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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 PROGRAM V

AID/LAC/P-315

Project Number:515-0222
Loan Number:515-K-607

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AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

1. PAAD Number Project No. 515-0222 515-K-607	
2. Country Costa Rica	
3. Category Balance of Payments Program Cash Transfer	
4. Date June 2, 1986	
5. To AA/LAC, Dwight A. Ink	6. OYB Change Number N/A
7. From LAC/DR, Terrence J. Brown	8. OYB Increase None. To be taken from: Economic Support Funds (ESF)
9. Approval Requested for Commitment of $ 40,582,000.00	10. Appropriation Budget Plan Code LESA-86-35515-KG31 (637-65-515-00-50-61)
11. Type Funding: ☐ Loan ☒ Grant 12. Local Currency Arrangement: ☐ Informal ☐ Formal ☐ None	13. Estimated Delivery Period: FY 1986 14. Transaction Eligibility Date: -
15. Commodities Financed	

16. Permitted Source	17. Estimated Source
U.S. only	U.S. $40,582,000.00
Limited F.W.	Industrialized Countries
Free World	Local
Cash $40,582,000.00	Other

18. Summary Description

The purposes of the program are to provide balance of payments support to A.I.D. stabilization efforts in Costa Rica, and to encourage policy and structural changes aimed at re-establishing dynamic growth in the economy through increased exports. The $40,582,000 grant which will be signed with the Government of Costa Rica will consist of a cash transfer to the Central Bank of Costa Rica, the dollar equivalent of which will be made available for sale to private producers. Imports from the U.S of raw materials, intermediate goods, construction materials, capital equipment, and spare parts in an amount at least equal to the grant will be required. An amount in local currency equivalent to the grant will be deposited by the Central Bank in the Special Account originally established under ESR II. Disbursement of local currency from the account will be made pursuant to implementation letters for the mutually agreed-upon development purposes specified in the PAAD. Since the $40,582,000 million authorized in this action is less than that requested in the PAAD text, it is subject to the Conditions, Covenants, and Special Provisions specified in Sections IV.E.1 and 2 of the PAAD, less those Covenants pertaining to the Housing Sector.

The Mission is authorized to vary the disbursement plan contained in Section IV.C.2.a of the PAAD as required to maintain an even and rational flow of foreign exchange into Costa Rica, but with the provision that the Mission will consult with AA/LAC prior to taking any action to withhold or delay all or any part of a disbursement. The Central Bank of Costa Rica will provide the colon equivalent of each dollar disbursement calculated at the highest rate of exchange, at the date of the disbursement which is not unlawful in Costa Rica.

19. Clearances	Date
LAC/DP:WWheeler	5/2/86
GC/LAC:GDavidson	5/2/86
PPC/EA:KKauffman	5/2/86
M/FM:CChristensen	6/3/86
LAC/CAP:PWAskin	5/2/86
LAC/DR:ILevy	5/2/86
DAA/LAC:MButler	
ARA/ECP:RBeckham	

20. Action

☐ APPROVED ☐ DISAPPROVED

Authorized Signature: Malcolm Butler

Date: JUN 6 1986

Title: Assistant Administrator, Bureau for Latin America and the Caribbean

CLASSIFICATION

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LIST OF ABBREVIATIONS

AID	Agency for International Development
BCCR	Central Bank of Costa Rica
CACM	Central American Common Market
CHMB	Central Housing Mortgage Bank
CNP	National Production Council
CODESA	Costa Rican Development Corporation
ESF	Economic Support Funds
ESR	Economic Stabilization and Recovery
GDP	Gross Domestic Product
GOCR	Government of Costa Rica
IMF	International Monetary Fund
PAAD	Program Assistance Approval Document
SAL	(World Bank) Structural Adjustment Loan

I. SUMMARY AND RECOMMENDATIONS

A. Summary

Costa Rica has long been distinguished by its democratic tradition and peaceful nature. Its army was abolished in 1949, and its human rights performance has been exemplary. During the quarter century ending in the mid-1970's it appeared to be a model developing country, enjoying substantial rates of economic growth and pursuing growth with equity. Such growth however, was based on a policy of import substitution and on overreliance on traditional agricultural commodities.

In addition, Costa Rica moved away from a market economy, nationalizing its banking system, increasing public sector employment to 20% of the labor force, and investing heavily in inefficient state run enterprises operated by the Costa Rican Development Corporation (CODESA). The losses of these subsidiaries, and the Central Bank credit required to finance them, became a serious drain on the national economy.

When the terms of trade turned against Costa Rica in the late 1970's and the Central American Common Market became a declining and unreliable trading partner, the country resorted to external borrowing to maintain a fixed exchange rate, to compensate for the fall in the value of its exports, and to cover its balance of payments deficit. By 1981, the economy was in a state of crisis and faced with an overwhelming debt service burden.

Since the administration of President Luis Alberto Monge took office in May of 1982, the economy has been stabilized with the help of A.I.D., the IMF, the World Bank, commercial bank creditors, and rescheduling of foreign debt. A.I.D. has signed four prior Economic Stabilization and Recovery Programs (ESR) with Costa Rica in the years 1982-1985. The 1984 ESR III program marked a shift of emphasis from stabilization to policy reform and structural changes required to re-establish economic growth. Under this program, major reforms in credit, interest, and exchange rate policies were effected, along with changes to improve the role of the private banking sector and to promote exports. The ESR IV program for 1985 not only continued progress on the prior years' agenda, but also added a major focus on the privatization of CODESA's subsidiaries and a reduction in the Central Bank debt built up by past operating losses of those subsidiaries.

The ESR V program for 1986 is proposed at a level of $120,582,000 of grant funding from Economic Support Funds (ESF), to be provided as a cash transfer. Analysis of Costa Rica's balance of payments for 1986 indicates that, even after reflecting inflows from the

World Bank and from debt relief, the proposed level of ESF assistance will be necessary to prevent strong import compression and growth of payment arrearages to such high levels as to impede orderly debt rescheduling.

The Mission proposes to obligate the entire $120,582,000 in a June 1986 agreement with the newly inaugurated Arias government, after final negotiation of specific covenants relating to the CODESA divestiture and to housing issues.[1] Funds under the agreement would be tranched in three instalments, to maintain an even and rational flow of foreign exchange, and to protect the Mission's negotiating leverage in assuring covenant compliance.

As under previous ESR agreements, the Government of Costa Rica (GOCR) will be required to provide an amount of foreign exchange equivalent to the dollar cash transfers, for sale to private, productive enterprises. It will also be required to show that it has imported eligible goods from the United States within a specified time period, in an amount at least equal to the cash transfers.

The GOCR will provide the local currency equivalent of the Grant for activities consistent with the objectives of the ESR V program. Among the presently programmed uses of this local currency are assistance for the CODESA divestiture, an addition to the Special Credit Line for the productive private sector, and initial funding of a secondary mortgage bank.

B. Recommendations

1. That this PAAD be approved, and that obligation of a grant of up to $120,582,000 in Economic Support Funds for Costa Rica be authorized, to be provided as a cash transfer.

2. That authority be delegated to AA/LAC to amend the Authorization as may be required to subsequently revise any Covenants or Special Provisions.

3. That the Mission be authorized to vary the disbursement plan contained in Section IV.C.2.a as required to maintain an even and rational flow of foreign exchange into Costa Rica, but with the provision that the Mission will consult with AA/LAC prior to taking any action to withhold or delay all or any part of a disbursement.

1/ The new government's position on these matters is set forth in recent letters of intent from the then President-elect and his First Vice President-elect, attached as Annexes II and III.

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II. BACKGROUND

A. Historical Conditions Through 1982

During the quarter century ending in the mid-1970's, Costa Rica appeared to be a model developing country. It operated as a true democracy, pursued a progressive social program, and experienced substantial rates of economic growth. Its Gross Domestic Product (GDP) grew by 7.0 percent per annum from 1966-1970, 6.0 percent per annum from 1971-1975, and 5.3 percent per annum from 1976-1980. Social development was as impressive as economic performance: adult literacy reached 90 percent, infant mortality declined sharply to under 20 per thousand, population growth dropped from 3.5 to 2.6 percent per annum, and open unemployment and underemployment were held to 5 percent and 6 percent of the labor force, respectively. A national system of social security (including near-universal health care), workmen's compensation, and other similar measures were institutionalized. Progress in meeting housing needs was less spectacular, but satisfactory. Income distribution was quite equitable in comparison with most developing countries. Such achievements were based on substantial public sector investment. Schools, health facilities, water and sewerage, roads, electricity, and communications facilities were widely distributed.

The progress during this period was financed by a strong expansion of the Costa Rican economy, related to (1) the creation of the Central American Common Market (CACM) and (2) the expansion of traditional agricultural exports: coffee, bananas, sugar, and beef. During the 1960's, private entrepreneurs rapidly expanded manufacturing to supply the domestic market and the CACM under protectionist, import-substitution policies.

The structural problems inherent in this import-substitution growth model were not well appreciated. By the early 1970's, growth generated through the CACM slowed and the economy began to pay the hidden costs of overprotection. As the decade progressed, interest rates became more subsidized and the exchange rate more overvalued. These forces contributed to heavy reliance on imported inputs, to the creation of excess capacity and to misallocation of foreign exchange. The country continued its expansion of industry and social services, financed by inflows of external private capital and by earnings generated from expanding traditional exports.

Costa Rica began to move away from a private sector market economy and towards a state-administered economy as regards prices, wages, and control over production. The Costa Rica Development Corporation (CODESA) was established in 1972 to promote industrial development in cooperation with the private sector. Unfortunately, the law which established CODESA allowed it access to Central Bank credit,

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which in turn has permitted continued support to unprofitable enterprises. In the process, it increasingly bought out private sector interests in joint enterprises. Thus, the 1970's saw the development of many inefficient state-owned businesses.

These state commercial enterprises, together with expansion of social services and public utilities, increased the public bureaucracy from about 6 percent of the labor force in 1950 to over 20 percent by the 1980's. The public sector was thus growing faster than the private sector upon which it was dependent for financial support.

In 1979, the terms of trade turned against Costa Rica as coffee prices fell sharply from their 1977 high and the price of petroleum doubled. The CACM, on which Costa Rica had depended so heavily, became a contracting and unreliable market. Costa Ricans were, collectively, living beyond their means.

Economic growth and development achievements contributed to a false sense of invulnerability; Costa Ricans were unprepared to deal with the devastating impact of the world economic recession in the late 1970's, as well as with the limitations of domestic economic policies. In the period 1978-1981, in order to avoid the difficulties of adjustment, the Costa Rican Government engaged in substantial external borrowing to maintain a fixed exchange rate, to compensate for the fall in the value of exports, and to cover the balance of payments deficit. This heavy external borrowing gave Costa Rica the dubious distinction of being one of the most indebted nations in the world, on a per capita basis. The authorities also permitted strong monetary expansion in an attempt to maintain existing levels of public and private consumption.

By 1981, foreign exchange reserves were exhausted and the attempt to maintain real income collapsed with a de facto moratorium on servicing the foreign debt. GDP declined by 2.3 percent in 1981, and by 7.3 percent in 1982. Unemployment and underemployment rates rose by 1982 to 9 percent and 14 percent respectively. Inflation exceeded 100 percent by the end of 1981.

The economic crisis had a drastic impact on the standard of living of the average Costa Rican. Real wages declined strongly in 1981 and 1982; even after some recovery in 1983 they were at only 74% of the 1979 level.

The economic decline can be attributed to much more than world recession and the escalation of political turmoil in Central America. The magnitude of the crisis resulted from failure of specific elements of the development policy which Costa Rica and most of its Central American neighbors had followed since the late 1950's: overreliance on traditional export commodities for foreign exchange generation, the policy of import-substitution, the creation of inefficient state-run enterprises, and heavy public sector borrowing all wrought havoc with the economy, and signaled the need for re-structuring. By the time the administration of President Luis Alberto Monge took office in May 1982, most elements of Costa Rican society were aware of the deteriorating economic situation and sufficiently alarmed to make possible the imposition of the discipline of a stabilization program. Subsequent progress towards stabilization and recovery is discussed in the two sections immediately following.

B. Current Economic Situation

A detailed discussion of recent economic history and an analysis of the current Costa Rican economy has been prepared for this PAAD and is attached as Annex I.

In general, the economic analysis in Annex I demonstrates GOCR efforts to curb fiscal deficits, and to reduce inflation and its ensuing exchange rate instability by monetary and fiscal restraint. The period 1982-1985 was one of recovery of economic stability. The stabilization program has had several positive results.

Maintenance of fiscal and monetary discipline resulted in a reduction of inflation (as measured by the wholesale price index) from 100% in 1982 to only 10% by the end of 1985.

Real wages increased by 34% over the 1982-1984 period, and the latest data for 1985 (through March) indicate a further increase of 4.5%. (Despite these increases, real wages in March 1985 were still 12% below the 1979 level.)

The deficit of the nonfinancial public sector was reduced from 14% of GDP in 1981 to 1.7% of GDP in 1985. Concurrently, central administration revenues increased from 13.5% of GDP in 1982 to 18.7% in 1985.

Further, the Monge administration took steps to make investments in export activities more attractive, with the result that Costa Rica's non-traditional exports (excluding coffee, sugar, bananas and beef) to non-CACM countries increased by $30.8 million in the period 1984-85. Additional increases are anticipated, particularly for ornamental plants, flowers, tropical fruits and vegetables, given resolution of marketing and infrastructure problems and continued investment.

The GOCR also succeeded in achieving compliance with International Monetary Fund (IMF) Standby arrangements for 1983 and 1985, in addition to rescheduling Costa Rican debt with external creditors. In early 1985, the GOCR obtained debt relief from the Paris Club and foreign

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commercial banks and also reached agreement with the World Bank for a Structural Adjustment Loan (SAL). The Paris Club agreement covered 90% of debt service in arrears as of December 31, 1984, and provided $74 million in new credit through March 31, 1986, as well as $167 million in debt relief in 1985. Also during 1985, the World Bank disbursed $40 million as a first tranch of the SAL, and net resources from the IMF amounted to $33 million. After the disbursement of $160 million in Economic Support Funds (ESF), the 1985 balance of payments support package to Costa Rica approximated $580 million.

On the negative side of the ledger, Costa Rica's balance of payments situation has remained weak; freely disposable reserves have rarely had monthly balances of as much as $40 million. Even for 1986 with higher coffee earnings projected on the order of $150-200 million, a substantial balance of payments surplus is not expected. In fact, predicted coffee earnings may be more than offset by declines in foreign exchange inflows from commercial banks, ESF disbursements and debt service relief. (See Annex I, pp 7-8; Tables II and VIII.)

Another factor influencing Costa Rica's external accounts is the deterioration of Central American trade. Continuing their decline since 1979, Costa Rica's exports to Central America dropped from $193.0 million in 1984 to $130.2 million in 1985. This drop in CACM exports more than offset gains in exports to non-traditional markets. Most of the problem lies in the failure of the CACM members to pay their trade debts promptly, and thus is largely beyond Costa Rica's control. At present, the decline in CACM trade appears to have bottomed out, and the Mission projects a slight improvement in 1986. (See Annex I, Table III.)

Even with substantial balance of payments assistance, Costa Rica has not been able to reestablish its external creditworthiness. In the period 1983-85, debt service payments averaged 36.8% of export earnings; this percentage is expected to rise to 50.6% in 1987-90. The amount of debt-relief projected by the IMF as required for the period 1986-1990 equals $959 million, or $240 million annually, clearly indicating the necessity of further debt reschedulings.

The Costa Rican public sector is a drain on private sector development. On the financial side, Central Bank annual losses are estimated at about ₡9.5 billion ($175 million) annually for both 1985 and 1986. I's losses are presently so high that, given monetary restraint, the Central Bank is unable to purchase income producing domestic assets to reduce its losses. Certain public sector institutions -- the national commodity marketing board (CNP), the national railway (FECOSA), the University of Costa Rica, and CODESA -- continue to run large deficits and to be overly bureaucratic and overstaffed. In the financial sector, the state-owned banks in Costa Rica have lower efficiency than private banks, implying lower returns for savers and higher costs to borrowers. CODESA, which is a major target of the ESR IV and V programs, is the most

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obvious case of public sector intrusion into an operation better left to the private sector. The operations of CODESA and its subsidiaries have accumulated over ₡11 billion ($200 million) in debts to the Central Bank since 1972, representing significant opportunity costs in lost economic growth potential.

C. Objectives and Status of A.I.D.'s Prior Economic Stabilization and Recovery Programs (ESR's) in Costa Rica

The ESF resources administered by A.I.D. have played a decisive role in the progress toward stabilization and recovery described in Section II.B above. A.I.D. has signed four previous ESR Agreements with Costa Rica, all of which have been fully disbursed, for a total of $465,735,000.

ASSISTANCE UNDER ESR I - IV ($000)

	FY	Signatory	Loan	Grant	Total
ESR I	1982	BCCR (Central Bank)	$15,000	$5,000	$20,000
ESR II	1983	BCCR	118,000	37,735	155,735
ESR III	1984	BCCR	35,000		
		GOCR		95,000	130,000
ESR IV	1985	BCCR		20,000	
		GOCR		140,000	160,000
		TOTAL	168,000	297,735	465,735

Like the ESR V program proposed here, each of the previous ESR programs was aimed at supporting Costa Rica's international balance of payments and increasing the amount of foreign exchange available to the private, productive sector. The earliest ESR programs focussed on immediate economic stabilization of Costa Rica, while subsequent programs have moved toward a heavier emphasis on laying the basis for sustained economic growth, reflecting the recommendations of the National Bipartisan Commission on Central America (NBCCA -- the "Kissinger Commission").

1. ESR I and II

The ESR programs for FY 1982 and 1983 were structured to complement an IMF Stand-by Arrangement. The colon was stabilized, and

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substantial amounts of local currency credit were made available to the private sector -- including the equivalent of some $45 million which was channelled through a new Central Bank credit line. Most of these funds were earmarked for retailing through private banks, to provide a competitive alternative to the inefficient state-run banking system. In addition, the GOCR developed "A Strategy for Export Promotion and Investment", which is being implemented with A.I.D. support. (A more detailed description of accomplishments under ESR I and II was provided in the PAAD for ESR III.)

2. ESR III

The FY 1984 program continued the effort to consolidate the stabilization of the economy, but also reflected a shift towards greater emphasis by A.I.D. on structural reform. The Mission's priorities under ESR III included:

(1) Improvements in the system for financial intermediation, including credit, interest rates, the role of the private banking system, and exchange rate policy; and easing of free zone regulations to encourage exports.

(2) Removal of taxes which were disincentives to exports and production; and the enacting of measures to decrease public sector expenditures.

The Mission's policy dialogue and its use of A.I.D. leverage over ESR III disbursements resulted in significant revisions in the Monetary Law of Costa Rica (Ley de la Moneda) and in the Organic Law of the Central Bank. The former ended the ability of debtors to pay off hard-currency loans in Costa Rican currency at an official exchange rate which was much lower than the market rate. (The risk to lenders that their loans might be repaid at substantially less than their foreign currency value made it impossible for Costa Rican private financial institutions to make hard currency loans.) The modification to the Organic Law of the Central Bank permitted the BCCR to discount (i.e. loan) funds, financed from external sources, directly to private sector banks. Before this policy change, private banks could not obtain loanable funds through the Central Bank. Thus, this change significantly increased the competitiveness of the the banking system in Costa Rica.

The ESR III agreement included major conditions with respect to credit and interest rates in an effort to simplify and rationalize the Central Bank's management of credit. Limits were imposed on subsidized credit for 1984; all other credit operations undertaken by the banking system were required to be made at real positive interest rates. In dialogue with the Mission, the BCCR continued its transition, begun under earlier ESR programs, away from administratively controlled

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credit allocations, and toward market allocation. The local currency equivalent of $25 million was channelled through the Special Credit Line for the productive private sector. (Further details on the objectives and results of ESR III can be found in the PAAD for ESR IV, as well as in Annex I to this PAAD.)

3. ESR IV

a) CODESA Divestiture [1/]

In FY 1985, the centerpiece of the Mission's strategic agenda under ESR IV was to promote the privatization of the various companies owned by the Costa Rican Development Corporation (CODESA). This process has been driven by parallel objectives: (1) to reduce, and possibly eliminate, inefficient public sector participation in commercial enterprises; and (2) to reduce the burden of Central Bank debt accumulated over the years by CODESA operations and losses. Achievement of these objectives will decrease deficits and demand for credit in the public sector, thereby freeing resources for the economically productive private sector. The actual privatization process has been designed in the light of a further objective: to limit the monetization of local currency made available under ESR programs (see Section III.C, pp. 20-21 below).

. History. The GOCR created CODESA in 1972 to serve as a development bank and venture capital partner, cooperating with the private sector to bring new businesses into existence. According to its original charter, CODESA was intended to play a short-term role in each enterprise. Its investments were expected to be turned over to the private sector when the enterprises became financially viable.

In actual experience, however, CODESA (which is owned almost entirely by the GOCR) has taken a majority or sole ownership position in many enterprises. The public sector has thus become responsible for the management of a range of commercial activities including aluminum milling, cement production, sugar refining, cotton processing, woodworking, and others.

Non-commercial and non-economic factors often predominated in the management and staffing of these subsidiaries of CODESA. Thus, it is not surprising that their inefficient operation has generated significant financial losses over the years. To keep its enterprises running, CODESA repeatedly tapped its access to credit at the Central Bank. CODESA's borrowings have increased five-fold since 1979, consistently accounting for one-third of all credit to the country's public sector.

1/ A detailed discussion of CODESA and the design of the divestiture process has been provided in Annex III to the PAAD for ESR IV (1985).

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By mid-1985, CODESA had accumulated debt at the Central Bank on the order of ₡11 billion. Calculated at a prevailing rate of about 25%, interest alone on this debt represented a drain on the economy of around ₡2.75 billion ($51 million) per year.

