COSTA RICA

CURRENT ECONOMIC SITUATION

AND PROSPECTS

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CURRENT ECONOMIC SITUATION AND PROSPECTS

I. THE MACROECONOMIC SITUATION

A. Performance of Productive Sectors

During the quarter century ending in the mid-1970s, Costa Rica appeared to be a model developing country. Its Gross Domestic Product (GDP) grew by 7.0 percent per annum in 1966-1970, 6.0 percent per annum in 1971-1975, and 5.3 percent per annum in 1976-1980. Even though the growth trend was declining, these data give no hint of the intensity and tenacity of the economic decline that was to be befall Costa Rica in the 1980s. Indeed social data were as auspicious as national accounting indicators: adult literacy reached 90 percent; infant mortality declined sharply to under 20 per thousand; population growth declined from 3.7 to 2.4 percent per annum; and open unemployment was held to less than 6 percent of the labor force.

Growth of the Costa Rican economy slowed sharply in 1980 and the change in GDP was negative both in 1981 (-2.3 percent) and 1982 (-9.1 percent). Preliminary estimates for 1983 with growth of 0.8 percent suggest only a bottoming out of recession, and the official forecast of a 2.3 percent growth rate for 1984 is far from indicative of full-blown recovery. Declining growth rates have also been spread among most sectors of the economy. (See Table I.) Notably in 1982, the year in which GDP declined by 9 percent, the over-all rate of decline for the basic productive sectors of the Costa Rican economy--agriculture, manufacturing, and construction--was -12.7 percent.

At the level of sub-sectors, the only one with any increase was utilities (and that was due to the coming on stream of an electric power station and the associated export of electric power). The strong spread effects and the magnitude of output decline suggest macroeconomic policy failure rather than a set or accumulation of problems unique to particular sectors. The important primary causes of the sharp decline in economic activity since 1980 include an excessive and poorly structured external borrowing in the years 1978-1981, an adverse movement of Costa Rica's terms of trade with the rest of the world (and notably declining export prices after 1977), excessively expansionary domestic demand related to monetization of enlarged public sector deficits, and also adverse market contraction throughout Central America. By year-end 1981 the Costa Rican economic situation included accelerating-to-triple-digit inflation, runaway exchange devaluation, and default on external public sector debt.

The manufacturing and construction sectors were hit harder by recession than other sectors. These sectors were particularly vulnerable to and negatively affected by the decline in real income which went along with accelerating inflation, by the erosive impact of devaluation on working capital, and by the disruption of the Central American Common Market (CACM). As expected (and as Engel's law implies) the effective demand for food did not decrease proportionately to the reduction of real income. In 1981 and 1982, taken together, agricultural production rose by 1.0 percent and manufacturing

output declined by 15.3 percent, and in 1983 agricultural production grew by 4.4 percent and manufacturing output declined by 1.8 percent. Going beyond the period of strong recession, during 1977-1983 agriculture's contribution to GDP increased by two percentage points (from 19.0 percent to 21.0 percent; see Table I). In contrast, manufacturing and construction sector shares in GDP declined by 3.7 percentage points (from 27.6 percent to 23.9 percent). However, while agricultural performance is usually less affected by declining real prices than that of manufacturing industry, Costa Rica's agricultural growth rate did not keep up with population growth during this period (2.1 percent versus 2.4 percent per annum.)

B. Consumption and Investment

Turning to national accounting expenditure aggregates, shown in Table II, the current (Central Bank) forecast of 1984 GDP (value in constant prices) is only marginally higher than 1977 GDP, impling lack of sustainable growth over the past seven years. On a per-capita basis, Gross Domestic Product, which is the value (in constant prices) of all goods and services produced within Costa Rica will be 12 percent lower in 1984 than in 1977 and consumption per capita will be fully 20 percent lower than in 1977. The erosion of GDP and consumption is even more dramatic if measured from the 1979 high. For example, measured from 1979, per capita consumption declines by 26.4 percent to 1984--an annual decline of 4.6 percent per annum.

Investment has also declined markedly in recent years. In comparison with the 1977 base (see Table II), the all-inclusive Gross Domestic Invesment concept indicates a 55 percent decline to 1984 and the Gross Fixed Investment concept indicates a 50 percent decline. The implication of low investment for growth of the Costa Rican economy during the next few years is significantly negative.

The inter-locking nature of national accounting aggregates reveals the real goods mechanism of economic decline and recovery for a small, open economy. As is shown in Part B of Table II, Costa Rica had a Net Foreign Balance deficit during the period 1977-80. This signifies that in constant prices Costa Rica's imports of real goods and services exceeded her exports of real goods and services by a magnitude approximating 6.8 percent of GDP. These aggregates do not explain how the Net Foreign Balance deficit was financed in 1977-80 nor why a deficit of this magnitude could not be financed during 1981-84. The fact that the 1977-80 deficit was financed and the potential deficit of 1981-84 was not financed is explained by the external financial resource (foreign exchange and credit) constraint of the balance of payments and will be examined further in discussion on the balance of payments The deficit Net Foreign Balance during 1977-80 signified that Gross Domestic Expenditure, which is also called absorption and is the sum of consumption and investment, could exceed the value of GDP by a sizeable margin.

Looking backwards, it now appears that Costa Ricans collectively were living beyond sustainable means, at least during the period 1977-1980. However, while in comparative terms, a Net Foreign Balance deficit of seven percent of GDP is not usually sustainable, what is more unusual is the subsequent 1980-84 reversal of this deficit to a surplus equivalent to 13.6

TABLE I

PERFORMANCE OF GROSS DOMESTIC PRODUCT BY PRODUCTIVE SECTORS, 1977-1984

A. Annual Percentage Change

	1977	1978	1979	1980	1981	1982	1983 (Prelim)	1984 (Proj)
GDP at Current Prices	27.4	14.7	14.5	19.7	37.9	69.9	29.6	17.9
GDP Deflator	16.9	7.9	9.1	18.8	41.1	86.8	28.6	15.2
GDP at Constant Prices	8.9	6.3	4.9	0.8	- 2.3	- 9.1	0.8	2.3
of which:								
1. Basic Productive Sectors	7.1	7.5	3.8	0.0	- 1.2	-12.7	0.6	3.1
Agriculture	2.2	6.6	0.5	- 0.5	5.1	- 4.9	4.4.	2.2
Manufacturing	12.7	8.2	2.7	0.8	- 0.5	-14.9	- 1.8	3.8
Construction	3.9	5.8	19.3	- 1.1	-21.7	-32.6	- 6.0	5.0
2. Government	5.0	5.0	5.9	3.6	1.8	- 2.2	- 0.3	- 1.0
3. Other Sectors	7.6	3.1	4.4	0.8	- 4.3	- 6.9	1.2	2.3
Gross Domestic Expenditure at Current Prices	26.7	17.3	17.1	19.8	31.1	55.3	36.3	19.5

B. Composition of GDP by Productive Sectors as Percent of GDP

	1977	1980	1982	1983
1. Basic Productive Sectors	46.6	46.2	44.8	44.8
Agriculture	19.0	18.0	20.2	21.0
Manufacturing	20.0	22.0	20.9	20.4
Construction	5.6	6.2	3.7	3.5
2. Government	9.8	10.0	11.2	11.1
3. Other Sectors	43.6	43.7	43.9	44.1
Utilities	2.1	2.3	3.0	3.5
Retail & Wholesale Trade	19.2	18.0	15.1	14.8
Transport. & Communication	6.0	7.0	7.7	7.7
Finance	4.8	5.2	5.7	5.8
Housing	7.1	6.9	7.9	7.9
Personal Services	4.5	4.3	4.5	4.3

