities?

No.

4. FAA Sec. 532(c), 620(a), 620-(f), 620D; FY1982 Appropiation Act Secs. 512 and 513. Is recipient country a Communist country? Will assistance be provided to Angola, Cambodia,

No.

Cuba, Laos, Vietnam, Syria, Libya, Iraq, or South Yemen? Will assistance be provided to Afghanistan or Mozambique without a waiver?

5. ISDCA of 1981 Secs. 724, 727 and 730. For specific restrictions on assistance to Nicaragua, see Sec. 724 of the ISDCA of 1981. For specific restrictions on assistance to El Salvador, see Secs. 727 and 730 of the ISDCA of 1981.

N/A

6. FAA Sec. 620(j). Has the country permitted, or failed to take adequate measures to prevent, the damage or destruction by mob action of U.S. property?

No.

7. FAA Sec. 620(l). Has the country failed to enter into an agreement with OPIC?

Costa Rica has entered into an agreement with OPIC.

8. FAA Sec. 620(o); Fishermen's, Protective Act of 1967, as amended, Sec. 5. (a) Has the country seized, or imposed any penalty or sanction against, any U.S. fishing activities in international waters?

Yes. However, the exact location of the fishing vessel is in dispute.

(b) If so, has any deduction required by the Fishermen's Protective Act been made?

No.

9. FAA Sec. 620(q); FY 1982 Appropriation Act Sec. 517. (a) Has the government of the recipient country been in default for more than six months on interest or principal of any A.I.D. loan to the country?

Yes. A waiver, however, has been approved by US Secretary of State.

(b) Has the country been in default for more than one year on interest or principal on any U.S. loan under a program for which the appropriation bill appropriates funds?

No.

10. FAA Sec. 620(s). If contemplated assistance is development loan or from Economic Support Fund, has the Administrator taken into account the

Yes.

amount of foreign exchange or other resources which the country has spent on military equipment? (Reference may be made to the annual "Taking into Consideration" memo: "Yes, taken into account by the Administrator at time of approval of Agency OYB." This approval by the Operational Year Budget can be the basis for an affirmative answer during the fiscal year unless significant changes in circumstances occur.)

11. FAA Sec. 620(t). Has the country severed diplomatic relations with the United States? If so, have they been resumed and have new bilateral assistance agreements been negotiated and entered into since such resumption? — No.

12. FAA Sec. 620(u). What is the payment status of the country's U.N. obligations? If the country is in arrears, were such arrearages taken into account by the A.I.D. Administrator in determing the current A.I.D. Operational Year Budget? (Reference may be made to the Taking into Consideration memo.) — No.

13. FAA Sec. 620A; FY 1982 Appropriation Act Sec. 520. Has the country aided or abetted, by granting sanctuary from prosecution to, any individual or group which has commited an act of international terrorism? Has the country aided or abetted, by granting sanctuary from prosecution to, any individual or group which has committed a war crime? — No.

14. FAA Sec. 666. Does the country object, on the basis of race, religion, national origin or sex, to the presence of any officer or employee of the U.S. who is present in such country to carry out economic development programs under the FAA? — No.

15. FAA Sec. 669, 670. Has the country, after August 3, 1977, deli- — No.

vered or received nuclear enrichment or reprocessing equipment, materials, or technology, without specified arrangements or safeguards? Has it transferred a nuclear explosive device to a non-nuclear weapon state, or if such a state, either received or detonated a nuclear explosive device, after August 3, 1977? (FAA Sec. 620E permits a special waiver of Sec. 699 for Pakistan.)

16. ISDCA of 1981 Sec. 720. Was the country represented at the Meeting of Ministers of Foreign Affairs and Heads of Delegations of the Non-Aligned Countries to the 36th General Session of the General Assembly of the U.N. of Sept. 25 and 28, 1981, and failed to disassociate itself from the communique issued? If so, has the President taken it into account? (Reference may be made to the Taking into consideration memo.)

No.

17. ISDCA of 1981 Sec. 721. See special requirments for assistance to Haiti.

N/A

B. FUNDING SOURCE CRITERIA FOR COUNTRY ELIGIBILITY

1. Development Assistance Country Criteria.

a. FAA Sec. 116. Has the Department of State determined that this government has engaged in a consistent pattern of gross violations of intenationally recognized human rights? If so, can it be demonstrated that contemplated assistance will directly benefit the needy?