Despite the magnitude of the resources it was consuming, its subsidiaries in 1983 were providing only 2,122 jobs (0.3% of the labor force) and producing only 1.1% of GDP. CODESA was siphoning off substantial resources which should have been devoted to more efficient activities.

Political Situation. Costa Rica has been governed since 1982 by the Liberación Nacional party, which retained power in the February, 1986 presidential and legislative elections. The major expansion of CODESA occurred a decade ago under the aegis of a former Liberación administration. There continues to be a faction in the incumbent party which has constituted an obstacle to reform of that corporation. However, with support from A.I.D., the administration of President Luis Alberto Monge (elected in 1982) began to address the problem. CODESA's debt was consolidated, and budgetary limits were placed on CODESA's borrowing power at the Central Bank.

The legislature passed a Financial Equilibrium Law (No. 6955) in February of 1984, providing the legal mandate and procedures for the sale by CODESA of the stock it owned in its subsidiaries. Article 55 of this law provides that shares of CODESA subsidiaries will be sold through public bid, subject to the following stipulations:

-- Certain subsidiaries are treated as "public utilities" which are to be transferred out of CODESA to other government entities. TRANSMESA (a bus company), FECOSA (a railroad), and the Free Zone Corporation are included in this category.

-- Only 40% of the shares of FERTICA (fertilizer) and CEMPASA (cement) may be sold to private interests, although a later cabinet decree provides that these shares may be sold along with a management contract which assures the private buyer's right to manage the companies.

-- CATSA (sugar refining) and CEMVASA (cement) may be sold only to Costa Rican cooperatives.

In August of 1984, CODESA was charged with developing a plan of divestiture. On October 5, 1984, a letter from President Monge to U.S. Ambassador Curtin Winsor requested USAID assistance in carrying out the divestiture.

In February of 1985, regulations were published providing specific guidelines under which CODESA's subsidiaries were to

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be sold. An important provision of these regulations was that proceeds from the sale of any subsidies were to be deposited directly with the Central Bank, and to be used only for the purpose of reducing CODESA's consolidated debt with the Central Bank. This debt reduction will help to repair some of the past damage done by CODESA's operations, just as divestiture of CODESA's subsidiaries will prevent recurrence of such damage in the future.

The National Commission. To assure that the divestiture process would be carried out in conformance with the the new law, a National Commission for the Divestiture of CODESA was established by Cabinet resolution in February of 1985. Its three prominent and respected members were given the necessary powers to bring about the sale or liquidation of the subsidiaries. A legal attack by CODESA management in the fall of 1985 against the authority of the Commission resulted in a vigorous reaffirmation of the Commission's powers by both the Attorney General and the Controller General of the republic.

The National Commission requests the Controller General (an independent official reporting to the legislature) to establish a minimum valuation of each subsidiary. Based on that valuation, the National Commission then puts the subsidiary up for public bid. The Controller has based his valuation on a technical analysis of the replacement cost of each enterprise. Such an analysis will typically yield a valuation which is higher than the price at which the company can be sold on the open market.

The same February 1985 Cabinet resolution mandated the prompt divestiture of CODESA's holdings. In compliance with covenants agreed to in ESR IV, this Cabinet resolution also precluded CODESA from acquiring new investments, and from borrowing additional funds for anything but short-term, self-liquidating working capital.

The Trust. In September of 1985, pursuant to a May agreement between A.I.D. and the GOCR, a private sector Trust was established (1) to bid on CODESA subsidiaries as they are put up for sale by the National Commission, (2) to take such actions as are necessary to prepare each subsidiary for ultimate resale to private purchasers or liquidation, and (3) to carry out such resale or liquidation. (The Trust's activities are funded by local currency provided under the ESR program.) It was concluded that an entity was needed to play such an intermediary role because the CODESA subsidiaries would typically be subject to various problems which would make it difficult to accomplish a prompt sale (within the thirty day bid process established by Law 6955) to a private commercial purchaser. Also, it was believed that potential purchasers might not find it easy to deal with CODESA as a seller. It was therefore concluded that the best way to accomplish an expeditious divestiture would be to establish a private sector Trust to make a quick purchase, and then to restructure the subsidiary as necessary for ultimate resale to a private operator, or for liquidation.

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The two principal purposes of the Mission's initiative have been to eliminate a drain on the Costa Rican economy by divesting CODESA's inefficient subsidiaries, and also to relieve part of the continuing burden created by CODESA's past borrowings from the Central Bank. The two-stage divestiture mechanism, with the Trust as an intermediary, serves both purposes. The Trust is designed to get the subsidiaries out of CODESA's possession more expeditiously than would be possible in a direct sale to private commercial buyers. And the Trust's purchase of a subsidiary accomplishes an immediate reduction of the Central Bank's debt burden, since the purchase price is deposited directly with the Central Bank in order to cancel part of CODESA's past debt to the Bank.

Five prominent Costa Rican businessmen of impeccable reputation are serving as Trustees. Recognizing the complexity of preparing subsidiaries for resale and then marketing them effectively, the Mission contracted a team to provide expert technical assistance to the Trust. A request for proposals published in June of 1985 attracted high quality bids from several groups. A contract was signed in October to retain a team composed of Price Waterhouse, First Boston, and International Resources Group. This team began its work in November, shortly before the first CODESA subsidiary (ALUNASA, an aluminum milling concern) was put up for public bid by the National Commission.

• Divestitures. The Trust bid on ALUNASA and bought that subsidiary at the end of 1985. It immediately proceeded to rationalize the management, staffing, and operations of the company. Preparations were made for a marketing effort, which began in March, 1985. It is expected that ALUNASA will be sold to a private operator by mid-1986.

ALCORSA, a cotton processing company, was put up for bid by the National Commission in December of 1985. Technical issues have delayed the successful conclusion of this bid process, which is expected to move forward again in 1986.

CODESA announced in March of 1986 that NAMUCAR, a multi-million dollar shipping company in which it held shares, would be liquidated. This process will be carried out directly, without the necessity of any intermediation by the Trust.

Actual experience with the operational and political complexities of this divestiture process have made it obvious that the timetable projected in the 1985 PAAD for ESR IV was overly optimistic. A revised estimate of the time required for the process is presented in Section IV.D.2.a, p. 28-29 below, which discusses divestiture activities under ESR V.

b) Other ESR IV Objectives

Economic Stabilization. The $160,000,000 of ESF dollar funds provided to Costa Rica in 1985 were an essential component in the success of the country's continued stabilization. This continued success in stabilization has been reflected on several fronts. 1/ Further reductions in inflation, to an annual level of about 10%, were achieved. Mission estimates for 1985 indicate that Costa Rica returned to a positive overall balance of payments posture. The Central Bank was able to continue with its program of controlled "mini-devaluations" of the colon; the fact that black market trading of the colon took place at a relatively small premium over the official rate is an indication of the Central Bank's progress in maintaining a realistic exchange rate policy.

These successes were achieved only with the support of substantial external balance-of-payments support. It is clear that further structural improvement of the economy will be necessary over the coming years in order to sustain this stabilization.

Laying the Basis for Self-Sustaining Growth. Constraints beyond Costa Rica's control limit the prospects for improvement in its traditional exports, as well as its exports to other countries of the Central American Common Market (CACM). Therefore, the Mission views the growth of non-traditional exports to non-CACM markets as being critical to Costa Rica's economic recovery. Such exports showed an encouraging growth of some $90 million in 1984 and 1985. The Mission expects this growth to continue in 1986. (See Section II.B, pp. 5-6 above; and Annex I, Table III.)

Long-term economic recovery in Costa Rica will require a general revitalization of the country's private sector, which was seriously decapitalized during the economic dislocations of the early 1980's. Thus, one of the major thrusts of ESF programs in recent years has been the use of counterpart local currency to improve the availability of credit to private business. By the end of 1985, a total of $90 million equivalent in local currency had been committed to a Special Credit Line for the productive private sector. The demand for this credit has been strong, and the mechanism for its allocation -- a rediscount facility at the Central Bank -- has functioned efficiently. The credit has been quickly and fully disbursed to over 200 private businesses. Of the total amount, over 70% has been earmarked for retailing through private banks, reflecting the Mission's continuing commitment to build up the country's private banking sector.

1/ See economic data in Annex I for details.

The Special Credit Line has had a significant impact in strengthening private banking in Costa Rica. It not only allows private banks to increase their loanable assets, but it also provides an incentive for them to raise more equity capital, in order to meet reserve requirements for obtaining access to the line. Total equity of private banks in Costa Rica was ₡1.18 billion at the end of 1985, an increase of 21% over the prior year.

On the dollar side, a major impact of the ESF balance-of-payments support has been to improve access by private business to the imports which are essential to its productivity.

Other specific initiatives have been incorporated into ESF agreements by means of covenants which are discussed in the following section.

4. Status of Compliance with ESF Covenants

Over the course of four ESF programs from 1982 to 1985, the GOCR has agreed to eighty-seven separate covenants embracing a wide range of policy and reporting requirements. Compliance with these agreements has generally been quite satisfactory. A detailed discussion of covenant status has been forwarded to Washington as a separate cable (San Jose 02668).

Credit and Interest Policy. The Central Bank has substantially increased credit availability to the private sector. In particular, it has complied with agreements to allocate large amounts of ESF counterpart funds to the Special Credit Line for productive private enterprises (discussed above). It has established separate credit lines for small industry and for low income mortgages. Because of legal problems, the Bank has failed to implement an ESR II covenant establishing a $10 million equivalent guaranty fund for private business; half of this amount has been reallocated to the Special Credit Line, and negotiations are in progress to allocate the balance to a successful existing credit fund for small industry.

In compliance with its agreements with the Mission, the Central Bank in 1985 continued its earlier progress away from administrative allocation of credit, and toward a market-driven allocation. (This progress has culminated in a 1986 credit program which dismantles most of the remaining specific credit allocations.) The Bank has complied with its agreements to maintain interest rates which are positive after adjusting for inflation, as well as with agreements to limit the total amount of subsidized credit extended through the national banking system. The Bank has failed to comply with covenants under ESR III and IV requiring (1) that credit should not be provided to cover losses caused by subsidization of basic food commodities by the National

Production Council, and (2) that at least 50% of all subsidized credit should be financed by funds other than those captured from the general public by commercial banks. These latter problems are under review and negotiation.

Foreign Exchange Availability and Rates. The Central Bank continued in 1985 to maintain a realistic unified exchange rate, achieving a real devaluation of 5% against September 1982 levels (according to a trading-partner-weighted index). This unification and devaluation removes what had been a serious disincentive to export activities.

Amounts equal to total ESF disbursements were provided for import needs of the productive private sector, and for imports of eligible U.S. commodities.

Export and Investment Promotion. Compliance was achieved with various covenants calling for improvements in export and investment policy, including establishment of free zone mechanisms. Costa Rica's success in increasing non-traditional exports to world markets has been discussed in Section II.B, p. 5-6 above (see also Annex I, Table III).

Because of unsatisfactory progress in rationalizing port tarriffs, funds originally intended to provide a one-time transfer to the GOCR to cover lost revenues from the new tariff structure are being reprogrammed to finance other Mission development activities.

Housing and Related Infrastructure. The Central Bank has agreed to support statutory changes necessary for the creation of a secondary mortgage bank, and a draft statute acceptable to the Mission is being debated in the legislature. A project to demonstrate the efficiency of provision of residential water and sewage by private contractors is in progress and on schedule.

CODESA. As discussed above, the GOCR has complied with covenants in 1984 and 1985 by

(1) limiting credit to CODESA,

(2) precluding CODESA from undertaking new investments, 1/

(3) ending CODESA involvement in the administration of the Special Credit Line,

1/ The National Commission has conveyed to the Mission a certification by CODESA's Internal Auditor to the effect that CODESA is in compliance with these credit and investment covenants. While the Mission is not aware of instances of non-compliance with these covenants, it is considering steps to obtain independent verification of compliance.

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(4) providing Central Bank credit necessary to consolidate third-party debts during the divestiture process,

(5) applying the proceeds of the ALUNASA divestiture to reduce CODESA debt to the Central Bank, and

(6) reducing the public sector credit ceiling by the amount of the proceeds of the ALUNASA divestiture.

Policy Reform Studies. Because of contracting delays, the GOCR has been late in executing studies on promotion of meat and sugar exports, and on pricing policy; completion of these studies is anticipated in June of 1986, after which action plans are to be prepared.

Policy Reform Projects. A project demonstrating the advantages of private sector road maintenance has been carried out, with excellent results. Almost all road maintenance in the country is presently done by the Ministry of Public Transport (MOPT) and other governmental bodies. The demonstration project convincingly displayed the advantages of road maintenance by private contractors: the quality, speed, and cost of their work compared very favorably with the performance of government bodies doing similar work. Expanded use of such private contracting would allow significant reductions in the size of the public sector. Based on the results of the A.I.D. demonstration project, the World Bank and the Inter-American Development Bank are both considering inclusion of private sector contracting, as well as structural changes in MOPT, as requirements under new loans for road maintenance and rehabilitation. The Mission and the GOCR plan to allocate further local currency under ESR V as counterpart funds for these loans.

The Central Bank has established a unit to check the prices of import and export transactions, in order to control fraud and capital flight. While substantial progress has been made in data gathering, the unit has not yet begun actual monitoring of transactions. This situation is not acceptable to the Mission: a covenant in the ESR V agreements will require immediate implementation of the price-checking process (see Section IV. E, p. 35 below).

In accordance with a covenant under ESR III, the Central Bank embarked in 1985 on a major effort to improve its data systems; completion of this work, with technical assistance provided by Price Waterhouse, is expected in 1987.

Reporting. The Central Bank's compliance with the extensive reporting requirements under the four previous ESF agreements has been uneven. The Mission has concluded that this situation arose in part because these reporting covenants were negotiated with Central Bank

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senior management, without sufficient input from the staff who would be responsible for compilation of these reports. The Mission plans to review the entire range of information requirements with Central Bank staff, and to reduce these diffuse requirements to a single reporting schedule which is more consonant both with the Mission's needs and with the capabilities of of the Bank to comply. In no case has a reporting problem entailed substantive damage to the Mission's program.

III. U.S. INTERESTS, STRATEGY AND RATIONALE

A. U.S. Interests

Costa Rica's long-standing democratic tradition and peaceful nature are unique in Central America. Its army was abolished in 1949, and Costa Rica prides itself on having more teachers than policemen. Its respect for human rights is outstanding, at a time when many of its neighbors are major violators of such standards. Both citizen and visitor alike travel freely and safely throughout the land, and refugees from the conflict and oppression in neighboring countries continue to seek its safety. Some 25,000 persons have officially entered Costa Rica as refugees from other Central American countries between 1974 and 1985; estimates of the number of unregistered immigrants range between 60,000 and 250,000.

The National Bipartisan Commission on Central America (Kissinger Commission) emphasized, in its report to President Reagan, the high degree to which Central America is both vital to U.S. interests, and particularly vulnerable at the present time. The Kissinger Commission clearly articulated how national interests are served by advancing the cause of democracy within the hemisphere. As historically the most successful social democracy in Latin America, Costa Rica is in a unique position to garner support for U.S. policy in Central America. The country serves as a paradigm of peaceful and democratic development for the region.

The recent economic crisis and political turmoil in neighboring countries have severely tested Costa Rican institutions and ingrained democratic traditions; the country has been able, thus far, to withstand the challenges, and, as described in Section II, C above, to undertake some of the difficult policy and structural changes required to re-establish growth and prosperity. It is significant that such changes have taken place within a democratic process, and have been accepted in a peaceful manner. However, many of the policy and structural changes undertaken since the beginning of the Monge administration in May of 1982, and others which are required, represent a radical shift in outlook and philosophy for Costa Rica, and quite naturally engender public and official concern. Thus, changes have sometimes appeared to us to occur slowly, and may continue to do so. Moreover, they have sometimes been hard won, with resistence and skeptical attitudes still remaining to these and further changes. Thus, any serious deterioration in the economic situation would severely affect the credibility of the recovery effort. For this reason, continued and substantial U.S. assistance is required to reinforce the economic recovery effort, and to reaffirm U.S. commitment to Costa Rica, its democratic process, and peaceful tradition.

B. <u>Multi-year ESF Assistance Strategy in Costa Rica</u>

Economic recovery in Costa Rica requires that the country move away from an import-substitution model and statist attitudes, towards export-led growth in a more market-oriented economy. This transition can best be obtained by encouraging revitalization of the more efficient private sector and by reducing the role of the public sector, which has contributed to the current economic crisis. The goals and objectives which implement this policy have been articulated in the Mission's Action Plans.

The goals of the program are:

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

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

Objectives being pursued in support of these goals include:

-- Economic Stabilization and Recovery -- To relieve Costa Rica's economic crisis and improve its balance of payments situation by alleviating the shortages of imported goods required for production, by increasing credit available to the productive private sector, and by restoring international confidence in Costa Rica and its currency. The Mission's initiatives are coordinated with, and complement the economic stabilization and recovery aims of, the IMF and World Bank programs in Costa Rica.

-- Strengthening of the Financial System -- To assist in the development of a strong private banking sector in Costa Rica. The direct effect of this development will be that the productive private sector will have access to credit which is both expanded in amount and more responsive in its delivery. Indirectly, the nationalized banks will be forced by competition to improve the quality and efficiency of their services.

-- Expansion of Exports and Investment -- 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. 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.

-- 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 through 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.

-- Improvement of Shelter Availability -- To expand production of shelter and residential infrastructure, mainly for low and moderate income families. The Mission is focusing on structural reforms in the housing finance system, which are discussed below in connection with ESR V.

C. Strategy for the ESR V Program

Stabilization. Economic stabilization remains a key objective of the Mission's program. The success of Costa Rica's stabilization efforts has depended on sizable levels of external balance of payments support. Such support will continue to be required until policy reforms demonstrate their medium and long term effects in the structural revitalization of the domestic economy. (See Annex I, pp. 6-8, Tables II and VIII.)

Policy and Structural Reform. ESR V will focus on expanding the progress made under earlier programs. Continuing exchange rate adjustment ("mini-devaluations") will be necessary. Further efforts will be exerted to restrict the amount of subsidized credit provided through the national banking system. Limits on credit to the public sector will be tightened, in order to free up economic resources for the more productive private sector.

On December 26, 1985, the Central Bank announced its credit program for 1986. The Mission objected to a provision of this program which limited private banks to a 2% expansion of credit in 1986. The Central Bank removed this restriction when it published a revised program on February 25, 1986. The ESR V agreements will contain a covenant requiring the Central Bank to maintain the provisions of this revised program. A recent cable (San José 2601) discusses the substantial structural progress which is reflected in the 1986 credit program.

An expansion of private sector credit will be accomplished through the allocation of up fo $20 million through private Costa Rican banks. A specific covenant will accelerate full implementation of the Central Bank's price-checking unit. Further local currency resources will be committed to the expansion of a successful existing project to demonstrate the efficiency of private sector construction and maintenance of roads (see Section II.C.4, p. 16 above).

CODESA. As discussed in Section IV.D.2.a, p. 28-30 below, a centerpiece of ESR V strategy will be continuation of the process of divesting the subsidiaries of CODESA, and reduction of the Central Bank debt burden created by the operations of CODESA and its subsidiaries. Key elements will include (1) a reaffirmation of the process by the new government taking office in May; (2) satisfactory progress in carrying out actual divestitures; and (3) reaching agreement with the GOCR such that CODESA will be precluded from owning or operating commercial enterprises in the future.

Monetization. The collapse of the Costa Rican economy in the early 1980's involved not only shortages of foreign exchange, but also excessive GOCR fiscal deficits and high inflation rates. Infusion of ESF dollars addresses the foreign exchange problem; but the local currency provided by the GOCR under its ESR agreements must be managed in a manner which does not exacerbate the deficit and inflation problems, as well as fueling excessive import demand. No matter how meritorious individual uses of these local currency funds may be, it must always be borne in mind that each additional colon which the GOCR spends under ESR programs has an impact on the domestic deficit, and also tends to fuel inflation and import demand by increasing the domestic money supply. Thus, all decisions about uses of these local currency funds require a careful weighing of these factors.

By 1984-1985, U.S. dollar assistance to Costa Rica had reached levels at which monetization (i.e. spending) of the full amount of local currency provided under each year's ESR agreement could not be permitted during that year without unacceptable consequences to the economy.

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Therefore it was agreed with the IMF that limits would be placed on the annual monetization of colones made available under ESR III and IV. In 1984, no more than $60 million (out of a total ESR grant of $95 million) was to be monetized. The monetization limit for 1985 was $80 million equivalent (as against a total ESP grant of $160 million).

These concerns remain [illegible] applicable to the ESR V program for 1986, and are fundamental to the design of the CODESA divestiture process. When ESR counterpart funds are used to reduce CODESA debt at the Central Bank, these funds are not monetized: only a book transaction occurs, in which parallel reductions are made in the ESR Special Account and in the CODESA debt account. (Exactly the same result occurs whether the reduction of CODESA debt is accomplished by a direct transfer of local currency to the Central Bank, or whether it is achieved through the intermediate step of "buying" a CODESA subsidiary with a local currency "purchase price" which is immediately transferred to the Central Bank to reduce CODESA debt.) The process makes it possible to take advantage of the political leverage of these funds without the fiscal, inflationary, and import-expansion consequences of having them infused into the money economy.

- Shelter Strategy. Costa Rica's serious shortage of low- and middle-income housing is exacerbated by inadequate financial systems and by the absence of a well-organized national shelter policy.

A major gap in the country's financial system is the absence of an effective facility for rediscounting home mortgages; therefore, the Mission's first priority in the housing area will be the passage of legislation creating a Central Housing Mortgage Bank (see details in Section IV.D.2.c, p. 31 below).

A second priority is the reform of the national shelter and urban planning functions. A consolidated organizational structure with clear lines of authority from the President is needed to coordinate shelter activities presently carried out by numerous ministries and semi-autonomous agencies.

A third priority will be the formulation of a bipartisan national housing policy and implementation strategy. This policy and strategy must be consistent with principles of affordability, financial self-sufficiency, private sector participation, and sustainable production/delivery systems.