TABLE II

PERFORMANCE OF GROSS DOMESTIC PRODUCT BY EXPENDITURE ITEMS, 1977-1984

A. As Percent of 1977 Real Value

	1977	1978	1979	1980	1981	1982	1983	1984
Gross Domestic Product	100.0	106.2	111.5	112.4	109.8	99.8	100.6	102.9
Net Foreign Balance	xx----------					-----	----	xxxx
Imports of Goods & Services	100.0	107.5	110.6	106.8	78.7	53.5	55.8	57.4
Exports of Goods & Services	100.0	109.9	113.5	108.6	120.7	108.5	108.5	112.0
Gross Domestic Expenditure	100.0	106.6	106.4	106.4	93.6	78.2	79.8	81.5
Total Consumption	100.0	107.6	111.1	109.7	100.8	92.2	93.6	94.1
Private Consumption	100.0	108.4	111.0	108.9	99.6	89.9	91.0	91.9
Public Consumption	100.0	103.7	111.2	113.3	106.9	103.9	106.7	105.3
Gross Domestic Investment	100.0	99.6	108.8	116.4	72.5	37.6	39.8	44.9
Gross Fixed Investment	100.0	108.1	124.7	112.9	84.8	52.0	48.2	49.5
Change in Inventories	xx----------					-----	-----	xxxx
Population	100.0	102.4	104.5	107.3	109.8	112.4	114.9	117.5
GDP per capita	100.0	103.8	106.7	104.7	100.0	88.9	87.5	87.6
Total Consumption per Capita	100.0	105.1	106.2	102.2	94.0	82.0	81.4	80.0
Private Consumption per Capita	100.0	105.8	106.3	101.5	92.8	80.0	79.2	78.2

(Note: xx-----xxxx signifies not calculated due to sign reversals)

B. As Percent of Gross Domestic Product

	1977/78	1979/80	1981/82	1983/84
1. Gross Domestic Product	100.0	100.0	100.0	100.0
2. Net Foreign Balance (- signifies surplus)	7.0	6.5	- 12.2	- 14.9
3. Imports of Goods & Services	45.2	42.2	27.2	24.2
4. Exports of Goods and Services	36.7	35.8	39.5	39.1
5. Gross Domestic Expenditure GDE=1+2=6+9	107.0	106.4	87.7	85.1
6. Total Consumption	80.3	78.7	73.5	73.6
7. Private Consumption	67.3	65.5	60.3	59.9
8. Public Consumption	13.0	13.2	13.2	13.7
9. Gross Domestic Investment	26.7	27.7	14.3	11.5
10. Gross Fixed Investment	25.2	26.5	16.2	12.0
11. Change in Inventories	1.5	1.2	- 1.9	- 0.5

percent of GDP. The swing amounts to 20 percent of GDP, and by international standards, this magnitude is exceptional. The 1984 forecast for imports of goods and services implies a level that is only 54 percent of the 1980 level. The level of Gross Domestic Expenditure forecast for 1984 is fully 23.4 percent below the 1980 level.

The principal element which explains the decline of Gross Domestic Expenditure (GDE), i.e. consumption plus investment, is inflation because inflation reduced real income, and thereby dampened demand for consumption goods, reduced profits and real working capital balances, and as a consequence strongly reduced investment. Exchange devaluation contributed also; directly to increase the cost and dampen demand for imports and indirectly through cost-push inflation. The essential question is whether an alternative and more timely stabilization/adjustment policy to lower Gross Domestic Expenditure would have produced a higher level of imports and consumption by 1984. The reasonable suspicion is that early reduction in demand (GDE) would have produced a higher volume of exports and GDP by 1984 but not that the Costa Rican economy could have avoided a recession solely by better management. At best, real incomes would have been reduced by increased taxes and decreased government services rather than by disruptive runaway inflation and exchange devaluation.

C. Employment and Wages

Growth of employment slowed in 1981-83. As shown in Table III, the rate of open unemployment was up slightly in 1981 (to 5.9 percent) and sharply in 1982 and 1983 (to 9.4 percent and 8.9 percent respectively). Growth of the total labor force declined in 1983 with a growth rate of only 0.7 percent as compared with rates of growth of over 3.0 percent for previous years. The rate of growth of the employed labor was, however, quite variable, declining from 3.6 percent in 1980 to 0.3 percent in 1981, and rebounding to 4.6 percent in 1982 and again declining to 1.2 percent in 1983. This variable performance suggests that people enter the labor force to counteract declining real household income, but there is a limit on their acceptance of lower real wages. The former appears plausible in 1982 and the latter in 1983. The tenable hypothesis is that potential labor force participants are simply dropping out, i.e. no longer seeking work.

Real wages declined strongly in 1981 and 1982. Measured from July to July of each year, private sector real wages declined by 1.7 percent in 1980, 16.0 percent in 1981 and 21.8 percent in 1982, and increased by 19.5 percent in 1983. By July 1983 the average real private sector wage was 60.5 percent of the November 1979 value. Thus, while 1983 brought an end to the decline of real incomes, the prospects for strong growth of real income in 1984 are dim.

D. Inflation and Devaluation

Up to 1980 Costa Rica's external and domestic financial gaps (disequilibria) were revealed mainly by the rapid growth of external debt and loss of international reserves. Inflation got underway in 1980 and became serious in 1981. Prior to 1981, Costa Rican households and businesses had only rarely experienced inflation of a magnitude in excess of 20 percent per annum. However, in 1981 and 1982 inflation was clearly in the 60 to 80 percent per annum range.

TABLE III

EMPLOYMENT AND REAL WAGES, 1978-1983

Part A--Employment and Unemployment Data

Data in Thousands

Year	Total Labor Force	Employed Labor	Unemployed Labor
1978	709.1	677.2	31.9
1979	735.4	699.4	36.0
1980	770.2	724.6	45.6
1981	795.8	726.6	69.6
1982	838.5	759.9	78.6
1983	844.4	768.9	75.5
	Percent Growth Per Annum		
1979	3.7	3.3	4.5
1980	4.7	3.6	4.9
1981	4.7	0.3	5.9
1982	3.2	4.6	9.4
1983	0.7	1.2	8.9

Part B - Real Wages (Percent Change)

Year	Total	Private Sector	Public Sector
1978	9.9	9.2	10.8
1979	3.4	3.7	0.9
1980	-3.9	-1.7	-8.4
1981	-14.8	-16.0	-13.5
1982	-24.1	-21.8	-26.6
1983	14.7	19.5	6.2

Source: Costa Rica: Una Economia en Crisis, p. 118 for years 1978-1980; based on the San Jose consumer price index and surveys of the Ministerio de Trabajo, Dirección General de Estatistica y Censos. Data for 1981 through 1983 are from the same source. Average for 1983 include only March and July surveys and percentage change is computed for the same period of 1982.

Looking only at the December-to-December rates of increase of various price indices presented in Table IV, the 1980 results ranged from 18 to 26 percent with some evidence of repression of prices of agricultural products in 1980. In 1981, Costa Rican price indices registered increases which ranged from 64 to 118 percent with the wholesale price index leading the way and farm product prices rising by about 100 percent. In 1982 nearly all the prices indices registered increases in the range of 79 to 89 percent. In contrast 1983 brought a strong deceleration of inflation with index movements ranging from only 6 to 17 percent.

Even though public authorities have some influence over the rate of inflation by setting prices, timing increases in the rates for public utilities, and issuing guidelines for minimum wages in the private sector, domestic price movements have responded to market forces. For the most part, price controls have been flexibly managed to allow passing on to consumers most of the increase in the cost of production. In total, the GOCR sets prices for 35 goods and services as well as maximum percentage markups to the wholesalers and retailers (5 percent and 10 percent on average, respectively) for several other products.