N/A

2. Economic Support Fund Country Criteria

a. FAA Sec. 502B. Has it been determined that the country has engaged in a consistent pattern of gross violations of internationally

Costa Rica has not engaged in a consistent pattern of gross violations of internationally recognized human rights.

recognized human rights? If so, has the country made such significant improvements in its human rights record that furnishing such assistance is in the national interest?

b. ISDCA of 1981, Sec. 725(b). If ESF is to be furnished to Argentina, has the President certified that (1) the Government of Argentina has made significant progress in human rights; and (2) that the provision of such assistance is in the national interest of the U.S.? N/A

c. ISDCA of 1981, Sec. 726(b). If ESF assistance is to be furnished to Chile, has the President certified that (1) the Government pf Chile has made significant progress in human rights; (2) it is in the national interest of the U.S.; and (3) the Government of Chile is not aiding international terrorism and has taken steps to bring to justice those indicted in connection with the murder of Orlando Letelier? N/A

3A(2) - NONPROJECT ASSISTANCE CHECKLIST

The criteria listed in Part A are applicable generally to FAA funds, and should be used irrespective of the program's funding sources. In Part B a distinction is made between the criteria applicable to Security Assistance and the criteria applicable to Development Assistance. Selection of the apppropriate criteria will depend on the funding source for the program.

CROSS-REFERENCES: IS COUNTRY CHECKLIT UP TO DATE? IDENTIFY. HAS STANDARD ITEM CHECKLIST BEEN REVIEWED?

A. GENERAL CRITERIA FOR NONPROJECT ASSISTANCE

1. App. Unnumbered; FAA Sec 653-(b)

(a) Describe how Committees on Appropriations of Senate and House have been or will be notified concerning the nonproject assistance.

The Congress has been notified through A.I.D.'s FY 1984 and FY 1985 Congressional Presentation.

(b) is assistance within (Operational Year Budget) country or international organization allocation reported to the Congress (or not more than $1 million over that figure plus 10%)?

Yes.

2. FAA Sec. 611(a)(2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?

Progress made toward meeting preconditions to obligation of assistance, which have been established by A.I.D. and which require Costa Rican legislative action, is satisfactory.

3. FAA Sec. 209, 619. Is assistance more efficiently and effectively given through regional or multilateral organizations? If so why is assistance not so given? Information and conclusion whether assistance will encourage regional development programs. If assistance is for newly independent country, is it furnished through multilateral organizations or in accordance with multilateral plans to the maximum extent appropriate?

   No.

4. FAA Sec. 601(a); (and Sec.-201(f) for development loans). Information and conclusions whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strenghten free labor unions.

   The assistance will increase the flow of international trade; foster private initiative and competition; and improve the technical efficiency of industry, agriculture, and commerce. In addition, certain monopolistic practices of the State-owned banking system will be discouraged.

5. FAA Sec. 601(b). Information and conclusion on how assistance wsill encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).

   The project is specifically intended to enhance U.S. private investment in Costa Rica and to expand U.S. markets for Costa Rican products.

6. FAA Sec. 612(b); Sec 636(h). Describe steps taken to assure that, to the maximum extent possible, the country is contributing local currencies to meet the cost of contractual and other services, and foreign currencies owned by the United States are utilized to meet the cost of contractual and other services.

   N/A

7. FAA Sec 612(d). Does the United States own excess foreign currency and, if so, what arrangements have been made for its release?

   No.

B. FUNDING CRITERIA FOR NONPROJECT ASSISTANCE

1. Nonproject Criteria for Economic Support Funding

   a. FAA Sec. 531. How will this assistance support promote economic or political stability? Is the country among the 12 countries in which Supporting Assistance may be provided in this fiscal year?

   The assistance will: (a) support efforts of GOCR to cope with critical economic problems; (b) provide immediate balance of payments support; and (c) provide foreign exchange and credit to the Costa Rican private sector.