Export Promotion. Exchange rate stabilization and increase of private sector productive credit are ESR V program components which will contribute directly to export performance, as will the allocation of modest amounts of local currency to export-oriented agricultural activities. The bulk of the Mission's export promotion activities have been funded through its Development Assistance dollar portfolio and through local currency made available under previous ESR programs.

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Tranching. Continuing its practice from prior years, the Mission proposes to tranche the disbursements under ESR V to provide an even and rational flow of foreign exchange, and to maintain leverage for assuring compliance with the covenants of this and previous ESR programs.

IV. PROGRAM DESCRIPTION AND RATIONALE

A. Program Components

The ESR V program consists of a grant of $120,582,000 to Costa Rica. The Mission proposes to obligate this amount in a single agreement, as indicated below.

The administration of President Oscar Arias was inaugurated on May 8, 1986. While negotiations with representatives of the new government have already started, 1/ final details are being actively worked out with the newly installed government representatives.

Therefore, following obligation of the full $120,582,000 under ESR V and completion of negotiations with the Arias government, the Mission proposes to disburse a first tranche of $40,582,000, likely in June. Funds will be tranched in three disbursements, as detailed in Section IV.C.2.a, p. 24 below, in order to maintain an even and rational flow of foreign exchange, and to preserve the Mission's negotiating leverage in assuring compliance with the conditionality attached to this and prior ESR programs.

The funds obligated under the agreement will be disbursed as a cash transfer. The uses of the local currency counterpart funds generated under the ESR V program are described in Section IV.D.2, p. 26-31 below.

B. Justification for the Grant

The Mission proposes that the $120,582,000 to be authorized by this PAAD be provided as a grant, rather than as a loan. Prior to debt relief, debt service is projected to consume more than 50% of all export earnings from 1986-1990. Reducing the burden of this projected debt service to a politically and economically more manageable 35% requires annual debt relief averaging $240 million for this period (down from the $270 million required for 1985-1989 under last year's projections). 2/

1/ See Section IV.E., p. 31 and Annexes II and III below.
2/ See Annex I, pages 8 and 11, and Tables II and VIII.

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Given Costa Rica's high debt servicing burden, maximum grant financing is consistent with U.S. interests in Costa Rica. Grant rather than loan financing reduces the debt service burden and the rate of debt accumulation, thereby supporting our stabilization and recovery objectives.

In addition, grant funding provides the necessary flexibility required for many of the proposed local currency uses. The Central Bank enabling legislation prohibits the Bank from granting borrowed funds, or their local currency equivalent, to any other entity.

C. U.S. Dollar Resources

1. Purpose and Terms for Dollar Resources

A total of $120,582,000 will be provided to the Central Bank in the form of cash transfers as balance of payments support to Costa Rica. Annex I (pp 7-8; Tables II and VIII) shows a $286 million projected balance-of-payments gap for Costa Rica in 1986. Even after reflecting financial inflows from the World Bank Structural Adjustment Loan and from debt relief, the level of ESF assistance proposed above remains necessary in order to maintain Costa Rica's foreign exchange reserve position and to prevent growth of arrearages to more damaging levels.

As under the four previous ESR programs, the ESR V agreements will require the Central Bank to make an equivalent amount of dollars available for sale to private enterprises in Costa Rica. Eligible private imports of production goods from the United States, in an amount equal to ESR V disbursements, will be required and monitored (see Section IV.E., p. 34 below). The Costa Rican private sector will be able to absorb resources of ESR V in the time frame provided for the assistance (through the end of calendar year 1986). The latest available Central Bank data, for the first nine months of 1985, indicate that Costa Rica's importation of qualifying goods from the U.S. has been running at an annual level of about $330 million per year. Separate figures for public and private sector imports are not available. But even making the most liberal possible estimates of the public sector component of those imports, it remains clear that private sector demand for qualifying U.S. commodities is well in excess of the $120 million assistance level proposed here.

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2. Disbursement of U.S. Dollar Resources

a. Disbursement Plan

The initial tranche of $40,582,000 will be disbursed following successful negotiation of ESR conditionality with the Arias administration (See Section IV. A, p. 22 above) and compliance with conditions precedent (Section IV. E, p. 31). The funds remaining after June will be disbursed in two increments of $40 million each in order to provide an even and rational flow of foreign exchange, and to enforce conditionality. The second tranche of $40 million will be made once the GOCR presents to USAID an acceptable economic and financial program to close the 1986 balance of payments gap. The third and final tranche for the remaining $40 million will be made upon satisfactory progress by the GOCR in negotiations with its external creditors and in the implementation of its financial/economic program referred to in the second tranche.

Thus, the disbursement plan to be incorporated into both assistance agreements is as follows:

ESR V DISBURSEMENT PLAN

Disbursements (projected)	Grant Funds (U.S. dollars)
First	40,582,000
Second	40,000,000
Third	40,000,000
TOTAL	120,582,000

The Mission requested, and was given, authorization to vary the disbursement plans under ESR II - IV as required to assure good management and regular availability of foreign exchange resources. Likewise, the Mission requests authorization to include in the assistance agreement under ESR V a plan for the disbursement of funds as detailed above, but with the provision that the Mission may vary this plan as required to maintain an even and rational flow of foreign exchange.

However, any variation to the disbursement plan which would involve witholding part or all of a disbursement would be based on prior consultation with AA/LAC.

b. Disbursements Procedures

Standard A.I.D. cash transfer procedures will be used. It is anticipated that disbursements will be made into a special account designated by the Central Bank, through electronic transfer of funds to the U.S. Federal Reserve Bank. Any deviation in this method will be by written approval of the Mission Controller.

c. Justification for Cash Transfer

As was the case in each of the previous ESR programs, use of a cash transfer (rather than a Commodity Import Program) is proposed for the ESR V program for several reasons. First, the cash transfer program maximizes the quick and flexible disbursement capability which is required to move foreign exchange into the Costa Rican economy in order to meet balance of payments and cash flow needs. Second, measures to limit capital flight are not needed, since there has been a positive flow of private capital into Costa Rica since 1982.

Net private capital inflows to Costa Rica for 1980-1985 were as follows:1/

1980	-$240.0 million
1981	-$ 69.0 million
1982	+$ 16.0 million
1983	+$ 68.0 million
1984	+$ 70.5 million
1985	+$ 67.5 million 2/ (preliminary)

1/ See Annex I, Table II (net private capital inflows are combined with errors and omissions and may change when final 1985 figures are published).

2/ Net private capital plus errors and omissions in Annex I, Table II was adjusted downward by $61.5 million, which corresponds to an increase in foreign exchange term deposits placed in state-owned banks as a result of higher than competitive interest rates in Costa Rica.

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This trend toward a reflow of private capital to Costa Rica reflects the stabilization of the economy and improvements in interest and exchange rate structures.

Finally, Costa Rica is using the A.I.D. funds to compensate for foreign exchange inflows lost as a result of factors leading to the current economic crisis. It normally trades with the U.S. well in excess of the dollar amounts provided under ESR Agreements. Total imports from the U.S. amounted to $395 million during 1984, and $286 million during the first nine months of 1985. Thus, there is nothing to be gained by using a Commodity Import Program.

D. Local Currency Resources

1. Provision of Local Currency Equivalent

Immediately following each dollar disbursement, the Central Bank will deposit an equivalent amount of local currency into a Special Account, as specified in the text of the Special Account covenant in Section IV.E., p. 34 below. This local currency equivalent will be calculated at the highest rate of exchange for purchase which is not unlawful as of each disbursement date.

2. Purpose and Terms for Local Currency Resources

The following table sets out present tentative plans for the general allocation of the local currency counterpart funds made available under ESR V. Specifics are discussed in ensuing sections.

ESR V LOCAL CURRENCY ALLOCATION

Activity	Amount (US$ million equivalent)
CODESA Divestiture and Central Bank Debt Reduction	50.0
Special Credit Line For Private Sector	20.0
Housing Bank	10.0
Agricultural School	16.0
Private Sector Road Maintenance	5.0
Counterpart to Mission Projects and Programs	4.0
Agribusiness Programs	5.25
Central American Peace Scholarships	0.75
Other	9.582
TOTAL	120.582

The Mission tries to fund its programs from current availabilities to the greatest extent possible, and thus to limit "mortgages" of future years' funding. The local currency program set forth in the Mission's Action Plan anticipates future year funding of the Agricultural School ($16 million equivalent in 1987), CODESA Divestiture and Debt Reduction (up to $50 million equivalent in 1987), and the Housing Bank (up to $40 million equivalent in 1987 and 1988).

a. Assistance to the GOCR in the Divestiture of Parastatal Enterprises and Reduction of Public Sector Debt

In addition to the $140 million equivalent in local currency already allocated under ESR IV, another $50 million will be devoted to the process of sale or liquidation of CODESA subsidiaries and reduction of the accumulated Central Bank debt burden created by past operations of CODESA and its subsidiaries. Progress under ESR IV for 1985 has been discussed in Section II.C.3.a, p. 9-13 above. Further detail on the history and financial condition of CODESA, as well as the design and constraints of the divestiture process, has been provided in Annex III to last year's PAAD for ESR IV.

Objectives. This year's program will continue to pursue the objectives set out under ESR IV:

-- To move toward the elimination of public sector participation in the operation of commercial enterprises; and

-- To reduce the burden of Central Bank debt created by past CODESA operations, thus freeing resources for more efficient uses.

In addition to these earlier objectives, the ESR V program will move on to address the status of the CODESA holding company itself. To prevent the recurrence of similar problems with the growth of parastatal enterprises, it is essential that agreement be reached with the GOCR so as to effectively preclude CODESA from acquisition or operation of commercial enterprises in the future.

Finally, the above objectives must be achieved through a mechanism which avoids the fiscal, foreign exchange, and inflationary impact of monetizing large amounts of local currency resources (see discussion of monetization issues in Section III.C, p. 20-21 above).

The program for achieving these objectives in 1986-1987 has been laid out in letters of intent signed by then President-elect Arias on March 17, 1986, and by Vice-President-elect Jorge Manuel Dengo on March 25, 1986. Annexes II and III to this PAAD contain copies of these documents, along with English translations. Prior to the June, 1986 signing of the ESR V grant agreement (see Section IV.A., p. 22

above), the Mission will negotiate specific conditionality with the new government, within the following framework provided by the letters of intent.

Reaffirmation of the Process. Success in carrying out the complex and politically delicate divestiture process is obviously dependent on the political will of the GOCR. The new government will issue a cabinet decree publicly reaffirming its commitment to the implementation of this process as a condition precedent to disbursement of the first tranche of funding (See Section IV. E).

Divestiture of Smaller Subsidiaries. The GOCR will commit itself to the sale or liquidation of CODESA's interest in all of its smaller subsidiaries by the end of calendar year 1986 (see Annex III, pp. 2, 8). Among these companies are:

Atunes de Costa Rica (a fishing operation)
CEMVASA (a cement producer)
FLEMAR (a shipping agency)
LACSA (the national airline, a small minority of whose shares is owned by CODESA)
MACASA (a wood processing firm)
NAMUCAR (a shipping company whose liquidation is already underway)
SANSA (a domestic airline in which CODESA is a minority shareholder)
Stabapari, S.A. (a wood milling company)
Tempisque Ferry Boat

The Mission will treat seriously the GOCR's commitment to complete these divestitures by the end of 1986, and will make every effort to encourage timely compliance. At the same time, experience of the legal and operational complexities which have emerged in previous divestitures makes it prudent to recognize the possibility that conclusion of some of these transactions may slip over into the following year, despite good faith implementation by the GOCR.

Larger Subsidiaries. The GOCR will commit itself to divesting the following assets of CODESA by no later than September of 1987 (see Annex III, pp. 3, 8):

ALCORSA (a cotton processor)
CATSA (a sugar refinery)
CEMPASA (a cement producer)
FERTICA (a fertilizer company)

"Forty-percent" Divestitures. Law 6955 of 1984, the statute authorizing the CODESA divestiture process, provides that no more than 40% of the shares of CEMPASA and FERTICA may be sold to the private sector, because of the "strategic" importance of these businesses. While the Mission does not view this as an ideal arrangement, it believes that it is a workable one provided that the eventual private buyer is assured of a management contract or a shareholders' agreement which guarantees its right to operate the business on a commercial basis, free from inappropriate political interference. The letters of intent accept this principle (see Annex III, pp. 2, 8).

Non-Private-Sector Divestitures. Law 6955 also provided that certain of the CODESA subsidiaries, because they were viewed as "public utilities", were not to be privatized, but were to be transferred out of CODESA to other GOCR agencies (See Section II.C.3.a, pp. 10 above). The Mission is not satisfied with the progress made by CODESA management during 1985 in effecting these transfers. Therefore, the Letter of Intent provides that the National Commission (the independent GOCR agency established to administer the privatization) will complete the transfer of these companies. (See Annex III pp. 3, 9 .)

The CODESA Holding Company. Divesting CODESA's present subsidiaries would be of limited value if the holding company were free to acquire or establish new commercial operations. An agreement with the GOCR to preclude CODESA from doing so will be an essential part of the ESR V program. Outright dissolution of CODESA would be a politically difficult solution. As another approach, the GOCR is considering the possibility of restructuring CODESA as a component of one of the national banks, but stripping it of all but its financial functions. (In addition to its commercial operations, CODESA has in the past served as a conduit for certain GOCR credit programs.) The Mission believes that this latter approach is acceptable, provided that CODESA is explicitly and effectively precluded from creating, financing, or operating new subsidiaries. (See Annex III, pp. 4, 10.)

b. The Special Credit Line and Private Sector Credit

To date, $95 million equivalent in local currency has been allocated to the Central Bank under earlier ESR agreements for the A.I.D. Special Credit Line. (In addition to $90 million accumulated by the end of 1985, an additional $5 million was deposited in March, 1986, in partial satisfaction of a prior guaranty fund covenant. (See Section II. C. 4, p. 14 above.)

As of December 31, 1985, local banks had disbursed funds from the Special Credit Line to about 200 firms. These funds were disbursed to ultimate borrowers quickly and efficiently. Operation of the Special Credit Line will be maintained via the present agreement.

Under ESR V, credit will continue to be made available to private sector enterprises through the provision of up to $20 million to private banks. Based on past experience, the Mission expects that

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existing private sector demand will readily absorb another $20 million equivalent while at the same time increasing loanable assets of private banks and providing incentives to raise equity capital by meeting reserve requirements.

c. Housing Bank

The colon equivalent of $10 million is presently earmarked for the initial capitalization of a new secondary mortgage bank. Legislation creating this Central Housing Mortgage Bank (CHMB) has been presented to the legislature.

The CHMB is modeled on similar institutions in the United States and other countries: it will be a second-tier financial institution specializing in mobilization of capital, mainly from the private sector, to finance long-term housing mortgages. The availability of substantial amounts of housing capital on a regular basis is an essential prerequisite to the higher levels of production needed to fill Costa Rica's housing deficit. To maintain constant rotation of this capital in new shelter projects, CHMB will operate in the national securities exchange (Bolsa de Valores) to discount the mortgages generated by approved members of the national housing finance system. The Board of Directors of CHMB (primarily drawn from the private sector) will regulate uniform terms and conditions for shelter financing by the various public and private institutions providing housing finance.

d. Agricultural School

The equivalent of $16 million is budgeted as incremental funding of local currency costs of the new Regional Agricultural School. The budget in the approved Project Paper includes local currency requirements of $89.6 million, of which $60 million has been programmed from ESR III funds. With the funds under ESR V, the balance of future year requirements is reduced and will be funded from FY 1987 local currency availablities.

e. Private Sector Road Maintenance

Under ESR III, a local currency project to demonstrate private sector road maintenance and rehabilitiation was executed with the Ministry of Public Transportation. Based on the excellent results of this pilot project, both the World Bank and the Inter-American Development Bank plan to include private contracting as a key element in their new road maintenance and rehabilitation loans. Under ESR V, local currency equivalent to $5 million is budgeted to be used as GOCR counterpart funds for these loans.

f. Agribusiness Programs.

Local currency equivalent to $2 million is reserved for initial implementation of the Mission's agribusiness export expansion strategy. This program will focus on technical assistance for the production and export of a small number of agribusiness products. The selection of these products is based on concrete market opportunities.

An equivalent of $3.25 million in ESR V local currency is reserved for incremental funding of the Coffee Technification and Diversification program. This program disseminates improved technology to help small coffee producers avoid crop losses from coffee rust. It also assists these small growers to plant marginal land in macadamia, cacao, cardamon, and other crops: diversified production will reduce the risk of reliance on coffee as a single crop.

g. Central American Peace Scholarships (CAPS)

An equivalent of $750,000 is earmarked for the CAPS program, which is providing high school, undergraduate, graduate and short-term technical/leadership training in the United States for individuals who would not otherwise have such an opportunity.

h. Other Local Currency Uses

The balance of local currency made available under ESR V, as well as interest earned in the Special Account, will be used for operating expense trust funds, property acquisition (including the new A.I.D. office building), program support, and other miscellaneous items.

E. Conditions and Covenants

Conditionality proposed for the ESR V program will assure that dollars provided are directed towards achieving the balance of payments and policy objectives of the program, that there is continued compliance with conditionality in existing ESR Agreements, that additional efforts required to further policy initiatives started under prior ESR programs are undertaken, that the local currency equivalent to the Grant is established, and that the basis for achievement of objectives identified for the local currency component of the program is established.

The Grant Agreement will be signed by A.I.D., the Central Bank and the GOCR likely in June. Based on discussions with President Arias prior to his inauguration, a number of provisions related to CODESA and the housing sector were accepted and included in letters of intent sent to the Mission (see Annexes II and III). These provisions, along with other conditionality concerns, will be incorporated as follows in the Grant Agreement:

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1. Conditions Precendent to First Disbursement

CODESA

Reaffirmation of Process

The GOCR will issue a cabinet decree which extends the existence and authority of the National Commission for the Reorganization of CODESA, and which reaffirms

(1) The requirement that CODESA's subsidiaries be sold, liquidated or transferred promptly;

(2) The prohibition against CODESA making new investments or otherwise participating in the formation of new businesses; and

(3) The prohibition against CODESA incurring new liabilities other than those required for short-term, self-liquidating working capital, or those incurred to pay off third-party debts as part of the divestiture of individual subsidiaries.

Valuations by the Controller General

The GOCR will issue a resolution which provides that the First Vice President of the Republic, assisted by the National Commission, will be delegated to negotiate with the Controller General a formula which will permit the participation of FINTRA (the private sector Trust) in cases where the adjusted book value method (used by the Controller in the public offering of earlier subsidiaries) would diverge from the real market value of a subsidiary being put up for bid.

2. Covenants

The Grant Agreement shall incorporate covenants requiring the Central Bank to provide the following:

Foreign Exchange for Private Enterprise

— To provide during calendar year 1986 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 under the Economic Stabilization and Recovery Program V; and to report to A.I.D. within three months of the last disbursement of these cash transfers, or by March 31, 1987 (whichever is earlier), information sufficient to indicate that such provision of foreign exchange resources has been accomplished.

U.S. Commodity Imports

-- To make available during calendar year 1986 a dollar amount equivalent to that disbursed as cash transfers to Costa Rica under the Economic Stabilization and Recovery Program V, for the importation from the United States by private enterprises in Costa Rica (including the agricultural sector) of raw materials, construction materials, intermediate goods, spare parts, and capital equipment required for production; and to report to A.I.D. by June 30, 1987, or within six months of the last disbursement of these cash transfers (whichever is earlier) that such transactions were accomplished.

Special Credit Line

-- To maintain the Special Credit Line in operation (including all funds added to it under this or previous Economic Stabilization and Recovery agreements, together with payments of interest and repayments of principal received by the Central Bank from that credit line), under the same conditions and regulations presently in force, until December 31, 1996, or such other date as may be agreed to between A.I.D. and the Central Bank.

Private Sector Credit

-- To agree to an increase in credit available through the private banks to the productive private sector, in an amount of local currency equivalent of up to twenty million United States dollars ($20,000,000), to increase loanable assets of private banks and to provide incentives to raise equity capital by meeting reserve requirements. This local currency amount shall be calculated at the highest rate of exchange for purchase which, as of the date of the first disbursement of funds under the Economic Stabilization and Recovery Program is not unlawful in Costa Rica.

Public Sector Credit

-- To restrict net credit outstanding through the national banking system to the non-financial public sector during calendar year 1986 to levels no higher than those agreed to with the International Monetary Fund for calendar year 1985, less the amount of any reductions in CODESA debt to the Central Bank funded under this or any previous Economic Stabilization and Recovery program; and to report to A.I.D. within three months of the end of each calendar quarter in 1986 information sufficient to demonstrate compliance with this condition.

Subsidized Credit

-- To restrict outstanding balances of subsidized credit during calendar year 1986 (defined as credit which is extended through the national banking system at interest rates lower than the basic passive rate) to levels (measured in colones) which are at the end of calendar year 1986 no higher than the level of such credit outstanding as of December 31, 1984, and which do not exceed that December 31, 1984 level by more than 5% on a purely seasonal basis during the course of 1986; and to report to A.I.D., within three months of the end of each calendar quarter of 1986, information sufficient to demonstrate compliance with this condition.

Exchange Rate

— To maintain during calendar year 1986 a unified exchange rate; and to review the appropriateness of the exchange rate on a continuing basis, and revise it when necessary, in accordance with the following factors, among others: relationship of actual and anticipated domestic prices to 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 foreign debt, and non-compensatory net capital inflows.

Positive Real Interest Rates

— To maintain the basic passive rate during calendar year 1986 (defined as the interest rate fixed by the Central Bank for six-month certificates of deposit) at a level higher than the prevailing rate of inflation.

National Credit Program

— To maintain and implement during calendar year 1986 the credit program announced by the Central Bank's Board of Directors on February 19, 1986, in all of its features.