Because of the openness of the Costa Rican economy, domestic prices had usually moved in line with those of trading partner countries. From the last quarter of 1980 to the third quarter of 1982--a relatively short period--the predominant exchange rate increased fourfold. (See Table V.) Devaluation had an obvious impact on the pace of domestic inflation but does not account for as much inflation as did in fact occur. A rough approximation of the impact of devaluation on domestic inflation can be obtained as follows: The ratio of imports to GDP was on the order of 35 percent in 1979-80. Therefore, a 400 percent devaluation would, in itself, create within a relatively short time period a 140 percent inflation.(1) However, domestic inflation was substantially higher than 140 percent during this period. For example, from June 1980 to December 1982 (30 months) the Costa Rica wholesale price index increased by 319 percent. This is more than double the magnitude of the import cost-push proxy value derived from devaluation.

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(1) The specific calculation is .35 times 5.0 equals 1.75; 1.75 plus 1.00 minus 0.35 equals 2.40. Note also that 1.00 is the original economy-wide price index and the component of GDP which is not imported is 1.00 minus 0.35.

TABLE IV

PRICE INDICATORS

A. Rate of Change in Percent of General Indices

	Wholesale Price Index (a)		Consumer Price Index (b)	
	Average Annual	December-to-December	Average Annual	December-to-December
1966-70	4.0	4.8	N.A.	N.A.
1971-75	17.3	17.4	N.A.	N.A.
1976-80	13.0	13.7	N.A.	N.A.
1977	7.5	7.4	4.2	5.3
1978	7.8	9.4	6.0	8.1
1979	16.1	24.0	9.2	13.2
1980	23.7	19.3	18.1	17.8
1981	65.2	117.2	37.1	65.1
1982	108.2	79.1	90.1	81.8
1983	26.2	5.9	32.6	10.7

B. Rate of Change in Percent of Specialized Indices

(December to December of Each Year)

	1980	1981	1982	1983
Basic Food Basket of Supermarkets (San José) (c)	25.5	73.7	89.3	6.7
Materials & Labor for House Construction (d)	20.1	63.8	84.6	14.8
Materials & Labor for Large Buildings (d)	25.8	77.3	78.6	17.0
Services (e)		71.4	85.8	N.A.
Prices to Producers of Selected Agricultural Products (f)	-15.3	108.5	104.3	- 0.7

SOURCES: (a) Banco Central de Costa Rica
(b) Dirección General de Estadística y Censos
(c) Supermercados Los Periféricos y COUNSEL (Consultores Económicos y Legales)
(d) Dirección General de Estadística y Censos
(e),(f) Banco Central de Costa Rica

TABLE V

EXCHANGE RATE (MONTHLY SELLING PRICES)

(Colones Per U.S. Dollars)

		Official Market	Banking Market	Free Market
1980	June (a)	8.60	--	8.76(b)
	September(a)	8.60	--	10.31(b)
	December	8.60	14.23	14.50
1981	March	8.60	16.49	17.28
	June	8.60	18.06	20.49
	September	8.60	18.90	26.30
	December	19.92	36.01	38.27
1982	March	20.18	37.78	44.37
	June	20.23	38.20	52.33 (c)
	September	20.28	40.28	54.46 (c)
	December	20.50	40.50	45.70
1983	March	20.50	40.50	44.93
	June (a)	20.50	40.64	44.46
	September (a)	20.50	41.57	43.31
	December (a)	20.80	43.65	43.65

SOURCE: IMF, SM/83/150/ (July 5, 1983) Costa Rica - Recent Economic Developments, p. 119.

(a) Consultores Económicos y Legales, Repertorio Económico (Enero 1984 and Marzo 1983).
(b) Denotes Buying Prices.
(c) Peak price market rate average is July 1982 at ¢65.52 per U.S. $1.00.

F. Inflation and Monetary Variables

The inflation not explained by devaluation is explained mainly by the previous but proximate expansion of domestic credit. Orthodox stabilization theory suggests that when domestic credit is growing too fast for consistency with real output growth and trading partner inflation, the balance of payment deficit will grow if it can be financed. Thus, the immediate inflationary impact of excessive expansion of domestic credit leaks abroad through increased imports and the concommitant foreign exchange reserve loss. When these reserves and external borrowing capacity are exhausted, the excessive expansion of domestic banking system credit must then generate a higher rate of domestic monetary growth and inflation. In this regard, banking system domestic credit in Costa Rica expanded by 35 percent in 1978, 42 percent in 1979, and 52 percent in 1980. (See Table VI.) The corresponding rates of increase of banking system net credit to the public sector were 48 percent in 1978, 109 percent in 1979, and 44 percent in 1980. Thus, during the third quarter of 1980, this growing inflationary bomb was finally triggered by the exhaustion of foreign exchange reserves and the forced reduction of commodity imports in 1981 and 1982.

Exploring further a monetary explanation of inflation, during the six-year period 1978 through 1983, total domestic credit expanded by 1,212 percent. However, domestic credit to the public and private sectors grew by only 314 percent and the stock of money (and quasi-money) grew by 362 percent. The growth of negative net international reserves, (defined to include medium and long-term foreign exchange loans to the banking system, and arrearages on external payments) was also very large--from a small base the negative net position grew some ninety-fold during the period. These facts go together in the sense that the strongly negative movement of the net international reserve position liquidated a substantial portion of the stock of money and explained why the stock of money grew much less rapidly than total domestic credit.

What is striking in the case of Costa Rica is that the high growth of total domestic credit (as defined by the IMF) was accompanied by a much lower growth of credit to the public and private sectors. The explanation resides in the build-up of large local currency counterpart arrears by the public sector (simply unpaid external debt service) and exchange subsidies granted by the Central Bank. Inasmuch as these items have the same effect as expanded banking system domestic credit, they are included by the IMF in its calculation of total domestic credit. Costa Rican monetary data do not include this more global concept of domestic credit and have a statistic for domestic credit that is nearly the same as only total credit to the public and private sectors. As expected, one cannot make the linkage from the relatively low rates of expansion shown by these data, for example 14.1 percent and 29.8 percent respectively in 1981 and 1982 and the much higher rates of inflation of these years. Indeed, if these data were truely representive of total domestic credit and given the observed expansion of money, one would also expect to find accumulation of foreign exchange reserves rather than disaccumulation. The IMF version of total domestic credit also tracks well with the decline of Costa Rica's net international reserves, explains the slower growth of the stock of money (liquidity), and corresponds more fully to the observed rate of inflation. If the rapid devaluation in 1981 and the

TABLE VI

PERFORMANCE OF MONETARY VARIABLES, 1978-1983

		1978	1979	1980	1981	1982	1983(a)
Part A. Annual Percent Change							
Aggregate Domestic Credit (IMF Def.)	35.2	41.9	51.5	62.9	104.5	35.5	
Credit to the Public Sector		47.9	108.6	43.8	21.2	20.1	18.0
Credit to the Private Sector		23.8	19.7	13.8	9.8	36.7	34.9
Credit to Public & Private Sectors		n.a.	40.4	24.4	14.1	29.8	28.8
Liabilities to the Private Sector (Money and Quasi-Money, M_3)		29.7	20.8	15.1	27.3	46.4	19.8
International Reserves, Arrears, and Medium Term Foreign Exchange Debt		n.a.	329	142	421	26	34
Part B. As Percent of GDP							
Credit to Public Sector		8.7	15.9	19.0	16.6	11.5	9.9
Credit to Private Sector		28.7	30.0	28.5	22.8	18.6	18.7
Money & Quasi-Money		34.9	38.0	37.5	36.3	35.0	35.3
Part C. In Constant Prices, December 1978 Equals 100.0							
Credit to Public Sector		100	168	300	110	74	82
Credit to Private Sector		100	97	92	48	36	47
Credit to Public & Private Sectors		100	113	118	62	45	55

Source: IMF/SM/83/150 (July 5, 1983) Costa Rica - Recent Economic Developments, p. 102; IMF, EBS/83/127 (June 20, 1983, Staff . . . Arrangement, p. 8.