2. Nonproject Criteria for Development Assistance

   a. FAA Sec. 102(c); Sec. 111; Sec. 281a. Extent to which activity will (1) effectively involve the poor in development, by extending access to economy at local level, increasing labor-intensive production, spreading investment out from cities to small towns and rural areas; and (2) help

   N/A

develop cooperatives, assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local government institutions?

b. FAA Sec. 103, 103A, 104, 105, 106, 107. Is assistance being made available: (include only applicable paragraph --e.g., a, b, etc.. -- which corresponds to sources of funds used. If more than one fund source is used for assistance, include relevant paragraph for each fund source.) N/A

c. FAA Sec. 207; Sec. 113. Extent to which assistance reflects appropriate emphasis on: (1) encouraging development of democratic, economic, political, and social institutions; (2) self-help in meeting the country's food needs; (3) improving availability of trained worker-power in the country; (4) programs designed to meet the country's health needs; (5) other important areas of economic, political, and social development, including industry; free labor unions, cooperatives, and Voluntary Agencies; transportation and communication; planning and public administration; urban development, and modernization of existing laws; or (6) integrating women into the recipient country's national economy. N/A

d. <u>FAA Sec. 281(b).</u> Describe extent to which program recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civic education and training in skills required for effective participation in governmental and political processes essential to self-government.

N/A

<u>FAA Sec. 201(b)(2)-(4) and -(8); Sec. 201(e); Sec. 211-(a)(1)-(3) and -(8).</u> Does the activity give reasonable promise of contributing to the development of economic resources or to the increase of productive capacities and self-sustaining economic growth; or of educational or other institutions directed toward social progress? Is it related to and consistent with other development activities, and will it contribute to realiable long-range objectives?

N/A

f. <u>FAA Sec. 201(b)(6); Sec. 211(a)(5), (6).</u> Information and conclusion on possible effects of the assistance on U.S. economy, with special reference to areas of substantial labor surplus, and extent to which U.S. commodities and and assistance are furnished in a manner consistent with improving or safeguarding the U.S. balance-of-payments position.,

N/A

3. Nonproject Criteria for Development Assistance (Loans only) — N/A

a. FAA Sec. 201(b)(1). Information and conclusion on availability of financing from other free-world sources, including private sources within the United States.

(1) (103) for agriculture, rural development or nutrition; if so, extent to which activity is specifically designed to increase productivity and income of rural poor; (103A) if for agricultural research, is full account taken of needs of small farmers; — N/A

(2) (104) for population planning or health; if so, extent to which activity extends low-cost, integrated delivery systems to provide health and family planning services, especially to rural areas and poor; extent to which assistance gives attention to interrelationship between (A) population growth and (B) development and overall improvement in living standards in developing countries. Is activity designed to build motivation for small families in programs such as education in and out of school, maternal and child health services, agriculture production, rural development, and assistance to urban poor? — N/A

(3) (105) for education, public administration, or human resources development; if so, extent to which activity strengthens nonformal education, makes formal education more relevant, especially for rural families and urban poor, or strengthens management capability of institutions enabling the poor to participate in development. N/A

(4) (106) for technical assistance, energy, research, reconstruction, and selected development problems; if so, extent activity is: N/A

(a) to help alleviate energy problem;

(b) reconstruction after natural or manmade disaster;

(c) for special development problem, and to enable proper utilization of earlier U.S. infrastructure, etc., assistance;

(d) for programs of urban development, especially small labor-intensive enterprises, marketing systems, and financial or other institutions to help urban poor participate in economic and social development.

(5) (107) by grants for coordinated private effort to develop and disseminate intermediate technologies appropriate for developing countries. N/A

b. FAA Sec. 201(b)(2); 201-(d). Information and conclusion on (1) capacity of the country to repay the loan, including reasonableness of repayment prospects, and (2) reasonableness and legality (under laws of country and United States) of lending and relending terms of the loan.

c. FAA Sec. 201(e). If loan is not made pursuant to a multilateral plan, and the amount of the loan exceeds $100,000, has country submitted to AID an application for such funds together with assurances to indicate that funds will be used in an economically and technically sound manner?

d. FAA Sec. 202(a). Total amount of money under loan which is going directly to private enterprise, is going to intermediate credit institutions or other borrowers for use by private enterprise, is being used to finance imports from private sources, or is otherwise being used to finance procurements from private sources?

4. Additional Criteria for Alliance for Progress

(Note: Alliance for Progress assistance should add the following two items to a nonproject checklist.) N/A

a. FAA Sec. 251(b)(1)-(8). Does assistance take into account principles of the Act of Bogota and Charter of Punta del Este; and to what extent will the activity contribute to the economic or political integration of Latin America?

b. FAA Sec. 251(b)(8); 251(h). For loans, has there been taken into account the effort made by recipient nation to repatriate capital invested in other countries by their own citizens? Is loan consistent with the findings and recommendations of the Inter-American Committee for the Alliance for Progress (now "CEPCIES" the Permanent Executive Committee of the OAS) in its annual review of national development activities?