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Price Checking Unit

To provide evidence acceptable to A.I.D. no later than 30 days following the signature of this Agreement that the process of import and export price verification by the Central Bank Price Checking Unit is fully operational; and thereafter to provide to A.I.D., at the end of each calendar quarter through December 31, 1988, reports in a form acceptable to A.I.D. on the operations of the unit, with particular emphasis on actual progress achieved in verifying import and export prices.

IMF Reports

-- To provide to A.I.D., from the signing of this agreement until the end of calendar year 1987, copies of all reports to the International Monetary Fund as required under present or future agreements or programs with that Fund; and to provide each such report to A.I.D. at the same time that it is provided to the Fund; and, in the event that at any time during such period no agreement or program with the Fund is in effect, to provide to A.I.D. during such period reports whose timing and content shall be substantially similar to those currently provided to the Fund.

Special Account for Counterpart Funds

-- Acting in its capacity as financial agent for the Government of Costa Rica for purposes of agreements under this Economic Stabilization and Recovery Program V, to deposit promptly the equivalent in colones of each dollar disbursement under this Program into the Special Account in the Central Bank originally established under Covenant 6.1(L) of the ESR II Assistance Agreement, which account will pay interest at a rate equal to the interest rate fixed by the Central Bank for six month certificates of deposit; and to calculate the colon equivalent of such dollar disbursements at the highest rate of exchange for purchase which, as of the date of the dollar disbursement, is not unlawful in Costa Rica; and to make disbursements from this Special Account pursuant to A.I.D. Implementation Letters.

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Divestiture of Smaller Subsidiaries 1/

-- By December 31, 1986 at the latest, CODESA will have sold or liquidated its interests in Atunes de Costa Rica, SANSA, LACSA, STABAPARI, MACASA, NAMUCAR, Tempisque Ferry Boat, FLEMAR, CEMVASA, and any other company in which it has any interest (except its shares in the national securities exchange and its seat on that exchange, as well as the companies named in the following covenant).

Divestiture of Remaining Larger Subsidiaries 1/

-- By September 30, 1987 at the latest, CODESA will have sold or liquidated its interests in ALCORSA, CATSA, CEMPASA, and FERTICA.

-- By December 31, 1986 at the latest, the articles of incorporation and by-laws of CEMPASA and FERTICA will have been amended as necessary to ensure the protection of private purchasers of 40% of their shares, including an appropriate management contract or its equivalent.

Non-Private-Sector Divestitures

-- The National Commission will be required to effect the transfer of the following CODESA subsidiaries: TRANSMESA (the bus company) to the Ministry of Public Works and Transport; FECOSA (the national railroad) to the National Railroad Institute; MINASA (the distributor of national mining concessions) to the Ministry of Industry, Energy, and Mines; and the Free Zone Corporation to the Center for Export and Investment Promotion. These transfers will have been effected no later than December 31, 1986.

Restructuring of the CODESA Holding Company

-- The First Vice President, together with the Central Bank and the National Commission, will contract for such studies or other work as they deem suitable to work out a possible absorption of CODESA by one of the state commercial banks or by some other institution, providing that CODESA will be precluded from creating, financing, or operating any new subsidiary.

1/ For descriptions of individual companies, see Section IV.D.2.A. p. 28 above.

The above work will be completed, along with all the detail necessary in advance of executive action, no later than September 30, 1986. Implementation plans will be presented within sixty days of the completion of this work.

b. Housing Sector Covenants

Public Agencies

-- The GOCR will implement policy and organizational reforms leading to the consolidation and specialization of the public institutions involved in housing construction and finance.

Central Housing Mortgage Bank

-- The executive branch of the GOCR will exert its best efforts to secure passage of a law establishing a Central Housing Mortgage Bank with the following characteristics:

-- Its Board of Directors will have majority representation from the private sector;

Its General Manager will have responsibility and authority for the technical and general administration of the Bank;

It will lend only to housing finance institutions which meet the Bank's legal and financial requirements;

It will finance loans at market rates of interest, without need of subsidies from the government; and

-It will finance mortgages with variable interest rates, in order to maintain the value of the mortgages.

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Prior Covenants

-- To comply with the terms of all covenants remaining in effect from earlier Economic Stabilization and Recovery agreements between A.I.D. and the Government of Costa Rica or agencies thereof.

The grant agreement will include the following special provision, giving A.I.D. the right to enforce compliance with all ESR covenants by suspension of disbursements, if necessary.

-- If A.I.D. determines at any time that the Government of Costa Rica is not in substantial compliance with any of the Covenants of this Agreement, or of the Grant, Loan, or Assistance Agreements signed on

March 20, 1985,
January 28, 1985,
August 1, 1984,
May 7, 1984,
December 13, 1983, and
July 14, 1982,

or any amendments thereof, between A.I.D. and the Government of Costa Rica or the Central Bank of Costa Rica, then in that event A.I.D. may suspend disbursements of the Grant until such time as satisfactory compliance has been obtained.

The Mission also proposes to include in the grant agreement a provision that calls for A.I.D. to notify the grantee when each disbursement may be requested by the Central Bank. Conditioning each disbursement on A.I.D. approval in this fashion makes it easier for the Mission to carry on an effective dialogue whenever a serious issue arises.

As indicated above, the Mission would consult with AA/LAC prior to taking any action to withhold all or part of any disbursement.

ANNEX I

ECONOMIC TRENDS AND PROBLEMS: MARCH 1986

1. Economic Trends and Events 1980-1983

Economic growth amounted to only 0.8% in 1980 and subsequently Gross Domestic Product (GDP) declined by 2.3% in 1981 and 7.3% in 1982, and the 1983 stabilization program brought GDP growth in that year to 2.3 %. Real incomes and consumption also declined during this period. On a per capita basis, 1983 GDP per capita was 89 % of the 1977 level and private consumption was 79% and investment 35% of their respective 1977 levels. Real wages declined strongly in 1981 and 1982 and even after some recovery in 1983 were at only 74% of the 1979 level. Inflation also 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 accelerating inflation was caused by strong exchange rate devaluation (319% in the 18-month period ending December 1981) and by rapid growth of domestic credit, which registered nominal annual rates of growth increasing from 35 percent in 1978 to 105 percent in 1982. Lower rates of inflation before 1981, i.e. less than 25 percent per annum, despite higher rates of credit expansion, are explained by rapid growth of imports (from $ 1.02 billion in 1977 to $ 1.52 billion in 1980). The Costa Rican experience of the late 1970s conforms to the usual open economy case in which a destabilizing growth of domestic credit enlarges imports until foreign exchange reserves and external creditworthiness are exhausted, at which time import compression and devaluation combine to produce strong inflation.

In the late 1970s Costa Rica borrowed heavily from foreign commercial banks to cover balance of payment deficits and to forestall exchange rate devaluation. In the period 1979-1981 current account deficits amounting to $ 1.6 billion were financed by foreign commercial bank loans, but with the sharp rise in debt service payments, particularly after 1980, a net inflow of external credit could not be maintained. In mid-1981 the GOCR suspended external debt service, essentially to maintain a reasonable level of imports, and at year-end 1982 the external debt service arrears amounted to $ 1.1 billion. The balance of payments/debt service crisis of 1981 was caused by the rapid increase in external debt, a sharp increase in interest payments on that debt, declining export (mainly coffee) prices, loss of Central American export markets, and (up to 1982) by imports increased by domestically-generated demand pressures.

In July 1982, shortly after coming to office, the Monge administration resumed partial payments on external debt service arrears, and such payments amounted to over $40 million in 1982. A one-year IMF Standby was approved on December 20, 1982 which provided approximately $100 million (SDR 92.5 million). In addition, US ESF assistance amounted to $175.7 million in 1982-1983. Buttressed by IMF and ESF resources to help close the balance of payments gap, by the end of 1983, the Government of Costa Rica had concluded commercial bank and Paris Club rescheduling agreements, and Costa Rica was again current on contractual external debt service. In January 1983, the GOCR signed a debt

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rescheduling agreements, and Costa Rica was again current on contractual external debt service. 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 in arrears and falling due between July 1, 1982 and December 31, 1983 to a seven-year period beginning December 1985. 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 were rescheduled to a period beginning in 1987 and ending in 1991. In addition, the agreement provided 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.

Apart from external support via debt reschedulings and B/P support assistance, Costa Rica's balance of payments improvement also rested upon decreased imports which resulted from the reduction of real incomes and aggregate demand. In this regard, Costa Rica's trade deficit declined from $527 million in 1980 to $25 million in 1982 and $131 million in 1983 with nominal dollar values imports (CIF) declining from $1,528 million in 1980 to $993 million in 1983 and with exports (FOB) declining from $1,001 million in 1980 to $862 million in 1983. Related to reduction of the trade deficit, import volume (referring to imports of goods and non-factor services per national accounts) declined by about 50 percent from 1980 to 1983. 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 achieved a very substantial compression 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 low levels of domestic investment.

The stabilization program supported by the Standby was designed to reduce inflationary pressures, to promote orderly exchange markets, and to facilitate resumption of public sector external debt service and was broadly successful. IMF and ESF assistance provided crictial support to Costa Rica's 1983 balance of payments enabling the recovery of price and exchange rate stability. By the end of 1983 the consumer and wholesale price indices were increasing at annual rates of only 10.7 and 5.9 percent, respectively. In addition, the five colon spread between the inter-bank and "free" market exchange rates that had existed at the outset of 1983 was eliminated during the course of the year. The Monge administration's major contribution to the stabilization program was a strong reduction of the public sector deficit. This deficit, which had increased from 6.7% of GDP in 1977 to a high of 14.3% in 1981 was reduced to 9.0% in 1982, and 3.4% in 1983. The reduction of the deficit can be attributed in part to expenditure cuts that began in 1982 but also in large measure to increases in the charges of the state-owned petroleum refinery, public utilities, social security contributions, and taxes in general.

2. Economic Performance in 1984 and 1985

Some aspects of Costa Rica's 1983 economic performance turned out better than expected and lulled policymakers into a premature reactivation of the economy. In particular, the larger-than-anticipated reduction in inflation of 1983 impacted on the economy via the relationship between increased real credit and real demand. In real terms credit to the private sector increased by about 40 percent in 1983 (see Table III). Despite this high rate of expansion, private sector holdings of money and quasi-money grew by about 20 percent in real terms, and this growth related strongly to a return flow to Costa Rica of financial assets previously held abroad by Costa Rican residents. Costa Rican policymakers judged that a substantial net inflow of private capital as well as official project disbursements would continue in 1984, thereby covering some expansion of imports, and they allowed banking system credit to expand rapidly (an over 30% annual rate) through the first half of the year. However, the foreign exchange position of the Central Bank deteriorated and by the second quarter of 1984 arrearages on external payments began to accumulate anew. Moreover, even though the GOCR had negotiated a Standby with the IMF in March 1984, it was unable to comply promptly with the "prior conditions" attached to that arrangement. Most observers here judge that delays in securing Legislative Assembly approval to Executive Branch economic proposals was caused by the lack of leadership in economic affairs that followed the departure of the President of the Central Bank, and _de facto_ leader of the Government's economic team, in March.

By mid-1984, imports were running about 20% higher than one year earlier, and in June, the Monge administration took corrective measures to dampen aggregate demand and imports by tightening credit conditions and enacting several tax and fiscal measures to reduce the fiscal deficit. In August 1984, President Monge restructured his economic team, thus providing a basis for renewed negotiations with the IMF and the Government also obtained Legislative Assembly approval for the Ley de Moneda (Currency Law) as was required for 1984 ESF assistance, and in early September the Government obtained Legislative Assembly approval for a fiscal package required by the IMF to reopen Standby negotiations. By January 1985, the Government had obtained confirmed commitments of an $80 million World Bank Structural Adjustment Loan (SAL) and a $75 million credit from foreign commercial banks as were required for a new IMF Standby. At year-end 1984 external payment arrearages amounting to $166.6 million are _ex post_ evidence of an unfinanced B/P gap and can be attributed to an unplanned growth of imports, delay until May 1985 of receipt of the commercial bank credit (which had been promised since July 1984) and some other external credit shortfalls.

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of the 1985 Standby were to continue low inflation, to reduce the balance of payments current account deficit, with a specific goal of $ 300 million for 1985, and to replenish foreign exchange reserves of the Central Bank, with a specific goal of $ 60 million for 1985. As with the 1983 Standby, the 1985 Standby was a key prior condition for the rescheduling of debt with external creditors. As is usual to such arrangements, specific quantitative ceilings were attached quarterly to cumulative central government expenditures, domestic banking system net credit to the nonfinancial public sector, net domestic assets (credit) of the Central Bank, the stock of external payment arrears, and a quantitative floor was attached to the Central Bank's net international reserve position. The major commitments included in the January 1985 Letter of Intent were as follows: (1) a limit on the over-all deficit of the nonfinancial public sector of 1.5 % in 1985, (2) no recourse by the nonfinancial public sector to net financing by the domestic banking system or to a net increase in bond placements outside the banking system, with the over-all fiscal deficit financed mainly by the use of foreign long-term borrowing on concessional terms, (3) a $25 million limit on new public sector external borrowing of up to 5-year term and a $50 million limit on such borrowings of up to 12-year term (except for the $75 million commercial bank loan which is treated as a compensatory inflow), (4) maintenance of positive real rates of interest in the domestic system of financial intermediation, (5) a flexible exchange rate policy which adjusts the exchange rate to reflect changes in the balance of payments and domestic and trading partner prices, (6) the elimination of foreign exchange payment arrears, other than those related to rescheduling agreements under negotiation, during the course of 1985 and under specific quarterly ceilings, (6) a pledge not to introduce or intensify restrictions on current (non-capital) international transactions, (7) a pledge to limit price controls and subsidies to a limited number of basic consumer products, mainly benefitting low income groups, (8) a pledge to a wage policy geared to reducing inflationary pressures while minimizing the effects of price increases on low-income groups with private sector minimum wages and public sector wages adjusted in absolute amounts in accordance with the increased cost of the "canasta basica."

During the first half of 1985 the GOCR obtained agreements with ten creditor countries in the Paris Club, with the foreign commercial banks, and with the World Bank on a Structural Adjustment Loan. The Paris Club minute (April 22, 1985) covered 90 % of debt service (principal and interest) in arrears at the end of 1984 and through March 31, 1986 and rescheduled this amount (less 10 percent to be repaid in three installments in the period 1986-1988) to a repayment period of 5 years after a grace period of 5 years. The GOCR-Bank Steering Committee agreement rescheduled all maturities falling due to participating commercial banks in 1985 and 1986 to a seven year repayment period after a grace period of three years. In addition to the rescheduling, the commercial banks made a $ 75 million new credit facility available and also shifted the dates for reduction of the repayment of the 1983

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Revolver Credit Facility by approximately one year (with first repayment now slated for December 1986). In addition to these sources of B/P assistance, ESF amounted to $ 160 million in 1985 and the World Bank provided a Structural Adjustment Loan (SAL) in amount of $80 million (but only $ 40 million of the SAL was disbursed in 1985).

Despite the size of the 1985 B/P support package, which approximated $ 0.6 billion, cross-conditionality among agreements coupled with four separate episodes of delays in necessary action by the GOCR Legislative Assembly, cast doubt, at times, on the fate of the program and undermined credibility of the Monge administration commitment to economic recovery. For example, delay in obtaining Legislative Assembly approval for the SAL (from a projected June ratification to August 7) delayed slated foreign exchange inflows (from the first tranche of the SAL and from the second tranche of the commercial bank new credit facility) and caused noncompliance at the end of June on the arrearage reduction test in the Standby. In addition, the mid-year IMF review of the Standby also suggested the need for a mid-course correction of the public sector financial program in the form of a downward revision of central administration revenues and expenditures, and the IMF required a supplementary Letter of Intent which also touched on several issues including wage policy, exchange rate policy, and foreign exchange deposits. The GOCR and IMF reached agreement on these modifications in early October and the GOCR was once again in compliance with the Standby. Even so, the revision of the Standby also delayed the marketing of the the commercial bank $ 75 million credit, and the second tranche ($ 56.25 million) of this credit was not available until late November. Thus, during most of the year freely-disposable foreign exchange reserves were uncomfortably low.

<u>Production.</u> In 1984 real Gross Domestic Product (GDP) grew by 6.3 % according to official estimates; see Table I. This contrasts with the low economic growth of 1983 and the absolute decline of GDP in 1981 and 1982. The sectors leading the 1984 recovery were agriculture (6.8 %), manufacturing (10.0 %), construction (18.3 %), and other services (4.7 %). The economic reactivation of 1984 was due to favorable climatic conditions (and the upswing portion of the coffee production cycle) and to a rise in domestic demand fueled by expansionary monetary, fiscal, and wage policies pursued in late 1983 and early 1984. GDP growth has been much lower in 1985 due to more restrictive demand management and to weaker performance of the basic productive sectors. Agricultural output declined sharply to a -1.0 % in 1985 due to reduced coffee and banana production, and these sectors account for nearly half of Costa Rican agricultural output. The manufacturing sector output growth also declined from a rate of 10.0 % in 1984 to 1.7 % in 1985. This stagnation was due to a sharp decline in manufactured exports to the Cental American region, related to the trade debt problems afflicting the region, and to a lower rate of increase in private sector disposable income.

<u>Inflation, Employment, and Real Income.</u> As measured by the consumer price index inflation was 17.3 % from December 1983 to December 1984 and 11.2 % from November 1984 to November 1985. Real wages

increased by 13.2 % in 1984 and the latest data to March 1985 indicate an increase of 4.5 %. The rate of open unemployment averaged 6.4 % in 1984 and 6.2 % in 1985, and the employed labor force grew by 3.9 % from November 1984 to November 1985.

Public Sector Finances. As is shown in Table VI, the nonfinancial public sector has moved toward financial equilibrium with the deficit of the nonfinancial public sector declining from 14.1 % of GDP in 1981 to 9.0 % in 1982, to 3.1 % in 1983, and to 1.9 % in 1984. Actual data is not yet available for 1985 but the deficit is projected to be marginally lower than the 1984 statistic. In recent years, the principal momentum reducing the deficit has been increased tax burden. For example, central administration revenues increased from 14.4 % of GDP in 1982 to 18.2 % in 1985. In addition, the financial condition of state enterprises has been improved mainly as a result of periodic increases in the tariffs of public utilities, and revenues of the Social Security Institute were also increased by a sharp increase in the payroll charge in 1982.

Monetary Performance. Banking system credit to the private sector grew by 17.9 % in 1984 and by 18.8 % in 1985; see Table V. Private sector holdings of money and quasimoney (banking system liabilities) increased by 11.6 % in 1984 and 16.7 % in 1985. However, a portion of the increased demand for money (and quasimoney) in 1985 reflects a one-time increase in foreign exchange deposits induced probably from foreign sources in response to higher-than-world market interest rates. (Adjusting for this effect in 1985 would reduce the increase in demand for money to 10.9 %.) Monetary policy in Costa Rica is constrained by the general openness of the economy, by high real interest rates prevailing throughout world money markets, and by the existing mini-devaluation (crawling peg) exchange rate program. These constraints produce interest rates in Costa Rica's organized financial markets that are effectively in the range of 25 to 35 % per annum and thus strongly positive in real terms. Credit users complain frequently concerning high positive real interest rates and from time to time about the general lack of credit. However, with the 12.4 % devaluation (12-month basis to December) registered in 1985 we doubt that 23.0 % six-month deposit rate is a strong inducement for holding local currency as compared with dollars, and we note that lower local currency deposit rates would run the risk of inducing capital flight and dollarizing the Costa Rican economy.

Balance of Payments. As is shown in Table II, after strong import compression reduced import expenditures from $1.5 billion in 1980 to less than $0.9 billion in 1982, by 1984 imports had risen to $1.1 billion. In [illegible]ation, from an average of $ 865 million in 1982-1983, exports rose to $ [illegible] million in 1984, but fell back to $932 million in 1985. As a res[illegible] the trade account deficit increased from $ 25 million in 1982 to an estimated $ 177 million in 1985. The growing trade deficit was reflected also in a $ 116 million increase in the deficit on current account of Costa Rica's balance of payments from 1982 to 1985, and in 1985 this deficit amounts to about 11 % of GDP. The over-all (or compensatory) outcomes in recent years also reflect balance of payment weakness. The moderate surpluses of 1983 ($ 51 million) and 1985 ($ 63 million) were offset by the 1984 deficit ($110 million). Direct balance of payments assistance operations, defined as disbursements of funds from ESF, the World Bank SAL, plus Paris Club and commercial bank debt service relief (including the Revolving Credit Facility), and net IMF resources amounted to $ 599 million in 1983, $ 297 million in 1984, and $582 million in 1985. Clearly, in absence of B/P assistance Costa Rica would have to cut back on imports and/or reduce interest payments on external debt. The weakness of Costa Rica's external accounts is illustrated by the fact that it would have to reduce imports to live solely on cash flow. By this we mean that if Costa Rica cut all debt service and had to forego all capital inflows as a consequence, imports would still have to be reduced even if capital flight did not accelerate. Taking 1985 as an example, imports would have to be cut by $51 million, which is the shortfall in cash flow calculated by excluding payment of official interest from the current account balance.

3. The Outlook for 1986 and the Medium Term

The outlook for the Costa Rican economy in 1986 is bound up with uncertainties surrounding the new government elect and the price of coffee. The Arias government elect has now selected its economic team, the outlines of the 1986 monetary and fiscal programs now exist, and initial conversations between government-elect economic team and the IMF took place on March 19-20. Uncertainties concerning the course of coffee and petroleum prices during 1986 necessarily reduce the certainty that can be attached to projections of Costa Rica's balance of payments and public sector financial operations. In the following discussion, we assume an average 1986 coffee price (FOB) at $2.00, an average import cost of petroleum products at $ 16.00 per barrel (for a cost saving of $ 15.0 per barrel over the average CIF cost to Costa Rica for 1984 and 1985), and that external support to Costa Rica for balance of payments purposes will approximate $ 300 million in 1986 as compared with $ 580 million in 1985. We expect that the Arias administration economic program will merit continued external donor and creditor support, although corrective actions may be required in some areas. Even though coffee prices have been around the $ 2.50 per pound (CIF New York) in March, the recent ending of drought conditions in Brazil suggests that coffee prices may weaken in the second half of 1986 unless freeze conditions decimate Brazil's 1987 crop (an event that will be known by the end of August 1986). The assumed $ 2.00 per pound FOB is based, importantly, on the scenario of declining coffee prices during the second half of the year. The less probable scenario of increasing prices would increase Costa Rica's 1986 coffee windfall, but it would impact more strongly on 1987 external accounts.