Note: End-of-year data for 1983 is projected only and not actual.

dampening of devaluation in the second half of 1982 are also considered, the timing lags become understandable. In 1983, the pace of reserve loss, expansion of domestic credit, and growth of liquidity have been nearly identical. In absolute values, domestic credit is the larger magnitude, and the expansion of imports has also had a substantial dampending effect on inflation in 1983.

F. Balance of Payments

Following the balance of payment surpluses in the five-year period 1973-1977, which occurred due to high international prices for coffee and to large capital inflows to the private and public sectors, Costa Rica's over-all payments position has since been in deficit. (See Table VII.) The 1978 and 1979 deficits were relative small, $ 40 million and $ 82 million respectively, due to continued large capital inflows. The most dramatic shift occurred in 1980, when the deficit rose to $ 514 million. In 1981 and 1982 the over-all B/P deficits remained high despite a strong improvement in the trade balance, where a $ 527 million deficit in 1980 was reduced to a $ 28 million in 1982.

The sustained and growing deterioration of Costa Rica's balance of payments from 1978 can be traced to several factors, as follows: (a) deteriorating terms of trade (notably the decline in export prices), (b) a sharp increase in external interest payments which impacted negatively on debt service, (c) the rapid increase in external debt in 1978 and 1979, clearly related to government policy , (d) an intensification of domestic demand pressures stemming largely from expansionary monetary and fiscal policies, and (e) the suspension of public sector payments on external debt service in August 1981.

The data presented in Table VII include interest and amortization payments on external debt as debit items even for the unpaid portion thereof. Thus, the fact of a payment arrearage is recognized as a source of financing for the over-all deficit. In principle this treatment is the same as for a Central Bank arrearage on liquidation of foreign exchange payments for imports, which is a relatively common type of arrearage. This treatment is also justified under the precept that we are concerned about how items are financed rather than whether formal or previously agreed upon transactions did in fact take place.

In reviewing development of the current account, it should be noted that roughly 60 percent of Costa Rica's exports consists in four traditional agricultural commodities: coffee, bananas, meat, and sugar. The remaining 40 percent are exports of non-traditional products, including some manufactured and processed agricultural goods. Following several years of rapid growth associated with the coffee boom and strong performance of non-traditional products, export growth slowed in 1978-80, and exports leveled off at $1.0 billion in 1981 and declined to less than $ 900 million in 1982 and 1983. Much of the weak performance of exports resulted from the fall in coffee prices and a weakening in the demand for nontraditional exports by the other Central American Common Market (CACM) countries.

Contrasting with the mild, 15 percent, decline of export earnings, commodity import expenditures declined from $ 1.5 billion in 1980 to $ 893

TABLE VII

COSTA RICA: BALANCE OF PAYMENTS 1978-1982, 1983 (PRELIMINARY), 1984 (PROJECTED)

(Millions of U.S Dollars)

Part A - Summary B/P	1978	1979	1980	1981	1982	1983	1984
I. Current Account	-363	-559	-664	-409	-252	-383	-394
Merchandise Trade	-302	-455	-527	-209	-28	-143	-185
Exports, FOB	864	942	1001	1003	866	851	899
Imports, CIF	-1166	-1397	-1528	-1212	-893	-994	-1084
Services	-78	-116	-152	-227	-259	-310	-288
Private Profit and Interest	-11	-36	-38	-11	1	-11	-17
Official Interest	-100	-110	-178	-293	-351	-375	-347
(Unpaid Portion)	--	--	--	(121)	(-233)	--	--
Other Services	33	30	64	77	91	76	76
Transfers	17	12	15	27	35	71	79c
II. Capital Account	322	453	127	-35	-81	388	253
Private Investment and Loans of over one year term	137	24	62	26	45	137a	140a
Public Sector,net	225	416	367	20	-65	251	113
Disbursments	419	654	597	330	187	519b	245
Repayments	-194	-238	-230	-310	-252	-268b	-132
(Unpaid Portion)	--	--	--	(-211)	(-179)	--	--
Errors and Omissions	-41	12	-302	-81	24	a	a
III. Other	1	24	23	5	--	13	13
IV. Over-all Balance	-40	-82	-514	-439	-248	19	-128
Official Reserves (+ is decrease)	40	82	173	106	-139	59	-50f
Arrears (+ is increase)(d)	--	--	341	332	387	-78e	--
V. B/P Gap To Be Financed	--	--	--	--	--	--	178

TABLE VII (Continued)

Source: Central Bank of Costa Rica and IMF

Notes: (a) For 1983 and 1984, Errors and Omissions are included in "Private Investment and loans of over one year term".

(b) For 1983, gross disbursements and gross amortization are lowered by $ 192 million if the rescheduling of this unpaid loan principal is excluded, both as a disbursement and as a repayment. Such treatment is also appropriate to obtain the magnitude of disbursements and repayments net of rescheduling.

(c) Includes $ 25 million US ESF grant.

(d) Arrears are unpaid interest and principal payments on public sector debt; a plus sign pertains to accumulation and a negative sign to disaccumulation.

(e) The $ -78 million does not represent only a decrease in arrears in 1983, but it represents the net of the following B/P entries for 1983: (1) $ -1,061.0 million of reduction of arrears, (2) $ +773.9 million of obligations rescheduled to medium term but not, as yet, entered in the capital account of the balance of payments, (3) $ +49.5 million to represent counterpart entry to liquidation of CDs in local currency, and (4) $ +160.0 million in the "revolver credit facility," which is a Central Bank liability.

Part B. As Percent of GDP	1978	1979	1980	1981	1982	
Exports		24.6	23.4	21.8	27.7	34.8
Imports		33.2	34.7	33.2	33.5	34.1
Current Account Deficit	10.3	13.9	14.4	11.7	9.6	
Capital Account	9.2	11.9	4.5	-1.1	-3.2	
Over-all Deficit	1.1	2.0	9.9	12.8	12.8	
Disbursed Public Sector Debt	29.9	35.2	39.2	65.3	102.3	

Part C. Terms of Trade 1974=100.0					
Unit Price of Exports	154.0	161.3	182.1	169.3	167.9
Unit Price of Imports	116.6	133.7	151.7	162.1	175.1
Terms of Trade	132.1	120.6	120.6	104.4	95.9

Source: Banco Central de Costa Rica (Part A); IMF (Parts B and C).

million in 1982, a level about 25 percent lower than that of 1978, and increased to $ 994 million in 1983. The drop in imports was entirely due to a decline in volume and reflected a serious shortage of foreign exchange, a weakening of economic activity, and a large depreciation of the Colon. Imports have also been reduced by a marked decline in public sector investment and lower disbursements of foreign loans associated with those projects.

The deficit in the services account increased rapidly and continuously from only $ 78 million in 1978 to $ 310 million in 1982, largely on account of increasing interest obligations on public sector external debt. Such obligations rose from $ 100 million in 1978 to $ 375 million in 1983. However, due to the general moratorium on debt service payments the accumulation of arrears on interest payments amounted to over $ 350 million in each year 1981 and 1982. The net on non-factor services rose from $ 33 million in 1978 to $ 91 million in 1982 and declined to $ 76 million in 1983. The strong (36 percent) increase of these earnings in 1982 reflected increased tourism.

As is noted above, net capital inflow declined sharply in 1980 and became negative in 1981-82. The weakness of the capital account during 1980 through 1982 resulted from a strong decrease in the inflow of private capital after 1978, a diminishing-to-negative net inflow of official capital after 1980 and strongly negative "errors and omissions" in 1980-81--probably reflecting the flight of private sector liquid capital. For several years prior to 1978, net capital inflow averaged 10 percent of GDP and private capital represented about 60 percent of the gross inflow. In 1978 and 1979 the net capital inflow was high, but whereas private capital inflows declined, public sector external borrowing increased, mainly in the form of new loans from international capital markets.