-10-

UNCLASSIFIED

Department of State

ANNEX II INCOMING TELEGRAM

ACTION AID-00

ACTION OFFICE LACE-03
INFO AALA-01 LACO-02 LADP-04 LADR-03 PPCE-01 PPPB-02 GC-01
GCLA-03 GCFL-01 FM-02 RELO-01 MAST-01 DO-01 /026 A4 302

INFO OCT-00 CIAE-00 EB-08 DODE-00 ARA-00 L-03 AMAD-01
/047 W

------------------336504 022212Z /38

P 022207Z MAR 84
FM AMEMBASSY SAN JOSE
TO SECSTATE WASHDC PRIORITY 3763

UNCLAS SAN JOSE 01691

AIDAC

E.O. 12356: N/A
SUBJECT: PROJECT 515-0186, LOAN 515-K-040 ECONOMIC STABILIZATION AND RECOVERY II; STATUS OF GOCR COMPLIANCE WITH CONDITIONS AND COVENANTS

1. AS OF 02/29/84, ALL CPS AND COVENANTS UNDER SUBJECT PROJECT HAVE BEEN SATISFIED WITH THE EXCEPTIONS LISTED BELOW.

2. COVENANT (M) TO ESTABLISH, USING THE COLON EQUIVALENT OF $3,000,000 OF THE THIRD AMENDMENT LOAN, A SMALL INDUSTRY CREDIT DISCOUNT LINE, SIMILAR IN OPERATIONS AND PROPOSES TO THAT ESTABLISHED UNDER AID LOAN 515-W-028, BUT ALSO OPEN TO PRIVATE BANKS AND WITH SUBLENDING TERMS AND PROCEDURES TO BE ESTABLISHED UNDER A REGLAMENTO SATISFACTORY IN FORM AND SUBSTANCE TO A.I.D., TO INCORPORATE REFLOWS FROM THE LOAN 028 SMALL INDUSTRY CREDIT PROGRAM INTO THE DISCOUNT LINE; AND TO FIX THE LENDING RATE TO THE FINAL BORROWER OF ALL CENTRAL BANK SMALL INDUSTRY CREDIT LINES AT A LEVEL WHICH IS NOT MORE THAN THREE POINTS BELOW THE SIX MONTH DEPOSIT RATE PAID BY PUBLIC COMMERCIAL BANKS.

- BCCR AND AID AGREED ON THE PROGRAM AND THE LANGUAGE OF THE DRAFT REGLAMENTO IN JANUARY, 1984. NO PUBLICATION OF REGLAMENTO HAS YET OCCURRED, SINCE FINAL PRESENTATION TO BCCR JUNTA HAS REPEATEDLY BEEN POSTPONED DUE TO "URGENCY" OF OTHER ISSUES SINCE MID-JANUARY WHICH HAS CENTERED THE JUNTA'S TIME.

3. COVENANT (N) TO PROMPTLY ESTABLISH OR CAUSE TO BE ESTABLISHED A NEW CREDIT GUARANTEE PROGRAM WHICH IS ACCEPTABLE TO A.I.D., AND WHICH GUARANTEES LOANS TO BE MADE BY MEMBER BANKS OF THE NATIONAL BANKING SYSTEM AND AUTHORIZED FINANCE COMPANIES FOR INDUSTRY, AGRO-INDUSTRY, EXPORT ACTIVITIES AND RELATED SERVICES, AND CONSTRUCTION; TO PROMPTLY DEPOSIT THE COLON EQUIVALENT OF UP TO $10,000,000 OF THE THIRD AMENDMENT LOAN INTO THE CREDIT GUARANTEE FUND TO BE ADMINISTERED UNDER THIS PROGRAM; TO ESTABLISH OR CAUSE TO BE ESTABLISHED, AN ADMINISTRATIVE UNIT FOR THE PROGRAM WHICH IS ADEQUATELY AND APPROPRIATELY STAFFED; TO INCORPORATE THE OPERATIONS AND GUARANTEE PORTFOLIO OF THE PRODUCTIVE CREDIT GUARANTEE PROGRAM INTO THE NEW GUARANTEE PROGRAM; AND TO ASSUME UNDER THE NEW PROGRAM SUCH CONTINGENT LIABILITIES AS A.I.D. MAY HAVE UNDER THE PCGP AGREEMENT EXECUTED ON FEBRUARY 26, 1979.