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Balance of Payments. The Mission projections for Costa Rica's 1986 balance of payments and exports are presented in Tables II and III. These projections have been prepared in consultation with the Central Bank, using its December 1985 projection as a point of departure. A preliminary report on the Central Bank forecast was forwarded by cable in San Jose 0099 (January 6, 1986), and our more detailed forecast for 1986 standard detailed B/P format was forwarded by cable in San Jose 2694 (March 24, 1986 as CERP 0102 Balance of Payments Report--Costa Rica).

The critical assumptions underlying our projection of Costa Rica's 1986 balance of payments includes coffee export earnings (FOB) at $ 480 million dollars (as compared with $ 315 million in 1985), import expenditures (CIF) at $ 1,150 million (up from $ 1,109 million in 1985), interest on public sector external debt at $ 307 million (down from $ 326 million in 1985), and balance of payments supporting assistance at $ 296 million in 1986 (down from $ 582 million in 1985). As projected for 1986, the 22 % increase in export earnings coupled with a 4 % increase in import expenditures and a 6 % decline in official interest payments underlies a $ 181 million improvement on current account as its deficit declines from $ 357 million in 1985 to $ 176 million in 1986.

Per the B/P gap format (see Table II) the improvement on current account is matched, as expected, by a $ 238 million reduction of the B/P financial gap (from $ 523 million to $ 286 million). However, in 1985 B/P supporting grants and credits approximated $ 580 million, but such assistance in 1986, as is presently known is less robust, approximating only $ 300 million. Thus, a strong reduction in net capital inflow offsets the coffee price-petroleum price-interest rate bonanza, and the resulting reserve growth is only $ 10 million. Given low level of freely-disposable foreign exchange reserves ($ 17 million) and arrears on external payments ($ 49 million) at the end of February 1986, the projected reserve growth is less than optimal, and recurring external payment crises, as were evident in 1984 and 1985, are likely to continue in 1986.

The 1986 Monetary Program. According to the Central Bank's 1986 monetary program, net domestic assets of the banking system are projected to expand by ₡20.4 billion in 1986, that is, 10.5 % (see Table V). This is in line with the approximate 10 % inflation postulate set by the Central Bank for 1986. Within net domestic assets, net credit to the nonfinancial public sector is not to expand at all; credit to the private sector is projected to increase by 10 percent; and the other assets accounts are projected to increase by 13 %. The expansion in other domestic assets by ₡14.3 billion in 1986 is strongly related to Central Bank operational losses, which are projected at ₡9.5 billion. Net international reserves of the banking system and net official international reserves are projected to grow by ₡1.2 billion, i.e. equivalent to US$ 20 million using an exchange rate of ₡60 to the US$ 1. The monetary program assumes that the expansion in net domestic assets of the banking system and the build-up of net official reserves will be backed up by a ₡9.3 billion (US$ 155.5 million) increase in banking

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system medium and long term foreign liabilities; a ₡4.7 billion (US$ 78.6 million) increase in the government trust fund (the government trust fund account includes the colones counterpa_t of AID grants); and a ₡7.6 billion (10.2 percent) increase in private sector holdings of money and quasimoney in the banking system.

Central Bank officials have anticipated that the growth in nominal credit for the economy as a whole would just match the increase in domestic prices, i.e., would result in zero growth of real credit to the private sector. In February, the Central Bank altered the program limit to allow banking system credit expansion at 12 % and Central Bank technicians estimate that within this global limit, state-owned banks will expand credit by 9.1 % and private commercial banks (which account for about 12 % of credit to the private sector) by 31 %. The 1986 credit program continues the process of moving from credit controls based on detailed allocation to more reliance on orthodox instruments of monetary control. In particular, the scope for quarterly credit ceilings is reduced to the portion of credit funded principally with demand deposits. This change signifies that the credit resources available to the clients of each bank will be more directly related to the ability of that bank to attract deposit resources. As a cautionary note, Central Bank officials have warned bank managers that its monetary and commercial bank credit programs will be reviewed during the year (1986) in the light of results of negotiations with international financial organizations on external financial assistance and on the course of international coffee prices.

Economic Growth. Central Bank officials believe that the restrictive credit policy will produce economic stagnation but that such is necessary due to low foreign exchange reserves and continuation of tight external resource availability. We believe, however, that zero economic growth for 1986 is not likely. Even though one might suppose that a credit program with zero real growth would lead to this result, real disposable personal income will increase in Costa Rica in 1986. We know less, however, about the possible distribution of this higher income between consumption and saving, but undoubtedly both will increase. The amount of real income growth resulting from improved terms of trade in 1986 is strongly dependent on the strength and duration of the upswing in coffee prices and on fiscal policy. Our early projection of GDP growth was 3.4 % (see Table I), and the more recent estimates of a leading economic consulting firm here is at 4.0 %. Apart from growth of disposable income, the subsidence of world inflationary pressures in 1986 and a nominal devaluation of the Colon on the order of 10 % could reduce domestic inflation to annual rates on the order of 6 to 8 %. This would also give rise to moderate growth of real credit and domestic demand. Moreover, fiscal policy also appears poised to enhance private sector demand through a reduction of the real tax burden, as is discussed below.

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Public Sector Financial Operations. Data released in early March by the Minister of Finance on central administration financial operations, presented in Table VI, indicate a 20.6 % increase in revenues and an 18.3 % increase in expenditures for 1986. In Table VI we project revenue and expenditure items for the rest of general government (of which the Social Security Institute is the largest element) and for the state enterprise sector as increasing by 10 percent. In regard to central administration revenues, the official projection for 1986 includes ₡ 2.5 billion of revenues increased coffee tax receipts and ₡ 1.0 billion as a transfer from RECOPE (the state petroleum enterprise). Exclusive of these windfall-related revenues, revenue growth amounts to 9.7 %. Apart from the prospect of a public sector wage increase costing ₡ 2.7 billion, no explanation has been given for the high (18 %) increase in expenditures, but if this wage increase is subtracted, expenditure growth would be more moderate (10.7 %). A public sector financial program that reduces the projected central administration deficit by 0.2 % (and according to our assumptions the deficit of the nonfinancial public sector by the same amount) is unambitious. This is particularly the case when set against a total public sector deficit (including Central Bank losses) which amounted to 7.1 % in 1985 and would approximate 6 % in 1986. Moreover, a very modest reduction in the central administration deficit can also be regarded unhealthy if viewed from its longer term consequences.

To illustrate this, we examine the consequences of reducing the central administration deficit as if there were no coffee-petroleum windfall. Without the ₡ 3.5 billion windfall included above, 1986 revenues would amount to ₡ 35.2 billion and this is ₡ 2.4 billion short of holding the ratio of revenues to GDP constant (18.7 % of 1986 GDP is ₡ 37.6 billion). On the expenditure side, holding the ratio of expenditures to GDP constant (20.4 % of 1986 GDP is ₡ 41.0 billion), and this is ₡ 0.8 billion short of proposed expenditures. Therefore, the cost of remaining independent of the windfall amounts to ₡ 3.2 billion in additional tax revenues, and reducing the deficit by 0.5 % of GDP would require an additional ₡ 1.0 billion in tax revenues or expenditure cuts. We understand that the required ₡ 4.2 billion in additional tax revenues approximates earlier projections of the 1986 fiscal gap made without reference to the coffee-petroleum windfall.

In addition, the public sector revenue windfall for 1986 as calculated by us to be compatible with our B/P projections is on the order of ₡ 6.0 to 7.0 billion (i.e. $ 105 to 123 million) out of a total amounting to $ 305 million ($ 165 million from coffee, $ 38 million from other exports, and $ 101 million from price reduction of petroleum products). About ₡ 2.0 billion of this revenue windfall is increased profits of RECOPE as long as retail petroleum prices are maintained at present levels. The implication of allowing increased fiscal expenditures and lagging fiscal revenues is simply to transfer the windfall to the private sector in a manner which is likely to increase future burdens on the private sector. Along with this, the burden on monetary policy is also increased. A more judicious fiscal program would orient the windfall to three uses: (a) a fiscal transfer to the Central Bank to reduce its monetized losses and facilitate open market operations to reign-in liquidity in 1986, (b) a program to pay-down external debt, and (c) alternative funding of tax relief, e.g. funding for the extant bill to reduce rates of the corporate income tax.

In regard to monetary policy objectives, the relevant definition of the public sector necessary includes the Central Bank. Present estimates of Central Bank losses set the magnitudes at ₡ 9.6 billion for 1985 and and ₡ 9.5 billion for 1986 (see Table VII). For example, a ₡ 2.0 billion transfer to the Central Bank split evenly between covering losses on increased sales of stabilization bonds and covering existing losses would reduce the ratio of the Central Bank operating loss to GDP in 1986 from the projected 4.7 % to 4.2 %. The functional importance of Central Bank losses and rationale supporting a program to reduce these losses is examined further in section (6).

<u>Debt Service and Relief</u>. Table VIII presents a recent IMF projection (SM/85/223) of Costa Rica's medium term balance of payments and external debt service. Prior to debt relief, debt service as a ratio of export earnings (i.e., exports of goods and nonfactor services) exceeds 50% in 1986 and 1987. Actually-paid debt service averaged 36.8 % of exports earnings during the period 1983-1985. For the period 1987-1990 the projection of public sector debt service as presently scheduled averages 50.6 % of export earnings. Rescheduling relief per IMF assumptions lowers the average debt service ratio to a more realistic 35.9 % for this period. The amount of debt relief (and non-USG B/P support) required per this projection for the four-year period 1986-1990 amounts to $ 959 million, i.e. $ 240 million annually, and this approximates 55 % of presently-scheduled principal payments. This projection confirms that further reschedulings of external public sector will be required to prevent default by reducing the debt service burden to a tolerable limit and that increments to debt service, even in the form of long term loans, will most likely simply increase the size of near-future debt reschedulings.

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TABLE I: SELECTED ECONOMIC INDICATORS, 1982-1986

	1982	1983	1984	1985	1986
GDP in Current Prices (A)	97,505	126,337	151,304	176,420	200,942
GDP in U.S. Dollar Equivalent (B)	2,450	3,037	3,408	3,426	3,525
GDP in Constant Prices 1977=100	102	104	111	113	116
GDP Per Capita in Constant Prices; 1977=100 (C)	89	89	92	91	91
Growth of GDP (Percent Change)	-7.3	2.3	6.3	1.6	3.4
Gross Domestic Product					
Basic Productive Sectors	-10.8	2.5	7.4	1.3	4.3
--Agriculture	-4.7	3.9	6.8	-1.0	3.5
--Manufacturing	-11.4	1.2	10.0	1.7	4.0
--Construction	31.9	2.7	18.3	9.7	10.0
Government	-2.9	-1.6	0.5	1.0	1.0
Other Sectors	-4.5	3.1	4.7	2.1	3.0
Prices (Percent Change)					
GDP Deflator (Annual Average)	84.2	26.7	14.2	14.8	10.5
Consumer Prices (Dec. to Dec.)	81.8	10.7	17.3	11.2(D)	N/A
Wholesale Prices (Dec. to Dec.)	79.1	5.9	12.2	7.6	N/A
Unemployment (Percent) (E)	9.5	9.0	7.8	6.2	N/A
Employed Labor Force (thousands; November of each year)	826.4	827.3	839.7	872.1	N/A
Real Average Wages (1977=100)	73	86	98	102(F)	N/A
Public Sector	67	74	84	86(F)	N/A
Private Sector	74	90	102	108(F)	N/A
Exchange Rate (Colones per US $) (Selling Price, December 31)					
Official Market	20.50	20.50	20.50	20.50	N/A
Banking or Unified Market	40.50	43.65	48.00	53.95	N/A

Notes:
(A) Millions of Colones.
(B) Millions of U.S. dollars.
(C) Per capita GDP was calculated based upon the population series from the BCCR National Accounts 1974-1983, and a 2.67 growth rate for population was used to obtain data for 1984, 1985, and 1986.
(D) November to November.
(E) March of each year.
(F) March 1985.

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TABLE II: BALANCE OF PAYMENTS, 1981-1986
(Millions of U.S. Dollars)

	1981	1982	1983	1984	1985 Estim.	1986 Proj.
:s, FOB	1,003	869	862	980	932	1,133
.s, CIF	-1,213	-894	-993	-1,101	-1,109	-1,150
ance of Trade	-211	-25	-131	-121	-177	- 17
or Services	77	96	122	118	108	115
Interest, Profit	-11	-5	14	-9	-4	-7
l Interest	-308	-342	-328	-314	-326	-307
d)	(-160)	(-106)	(-275)	(-210)	(-303)	(-301)
aid/Rescheduled)	(-148)	(-236)	(-52)	(-104)	(-23)	(- 6)
ance on Services	-243	-251	-192	-206	-222	-199
ers	27	36	31	38	42	40
ance on Current Account	-426	-241	-292	-288	-357	-176
e Capital and E.+ O.	-69	16	68	71	129	70
al Capital, Net	25	-89	275	108	291	149
ments	335	191	350	296	378	346
jects)	n.a.	(171)	(194)	(166)	(178)	(186)
)		(20)	(156)	(130)	(160)	(120)
D-SAL		--	--	--	(40)	(40)
tion	-310	-280	-267	-341	-406	-365
d:	(-99)	(-63)	(-93)	(-112)	(-155)	(-235)
id/Rescheduled)	(-211)	(-217)	(-174)	(-229)	(-252)	(-130)
tion Relief	--	--	158	154	252	130
ercial Banks)					(167)	(110)
is Club)					(51)	(14)
her)					(34)	(6)
t Relief (Paris Cl.)	--	--	34	--	23	6
					46	32
ce on Capital Account	-44	-73	343	179	420	219
all Balance	-470	-314	51	-110	63	43
g (+ is B/P deficit)	470	314	-51	110	-63	-43
.. (+), Reduc. (-) Arrears	359	453	-321	174	- 112	-33
rsion of CDs	--	--	52	--	--	--
lver Credit Facility	--	--	152	50	75	0
ation Adjustment	5	-11	8	0	--	--
Official Reserves	106	-129	58	-114	4	-10
et Use IMF Resources		(-10)	(99)	(-36)	(21)	(0)

Cable: CERP 0102 Balance of Payments Report: Costa Rica (March 1986)

TABLE II: (CONTINUED)

Balance of Payments Financial Gap Format for 1984-1986
(Millions of U.S. Dollars)

		1984	1985	1986
	Current Account Balance	-288.4	-357.2	-176.0
Plus	Private Capital and E. & O.	70.5	129.0	70.0
Plus	Official Amortization	-341.4	-406.3	-365.0
Plus	Other Official	--	45.6	32.0
Plus	Project Loans	165.9	177.5	186.0
Equals	Basic Financial Gap	-383.4	-411.4	-253.0
Plus	Reduction (-) or Increase (+) of Arrears	174.0	-111.8	-32.6
Equals	Financial Gap (-)	-219.4	-523.2	-285.6
Less	(Financial Inflows)	(297.4)	(582.3)	(296.0)
	ESF Loan & Grant	130.0	160.0	120.0
	Debt Relief	153.7	274.6	136.0
	Revolver Credit Facility and Net Change in Trade Credit	49.7	74.9	-0-
	IMF Net Resources	-36.0	32.8	-0-
	IBRD Structural Adjustment Loan	--	40.0	40.0
Equals	Over-all Balance	78.0	59.1	10.4
Less	Change in FX Reserves (- is an increase)	-78.0	-59.1	-10.4
Equals	Zero Per B/P Accounting	0	0	0

Note: This table is a restatement of capital and compensatory accounts shown above, but with enlarged detail.

TABLE III: EXPORTS BY PRINCIPAL PRODUCTS, 1982-1986
(Value in millions of U.S. dollars,
volume in thousands of units,
and prices in U.S. dollars)

	1982	1983	1984	1985	1986
Coffee					
Value	236.9	230.1	267.3	315.1	480.0
Volume (46 Kg. sacks)	2,040	2,357	2,457	2,702	2,400
Price (per 46 Kg.)	116.13	97.63	108.8	116.6	200.0
Bananas					
Value	228.1	240.3	251.0	212.0	207.0
Volume (Metric tons)	1,013	1,012	1,020	855	910
Price (per Metric ton)	225.21	237.50	246.1	248.0	227.5
Beef					
Value	53.1	31.9	43.5	52.9	55.7
Volume (Kilograms)	24,268	13,920	20,504	26,954	27,000
Price (Per kilogram)	2.19	2.29	2.12	1.96	2.20
Sugar					
Value	16.6	23.9	35.5	10.5	15.4
Volume (46 Kg. sacks)	1,191	1,173	2,231	697	925
Price (per 46 Kg.)	13.9	20.34	15.91	15.01	16.60
Sub-total: Traditional Exports	534.7	526.2	597.3	590.5	758.1
Non-Traditional Exports	334.3	346.3	409.1	369.2	405.0
To: Central American Common Market	167.2	198.2	193.0	130.2	140.0
To: Rest of the World	167.1	148.2	216.1	239.0	265.0
(of which drawback)*	n.a.	n.a.	(26.1)	(28.0)	(30.0)
Total Exports, FOB*	869.0	872.6	1,006.4	959.7	1,163.1

Source: Central Bank of Costa Rica, February 21, 1986, for revised data for 1984 and 1985; December 18, 1985, for forecast of 1986 except for coffee and composition of nontradtional exports, which are per USAID/CR estimates.

Note: *Total exports per Table III are larger than total exports (FOB) per Table II due to inclusion in Table III of value-added by drawback firms as export income. In Table II this value-added in included as a nonfactor service income.

TABLE IV:

NET INTERNATIONAL RESERVES OF THE CENTRAL BANK OF COSTA RICA, 1982-1985
(December 31 of each year; millions of U.S. dollars)

	1982	1983	1984	1985
1. NET OFFICIAL RESERVES	-114.9	-92.8	-28.4	-77.0
Assets	244.3	306.7	420.3	494.9
Freely Disposable	133.9	58.6	95.7	113.9
Gold	13.3	24.4	8.8	21.3
Bank Deposits	83.9	32.7	20.2	81.7
Foreign Exchange	36.7	1.3	1.3	0.9
Securities	--	--	65.4	9.5
Special Drawing Rights	--	0.6	--	0.5
Other Assets	110.4	248.1	324.6	381.0
Time Deposits (CA Central Banks)	41.2	134.8	184.8	238.8
Multilateral (CA clearing arrangements)	53.4	87.8	115.1	113.7
Contribution to CA Stab. Fund)	15.8	17.8	19.2	19.2
Other		7.7	5.5	9.3
Liabilities	-359.2	-399.5	-448.7	-539.1
Net Position with IMF	-92.9	-191.9	-155.6	-188.6
Revolving Credit Facility	--	-152.3	-201.9	-276.8
Other Short-Term	-266.3	-55.3	-91.0	-73.7
Drawing in CA Stab. Fund	N.A.	-32.0	-30.0	-30.0
Banco de México (and clearing)	N.A.	-5.0	-40.8	-3.2
Banco República de Colombia	N.A.	-5.0	-5.0	-3.7
Other	N.A.	-13.3	-15.2	-36.8
Adjustment of Short-Term Liabilities (IMF)	--	--	--	-32.8
2. PAYMENT ARREARS	-1,095.0	-40.6	-144.4	-32.6
Over 15 working days (imports)	N.A.	40.6	26.0	--
Other	N.A.	--	118.4	-32.6
3. NET INTERNATIONAL RESERVES (1+2)	-1,209.9	-133.1	-172.8	-109.6

Source: Central Bank of Costa Rica and IMF.

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TABLE V: MONETARY ACCOUNTS 1981-1986
(millions of colones;
December 31 of each year)

	1981	1982	1983(a)	1984	Estimate 1985	Program 1986
Central bank						
Net international reserves	-32,755	-48,648	- 5,994	-11,886	- 4,680	- 3,480
Official reserves	- 7,457	- 2,682	- 4,180	- 1,890	- 4,680	- 3,480
Payments arrears rescheduling	-25,298	-45,966	- 1,814	- 9,996	0	0
Net domestic assets	37,181	55,585	14,942	23,353	17,580	17,695
Net credit to public sector	9,651	11,881	28,985	35,649	37,139	37,139
Net credit to banks	- 6,951	- 9,872	- 8,057	-12,907	-13,233	-15,503
Government trust funds (b)	--	--	- 1,098	- 4,478	-13,105	-17,820
Stabilization bonds	- 1,542	- 4,755	- 5,090	- 4,895	- 4,923	- 2,694
Long-term foreign liabilities	-21,498	-25,271	-68,127	-93,578	-100,776	-110,112
Other assets net	32,223	37,636	66,515	95,126	112,378	126,665
Counterpart arrears	25,298	45,966	1,814	8,436	0	0
Currency issue	4,426	6,937	8,948	11,467	12,900	14,215
Banking System						
Net international reserves (c)	-32,294	-48,131	- 4,290	- 9,918	- 4,086	- 2,886
Net domestic assets	83,848	117,644	128,003	175,134	196,683	217,096
Net credit to public sector	9,294	11,620	26,697	30,721	30,798	30,798
Central Government	(7,370)	(6,592)	(10,067)	(11,400)	(12,618)	(12,618)
Rest of public sector	(1,924)	(5,028)	(16,630)	(19,321)	(18,180)	(18,180)
Credit to private sector	13,228	18,109	27,549	32,531	38,647	42,528
Other assets net	36,028	41,949	71,943	103,446	127,238	143,770
Counterpart arrears	25,298	45,966	1,814	8,436	0	0
Government trust funds (b)	--	--	1,098	4,478	13,105	17,820
Long-term foreign liabilities	24,732	29,156	69,998	97,145	105,283	114,612
Liabilities to private sector	26,822	40,357	52,617	63,593	74,209	81,778

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TABLE V (CONTINUED)

Percentage Change(d)

Banking System	1982	1983	1984	1985	1986
Net domestic assets	33.9	13.3	12.0	12.3	10.5
Net credit to public sector	25.3	3.3	-4.9	0.3	0
Credit to private sector	36.7	22.1	17.9	18.8	10.0
Liabilities to private sector	48.5	28.7	11.6	16.7	10.2

Source: Central Bank of Costa Rica, December 1985.