Costa Rica had a substantial B/P gap or constraint during the entire period presented in Table VII. The need to recess the economy was simply avoided in 1978 and up to approximately 1981 by an attempt to maintain real imports, albeit ultimately unsuccessfully. Thus, the gap was filled first by excessive external borrowing and then by default on the service of that debt. Finally in 1983 the B/P gap was closed by the combined resources of bilateral debt rescheduling, commercial bank debt rescheduling, an IMF Stand-by, and U.S. ESF and PL 480 resources.

Turning to 1984, it must be recognized that the data presented in Table VII are the first official projections of Costa Rica's 1984 external payments, and they may be altered during GOCR-IMF negotiations. Our inspection of data indicates that the Central Bank's projected financing gap of $ 178 million is understated by inclusion of $ 25 million of FSF disbursement in the Transfer (Grant) account and of $ 34 million in the Public Sector Disbursements account. A more serious understatement of the gap appears likely in regard to private capital. The projected net inflow for 1984, $ 140 million, may not be realized due to the fact that this estimate is substantially higher than the confirmed 1982 inflow, $ 69 million. The exceptionally high 1983 inflow, $ 137 million, combining private capital and errors and omissions may not be repeated in 1984 because it may contain a sizeable once-and-for-all return flight of private liquid capital. For this reason the more likely net inflow is $ 30-50 million lower than the Central

Bank projection. There may also be some overstatement of disbursement of loans to public sector entities. More conservatively, the Central Bank projects that 1984 commodity export earnings will increase by 5.6 percent and that 1984 import expenditures will increase by 9.1 percent in nominal dollars, which is about 4.0 percent in real terms. These projections appear reasonable in light of international and Central American market conditions and in light of the real import growth necessary for a GDP growth of about 3 percent during 1984.

In summary, at present writing (February 1984), our estimate of the "true" B/P gap to be financed by IMF and US ESF and PL 480 (Title I) resources is $ 267 million, consisting of the Central Banks projected $ 178 million plus $ 25 million (already-entered) ESF, $ 34 million (already-entered) PL 480, and $ 30 million overstated net inflow to the private sector. This $ 267 million gap contains a $ 50 million projected increase in Central Bank reserves, which is undoubtedly needed to cover seasonal variations in foreign exchange movements.

G. External Debt

Costa Rica's debt service burden has been quite heavy in recent years. Contractual (including short term, IMF, and unpaid) debt service payments more than doubled between 1978 and 1982, from $ 302 million to $ 656 million. This represented an increase in the contractual debt service ratio from 29 percent in 1978 to 58 percent in 1982, and the rise in the debt service ratio in 1981 and 1982 was due in part to the decline in export earnings. However, because of the general moratorium on debt service payments in August 1981, actual debt service payments were only $ 259 million in 1981 and $ 201 million in 1982. Therefore, calculated on the basis of actual payments, the debt service ratio was only 21 percent in 1981 and 18 percent in 1982.

Costa Rica's outstanding (disbursed-basis) public and publicly guaranteed external debt grew at an annual average rate of 25 percent from 1978 to 1982, rising from $ 1.0 billiion at the end of 1978 to $ 2.6 billlion at the end of 1982. Even though reliable information on short-term (less than one year) debt is still unavailable, based on the information that was collected in a recent survey of public sector institutions, outstanding short-term debt is estimated to amount to around $ 300 million, bringing the total outstanding public debt to roughly $ 2.9 billion at the end of 1982. Data on public sector debt is presented in Table VIII with categorization by class of GOCR borrowing entity and class of external lender.

Much of Costa Rica's current debt problem results from the unfavorable terms at which these debts were contracted, particularly between 1979 and 1981. The average maturity of total debt contracted declined from 15.3 years in 1979 to only 9.1 years in 1981, while the average grace period fell from 5.4 years to 3.5 years. Also, the average interest rate rose from 8.7 percent in 1978 to around 11 percent in the following years.

Following the installation of the Monge administration in May 1982, Costa Rica resumed partial payments in respect to arrears. Starting July 15, 1982, Costa Rica began to make monthly payments in accord with a

TABLE VIII

PUBLIC SECTOR EXTERNAL DEBT, DECEMBER 31 OF EACH YEAR

(Disbursed Basis; Loans of Over One Year Term; Millions of U.S. Dollars)

	1978	1979	1980	1981	1982
Total Debt	1,050.4	1,417.4	1,801.7	2,363.8	2,578.0
By Borrower					
Central Government	355.5	452.5	530.5	579.8	622.6
Public Enterprises	364.2	448.2	602.2	706.8	704.7
(of which: ICE)	(272.3)	(322.3)	(422.4)	(485.1)	(501.2)
Public Financial Institutions	282.6	461.3	620.2	1,023.3	1,191.8
Central Bank	152.4	(292.9)	(436.8)	(843.0)	(1,104.7)
Commercial Banks	(121.7)	(151.2)	(162.2)	(159.6)	(158.2)
Other (a)	(8.5)	(16.3)	(21.2)	(20.7)	(18.9)
Rest of Public Sector	48.1	55.4	48.7	52.1	58.9
By Lender					
Bilateral	207.8	256.1	351.3	455.7	582.1
Mexico	--	--	(44.4)	(67.9)	(134.2)
United States	(78.4)	(83.3)	(84.4)	(90.1)	(128.8)
Venezuela	(53.6)	(68.7)	(88.7)	(145.7)	(166.9)
Others	(75.8)	(104.1)	(133.8)	(152.0)	(152.2)
Multilateral	408.8	472.0	546.9	596.2	623.2
BCIE	(125.4)	(142.2)	(150.4)	(156.5)	(157.0)
IBRD	(140.8)	(155.5)	(178.3)	(192.0)	(199.6)
IDB	(137.0)	(165.9)	(210.0)	(239.7)	(258.9)
Others	(5.6)	(8.4)	(8.2)	(8.0)	(7.7)
Commercial Banks	368.4	617.8	708.4	796.3	809.5
Banks/CDs (b)	20.0	19.5	141.4	458.4	502.4
Suppliers	39.9	47.0	49.8	54.2	57.3
Other	5.5	5.0	4.5	3.7	3.5

Sources: National Planning Office (OFIPLAN); Central Bank of Costa Rica; IBRD Debtor Reporting System; IMF staff estimates

Notes: (a) Includes the Savings and Loan Department (DECAP), the National Housing and Urban Institute (INVU), the Cooperative Development Institute (INFOCOOP), and the Community Development Bank.

(b) Includes U.S. dollar denominated certificates of deposits amounting to $293 million in 1981 and $354 million in 1982.

specific formula which related debt service to net monthly export receipts. Monthly payments under this formula in 1982 were distributed according to the share of various groups of creditors in total outstanding arrears, i.e. approximately 69 percent for commercial banks, 6 percent for official bilateral creditors, 5 perecent for bonds, and 20 percent for CDs. Payments under this plan amounted to some $ 40-50 million in 1982. However, significant breakthroughs on major debt rescheduling took place in 1983.

On January 11, 1983, Costa Rica signed a debt rescheduling agreement under the aegis of the Paris Club with ten creditor countries. These creditors agreed to provide debt service relief through rescheduling or refinancing of principal and interest on official and officially guranteed debt or more than one year term, contracted prior to July 1982 and falling due between July 1, 1982 and December 31, 1983. Eighty-five percent of the debt service falling due in the consolidation period is rescheduled for repayment in ten equal semiannual installments starting on September 30, 1987 and ending on March 31, 1992. The remaining 15 percent is to be repaid as follows: 5 percent as obligations fall due, and in no case later than December 31, 1983; 5 percent on September 30, 1984; and 5 percent on September 30, 1985. A "goodwill" clause in respect of debt service payments falling due in 1984 was incorporated in the agreed minute provided that Costa Rica continue to have an upper credit tranche arrangement with the IMF and that it reach an effective arrangement with banks and other creditors for the settlement of debts. Interest to be charged on the rescheduling is determined bilaterally between each of the participating creditors and Costa Rica.