- BCCR AND MISSION WAITED UNTIL ANALYSIS/EVALUATION OF PCGP BY LOCAL PEAT MARWICK OFFICE WAS COMPLETED PRIOR TO INITIATING STAFF DISCUSSIONS OF HOW THE NEW GUARANTEE PROGRAM WOULD WORK. BCCR DID NOT RECEIVE REPORT UNTIL LATE DECEMBER. AT JANUARY MEETINGS, CONSENSUS WAS

REACHED TO PROVIDE FINANCIAL GUARANTEES TO EXPORTERS AND TO INVESTIGATE POLITICAL RISK AND CATASTROPHIC INSURANCE FOR EXPORTERS. BCCR AND INS (NATIONAL INSURANCE INSTITUTE) ARE ANALYZING ANTICIPATED NEED AND THE APPROPRIATE PREMIUMS TO BE CHARGED FOR FINANCIAL, POLITICAL AND CATASTROPHIC ELEMENTS. RESULTS DUE IN MARCH WILL BE USED AS A BASIS TO ESTABLISH AN EXPORT CREDIT RESERVE: REMAINING AMOUNT FROM $10,000,000 EQUIVALENT, PLUS APPROPRIATE OPERATIONS FROM OLD PGCP WILL BE BASIS FOR DEVELOPMENT OF A NEW DOMESTIC CREDIT GUARANTEE PROGRAM. PROJECTED IMPLEMENTATION DATE: JUNE, 1984.

4. COVENANT (R) TO NEGOTIATE WITH THE IMF FOR A 1984 STAND-BY AGREEMENT OR EXTENDED FUND FACILITY, AND TO IMPLEMENT THE ECONOMIC STABILIZATION PROGRAM RESULTING FROM THOSE NEGOTIATIONS.

- NEGOTIATIONS ARE IN PROGRESS. JONES

UNCLASSIFIED

ACTION AID-7 INFO AMB DCM ECON/10

VZCZCSJ0158

ANNEX IV

OO RUEHSJ
DE RUEHC #3961 0550328
ZNR UUUUU ZZH
O 232306Z FEB 84
FM SECSTATE WASHDC
TO AMEMBASSY SAN JOSE IMMEDIATE 8018
BT
UNCLAS STATE 053961

24-FEB-84
TOR: 12:35
CN: 08764
CHRG: AID
DIST: AID

USAID Route To	Costa Rica Act.	Info
MDIR		✓
DDIR		✓
MO		
PDO	X	
GDD		
PO		✓
TO		
OPS		
CONT		✓
RDO		
ADM		
GSO		
PER		
MR		✓
CPU		
ROCAP		

AIDAC

E.O. 12356: N/A
TAGS:
SUBJECT: COSTA RICA ESF CONCEPTS PAPER - FY 1984

THE BUREAU REVIEWED ON JANUARY 24 THE MISSION'S CONCEPTS PAPER OUTLINING THE STRATEGY TO BE USED IN NEGOTIATING CONDITIONS WITH THE GOVERNMENT OF COSTA RICA (GOCR) RELATED TO THE OBLIGATION AND DISBURSEMENT OF THE ESF RESOURCES DURING FY 1984. -

2. THE CONSENSUS WAS THAT THE CONCEPTS PAPER WAS AN EXCELLENT DOCUMENT AND THAT THE STRATEGY CONTAINED IN IT WAS HIGHLY APPROPRIATE TO THE SITUATION CONFRONTINGTHE MISSION. THE STRATEGY AND CONDITIONS OUTLINED IN THE - PAPER WERE APPROVED BY THE BUREAU SUBJECT TO -THE - FOLLOWING MODIFICATIONS AND UNDERSTANDINGS:

A. GRANT/LOAN SPLIT-- THE MISSION'S PROPOSED STRATEGY OF AN ALL-GRANT PROGRAM SHOULD BE MODIFIED SUCH THAT NOT MORE THAN 50 PERCENT OF ESF FUNDS MAY BE OBLIGATED IN FY84 AS A GRANT. THE EXACT AMOUNT OF GRANT FUNDS WILL

NEED TO BE JUSTIFIED BY THE MISSION IN A PAAD TO BE SUBMITTED BY THE MISSION SOMETIME IN EARLY MARCH.