Notes to Table V:

Exchange rates utilized for conversion of foreign exchange to colones are as follows per U.S.$ 1.00: (1981) ₡38.50; (1982) ₡41.40; (1983) ₡45.00; (1984, 1985 and 1986) ₡60.00.

(a) Reflects the full effect of rescheduling of payments arrears.
(b) Includes counterpart of grants to the government and to Central Bank.
(c) Includes payments arrears only for net international reserves of the banking system. Other payments arrears, i.e., of Central Bank and of the banking system are not included as they were not known at the time of construction of this table. We are, however, of $ 32.6 million of foreign exchange payment arrearages.
(d) Percentage changes have been calculated using the same exchange rate for the conversion of foreign exchange to colones in each of the years compared.

TABLE VI: OPERATIONS OF THE NONFINANCIAL PUBLIC SECTOR, 1982-1986(A)
(In millions of colones)

	1982	1983	1984	1985	1986
Central administration	-3,258	-4,627	-4,517	-3,225	-3,100
Revenue	14,026	21,417	27,012	32,100	38,700 (B)
Expenditure	17,284	26,044	31,529	35,325	41,800 (B)
Current	(15,072)	(20,953)	(26,137)	N/A	N/A
Capital	(2,212)	(5,091)	(5,392)	N/A	N/A
Rest of general government	184	2,412	1,568	2,500	2,700
Revenue	10,782	17,555	15,176	20,200	22,200 (C)
Expenditure	10,598	15,143	13,508	17,700	19,500 (C)
Current	(9,085)	(13,806)	(11,916)	N/A	N/A
Capital and net lending	(1,513)	(1,337)	(1,592)	N/A	N/A
State enterprises	-5,696	-1,737	7	-2,400	-2,700
Revenue	18,374	29,545	34,152	37,200	40,900 (C)
Expenditure	24,070	31,282	34,145	39,600	43,600 (C)
Current	(20,653)	(26,826)	(30,217)	N/A	N/A
Capital and net lending	(3,417)	(4,456)	(4,328)	N/A	N/A
Public sector current account deficit (-)	-2,431	5,020	7,510	N/A	N/A
General government	-17	2,897	3,867		
State enterprises	-2,414	2,123	3,643		
Public sector overall deficit (-)	-8,770	-3,952	-2,842	-2,100	-3,100
External (net)	-1,505	- 324	- 384	N/A	
Domestic	2,697	14,766	159	N/A	
Banking system	(1,872)	(13,889)	(-1,122)	N/A	
Other	(825)	(877)	(1,281)	N/A	
External arrears	7,578	-13,767	3,067	N/A	
Central administration items as percent of GDP--					
----Deficit (-):	3.4	-3.6	-3.0	-1.7	-1.5
----Revenue:	14.4	17.0	17.9	18.7	19.3
----Expenditure	17.7	20.6	20.9	20.4	20.8
Nonfinancial public sector deficit (-) as percent of GDP	-9.0	-3.1	-1.9	-1.7	-1.5
Central Bank operating deficit (-) as percent of GDP	-5.6	-5.0	-4.7	-5.4	-4.7
Total Public Sector deficit (-) as percent of GDP	-14.6	-8.1	-6.6	-7.1	-6.2

Notes: See Table VII.

TABLE VII:
ESTIMATED NET LOSSES OF THE CENTRAL BANK, 1985 - 1986
(In millions of colones)

	1985 (₡60=US$1)	Proj. 1986 (₡60=US$1)
I. Interest Earned	7,277	5,863
1. Rescheduling - Tranche I	1,734	1,734
- Tranche II	750	678
- Revolver	600	390
2. Interest received	4,193	3,061
II. Interest paid	15,840	14,410
1. External Debt	11,568	12,240
2. Bank deposits F/E	1,074	1,020
3. Stabilization bonds	800	600
4. ESF trust account	1,000	550
5. Other	1,398	--
III. DIFFERENCE (I-II)	-8,563	-8,547
IV. OTHER NET OPERATING LOSSES	- 990	- 990
V. TOTAL LOSSES (III+IV)	-9,553	-9,537

Source: Central Bank of Costa Rica (01/14/86)

Note: According to Central Bank staff, accounting for this table is on a cash-flow basis, i.e., receipts and payments received in currency rather than on accruals basis.

Notes to Table VI: Source: Ministry of Finance. (A) Data for 1984-1986 reduce coverage of public sector operations to include the 19 largest decentralized institutions and state enterprises. (B) Data on central administration operation for 1985 and projection for 1986 were released by Minister of Finance on March 4, 1986. The revenues projection for 1986 includes ₡2.5 billion from higher revenues due to higher prices of coffee and ₡1.0 billion as a transfer from RECOPE (i.e., would continue same practice as 1985 and also hold retail petroleum product prices at present levels).
(C) Assumes growth of revenues and expenditures of 10 % in 1986 for the rest of general government and the state enterprise sector.

TABLE VIII: PROJECTED BALANCE OF PAYMENTS AND DEBT SERVICE, 1984-1990
(Data in millions of U.S. dollars and percent)

	1984	1985	1986	1987	1988	1989	1990
B/P Current Account Balance	-327	-310	-258	-210	-213	-229	-246
Net Private Capital	95	42	73	76	83	132	140
Net Public Sector	89	138	31	-237	-62	-85	-64
Disbursements to Public Sector	201	293	263	348	353	305	300
Amortization of Public Sector	-412	-406	-361	-585	-415	-390	-364
Refinancing (Existing Agreements)	154	278	135	--	--	--	--
Official Transfers (Inc. ESF grants)	109	212	172	120	65	65	60
Financial Gap (Req. B/P assistance)	--	--	56	330	212	209	208
Over-all Balance (Inc. Net. Int. Res.)	-110	105	80	79	85	92	98
Public Sector Debt Service	426	481	576	931	767	750	732
--Amortization	112	155	232	585	415	390	364
--Interest	314	326	344	346	352	360	368
Debt Service as Ratio of Exports of Goods and Nonfactor Services							
---Before Debt Relief (Percent)	58.7	60.5	55.0	67.2	50.7	44.8	39.5
--After Debt Rescheduling (Percent)	35.2	38.4	45.0	44.6	37.4	32.9	28.7

Source: See text; based upon IBRD Debt Reporting Service; information of GOCR, and IMF staff estimates.

Note: Estimates for the years 1984, 1985, and 1986 included in this table do not necessarily conform to B/P estimates presented in Tables II and III due to the fact that this estimate was prepared in July-August 1985.

4. Economic Transformation

In recent years writers on political economy have come to distinguish and separate analysis of a country's economic problems into stabilization and structural categories. Within this dichotomy the term stabilization connotes a programmatic remedy for an economy de-stabilized by temporary foreign exchange scarcity and accelerating inflation. Structural reform or adjustment connotes that there are chronic, if not acute, problems with the country's economic structure and that these problems are susceptible to correction only during a longer time period. From the viewpoint of results, an economy can be stabilized in a relatively short period of time, such as two or three years, with a coherent monetary, fiscal, and exchange rate program, and one can see the evidence of stabilization in a strongly reduced rate of inflation and public sector deficit. Structural reform is more elusive in regard to evidence of success and the relevant time period in which to find that success. Moreover, the country-specific economic topology may posit important differences for structural reform. For Costa Rica, a small open economy, export growth is the lifeline to higher standards of living and evidence of successful economic transformation. Attainment of this goal and restoration of Costa Rica's external creditworthiness, for which evidence of success is very recent and only partial, requires also the avoidance of sharp declines in real income, sharp increases in unemployment, as these are very likely to discredit sound but longer-term economic programs, i.e., economic programs that improve the mobilization of domestic savings, increase investment in export expansion, reduce waste in the public sector, and also reduce waste in the private sector--which may necessarily include curbing areas of high profitability obtained solely from tariff protection.

Even though IMF programs are commonly identified as focussed on stabilization objectives and World Bank balance of payments support operations bear the title of Structural Adjustment Loans, at this juncture in Costa Rica we believe that these programs should be judged from the optic of longer term economic transformation. Even though Costa Rica attained general compliance with the two formal IMF Standbys in the period 1983-1985, and the evidence indicates increasing economic stability, the country has not yet restored its external creditworthiness sufficiently to obviate the need for new IMF arrangements and further rescheduling of external debt. In addition, certain policy instruments that have been governed in the case of Costa Rica principally through IMF arrangements, notably the exchange rate and the public sector deficit, are key elements in any coherent program of longer-term economic transformation. The World Bank and AID programs are more obviously aimed at economic transformation and recovery over a medium to long-term time horizon (5-10 years) and aimed at improved economic efficiency in both the public and private sectors.

5. Transformation of Trade Structure

The structure of Costa Rica's existing trade arrangements within the heavily proteced Central American Common Market (CACM) has produced a structure of production oriented to the small domestic and regional markets rather than for markets outside the region. At present, the CACM is in crisis, and slow growth of this market must be assumed under the best of circumstances. Moreover, a recent study shows that the net effect of Costa Rica's exports to the CACM is not large. In the most prosperous years of the CACM, Costa Rica's exports of manufactured goods to the region represented about 12 % of the gross value of industrial production and that about 80 % of industrial output was consumed. internally. Even in the late 1970s and early 1980s, when exports of manufactured goods to the CACM equaled one-fifth of all commodity exports, the value added of these goods approximated only 1.6 % of GDP. Apart from low impact, the CACM Common External Tariff (CET) has imparted a high degree of effective protection to final consumer goods industries. Consequently, consumer goods industries avoid the competition from imported goods that would help them to become price competitive in third country markets.

Costa Rica's trade with Central America has declined in real terms since 1979, and in 1985 the crisis of the CACM Clearing House produced a $ 62 million decline in Costa Rica's exports to the CACM (i.e., from $ 193 million in 1984 to $ 130.2 million according to preliminary 1985 data; see Table III). The clearing house crisis began in the period 1980-1982 with the Nicaraguan freeloading off other CACM members, and Nicaragua now owes $ 400 million to other CACM countries, and about half of that to Costa Rica. As a result of imitation as well as through retention of over-valued exchange rates, the other three CACM countries have also run up significant net debit balances with Costa Rica, which totalled $ 131 million by mid-1985. In May 1985, the Central Bank of Costa Rica imposed a limit on its exports to each of the other CACM countries, allowing exports only to the extent of its imports from each country for all payments processed through the Clearing House. In July the Central Bank of Costa Rica obtained agreements with the central banks of Honduras and El Salvador which provide credit terms to them in regard to new trade arrearages and the one-to-one limit on exports to those countries was dropped. However, approximately equivalent credit terms were imposed on Costa Rican exporters by the Central Bank of Costa Rica, who are paid in a combination of cash and Central Bank certificates of deposit. Inasmuch as the CDs were readily negotiable at the San Jose stock exchange, the discount from the unified colon exchange rate was not large--less than 10 %. However, in February 1986 the Central Bank enacted new regulations governing trade with El Salvador and Honduras that, in effect, enforce payment for exports to these countries in convertible foreign exchange (and eliminate payment through the CACM Clearing House) and imports from these countries are now subject to the same prior deposits as apply to other third countries.

Adoption of a tougher collection policy by Costa Rican authorities on CACM trade debt is a direct consequence of the fact that Costa Rican exports to the CACM have an average 50 % imported component and that

Costa Rica has to pay for those imports with convertible foreign exchange. Thus, if one assumes that the CACM trade debt to Costa Rica would continue to grow to the point where credit balances become de facto gifts, then a reduction in Costa Rica's exports to the CACM would save foreign exchange. We suspect that the impact of these new measures will signify stagnation of Costa Rican trade with Central America in 1986 even with a coffee boom. In the case of Guatemala, after several months of export paralization under the one-to-one rule, a settlement was reached in regard to payment and in early 1986 Costa Rica resumed unrestricted trade with Guatemala. In the case of Nicaragua, with the exception of electric power (which is paid with Nicaraguan exports to Costa Rica), all other Costa Rican exports to that country have to be paid in advance in convertible foreign exchange.

Beginning in 1983 the Monge administration undertook several actions to make exporting more attractive. These included suppression of a tax on the exchange rate differential, removal of an ad valorem export tax on nontraditional exports to outside of the CACM, removal of income tax on nontraditional exports to outside of the CACM, creation of a ministry of exports, and the unification of exchange rates. Costa Rica's nontraditional exports (i.e., excluding coffee, bananas, sugar, and beef) to third country markets, i.e. non-CACM, increased by $ 90.8 million in the two-year period 1984-1985. Available data indicate significant increases in exports of shrimp, alcohol, furniture, clothing and undergarment items, cut flowers and ornamental plants, cacao, and chocolate. The increase in nontraditional export earnings cited here is less impressive than shown by U.S. data on imports from Costa Rica because the U.S. data is on a gross value basis while the Costa Rican data include only value-added for drawback industries. The Cental Bank estimates drawback value-added at $ 25 million for 1985. Further increases in nontraditional exports, particularly ornamental plants and flowers, and selected fruits and vegetables, macademia nuts, cacao, and pineapple are possible in coming years if specific market problems and infrastructure problems are solved and if additional investment takes place.

Good exchange rate management is a key necessary condition for the expansion of Costa Rica's nontraditional exports and also for the health of her traditional exports. In particular, nontraditional exports will not expand unless they are sufficiently profitable because potential investors avoid activities of low profitability and because the already committed investors would lack the profits to plow back into expansion of their export operations. Given the practical limits to export subsidies, i.e., the impact on fiscal expenditures and foreign competitor legal retaliation, good exchange rate management is the remaining most effective policy tool for increasing export profitability. Recourse to this tool may be necessary even if, for distributional reasons, increased profits for certain other exports are captured via increased taxes.

Given the relative openness of the Costa Rican economy, which entails a high inflation pass-through from devaluation, real effective devaluation on the order of 5 % per annum is probably a politically feasible limit due to the adverse effect on real incomes from stronger devaluation. For example, in nominal terms such devaluation would outrun domestic inflation by about 5 percentage points, e.g. a devaluation of 15% in the context of 10% inflation (assuming trading partner inflation at zero). Given the inauspicious medium-term outlook for Costa Rica's balance of payments, the existing trade deficit, and the size of the B/P current account deficit, it is not inconsistent to press for continuing real devaluation while eschewing the stronger devaluations which are quickly eroded by accelerating inflation. The Colon is still overvalued in the sense that the market clearing exchange rate without substantial external balance of payments assistance would be much higher (and with lower real incomes in Costa Rica).

Costa Rica's exchange rate management has improved in recent years. In 1983 the Central Bank unifed the "free" bank and inter-bank exchange rates and reduced the percentage of export proceeds that had to be liquidated at the lower official rate (₡ 20 per U.S. dollar). In 1984 the colon was devalued from ₡ 43.65 to ₡ 48.00 (nominally by 10.0 %) in four mini-devaluations, and in 1985 the colon was devalued from ₡ 48.00 to ₡ 53.95 (nominally by 12.4 %) in twenty-one mini-devaluations. According to the purchasing power parity concept and taking September 1982 as the base period, as of October 1985 the real devaluation of the Colon for this three-year period amounted to 5.0 % according the trading-partner weighted index prepared by the Central Bank.

Apart from exchange rate, excessive levels of tariff protection incorporated in the Common External Tariff (CET) of the CACM has also been an important source of anti-export bias and of economic waste. High levels of effective protection encouraged businessmen to invest in production for the domestic and Central American markets rather than in production for the world market. CACM member countries agreed in December 1984 to a reform of the CET to reduce the level of effective protection (i.e., the percentage by which the domestic value-added can exceed the internationally competitive value-added) to a range of 50 % to 150 %. This reform was ratified by CACM governments in early 1985; the specific tariffs were agreed upon in September 1985; and the new tariffs and custom valuation system were implemented on January 1, 1986. Related to this reform, Costa Rica negotiated with the World Bank for a Structural Adjustment Loan ($ 80 million) and tariff reform was also a key condition of this program. The tariff reform must be viewed as a first step toward the rationalization of Costa Rican manufacturing industry inasmuch as it will discourage investment in the production of goods which require excessive protection, that is production where costs are strikingly higher than those in the world economy. Thus, the benefits are mainly in the form of directing new investment resources to areas of higher social (as well as private) profitability.

6. Reform of the Financial Sector

A significant reform process led by the Central Bank has reduced the scope of administrative allocation of bank credit and to increased the role of interest rates in allocating credit and mobilizing domestic savings. The Central Bank's 1986 credit and interest rate programs incoporate precepts formulated and agreed upon in policy disucssions between personnel of the AID Mission and the Bank during the second half of 1983. Beginning in 1984 the Central Bank took steps toward eliminating "topes", i.e., the numerous allocative credit categories, that had been for many years its principal tool of credit allocation and albeit a non-price allocative instrument. As recently as 1983, its credit program contained quarterly ceilings for each of the four state-owned commercial banks for eight broad economic categories and, within these, there were 53 specific "topes" defined by activity or crop. The 1984 program contained five broad allocative categories and a total of 23 "topes". The 1985 credit program continued the movement away from credit allocaction and consisted of only quarterly global credit ceilings for each of the four state-owned banks with a breakdown by three broad economic categories. The 1986 credit program continues the process of moving from credit controls based on detailed allocation to reliance on orthodox instruments of monetary policy and market determined interest rates.

Prior to 1983, interest rates on loans were used in conjunction with the system of detailed credit allocation as a means of subsidizing activities that the government wanted to promote. Moreover, interest rates on both deposits and loans (also set by the Central Bank) were frequently negative in real terms. Interest rates on bank term deposits were seldom set at levels to attract savings but rather as a means to keep the cost of credit low. With the decline of inflation and in line with the policy goal of the Monge administration, positive real interest rates emerged in late 1983. Beginning in 1984, subsidized credit has been extended only to small producers and the total amount has been limited to less 16 % of the total credit portfolio of state-owned banks. In December 1984, the Central Bank allowed banks more flexibility in the setting of interest rates, and, at present, each bank is allowed to charge on loans and to pay on deposits up to 3 percentage points above or below the respective rates set by the Central Bank. However, for the unsubsidized credit portfolio bank interest charges are still set by four defined economic activities, with base rates ranging from 20 % to 28 % per annum and reflecting a political bias favoring agriculturalists and manufacturors with less costly credit than merchants and consumers.

The state-owned commercial banks represent the predominant share of financial intermediation activities in Costa Rica, accounting to about 95 % of deposits and 85 % of loans in all banks and finance companies. This market dominance is explained by the monopolistic privilege on demand deposits granted to the state-owned banks since 1948. However, due to lack of competition and overegulation, state banks have cumbersome operating procedures, suffer political interference in the granting of

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credit, and have high operating costs and low portfolio turnover. Poor service and the need to make repeat trips to the bank also impose high transaction costs to savers and borrowers. For example, a recent study based on a sample of 394 loans made in 1983 at selected rural branches of a leading state bank indicated that the non-interest costs of obtaining and presenting the required loan-related documents as well as visits to push the approval process amounted to 11.5 % on an annualized basis.

A fair comparison of the state-owned banks of Costa Rica with banks of the same size in other Western countries would conclude, we believe, that the former are overly bureaucratic in procedural form and operations and are overstaffed. This obviously translates into lower returns to savers and higher costs to borrowers. Rough estimates indicate that the spread between the average rate charged on loans and the average rate paid on deposits at the state banks is about ten percentage points. However, despite this high spread, their profitability is low when compared with private banks operating in Costa Rica. In 1984, profitability expressed as an average return on equity was 3.7 % for state banks and 21.9 % for private banks, and as an average return on total assets it was 0.2 % for state banks and 4.5 % for private banks.

Any worthwhile reform of the Costa Rican banking system should aim at improving its efficiency. We recognize that the specifics of any reform of the financial sector would generate political controversy. However, the inefficiencies of the Costa Rican financial sector are too large to be easily reduced in the absence of a substantial reform effort. In our view, a genuine, worthwhile reform must include (a) the ability of all commercial banks, state and private, to deposit accounts on equal terms, (b) the powers of bank top managment should be increased and those of directors should be decreased (in practice this would apply more to the state-owned banks), and (c) the powers of the Superintendency of Banks, particularly to audit banks and impose sanctions, should be increased. In regard to the state-owned banks, laws and regulations should be adopted to give bank administrators and lower level loan committees more ample attributions to approve loans, to simplify bank proceedures, to reduce processing bottlenecks, thereby reducing the presently high transactions costs. In regard to private banks and finance companies, the laws and regulations that limit their scope and activities should be removed. The recent reforms of interest rate structure to positive real rates, to market determination of interest rates, and away from negative real rates of interest and from the non-price directed allocation of credit should be retained. We judge that the existing dispersion in interest rate structure is high, largely due to administrative determination, and would be lower with a more market determined structure, that is, in accordance with the term, cost, and risk associated with different types of deposits, borrowers, and activities.