On April 22, 1983, Costa Rica signed a Memorandum of Understanding with the steering committee for the commercial banks regarding debt rescheduling. In essence, the commercial banks agreed to a 100 percent rescheduling of all principal in arrears and falling due up to December 31, 1983 (Tranche I) and all principal payments falling due in 1984 (Tranche II). Furthermore, the commercial banks agreed to provide a revolving credit equivalent to 50 percent of all interest in arrears (payable and due in 1983) and current interest falling due up to December 31, 1983. Interest charged on the rescheduling is 2.25 percent over the three-month LIBOR, or 2.125 percent over the U.S. prime rate or the adjusted three-month U.S. certificated of deposit rate, whichever is higher.

The repayment term of these tranches are as follows: Tranche I. Five percent of all past due and current principal repayments in 1983 have to be repaid as follows: 2.5 percent on January 1, 1984 and 2.5 percent on July 31, 1984. The balance of 95 percent is consolidated and repaid in 18 quarterly installments starting on March 31, 1987 and ending on June 30, 1991 as follows: 20 percent (of the remaining 95 percent) in 1987, 20 percent in 1988, 25 percent in 1989, 25 percent in 1990, and 10 percent in 1991. Tranche II. Five percent of principal repayments falling due in 1984 are rescheduled and repaid on January 1, 1985. The remaining 95 percent is consolidated and repaid in 14 quarterly installments starting on March 31, 1988 and ending on June 30, 1991 as follows: 25 percent in 1988; 30 percent in 1990; and 20 percent in 1991.

The revolving credit is in the form of (a) disbursements in direct payment to an exporter, (b) disbursements to the borrower in reimbursement of

amounts certified by the borrower as having been paid to the exporter between April 1, 1983 and the date of the revlving agreement, or (c) disbursements against letters of credit. Repayment of each individual loan under this facility must be made not later than 180 days after the date of disbursement, and repaid amounts could be drawn against.

The total amount available under the revolving credit is equivalent to 50 percent of the interest (current and past due) which has been or shall be paid subsequent to December 31, 1982 and prior to January 1, 1984. It is estimated that this revolving agreement amount to around $ 225 million. The interest rate applicable to the revolving credit is 1.75 percent over the three-month LIBOR or 1.625 percent over the adjusted three-month U.S. CD rate, whichever is higher. Repayment of the revolving credit takes the form of lowering the total outstanding amounts that are available. In effect, repayment takes place at the rate of 20 percent by May 1985, another 20 percent by November 1985, another 20 percent by February 1986, and finally, the remainder of 40 percent will have to be made by May 1986.

II. PUBLIC SECTOR FINANCES

A. Developments Since 1977

The financial picture for the consolidated public sector in Costa Rica improved markedly in 1983 after experiencing a crisis between 1979 and 1981. The public sector deficit rose from 6.7% of GDP in 1977 to 13.7% in 1981 before it was reduced to 9.5% in 1982 and about 5% in 1983. Finances both in the general government and in the public sector enterprises were responsible for these developments. As tax revenues stagnated under falling export prices and the general economic downturn, and as expenditures were fueled by growing external debt service, the current account deficit of the general government grew from .5% to 2.3% of GDP between 1977 and 1980. The rapid devaluation of the colon and the subsequent rise in domestic inflation were not accompanied by increases in the rates and charges of the state enterprises; consequently, the current account of the public sector enterprises moved from a surplus totalling 3.4% of GDP in 1977 to a deficit equalling 2.8% of GDP in 1981.

The absence of reliable data precludes an accurate assessment of public sector finances for 1983, but all indications point to an improvement. A conservative estimate of the public sector deficit in 1983 is between 4 and 5% of GDP, down from 9.5% in 1982. This decline can be attributed somewhat to expenditure cuts in the general government that began in 1982, but the lion's share of the improvement belongs to a sharp reversal in the financial fortunes of the public sector enterprises. Increases in rates and charges (mainly in the state owned petroleum refinery RECOPE and in the electric power company ICE) turned a public enterprise current account deficit that equalled 2.7% of GDP in 1982 to a surplus of around 2% in 1983.

Financing of the public sector deficit has bounced from banking system credit to foreign loans to domestically placed debt. In 1978, banking system credit financed 31% of the deficit; in 1980 that figure had risen to 45%. In 1981 and 1982 disbursements of previously contracted external debt and nonpayment of contracted interest covered most of the deficit. In 1983, with an IMF program that set limits on banking system credit to the public sector and external borrowing, private sector purchases of public sector bonds filled the gap. And this occurred due to very attractive yields and tax exempt features of these bonds.

B. Outlook for 1984

The lack of solid data for 1983 also hampers projections for 1984, but it is fairly certain that without the recently enacted (February 1984) emergency revenue and expenditure measures, the public sector deficit would again be on the rise in 1984. Wage increases for the public sector -- many of which were approved last year but deferred until 1984 -- and other expenditure increases were featured in the 1984 budget submitted to the National Assembly. These, along with revenue projections under an assumed 15% nominal increase in GDP, would have produced a consolidated public sector deficit totalling 6.7% of GDP in 1984, a reversal of the downward trend that began in 1982.

An emergency law was passed in February of 1984 that contained several revenue increasing and expenditure reduction measures. Among these were:

-- a 10% income tax surcharge (to replace the
-- obligatory transfers from the state enterprises to the central government
-- assorted cuts in general government expenditures including subexecution

It is estimated that these recently enacted measures -- as well as a 25% increase in the sales tax on gasoline that the National Assembly will soon consider -- will reduce the consolidated public sector deficit to 3.3% of GDP from the without-measures projection of 6.7% in 1984. However, it must be emphasized that these budgetary actions are stopgap in nature and do not reflect a durable restructuring of public sector finances.

C. Structural Problems

The central problem of public sector finances in Costa Rica today is the absence of current account savings. Without savings, it will not be possible to finance public sector investment without relying excessively on internal and/or external debt.

1. The General Government

Examinating the structure of general government revenues and expenditures in the light of political reality suggests that the larger margin for improvement lies with the former. Expenditures in the general government in 1983 were lower as a percentage of GDP than in 1977, and government employment was lower than in 1980. A contraction in expenditures that would be politically feasible would not yield significant savings on current account. This is not to say that expenditures should not be restrained. The current level of expenditures as a percentage of GDP (about 20%) should be maintained by a freeze on public sector employment and moderation in wage increases.

General government current account savings can best be generated by increasing the efficiency and bouyancy of the tax system. Direct taxes (25% of total revenue in 1982) should be reformed by removing the income tax surcharge which acts as a disincentive to investment. The revenues lost through this action could be replaced by improving the efficiency of collections through computerization, better trained staffs and by more diligent pursuit of past due collections.