B. CONDITIONALITY--

-- 1) THE BEST APPROACH FOR ADVANCING STRUCTURAL REFORMS APPEARS TO BE TO DEAL WITH THE BROAD RANGE OF ISSUES DISCUSSED IN THE CONCEPTS PAPER. IN PUTTING THE CONDITIONS TOGETHER FOR NEGOTIATION, HOWEVER, THE MISSION SHOULD EXAMINE THE TRADEOFFS BETWEEN THE BROAD FRONT STRATEGY, AND THE INCREMENTAL APPROACH WHICH ENVISIONS DEALING WITH A FEW POINTS AT A TIME BEFORE MOVING ON TO OTHERS. IN EITHER CASE, THE MISSION SHOULD BE SPECIFIC IN ITS PAAD PRESENTATIONS AS TO WHAT POINTS IT HAS NEGOTIATED AND PARTICULARLY THE ACTIONS IT EXPECTS TO ELICIT FROM THE GOCR IN RETURN FOR ESF RESOURCES.

A CONDITION PRECEDENT TO AUTHORIZATION OF THE FY84 ESF PACKAGE WILL BE THE NEGOTIATION OF, AND ACCEPTANCE BY IMF MANAGEMENT (NOT BOARD) IN WASHINGTON, A LETTER OF INTENT FROM THE GOCR FOR A 1984 STAND-BY ARRANGEMENT. FURTHER,

A CONDITION PRECEDENT TO DISBURSEMENT UNDER THE FY84 ESF PROGRAM WOULD BE SIGNATURE OF SUCH A STAND-BY AGREEMENT BY THE IMF AND THE GOCR. THE BUREAU CONCURS WITH THE MISSION'S INTENT TO COORDINATE ITS ACTIONS WITH THOSE OF THE IMF. WE WOULD SUGGEST THAT, WHILE ESF DOLLAR AND LOCAL CURRENCY RESOURCES WILL HAVE TO BE TAKEN INTO ACCOUNT IN THE ESTABLISHMENT OF ANY STANDBY ARRANGEMENT, THE MISSION SHOULD TAKE CARE TO RETAIN DIRECT NEGOTIATING CONTROL OF THOSE RESOURCES SO THAT THE ARRANGEMENT DOES NOT PREEMPT THE MISSION'S PLANS FOR THE USE OF ITS FUNDS.

-- 2) AS REGARDS THE SUBSTITUTION OF LOCAL CURRENCY GENERATIONS FOR CERTAIN TAXES WHICH CREATE DISINCENTIVES TO EXPORT AND INVESTMENT ACTIVITIES, THE TACTIC WAS ACCEPTED AS APPROPRIATE TO THE SITUATION AT HAND. HOWEVER, THE MISSION SHOULD VIEW THE SUBSIDY APPROACH AS AN ESSENTIALLY TRANSITORY MECHANISM WHICH WILL BE PHASED OUT AS PART OF OUR OVERALL EFFORT TO PERSUADE THE GOCR TO LIVE WITHIN ITS FISCAL MEANS.

C. NEGOTIATING/PAAD SUBMISSION CONSIDERATIONS--

-- 1) FYI, AN FY1984 SUPPLEMENTAL REQUEST HAS BEEN SUBMITTED TO THE CONGRESS WITH THE FY85 CONGRESSIONAL PRESENTATION WHICH INCLUDES AN ADDITIONAL DOLS 60 MILLION IN ESF FOR COSTA RICA ABOVE THE DOLS 70 MILLION CURRENTLY IN THE APPROVED OYB. HOWEVER, SINCE IT WILL BE SOME TIME BEFORE CONGRESSIONAL REACTION TO THE SUPPLEMENTAL IS KNOWN AND FUNDING IS APPROPRIATED, THE INITIAL PAAD FOR FY1984 SHOULD BE LIMITED TO DOLS 70 MILLION. SUBSEQUENT SUPPLEMENTS TO THE INITIAL PAAD MAY REQUEST AUTHORIZATION OF ADDITIONAL ESF FUNDS BASED ON CONGRESSIONAL RESPONSE TO THE AGENCY'S REQUEST AND SHOULD DISCUSS PROGRESS MADE IN THE MISSION'S NEGOTIATION OF INITIAL CONDITIONS, AS WELL AS LAYING OUT ANY NEW POINTS WHICH IT WOULD PLAN TO PUSH WITH THE GOCR.