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7. Transformation of Public Sector Finances

The public sector deficit has been reduced in recent years, in total from 14.6 % of GDP in 1982 to about 7.1 % of GDP in 1985; see Table VI. The latter is still too high for price stability and a goal of 3.0 % of GDP by 1990 would be in line with stronger price stability and a B/P current account deficit on the order of 5.0 % of GDP. However, the method of achieving this longer-term goal also impacts on other economic objectives. In recent years, particularly since the economic crisis of 1980-1982, reduction of the public sector deficit has been accomplished through increasing tax revenues and the charges of state enterprises rather than through containment of public sector expenditures. In addition, public sector and central government current account savings are small, and this fact plus the goals of reducing the over-all public sector deficit impact against capital formation in the public sector. Moreover, a higher tax burden also reduces private sector disposable income and this can impact negatively upon capital formation in the private sector. The Monge administration has relied primarily upon stop-gap revenue measures to reduce the deficit of Costa Rica's nonfinancial public sector and not upon measures to reduce current expenditures in real terms and public sector employment. The importance of an early reduction of deficit to price stability obviously tilted Costa Rican policymakers toward revenue enhancement. However, the consequences of that tilt are unfavorable to longer-term economic growth and external donors have sought to counter public sector expansion. In particular, the 1985 IMF Standby set a cumulative limit on central administration expenditures (which was implemented) and the World Bank SAL requested a freeze on public sector employment (which was not entirely effective, public sector employment increased by 3,000 positions from March 1984 to the end of 1985).

During the past decade the tax burden in Costa Rica has increased. Central administration tax revenues grew from 12.5 % of GDP in 1975 to 17.9 % of GDP in 1984, and available data indicate that the total tax burden including social security charges increased from 16.7 % of GDP in 1976 to 25.6 % of GDP in 1984. The large public sector deficits of the late 1970s plus economic stagnation after 1980 accounts for these higher ratios. Even though one might suspect that the growing tax burden caused the recent economic crisis and stagnation, evidence supporting this hypothesis is not impressive, at least for the period 1975-1984. As noted in San Jose cable (85) 9857, a recent Mission-sponsored study of the evidence on saving, investment, and economic growth as linked to the tax burden, failed to find a significant causal linkage. That study cited, however, the importance of three noteworthy non-tax economic policies, as follows: (a) interest rates set at levels that made them negative in real terms and which produced a low ratio of domestic savings to GDP and also a generally low quality of private sector investment activity, (b) heavy public sector external borrowing used mainly to defending a fixed exchange rate

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held at substantially overvalued levels, which stimulated the consumption of imported goods and decreased the profitability of exports, and (c) a highly protectionist tariff, which favored domestic manufacturing and oriented investment toward expansion based mainly upon the domestic market. This study also noted that the relative burden of the income and profits tax was low until after 1982 and indirect taxes were relatively high and that from this point of view the tax structure had been favorable to saving and investment. However, the study does not rule out a possible future negative impact from a higher tax burden after 1982. As a signal of public awareness of the heavy burden of these taxes, during the 1986 election campaign both of Costa Rica's major political parties advocated reduction of the personal and corporate income tax rates. In San Jose 9857 we concluded that due to changes enacted in 1984 the personal income tax in Costa Rica is not now as onerous due to the broadening of brackets, increased tax credits, and preferential treatment of capital income. However evasion is serious, suggesting that further rate reductions should be undertaken along with improved administration. In regard to the corporate income tax, the dominant marginal rate is high (50 %), and this encourages evasion and discourages investment.

The deficit of the nonfinancial public sector has been reduced in successive stages in recent years from 9.0 % of GDP in 1982 to 1.7 % of GDP estimated for 1985. However, as is indicated in Table VII, the Central Bank net operational losses account for a sizeable portion of Costa Rica's public sector deficit, and these losses have been on the order of 5 % of GDP in recent years. Inclusive of these losses, the over-all public sector deficit has been reduced from 14.6 % of GDP in 1982 to 6.2 % as a preliminary estimated for 1985. The economic significance of Central Bank financial losses consists in the fact that these losses require money creation in the form of an expansion of Central Bank currency issue and this has the same impact as monetization of a deficit of the nonfinancial public sector. The effect is also identical, other things equal, less banking system credit is then available to the private sector. In broad perspective, IMF-format monetary tables (see Table V) demonstrate the more usual elements creating and extinguishing money. For example, a balance of payments surplus (i.e., increase in net international reserves) or an increase in banking system credit to the public (private) sectors or Central Bank losses increase money in circulation, and a balance of payments deficit (i.e., decrease in net international reserves) or a decrease in banking system credit to the public (private) sectors or a reduction in Central Bank losses reduce money in circulation.

As is confirmed in Table V (see net domestic assets, "other assets, net"), the major source of monetary expansion in Costa Rica arises from losses of the Central Bank, and these losses arise mainly from the imbalance between the size of its interest-earning assets and of its interest-paying liabilities. Regarding the

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latter, the largest element is interest on external debt accumulated in the late 1970s to defend the Colon. Other interest-paying liabilities include Central Bank interest payments on stabilization bonds and its interest payments on dollar-denominated deposits of the Costa Rican commercial banks. At present, and due to low interest-earning assets, Central Bank interest income is low. Even though cited in Table VII, interest payments on ESF local currency deposits are not properly judged as a Central Bank loss item as long as the demonetization of such deposits exceeds the amount of interest paid.

The Central Bank has to make heavy interest payments on medium and long term external debt, of which ₡ 9.4 billion are on its "own" external debt. Unfortunately, the measures that can be taken by the Central Bank to reduce its losses are quite limited. In 1985 the Central Bank redeemed most of its stabilization bonds, which reduced interest payments, and over the longer term the Central Bank could attempt to increase interest earnings through expanding rediscount operations. However, rapid implementation of that solution is obviated by the existing size of Central Bank losses as well as prudent limits to monetary expansion. The heart of the issue is that Central Bank losses are presently so high that given due exercise of monetary prudence the Central Bank is unable to purchase other domestic assets so as to gain the additional earnings needed to reduce its losses. In effect, there is no way out of this vicious circle without a fiscal subsidy. We are informed that central government is considering a subsidy of the Central Bank in 1986 on the order of ₡ 1.0 billion.

The usual, standard case argument concerning central bank losses is that such losses are only transitory and hence not to be viewed with the same abhorrence as the deficits on the nonfinancial public sector. The argument goes as follows: Central Bank losses are usually reduced strongly during the surplus phase of the balance of payments cycle. That is, foreign exchange reserves are built up and placed in interest bearing securities outside the country and the earnings of these securities come to offset the losses. Obviously, if Costa Rica were able to build up net international reserves to about $1.5 billion, its Central Bank losses would disappear.

Apart from the consequences of public sector expenditures on inflation, the size and complexity of the public sector in Costa Rica raises the question of efficiency of public sector operations. The CODESA divestiture program is justified as a method of reducing the drain of financial sector credit resources to an allocation which is unable to pay interest and to make those resources available not only to private sector borrowers but also to users who are willing and able to pay interests rates well in excess of 20 %

per annum. Even though CODESA is an exceptional case of intrusion of the public sector into an operation better left to private sector and possibilities of liquidation through bankruptcy, an honest examination of public sector operations would likely uncover several areas where public services could be provided in more efficiently, that is, at lower cost and with fewer public sector employees.

Over-staffing in the public sector is suggested by the fact that public sector employment has been growing faster than private sector employment. During the past two decades the share of public sector employment in total employment has gone from 13.3 % (1963) to 19.0 % (1983). Costa Rica's relatively low open unemployment rate is explained in part by high public sector employment. As is noted in a recent study (Gary S. Fields, Employment and Economic Growth in Costa Rica, December 1985) expansion of public sector employment poses a potential problem for two reasons. One is that public sector employment expansion may or may not proceed in accordance with labor productivity, and we know of no systematic studies addressing the question of whether employment in the public sector at the margin is more or less productive than in the private sector in Costa Rica. However, what is clear is that public sector wages are on the average about 70 % higher than private sector wages, and that these wage differentials stand up even after standarizing for differences in workers' education and experience. Consequently, private sector workers in Costa Rica on the whole aspire to jobs in the public sector, and this in turn leads to shortages in private sector occupations which require the highest amounts of education. We suspect that income distribution consequences of abundant public sector employment are unfavorable, i.e., low income taxpayers support higher income public sector workers, and perhaps for a volume of public sector employment that is higher than necessary.

ENGLISH TRANSLATION

March 17, 1986

Mr. Lewis Tambs
Ambassador
Embassy of the United States
of America
San Jose

Dear Mr. Ambassador:

It is a pleasure to write to you at this time to convey my regards and to acquaint you with a series of deliberations that I have pursuing since my election to the Presidency of the Republic on February 2 of this year.

Various policies and programs developed by the administration of President Mongê involve obligations which will extend into the period during which I must preside over the Government of Costa Rica. In reviewing these programs, I am particularly interested in becoming acquainted with the agreements reached with various international entities.

I have begun a careful study of the economic support arrangements that this country has obtained from friendly countries and financial institutions. A.I.D. financial assistance to the Government of Costa Rica has received my special attention: I cannot fail to express the gratitude we feel towards the Government of the United States for this assistance.

In a recent visit with Messrs. Daniel Chaij, Richard Archi and Rodolfo Cortés, as well as Messrs. Jorge Rossi, Jorge Manuel Dengo and Rodrigo Arias, I was informed of progress in implementing various programs supported by A.I.D., including especially the divestiture of the CODESA enterprises, the organization of the Housing Mortgage Bank, and the International Agricultural School for the Humid Tropics.

At that time, Mr. Chaij expressed his concern about some aspects of the above-mentioned programs. In the case of CODESA he indicated that, with the change of government, there might be doubts on the part of the U.S. Government as to whether the new Government of Costa Rica would alter the present course of action. In the case of the International Agricultural School for the Humid Tropics, there has been concern about the delay in the process and some confusion about its status as an international institution, about the exonerations which have been requested, and about its relationship with the Costa Rican Council of Rectors. Finally several very specific points were raised in connection with the progress of the Housing Mortgage Bank bill, and the financing the Bank would receive from A.I.D.

With respect to CODESA, allow me to reaffirm the determination of my Government to continue and accelerate the program which was established in accordance with (our) agreement and in compliance with Executive Decree No. 16007-E-MEC. We do not contemplate any change in the process which has been initiated; my goal is the strengthening of the private sector action as the main dynamic element of the economy of Costa Rica.

The function of the State, in the view of the Liberación Nacional party, will continue to be one of promoting and regulating, without contemplating the participation of the Government and its institutions in the processes of production (after the model of the "Entreprenurial State").

I do not consider it opportune to detail here what in my opinion would be a repetition of elements of the agreements now in force concerning CODESA or other programs; but I have asked the First Vice President of the Republic, Ing. Jorge Manuel Dengo and the Minister of the Presidency, Lic. Rodrigo Arias, to formulate a complementary memorandum to this letter, based on the reaffirmation of the intentions of my Government to go forward with the processes initiated by the present administration. The above-mentioned document will treat in an specific way the different aspects that could be subjects of concern or uncertainty for the Government of the United States.

Sincerely,

Oscar Arias Sánchez
President-elect of Costa Rica

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San José, 17 de marzo de 1982

Señor
Lewis Tambs
Embajador
Embajada de los Estados Unidos
de América
Su Despacho

Estimado señor Embajador:

Es un placer para mí dirigirme a usted en esta oportunidad para saludarlo y hacerle partícipe de una serie de consideraciones que he venido haciendo desde mi designación a la Presidencia de la República el pasado dos de febrero del año en curso.

En el proceso de familiarizarme con las distintas políticas y programas que ha venido desarrollando la administración del Presidente Monge, que implican una serie de obligaciones que se proyectan al período en que me corresponde presidir el Gobierno de Costa Rica, me he interesado especialmente por conocer los acuerdos a que se ha llegado con diversas instituciones internacionales.

He iniciado un estudio cuidadoso de las políticas de apoyo económico que el país ha obtenido de países amigos y de instituciones financieras. Especial atención me han merecido los programas que financia la A.I.D. en apoyo al Gobierno de Costa Rica, sobre lo cual no omito manifestarle el agradecimiento que tenemos hacia el Gobierno de los Estados Unidos.

En una reciente visita que me hicieran el señor Daniel Chaij, el señor Richard Archie y el señor Rodolfo Cortés, a la cual asistieron también el señor Jorge Rossi, el Ing. Jorge Manuel Dengo y el Lic. Rodrigo Arias, me informaron del avance en la ejecución de los diversos programas que han recibido apoyo de la A.I.D., en especial de el relacionado con la venta de las empresas de CODESA, el de la organización de la Caja Hipotecaria de la Vivienda y el de la Escuela Internacional de Agricultura para el Trópico Húmedo.

En esa oportunidad, el señor Chaij manifestó su preocupación sobre algunos aspectos de los anteriores programas. En el caso de CODESA indicó que con el cambio de administración podrían existir dudas en el Gobierno de los Estados Unidos de que el curso de acción que se ha venido siguiendo pudiera ser modificado por el nuevo Gobierno de Costa Rica. En el caso de la Escuela Internacional de Agricultura para el Trópico Húmedo, la preocupación ha sido respecto a la tardanza del trámite y a cierta confusión sobre el status de institución internacional, las exoneraciones solicitadas y la relación con el Consejo de Rectores de Costa Rica y finalmente diversos puntos muy específicos relativos al trámite del proyecto de Caja Hipotecaria para la Vivienda y el financiamiento que ésta tendría por parte de la A.I.D.

En relación con CODESA me permito ratificar a usted, el empeño que tiene mi Gobierno por continuar y acelerar el programa establecido de acuerdo con el convenio y de conformidad con lo establecido en el Decreto Ejecutivo No. 16007-E-MEC. No contemplamos ningún cambio en el proceso iniciado y mi deseo es el fortalecimiento de la acción del sector privado como el principal elemento dinámico de la economía de Costa Rica.

La función del Estado, dentro de la tesis del Partido Liberación Nacional, seguirá siendo una función promotora y reguladora sin que se contemple la participación del Gobierno y sus instituciones en los procesos de producción de bienes que caracterizan a un "Estado empresario".

No creo oportuno precisar o puntualizar lo que a mi juicio sería una repetición de los aspectos de los convenios vigentes relacionados con CODESA o con los otros programas, pero le he solicitado al Primer Vice Presidente de la República, Ing. Jorge Manuel Dengo y al Ministro de la Presidencia, Lic. Rodrigo Arias, para que formulen un memorandum complementario a esta nota, basado en la ratificación de las intenciones de mi Gobierno, de continuar adelante con los procesos iniciados en la presente Administración. El documento en mención puntualizará en forma específica los distintos aspectos que pudieran ser motivo de preocupación o incertidumbre por parte del Gobierno de los Estados Unidos.

Cordialmente,

Oscar Arias

Oscar Arias Sánchez
Presidente Electo de Costa Rica

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ENGLISH TRANSLATION

San José, March 25, 1986

Mr. Lewis Tambs
Ambassador
United States Embassy
San José

Dear Mr. Ambassador:

I am pleased to write to you, at the instructions of the President-elect, to confirm in detailed form the willingness of the new Government to maintain the agreements relating to the sale of CODESA's subsidiaries, and also to define the necessary conditions to establish a Central Housing Mortgage Bank.

- Execution of the CODESA program

In regard to the first point mentioned above, there are certain decrees and agreements which establish the basis for the sale or transfer of CODESA's susbsidiaries. Among these, the most important are: a) Law No. 6811 dated September 10, 1982; b) Law No. 6955 dated February 24, 1984; c) Decrees Nos. 16007-P-MEC and 16520-P-MEC; as well as various Cabinet agreements related to the sale of shares and extension of the program's deadline. Finally there is a Memorandum of Understanding between the Government of Costa Rica and the Agency for International Development (AID), where terms of financial support of the program are defined.

In the Memorandum of Understanding, the Government through its President and Cabinet, agreed on February 6, 1985, that CODESA would have to:

A. immediately sell its subsidiaries;

B. neither make new investments nor participate in the creation of new subsidiaries;

C. incur no new obligations, nor give any guarantee to finance investments, except for existing commitments that have been ratified by the Cabinet. The parties have agreed on A.I.D. financial support, up to an amount of $140 million in local currency under the Grant Agreement for Economic Stabilization and Recovery of Costa Rica, to help in selling CODESA's subsidiaries.

(There are other relevant items which we need not mention here).

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In accordance with the above-mentioned documents and with the President-elect's letter of March 17, 1986, I am pleased to inform you of the firm intention of the new Government to issue a Decree, and to make any additional arrangements which may be required, to extend the mandate of the National Commission for the reorganization of CODESA as long as is necessary in order to comply fully with the established program.

A. For the purposes of selling the shares or liquidating the investments of CODESA in its subsidiaries or enterprises, as well as of liquidating the subsidiaries' assets, the Government of Costa Rica relies on the AID financial support conferred by means of the following grants:

a) Original grant: an amount equivalent in colones of up to U.S.$140 million, minus the amounts of the investments made and costs incurred in connection with ALUNASA.

b) Additional grant: for the amount necessary, if the amount indicated in the previous paragraph is not sufficient for carrying out the provisions of this document.

In addition, A.I.D. shall finance the operating costs of the National Commission for the Reorganization of CODESA, as well as the studies, preparatory work, and technical assistance required to comply with what is specified in this document.

B. Along with the ratification of the commitment related to the sale or liquidation of CODESA subsidiaries, we propose to extend the mandate of the National Commission for the Reorganization of CODESA, and to charge the Commission, as well as CODESA's Administrative Council and Executive Presidency, with the following activities and implementation schedule:

a) To approve the necessary changes in the articles of Cementos del Pacífico, S.A. (CEMPASA) and Fertilizantes de Centroamérica (FERTICA), in order to include in their text guarantees sufficient to protect those who acquire the forty percent (40%) of the shares of such enterprises, including a management contract which assures the enterprise's efficiency and productivity.

b) During 1986, CODESA shall sell or liquidate its shares or investments in the following enterprises: ALCORSA, Atunes de Costa Rica, SANSA, LACSA, STABAPARI, MACASA, MULTIFER, RAMUCAR, TEMPISQUE FERRY BOAT, FLEMAR, Cementos del Valle and any other enterprise not mentioned by name, in which CODESA is a majority or minority shareholder, except the shares in the National Securities Exchange and in CODESA's seat on this Exchange.

c) The following CODESA subsidiaries shall be sold or liquidated during the first nine months of the calendar year 1987: CATSA, CEMPASA and FERTICA. During the remaining months of 1986, the National Commission for the Reorganization of CODESA shall have total power to carry out the studies and preparatory work needed prior to the sale of these enterprises' shares.

d) The National Commission for the Reorganization of CODESA shall complete the transfer of the operations and shares (including all the assets and liabilities) of the following enterprises:

(1) Transportes Metropolitanos, S.A. (TRANSMESA) to the Ministry of Public Works and Transportation (MOPT), which shall maintain it as a decentralized unit. TRANSMESA debt, consolidated in CODESA's debt with the Central Bank of Costa Rica, shall be cancelled by the Ministry of Finance with Government Bonds in favor of the Central Bank to be credited to CODESA's existing debt. The value of TRANSMESA shares shall receive the same treatment.

(2) Corporación de la Zona Franca to the Centro para la Promoción de las Exportaciones y las Inversiones (CENPRO). The value of the shares transferred to CENPRO, as well as the debts of the Corporación de la Zona Franca consolidated in CODESA's debt to the Central Bank of Costa Rica, shall be cancelled by the Ministry of Finance with Government Bonds in favor of the Central Bank to be credited to CODESA's existing debt.

(3) MINASA shall be transferred to the Ministry of Industry, Energy and Mines (MIEM). The value of the shares transferred to MIEM as well as MINASA's debts consolidated in CODESA's debt to the Central Bank of Costa Rica shall be cancelled by the Ministry of Finance with Government Bonds in favor of the Central Bank of Costa Rica to be credited to CODESA's existing debt.

C. To extend to the first nine months of 1987, the term for accomplishing of the policies indicating ordinary and future CODESA activity to be fulfilled in cooperation with the general Public Administration, the Central Bank of Costa Rica, and the Comptroller General of the Republic, as well as the financial support of A.I.D., comprised in the following binding directives:

a) The sale, liquidation or transfer of CODESA enterprises in accordance with what is being agreed in this document;

b) The prohibition to effect any new, majority or minority, investments, or to participate in the formation of new enterprises; and

c) The prohibition to incur new obligations or provide guarantees to finance investments or provide new financing to any enterprise except for operating costs or payment of liabilities with third parties which its subsidiaries might have and that will be cancelled prior to the sale of such subsidiary; in both cases with the authorization of the National Commission.

D. To delegate to the First Vice-Presidency of the Republic, with the support of the National Commission for the Reorganization of CODESA, the obtaining of an agreement with the General Comptroller of the Republic, and AID, of a formula which makes the participation of FINTRA feasible in those cases where there is a difference between the value of an enterprise as determined by the Comptroller and the real market cost of such enterprises. This formula shall be agreed upon before June 30, 1986.-

E. Simultaneously with the above mentioned actions, to delegate to the First Vice-Presidency of the Republic, in order to contract, jointly with the Central Bank of Costa Rica and the National Commission for the Reorganization of CODESA, the studies and reports which are considered necessary and advisable, utilizing national and foreign technical resources, to define the possible fusion of CODESA and its original development objectives in one of the government commercial banks, or any other institution, provided that CODESA cannot create, finance or operate any new subsidiary. The maximum term for finishing and submitting this report with as much detail as necessary to take required executive actions shall be September 30, 1986.

F. In order to comply promptly with the contents of this document, the Administration Council of CODESA, the National Commission for the Reorganization of CODESA, the Central Bank of Costa Rica, the Ministry of Finance and the Comptroller General of the Republic, will duly coordinate activities; for the same purposes, A.I.D. shall give instructions to both FINTRA and the consortium contracted to provide it financial support to coordinate activities.

Mr. Ambassador, the policies stated in this document are considered adequate to accomplish the economic objectives associated with the determination to carry out the sale, transfer or liquidation of the various CODESA subsidiaries, preserving at the same time the promotional function for which CODESA was created.

Housing Sector

With respect to the housing area, the Government of the President Arias Sánchez will incorporate the following elements within its programs related to this sector:

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A. The execution of structural and political reforms within the institutional framework, which shall result in the consolidation and specialization of the public institutions involved in housing construction or financial activities related to housing.

B. To carry out studies and research activities to support the formulation of national housing policies and to carry out strategies to guide and manage development initiatives raised by the private sector and the public sector.