The structure of indirect taxes on domestic and international trade could also be reformed. The domestic indirect taxes (28% of total revenues in 1982) could be restructured along the lines of a value added tax. But the greatest impact would come from changes in the structure of taxes on imports and exports. Tax revenues from import tariffs (8% of total revenues in 1982) would fall under the lowering of the CET (common external tariff). Tax revenues from exports (37% of total revenues in 1982) would also be lowered by completely eliminating the tax on non-traditionals to third markets and by substituting a graduated marginal tax for the specific taxes now

TABLE IX

COSTA RICA: OPERATIONS OF THE NONFINANCIAL PUBLIC SECTOR

Colones (millions)

	1977	1978	1979	1980	1981	1982	1983 1/	1984 2/	1984 2/
I. Current revenue	6306	6816	7691	8687	10060	16327	23000	23800	27800
A. Tax revenue	4986	5978	6687	7662	10732	18165		-	
1. Direct taxes	(1920)	(2661)	(2953)	(3345)	(4402)	(7304)		-	
2. Indirect taxes	(3066)	(3317)	(3734)	(4317)	(6330)	(10861)		-	
B. General Government Non-Tax Revenue	983	1373	1460	1737	1152	1650	-		
C. Public Enterprise Current Account Surplus or Deficit	886	291	14	7	-1627	-2635	(2000)	(1800)	-
D. Adjustment	-549	-826	-470	-719	197	-853			
II. CAPITAL REVENUE	20	19	47	73	208	364	350	350	350
III. TOTAL EXPENDITURE	8083	9513	11960	14262	18075	25887	29500	34000	33000
A. General Government Curent Expenditures	5562	6411	8133	9638	12237	19702	20250	25000	
B. Capital Expenditures and Net Lending	2521	3102	3827	4624	5838	6185	9250	9000	-
(1) Fixed Capital Formation	(2117)	(2420)	(3113)	(3799)	(5222)	(5247)		-	
(2) Transfers	(72)	(110)	(88)	(56)	(260)	(362)		-	
(3) Other	(332)	(572)	(626)	(769)	(356)	(576)		-	

CONT. TABLE IX

	1977	1978	1979	1980	1981	1982	1983 1/	1984 2/	1984 2/
IV. OVERALL SURPLUS OR DEFICIT - FINANCING	-1757	-2678	-4222	-5502	-7807	-9196	-6500	-9850	-4850
A. External (net)	-	1764	1937	1936	4767	2094	2100		
B. Domestic	-	887	2713	2699	1739	2697			
(1) Banking System and Non-Bank Intermediaries	-	(824)	(2792)	(2481)	(1684)	(1971)	2200		
(2) Private Sector	-	(65)	(-145)	(266)	(-76)	(582)	2200		
(3) Change in Floating Debt	-	(-2)	(66)	(-48)	(131)	(144)	-		
C. Interest in arrears (change)	-	-	-	-	1655	4066	-		
D. Residual	-	27	-428	867	-354	339	-		
Memorandum Items:									
GDP (in current colones)	26331	30194	34584	41405	57176	97068	127771	147000	147000
Overall surplus or deficit as a % of GDP	6.7	8.9	12.2	13.3	13.7	9.5	5.1	6.7	3.3
General government current account surplus or deficit as % of GDP	-0.5	.4	-1.3	-1.0	-.8				
General government current expenditures as % of GDP	21.1	21.2	23.5	23.3	21.4	20.3			
General government current revenue as % of GDP	20.6	21.6	22.2	21.0	20.4	19.5			

1/ estimated
2/ projected

SOURCE: IMF, USAID/ROCAP estimates

applied to bananas, meat and seafood. The specific tax on bananas provided 13% of total revenues in 1982, but with low world prices for bananas, it is imposing a burden on banana producers and one likely to result in a production decline. But these revenue looses would be replaced, and overall indirect tax revenues increased, by the elimination of the free entry of capital goods under the fiscal incentives law. If a 10% tariff were placed on the importation of machinery and equipment -- a measure recommended under the World Bank Structural Adjustment Loan proposal and one that would not discourage investment -- the revenue gain would be considerable. For example; in 1982 it would have amounted to almost 3 billion colones, an amount that would equal 22% of total revenues collected in that year, and half of the amount collected through all taxes on international trade.

In all, these reforms would make it possible to increase total revenue to 25% of GDP from the 20% that exists today. If current expenditures were held to 20% of GDP, the added revenues would generate a 5% savings in the current account of the general government.

2. The Public Sector Enterprises

A current account surplus must also be established -- or rather, re-established -- in the finances of the public sector enterprises. In 1977, the 15 enterprises collectively generated a current account surplus equalling 3.4% of GDP. In 1983, it equalled 2.2% of GDP, but this consisted largely of the surpluses of RECOPE. Others, such as CODESA, CNP, IDA and ICAA, accumulated deficits. Rates should be increased for power and telephones (ICE), water (ICAA) and the railways (FECOSA). In some cases, cost reduction could be affected by reducing employment through attrition and improved management practices.

3. The Problem of CODESA

The largest problem among the state enterprises is the holding company, CODESA, and as such, it deserves special mention. CODESA was formed in 1972 as a development institution to promote new productive activities in Costa Rica. Thirty-three percent of the common stock and 4 of the 7 directors were to go to the private sector.

During the last 10 years CODESA has taken a controlling interest in 27 companies, of which 8 were liquidated, 2 are inactive leaving 17 active operating companies. Of these 17, only four can be regarded as new industries. In 1983 CODESA's group of companies had a current account deficit of 973 million colones which was financed by bond issues sold to the Central Bank. The largest and most serious indebtedners of the CODESA group is with foreign banks; as of September 30, 1983, it mounted to $77.3 million plus $7.9 million in past-due interest.

The condensed financial information of the CODESA group of companies shows that during its 10 year of existence CODESA was not able to create a single viable new industrial entity. It has, therefore, contributed very little to the industrial development of the country. On the contrary, it has diverted a substantial amount of scarce financial resources to unproductive enterprises. The cash-flow position of CODESA would be greatly improved by the liquidation and/or restructuring of the four enterprises that represent 75% of CODESA's portfolio: FERTICA (fertilizer), CATSA (sugar), ALUNASA (aluminium) and Cementos del Pacífico (cement).

TABLE X

Costa Rica: Central Administration Revenue

(millions of colones)

I. TOTAL REVENUE	4026		12792	1.00
A. Tax revenue	3887	.97	12482	.98
1. Direct taxes	1043	.26	3215	.25
2. Indirect taxes	2844	.71	9267	.72
a. Domestic	1479	.37	3562	.28
b. International	1365	.34	5705	.45
(1) Taxes on imports	652	.16	982	.08
(a) Import duties	447	.11	647	.05
(b) Import surcharges	170	.04	301	.02
(c) Other	35	.01	34	.01
(2) Taxes on exports	709	.18	4712	.37
(a) Ad-valorem	239	.06	1542	.12
(b) Bananas	198	.05	1681	.13
(c) Coffee	248	.06	699	.05
(d) Exchange differential	-	-	766	.06
(e) Other	24	.01	24	.01
(3) Other	4	-	11	-
B. Non-tax Revenue	139	.03	310	.02

SOURCE: IMF

III. THE FINANCIAL SYSTEM

In Costa Rica, financial intermediation is largely in the hands of the state owned banking system. State banks mobilize almost 100 percent of total deposits and provide about 95 percent of total Banking System credit. Private commercial banks and private finance companies cannot accept demand and savings deposits from the domestic private sector; consequently, they are limited to their own capital, to borrowing from abroad and to time deposits over six months.

Government owned banks as well as private financial intermediaries are subject to Central Bank control. In the main, regulations are concerned with legal reserve requirements, interest rates ceilings and the composition of loan portfolios.

A. Structural problems within the state banking system (SBN)

There is concern that the structural problems that now exist within the SBN rob it of the flexibility which it needs to respond to the credit demands of new, dynamic sectors of the economy and if these are not dealt with, a major constraint will be posed to the growth of the Costa Rican economy over the next decade. The major problems will be addressed in this section are: credit ceilings, differential interest rates, subsidized credit, high administrative costs and overregulation.

1. Administered credit

Until last year, the Costa Rican banking system had the policy of administratively setting low subsidized interest rates. The excess demand that resulted was administratively rationed by means of a complicated system of credit ceilings and differential interest rates.

The annual credit program is one of the main devices that the Central Bank utilizes to allocate credit resources of the state banks among different economic activities. This instrument consists of quantitative, quarterly, portfolio ceilings that are established by the Central Bank for each of the four state banks on broad economic activities as well as on a product-by-product basis. The ceilings established for activities that the government wants to promote are set high, and low for those activities that the policymakers wish to discourage. In this manner, the program administratively discriminates among activities and products. For example, activities such as commerce, services and housing, were until recently almost completely rationed out of the credit program. With respect to private banks and finance companies the credit programs only specifies a certain portfolio composition.