-- 2) THE MISSION SHOULD CONSIDER THE POINTS MADE BY JUAN BUTTARI, PPC/PDPR/ED, IN HIS MEMO OF JANUARY 23 RELATING TO TAX REFORM, REVISION OF PRICING POLICIES, PUBLIC SECTOR EMPLOYMENT AND WAGES, THE CREDIT AND BANKING SYSTEM, AND THE TRANSFER OF ENTITIES FROM THE PUBLIC TO THE PRIVATE SECTOR, AND DISCUSS THEM, WHERE APPROPRIATE, IN THE INITIAL PAAD SUBMISSION FOR FY1984.
SHULTZ
BT
#3961

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VZCZCSJI *
RR RUEHC
DE RUEHSJ #1155 044 **
ZNR UUUUU ZZH
R 132110Z FEB 84
FM AMEMBASSY SAN JOSE
TO SECSTATE WASHDC 3387
BT
UNCLAS SAN JOSE 01155

ANN

CLASS: UNCLASSIFIED
CHRGE: AID 02/10/84
APPRV: MDIR:DACHAIJ
DRFTD: LO:JSILVER:OS
CLEAR: 1.OPS:AWILLIAMS
2.LO:LKORNFELD
3.DDIR:BBSCHOUTEN
DISTR: AMB DCM MDIR
DDIR LO OPS
PO MF

AIDAC

E.O. 12356: N/A
SUBJECT: MODIFICATION TO COSTA RICA S FREE ZONE LAW

1. ON JANUARY 30, 1984, COSTA RICA LEGISLATIVE ASSEMBLY PASSED MODIFICATION TO EXISTING FREE ZONE LAW. THIS MODIFICATION WAS SUBMITTED FOR CONSIDERATION BY MINISTER OF INVESTMENT AND EXPORTS.

2. THE REVISED LEGISLATION BOTH PERMITS DESIGNATION OF EXISTING INDUSTRIAL INSTALLATIONS AS FREE ZONES, AND PERMITS ESTABLISHMENT OF A FREE ZONE AREA IN MESETA CENTRAL WHERE BASIC INFRASTRUCTURE IS CONCENTRATED.

3. REVISED LAW BECOMES OPERATIONAL AFTER PUBLICATION IN OFFICIAL GAZETTE (LA GACETA), WHICH NORMALLY REQUIRES 10-15 WORKING DAYS FOLLOWING PASSAGE. WINSOR
BT
#1155

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ANNEX VI

SAN JOSE CABLE 3090 (1983), CLASSIFIED

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ACTION AID-7 INFO AMB DCM ECON /10

ANNEX VII

VZCZCSJ0599
OO RUEHSJ
DE RUEHC #8881 1472136
ZNR UUUUU ZZH
O 272038Z MAY 83
FM SECSTATE WASHDC
TO AMEMBASSY SAN JOSE IMMEDIATE 4092
BT
UNCLAS STATE 148881

27-MAY-83
TOR: 21:39
CN: 16523
CHRG: AID
DIST: AID

AIDAC

E O. 12356: N/A
TAGS:
SUBJECT ESR II (515-K-040): EXTENSION OF COVENANT COMPLIANCE DATES

REF.: SAN JOSE 3090

1. BUREAU CONCURS WITH EXTENSIONS OF DATES FOR COMPLYING WITH COVENANT 6.1(G) AND CONDITION PRECEDENT TO DISBURSEMENT CONTAINED IN SECTION 3.3 OF SUBJECT LOAN AGREEMENT. ALSO CONCUR WITH APPROACH DESCRIBED IN PARAS 3 AND 5 OF REFTEL FOR EXTENDING THESE DATES. PLEASE ADVISE WHEN COVENANT/C.P. HAVE BEEN SATISFIED.

2. WITH RESPECT TO DISBURSEMENT PROCEDURE DESCRIBED IN PARA 6 OF REFTEL, BUREAU CONCURS WITH MISSION JUDGMENT AND AUTHORIZES MISSION TO PROCEED IN MANNER DESCRIBED IN REFTEL. DAM
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#8881

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USAID Route To	Costa Rica Act	Info
MDIR		✓
DDIR		✓
MO		
IO	✓	
GDO		✓
PO		✓
LO		
OCT		
CONT		✓
RDO		
ALM		
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PER		
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RECAP		