C. The approval of a new law by the Legislative Assembly establishing a Caja Central Hipotecaria (Central Mortgage Bank) as a second level financial institution with the main purpose of mobilizing local and foreign capital for mortgage investments, mortgage rediscounts in secondary markets, and other financial activities related to housing finance. The new Central Mortgage Bank shall include:

   a) The separation of DECAP from the Banco Crédito Agrícola de Cartago and the transfer of its assets, liabilities and personnel to the new Bank.

   b) A Board of Directors with equal representation from the private sector. This Board shall be responsible for defining Bank policies and, with respect to the technical and general administration of the Fund, the Board of Directors shall name a General Manager, who shall be responsible for such activities.

   c) The policy that the funds mobilized by the Bank shall be lent only to the members of the Housing National Financial System and the National Banking System, who specialize in housing finance and banking and comply with the financial and legal requirements to be established in the Bank's statutes.

   d) The policy to maintain interest rates of all loans at a level which reflects the market rate, in order to maintain the financial feasibility of the investments without needing subsidies or transfers from the Government. In addition, the Bank shall maintain the value of the mortages by means of a policy of variable interest rates.

D. In order for the Central Mortgage Bank to reach all sectors, it is necessary that it be able to receive and transfer soft funds, such as those that would come from Asignaciones Familiares and those in the future which might come from the retirement plan or additional payroll charges. These resources would serve as a one time to subsidy for housing (in the cost), and not for subsidizing interest rates.

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E. The policies stated in this document are considered adequate to accomplish the objectives of establishing a Central Morgage Bank, to resolve the sale, transfer and liquidation of the Corporación Costarricense de Desarrollo (CODESA) subsidiaries and to define the future of CODESA and its development purposes.

I hope that by this means we are complying with the instructions of the President Elect and I remain at your service for any explanation or extension of the points stated in this document.

Sincerely,

Ing. Jorge Manuel Dengo
First Vice President Elect

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San José, 25 de marzo de 1986

Señor
Lewis Tambs
Embajador
Embajada de los Estados Unidos
de América
Su Despacho

Estimado señor Embajador:

Me es muy grato dirigirme a usted en relación con instrucciones que he recibido del señor Presidente Electo, para ratificarle en forma detallada la disposición en que se encuentra el nuevo Gobierno de mantener la vigencia de los convenios relacionados con la venta de las empresas de CODESA, así como de concretar las condiciones necesarias para establecer una Caja Central Hipotecaria para la Vivienda.

Ejecución del programa de CODESA

Con respecto al primer punto, existen varios decretos y convenios que sientan las bases para llevar a cabo el programa de venta o traspaso de las empresas de CODESA. De estos, los de mayor relevancia para asegurar la continuidad del proceso en que está empeñado el Gobierno de Costa Rica, son los siguientes: a) la ley No.6817 del 10 de setiembre de 1982; b) la ley No.6955 del 24 de febrero de 1984; c) los decretos #16007-P-MEC y #16520-P-MEC; así como distintos acuerdos del Consejo de Gobierno relativos tanto a la venta de las acciones como a la ampliación de los plazos de vigencia del programa. Finalmente está el memorandum de entendimiento entre el Gobierno de Costa Rica y la Agencia Internacional para el Desarrollo (AID), en que se definen los términos del apoyo financiero del programa.

El memorandum de entendimiento con la A.I.D. indica que: El Gobierno por medio del Presidente y el Consejo de Gobierno, el día 6 de febrero de 1985, acordó que CODESA deberá:

A. vender sus empresas inmediatamente;
B. no hacer nuevas inversiones ni participar en la formación de nuevas empresas;
C. no contraer obligaciones nuevas ni dar garantías para financiar inversiones, salvo los compromisos ya adquiridos y ratificados por el Consejo de Gobierno. Las partes han convenido en la asistencia financiera de la A.I.D. para ayudar a la venta de las empresas de CODESA, hasta por un monto de $140 millones en moneda local, generada bajo el Convenio de Donación para la Estabilidad y Recuperación Económica de Costa Rica. Existen otros considerandos que no es del caso citar aquí.

De conformidad con los documentos mencionados anteriormente y con la manifestación de la carta del señor Presidente Electo del 17 de marzo de 1986, me es grato manifestar a usted, la firme intensión del nuevo Gobierno de emitir un Decreto y las disposiciones adicionales del caso, que extienda el mandato de la Comisión Nacional para la Reestructuración de CODESA por el tiempo necesario para permitir el cumplimiento caval del programa establecido.

A. Para la venta de acciones o liquidación de inversiones de CODESA en sus subsidiarias y filiales, lo mismo que para la liquidación de activos de las primeras, el Gobierno de Costa Rica cuenta con la asistencia financiera de la A.I.D. otorgada mediante las siguientes donaciones:

a) Donación original: una suma equivalente al valor en colones de hasta U.S.$140 millones, menos el monto de las inversiones y gastos realizados en ALUNASA.

b) Donación adicional: por la suma que sea necesaria, si el saldo indicado en el párrafo anterior resultara insuficiente para llevar a cabo lo estipulado en este documento.

Además, la A.I.D. financiará el costo del funcionamiento de la Comisión Nacional para la Reestructuración de CODESA, así como el de los estudios, trabajos preparatorios y asistencia técnica que se requieran para cumplir con lo especificado en este documento.

B. Con la ratificación del compromiso relacionado con la venta o liquidación de las subsidiarias de CODESA, se propone extender el mandato a la Comisión Nacional para la Reestructuración de CODESA y encomendarle a ésta y al Consejo de Administración y Presidencia Ejecutiva de CODESA las siguientes acciones y calendario de ejecución:

a) Aprobar las reformas necesarias en los Estatutos Sociales de Cementos del Pacífico, S.A. (CEMPASA) y Fertilizantes de Centroamérica (FERTICA), con el propósito de que en su texto se incluyan garantías suficientes de protección para quienes adquieran el cuarenta por ciento (40%) de las acciones de tales empresas, incluyendo un contrato de administración que garantice la eficiencia y la productividad de la empresa.

b) Durante el año 1986 CODESA venderá o liquidará sus acciones o inversiones en las siguientes empresas: ALCORSA, Atunes de Costa Rica, SANSA, LACSA, STABAPARI, MACASA, MITIFER, NAMUCAR, TEMPISQUE FERRY BOAT, FLEMAR, Cementos del Valle y cualquier otra no mencionada por nombre propio, en la cual CODESA tenga una posición accionaria mayoritaria o minoritaria, excepto las acciones en la Bolsa Nacional de Valores y en el puesto que CODESA tiene en la misma Bolsa.

c) Las siguientes subsidiarias de CODESA se venderán o liquidarán durante los primeros nueve meses del año calendario 1987: CATSA, CEMPASA y FERTICA.

Durante los meses restantes de 1986, la Comisión Nacional para la Reestructuración de CODESA tiene potestad total para llevar a cabo los estudios y trabajos preparatorios necesarios previos a la venta de las acciones de estas empresas.

d) La Comisión Nacional para la Reestructuración de CODESA completará el traspaso de las actividades y acciones, incluyendo todos los activos y pasivos, de las siguientes empresas:

(1) Transportes Metropolitanos, S.A. (TRANSMESA) al Ministerio de Obras Públicas y Transportes (MOPT), que la mantendrá como una unidad descentralizada. La deuda de TRANSMESA, consolidada en lo que CODESA adeuda al Banco Central de Costa Rica, la cancelará el Ministerio de Hacienda en Bonos del Gobierno a favor del Banco Central para abonarse a la deuda pendiente de CODESA. Igualmente se hará con el monto del valor de las acciones de TRANSMESA.

(2) Corporación de la Zona Franca al Centro para la Promoción de las Exportaciones y las Inversiones (CENPRO). El valor de las acciones traspasadas al CENPRO igualmente que las deudas de la Corporación de la Zona Franca consolidadas en lo que CODESA adeuda al Banco Central de Costa Rica las cancelará el Ministerio de Hacienda con Bonos del Gobierno a favor del Banco Central para abonarse a la deuda pendiente de CODESA.

(3) MINASA se traspasará al Ministerio de Industria, Energía y Minas (MIEM). El valor de las acciones traspasadas al MIEM igualmente que las deudas de MINASA consolidadas en lo que CODESA adeuda al Banco Central de Costa Rica las cancelará el Ministerio de Hacienda con Bonos del Gobierno a favor del Banco Central de Costa Rica para abonarse a la deuda pendiente de CODESA.

C. Ampliar a los primeros nueve meses de 1987, el plazo para el cumplimiento de las políticas señaladas como actividad ordinaria y futura de CODESA, que ésta ha debido acatar con el concurso de la Administración Pública en general, del Banco Central de Costa Rica y de la Contraloría General de la República y la asistencia financiera de la A.I.D., comprendidas en las siguientes directrices vinculantes:

a) La venta, liquidación o traspaso de las empresas de CODESA conforme a lo acordado en el presente documento;

b) La prohibición de efectuar cualesquiera nuevas inversiones mayoritarias o minoritarias o participar en la formación de nuevas empresas; y

c) El impedimento de contraer nuevas obligaciones o dar garantías para financiar inversiones o dar nuevo financiamiento a ninguna empresa excepto para gastos de operación y pagar pasivos con terceras personas que tengan sus subsidiarias y que se vayan a liquidar previo a la venta de tal subsidiaria; en ambos casos con la autorización de la Comisión Nacional.

D. Delegar en la Primera Vice Presidencia de la República, la cuál contará con el apoyo de la Comisión Nacional para la Reestructuración de CODESA, la obtención de un acuerdo con la Contraloría General de la República, y la AID, para lograr una fórmula que haga viable la participación de FINTRA en aquellos casos en que haya diferencia entre el valor dictaminado por la Contraloría y el costo real de mercado de dichas empresas. Esta fórmula se deberá acordar antes del 30 de junio de 1986.

E. Simultáneamente con las acciones anteriores, delegar en la Primera Vice Presidencia de la República para que conjuntamente con el Banco Central de Costa Rica y la Comisión Nacional para la Reestructuración de CODESA contraten los estudios y trabajos que estimen necesarios y convenientes, valiéndose de recursos técnicos nacionales o extranjeros, para definir la posible fusión de CODESA y de sus objetivos originales de desarrollo en uno de los bancos comerciales del estado, o cualquier otra institución, siempre que ésta no pueda crear, financiar u operar una subsidiaria nueva. El plazo máximo para completar y presentar este trabajo en todo el detalle necesario para tomar las acciones ejecutivas requeridas será el 30 de setiembre de 1986.

F. El Consejo de Administración de CODESA, la Comisión Nacional para la Reestructuración de CODESA, el Banco Central de Costa Rica, el Ministerio de Hacienda y la Contraloría General de la República, se coordinarán debidamente para el puntual cumplimiento de todo lo especificado en este documento; con igual fin la A.I.D. dará instrucciones tanto a FINTRA como al consorcio contratado para suministrar asistencia financiera a ésta última.

Señor Embajador, las políticas expresadas en este documento se consideran adecuadas para lograr los objetivos económicos buscados con la decisión de realizar la venta, traspaso o liquidación de las distintas subsidiarias de CODESA, preservando al mismo tiempo, la función de carácter promocional que originó esta Institución.

Sector Vivienda

En cuanto al área de la vivienda, el Gobierno del Presidente Arias Sánchez incorporará dentro de las medidas y programas relacionados con este sector, los siguientes aspectos:

A. La ejecución de reformas tanto de estructura como de política en el marco institucional, lo cual resultará en la consolidación y especialización de las instituciones públicas involucradas en la construcción de viviendas o actividades financieras relacionadas con éstas.

B. Llevar a cabo estudios e investigaciones para apoyar la formulación de políticas nacionales de vivienda y ejecutar estrategias para guiar y manejar iniciativas de desarrollo planteadas por el sector privado y el sector público.

C. La aprobación de una nueva ley por la Asamblea Legislativa estableciendo una Caja Central Hipotecaria como una institución financiera de segundo nivel

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con el propósito principal de mobilizar capital doméstico y extranjero para inversiones en hipotecas, redescuentos de hipotecas en mercados secundarios y otras actividades financieras relacionadas con el financiamiento de viviendas. La nueva Caja Central Hipotecaria incluirá:

a) La separación de DECAP del Banco Crédito Agrícola de Cartago y la transferencia de sus activos, pasivos y personal a la nueva Caja.

b) Una Junta Directiva con representación paritaria del sector privado. Esta Junta tendrá la responsabilidad de definir las políticas de la Caja y en lo que respecta a la administración técnica y general de la Caja, la Junta Directiva nombrará a un Gerente General, quién tendrá a su cargo dichas funciones.

c) La política de que los fondos mobilizados por la Caja serán prestados solamente a los miembros del Sistema Financiero Nacional de Vivienda y del Sistema Bancario Nacional, quienes se especializan en financiamiento de vivienda y banca y cumplirán con los requisitos financieros y legales a establecerce en los estatutos de la Caja.

d) La política de mantener la tasa de interés de todos los préstamos a un nivel que refleje la tasa de mercado para así mantener la viabilidad financiera de las inversiones sin la necesidad de subsidios o transferencias por parte del Gobierno. Además, la Caja mantendrá el valor de las hipotecas a través de una política de tasas de interés variables.

D. Para que la Caja Central Hipotecaria pueda llegar a todos los sectores, es necesario que pueda recibir y traspasar fondos blandos, como serían los provenientes de Asignaciones Familiares y los que en el futuro provengan de la cesantía o recargos adicionales a la planilla. Estos recursos servirían para subsidiar vivienda de una sola vez (en el costo), y no para subsidiar tasas de interés.

E. Las políticas expresadas en este documento se consideran adecuadas para lograr los objetivos de establecer una Caja Central Hipotecaria, resolver la venta, traspaso y liquidación de las subsidiarias de la Corporación Costarricense de Desarrollo (CODESA) y el futuro definitivo de CODESA y sus fines de desarrollo.

Espero en esta forma dar cumplimiento a las instrucciones del señor Presidente Electo y quedo a sus órdenes para cualquier aclaración o ampliación de los puntos expresados en este documento.

Atentamente,

Ing. Jorge Manuel Dengo
Primer Vice Presidente Electo

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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 Economic Support Fund assistance and the criteria applicable to Development Assistance. Selection of the criteria will depend on the funding source for the program.

CROSS-REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? IDENTIFY. HAS STANDARD ITEM CHECKLIST BEEN REVIEWED? Standard Item Checklist has been reviewed

A. GENERAL CRITERIA FOR NONPROJECT ASSISTANCE

1. FY 1986 Continuing Resolution Sec. 524; FAA Sec. 634A. Describe how authorizing and appropriations committees of Senate and House have been or will be notified concerning the project.	Congress has been notified through AID FY 1986 Congressional Presentation. A Congressional Notification will be provided for Congressional review.
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?	No further preconditions for obligation are necessary. Prior Costa Rica compliance is satisfactory.
3. FAA Sec. 209. 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.	No
4. FAA Sec. 601(a). Information and conclusions whether assistance will encourage	Assistance will increase international trade, foster private initiative and competition, and improve technical

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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.

efficiency of industry, agriculture and commerce.

5. FAA Sec. 601(b). Information and conclusion on how assistance will 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 expand U.S. markets for Costa Rican products and to enhance U.S. private investment in Costa Rica.

6. FAA Sec. 612(b); Sec 636(h); FY 1986 Continuing Resolution Sec. 507. 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 in lieu of dollars.

Agreements with GOCR encourage use of local currencies for local needs.

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

No

8. FAA Sec. 601(e). Will the assistance utilize competitive selection

Yes

procedures for the awarding of contracts, except where applicable procurement rules allow otherwise?

9. FAA 121(d). If assistance is being furnished under the Sahel Development Program, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of A.I.D. funds? — N/A

10. FY 1986 Continuing Resolution Sec. 533. Is disbursement of the assistance conditioned solely on the basis of the policies of any multilateral institution? — No

B. FUNDING CRITERIA FOR NONPROJECT ASSISTANCE

1. Nonproject Criteria for Economic Support Fund

a. FAA Sec. 531(a). Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of part I of the FAA? — Yes

b. FAA Sec. 531(c). Will assistance under this chapter be used for military, or paramilitary activities? — No

c. FAA Sec. 531(d). Will ESF funds made available for commodity import programs or other program assistance be used to generate local currencies? If so, will such — Yes/Yes local currencies be available to support activities consistent with the objectives of FAA sections 103 through 106?

d. ISDCA of 1985 Sec. 205. Will ESF funds made available for commodity import programs be used for the purchase of agricultural commodities of United States-origin? If so, what percentage of the funds will be so used?

No

e. ISDCA of 1985 Sec. 801. If ESF funds will be used to finance imports by an African country (under a commodity import program or sector program), will the agreement require that those imports be used to meet long-term development needs in those countries in accordance with the following criteria?

N/A

(i) spare parts and other imports shall be allocated on the basis of evaluations, by A.I.D., of the ability of likely recipients to use such spare parts and imports in a maximally productive, employment generating, and cost effective way;

(ii) imports shall be coordinated with investments in accordance with the recipient country's plans for promoting economic development. A.I.D. shall assess such plans to determine whether they will effectively promote economic development;

(iii) emphasis shall be placed on imports for agricultural activities which will expand agricultural production, particularly activities which expand production for export or production to reduce reliance on imported agricultural products;

(iv) emphasis shall also be placed on a distribution of imports having a broad development impact in terms of economic sectors and geographic regions;

(v) in order to maximize the likelihood that the imports financed by the United States under the ESF chapter are in addition to imports which would otherwise occur, consideration shall be given to historical patterns of foreign exchange uses;

(vi)(A) seventy-five percent of the foreign currencies generated by the sale of such imports by the government of the country shall be deposited in a special account established by that government and, except as provided in subparagraph (B), shall be available only for use in accordance with the agreement for economic development activities which are consistent with the policy directions of section 102 of the FAA and which are the types of activities for which assistance may be provided under sections 103 through 106 of the FAA;

(B) the agreement shall require that the government of the country make available to the United States Government such portion of the amount deposited in the special account as may be determined by the President to be necessary for requirements of the United States Government.

f. ISDCA of 1985 Sec. 207. Will ESF funds be used to finance the construction of, or the operation or maintenance of, or the supplying of fuel for, a nuclear facility? If so, has the President certified that such country is a party to the Treaty on the Non-Proliferation of Nuclear Weapons or the Treaty for the Prohibition of Nuclear Weapons in Latin American (the "Treaty of Tlatelolco"), cooperates fully with the IAEA, and pursues nonproliferation policies consistent with those of the United States? — No

g. FAA Sec. 609. If commodities are to be granted so that sales proceeds will accrue to the recipient — N/A country, have Special Account (counterpart) arrangements been made?

2. Nonproject Criteria for Development Assistance

a. FAA Sec. 102(c); Sec. 111; Sec. 281(a). Extent to which activity will (a) effectively involve the poor in development, by extending access to economy at local level; increasing labor-intensive production and the use of appropriate technology, spreading investment out from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (b) help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local governmental institutions; (c) support the self-help efforts of developing countries; (d) promote the participation of women in the national economies of developing contries and the improvement of women's status; and (e) utilize and encourage regional cooperation by developing countries? N/A

b. FAA Sec. 103, 103A, 104, 105, 106, 107. Is assistance being made available: (include only applicable para- N/A

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graph which corresponds to source of funds used. If more than one fund source is used for assistance, include relevant paragraph for each fund source.) N/A

(1) (103) for agriculture, rural development or nutrition; if so (a) extent to which activity is specifically designed to increase productivity and income of rural poor; (103A) if for agricultural research, full account shall be taken of the needs of small farmers, and extensive use of field testing to adapt basic research to local conditions shall be made; (b) extent to which assistance is used in coordination with efforts carried out under Sec. 104 to help improve nutrition of the people of developing countries through encouragement of increased production of crops with greater nutritional value, improvement of planning, research, and education with respect to nutrition, particularly with reference to improvement and expanded use of indigenously produced foodstuffs; and the undertaking of pilot or demonstration of poor and vulnerable people; and (c) extent to which activity increases national food security by improving food policies and management and by strengthening national food reserves, with particular concern for the needs of the poor, through measures encouraging domestic N/A

(4) (106) for technical assistance, energy, research, reconstruction, and selected development problems; if so, extent activity is: (i) (a) concerned with data collection and analysis, the training of skilled personnel, research on and development of suitable energy sources, and pilot projects to test new methods of energy production; and (b) facilitative of geological and geophysical survey work to locate potential oil, natural gas, and coal reserves and to encourage exploration for potential oil, natural gas, and coal reserves. N/A

(ii) technical cooperation and development activities, especially with U.S. private and voluntary, or regional and international development, organizations;

(iii) research into, and evaluation of, economic development processes and techniques;

(iv) reconstruction after natural or manmade disaster;

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

(vi) for special development, especially small labor-intensive enterprises, marketing systems, and financial or other institutions to help urban

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poor participate in economic and social development.

(5) (107) is appropriate effort placed on use of appropriate technology? (Relatively smaller, cost-saving, labor using technologies that are generally most appropriate for the small farms, small businesses, and small incomes of the poor.) N/A

c. FAA Sec. 118(c) and (d). Does the assistance comply with the environmental procedures set forth in AID Regulation 16. Does the assistance take into consideration the problem of the destruction of tropical forests? N/A

d. FAA Sec. 281(b). Describe extent to which the activity 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

e. FAA Sec. 122(b). 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? N/A production, building national food reserves, expanding available storage facilities, reducing post harvest food losses, and improving food distribution.

(2) (104) for population planning under sec. 104(b) or health under sec. 104(c); if so, extent to which activity emphasizes low-cost, integrated delivery systems for health, nutrition and family planning for the poorest people, with particular attention to the needs of mothers and young children, using paramedical and auxiliary medical personnel, clinics and health posts, commercial distribution systems and other modes of community research. N/A

(3) (105) for education, public administration, or human resources development; if so, (a) 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; and (b) extent to which assistance provides advanced education and training of people in developing countries in such disciplines as are required for planning and implementation of public and private development activities. N/A

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