Along with the credit ceilings, the Central Bank sets the interest rates to be charged on loans. These regulations are also applicable to private banks and finance companies. The interest rate structure that results from these regulations does not necessarily reflect differential costs or risks associated with different classes of borrower or with different economic activities, but principally the desires of policymakers to favor some sectors or activities over others.

The administrative allocation of credit has rendered the SBN very inefficient. Scarce credit resources do not go to the socially most profitable uses, but largely to where policymakers and bank officials and administrators wish to channel it. Political pressure, friendship, collateral and compensating balances play a large part in credit allocation.

Subsidized credit is utilized by Central bank as a mechanism to promote the development of new products and to provide cheap credit to small producers. However, interest subsidies have proven to be a very poor tool in achieving these results. The size of the subsidy is proportional to the size of the loan and the size of the loan is proportional to the wealth of the borrower. Accordingly, wealthy borrowers receive large subsidies, while small producers receive small subsidies or none of all. Consequently, the subsidy seldom reaches its intended beneficiaries. Moreover, it is doubtful that small producers really need subsidized credit to produce or diversify into new products. If they find that producing is not profitable, they will not produce, regardless of the subsidies.

All these mechanisms have restricted the access of borrowers to credit and have contributed to a high concentration of loan portfolios with consequences for the distribution of income. A study conducted by the University of Costa Rica's Institute for Economic Research in 1978, showed that the degree of concentration in the loan portfolios of the state banks was very high. In one typical institution 1.6 percent of the loans accounted for more than 45 percent of the credit.

The Costa Rican banking authorities have demonstrated that they are cognizant of these problems and have made some improvements in the system. A state bank commission has been appointed to examine problems in the SBN. This action may, however, prove to be more symbolic than productive, for the members of this commission are, for the most part, former senior executives of the SBN who have on previous occasions moved with glacial slowness on issues of banking reform.

More significant has been a reduction in the administration of credit and a little movement--under pressure--towards improving the relative position of the private banks. The number of credit categories, or ceilings, has been reduced from 75 to 6 and the set of differential interest rates from 6 to 5. The private banks are now able to set their active and passive rates one point higher than the state banks.

2. Reserve Requirements and Bank's Costs

Administrative costs in the SBN is high, mainly as a result of the virtual absence of competition. Bank administrators have no incentive to adopt new financial technology and to reduce the bureaucracy and the excessive red tape that results from excessive and rigid banking regulations.

Banks are subject to high reserves requirements on deposits. The reserve requirement for demand deposits is 32 percent (7 percent has to be held in low yielding government bonds) and the reserve requirement on time deposits is 10 percent to be held in government bonds. These regulations apply also to private banks and finance companies. High reserve requirements and high administrative costs translate into high costs for savers through lower returns and for borrowers through increased cost of funds.

TABLE XI

INTEREST RATES ESTABLISHED FOR THE 1983 AND 1984 CREDIT PROGRAMS (PERCENT

	Avg. 1983		Jan. 1984	
	Interest	Com (A)	Interest	Com (A)
A. Interest Rates Established by Law				
1. Forestry activities included under the regulations of Law No. 6184	8	-	9	-
2. Discounts of collateral paper	8	17.5	8	13.5
3. Self governing campesino communal enterprises (Law 5494)	8	4	8	4
4. Cooperatives of Small Agricultural Producers Assisted under the ITCO Law No. 5494	6	6	6	6
B. 1. Small agricultural, industrial and artisan producers	12	-	12	-
2. Development of rural women and youth	12	-	12	-
3. Cattle raising -beef production	18	-	-	-
4. Cattle raising -milk production	18	-	-	-
5. Coffee, sugar and rice marketing, cattle fattening and raising, manufacturing, agroindustry, construction and housing	25.5	-	21.5	-
6. Rest of agricultural activities	22	-	18	-
. Rest of economic activities	30	-	26	-

(A) Annual commision

A. Obstacles to Nontraditional Export Growth

The exchange rate or, broadly speaking, the exchange rate regime, incorporates the price signals that provide the incentives -- or the disincentives -- for exports. An overvalued exchange rate will encourage production for domestic markets at the expense of foreign markets. This really applies to exports of manufactures -- or other nontraditionals -- and not to traditional commodity exports such as coffee, bananas, beef and sugar whose prices are quoted in dollars in international markets. An overvalued exchange rate, while affecting the level of farm incomes in the traditional commodity sector, will not make these commodities less price attractive to foreign buyers.

B. Purchasing Power Parity

In the first instance, currency overvaluation can occur when domestic inflation rates are higher than those in the country's trading partners. It is not certain, however, that such is now the case in Costa Rica. Comparing only Costa Rican domestic inflation to the devaluation of the colon, we see no immediate evidence of overvaluation: from January 1980 to December 1983, there was a 3.5 fold increase in the wholesale price index, but a 4 fold devaluation of the effective rate at which exporters were liquidating export earnings. More sophisticated calculations yield slightly different results. Using a World Bank/IMF purchasing power parity methodology and data from 1974 (when most agree that the colon was in rough equilibrium) to mid-1983, it was found that the colon was about 6% overvalued when the set of trading partners includes only the U.S. and about 16% when the set is broadened to include other high income markets for Costa Rica's nontraditional exports.

However, the results of these calculations must be judged in light of recent developments in Costa Rica and in light of the value of the U.S. dollar. At the end of 1983, the government unified the interbank and free rates, reducing the number of exchange rates to two, and reduced the percentage of export proceeds that must be liquidated at the official rate. These actions effectively devalued the colon by 8%. Furthermore, inflation at the wholesale level in Costa Rica, which had already begun to slow in the beginning of 1983, slowed dramatically in the last half of the year. Lastly, the calculations that include a set of trading partners whose currencies are not tied to the dollar (such as Western Europe) have been strongly influenced by the overvaluation of the dollar. A 10% slide in the value of the dollar against the main European currencies (which some analysts predict for the 2nd half of 1984) together with the developments that have already taken place in Costa Rica late last year, may be enough to signficantly reduce the degree of overevaluation that existed in mid-1983.

C. The Trade Regime

In the second instance, commercial policy, or the pattern of trade arrangements, leads to a degree of overvaluation. Import restrictions tend to lesser the demand for foreign exchange hence the pressure on the exchange rate will be lower than it otherwise would be. This situation exists in Costa Rica. The common external tariff (CET) adopted by all the CACM member

countries forms a protected regional market for import substitution industries. Import substitution is encouraged for those imports which bear high tariffs and duty free imports -- intermediate and raw materials for import substituting industry -- are subsidized by the low price of foreign exchange.

D. A Policy to Stimulate Extraregional Exports of Nontraditional Products

A flexible exchange rate regime, rather than a specific devaluation, would be the most prudent course of action for Costa Rica to follow at this time. It is not certain that at the present time the colon is significantly overvalued on a purchasing power parity basis. What is important is that the authorities remain firm in their announced intention of moving from a fixed rate system to one that incorporates a flexible response to conditions that worsen the competitive position of nontraditional exporters.

The Government of Costa Rica should take action to remove those features of the trade regime that discourage export growth:

-- The overall level of the CET should be lowered and tariffs on intermediate and capital goods should be raised. These measures will bring competitive pressures against final goods industries and encourage investment in intermediate and capital goods industries.

-- Export taxes on nontraditional products to extraregional markets should be eliminated completely.

Traditional exports should not be ignored in the reform of the trade regime. Quantitative restrictions on export quality beef and sugar should be minimized. Export taxes should follow the graduated marginal tax now applied to coffee exports rather than the specific taxes that are applied to bananas and seafood.

TABLE XII

Costa Rica: Composition of Exports, 1981
(US $ 000)

		Regional	Extraregional	Total
I.	(Traditional) Primary products	3.6	489.1	492.7
II.	Manufactured products	226.7	259.6	486.3
III.	Other	7.7	21.3	29.0
IV.	Total	238.0	770.0	1008.0