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CONCEPTS PAPER

ESF PROGRAM FY1984

I. INTRODUCTION

The purpose of this paper is to provide a basis for a discussion of the conditionality and other elements that should be negotiated with the GOCR in the context of the FY 1984 ESF Agreement. It should, however, be recognized that some items may have to be postponed to FY 1985. The paper indicates the strategy which the Mission has been pursuing. It also describes the status of the preparatory work on conditionality undertaken to date, and sets forth proposals and issues concerning specific policy and structural reforms, IMF relationships, levels and composition of assistance, and uses of dollars and local currency. It is hoped that guidance can be provided to the Mission which is explicit as to priorities and negotiating parameters, but which permits maximum flexibility in the conduct of the negotiations themselves. The results will be reflected in the PAAD

It is anticipated that formal negotiations with the GOCR will begin immediately upon completion of the review of this Concepts Paper. This is conditional, however, on the status of the GOCR's negotiations with the IMF. The Mission considers the AID and the IMF Agreements to be mutually supportive actions. We must, therefore, know -- at least on an informal basis -- what will be stipulated in the IMF Agreement before getting down to specifics in our own negotiations. Close coordination with the IMF is thus essential.

In FY 1982 and FY 1983, all ESF Agreements were with the Central Bank (BCCR). It is probably neither practical nor desirable to continue with this pattern. The reason is that many of the structural reforms we wish to incorporate in the FY1984 Agreement lie outside of the mandate of the BCCR. The alternatives open to us are to execute one Agreement with the Central Government, or to execute two Agreements: one with the BCCR and one with the Central Government. If all the ESF assistance is provided on a grant basis, it would be possible to process one Agreement with the Central Government rather than two Agreements. The leverage with the GOCR might be greater if this procedure was used and the total amount of the FY 1984 assistance was tied to its acceptance of the reforms embodied therein.

The principal reason for considering two Agreements is the relationship between the dollar cash flow requirements of the BCCR during the first quarter of FY 1984, and the timing of our initial disbursements. The provision of some funds, starting not later than March or April, will be of over-riding concern. We believe that we can reach speedy agreement with the BCCR on conditionality items that lie within its mandate, and meet a March/April initial disbursement date. Other items may require considerably more time to analyze and negotiate. These would be left to a second and later Agreement with the

Central Government. We do not believe that negotiations with the Central Government covering all aspects of structural change could be completed, reflected in a PAAD, and then consolidated into a formal Agreement in time to initiate disbursements before May or June. We thus recommend planning on two Agreements.

It will be noted that the feasibility of a one Agreement approach was made conditional on funds being made available on a grant basis. The justification for grant funding will be set forth in Section V. of this paper. In the present context, i.e. the relationship between grant funding and one Agreement with the Central Government, the qualification stems from the Mission's concern that the Agreement(s) be so structured that they do not require ratification by the Legislative Assembly. Under Costa Rican law, loans to the Central Government require ratification; grants do not. Operations of any type with the BCCR are also exempt.

We have given serious consideration to the pros and cons of crafting the Agreement(s) so that they would require ratification by the Legislative Assembly. On the one hand, almost all structural reform measures will require legislative action at some point in the process. Consequently, it can be argued that legislative ratification would provide for cognizance of the reforms by that body, and something of a commitment to take positive action when proposals were presented to it by the Executive.

The arguments for avoiding legislative ratification are two: the uncalculable delay factor that is implicit in such a procedure; and more importantly, the certainty that an open debate would ensue in which the U.S. would be charged with interference with national sovereignty, unfavorable headlines in the press, and perhaps a demogogic refusal to ratify as an end result. In sum, while conceptually there is much to be said for requiring legislative ratification, the realities of the Costa Rican political scene argue in favor of a more prudent and pragmatic position. All the proposals that follow in this document are thus based on the position that we will not seek legislative ratification.

Assuming a two Agreement procedure, with no legislative ratification, we see the following schedule of events:

Mid-February[1/] - Submit a PAAD to AID/W covering funds and conditions relating to an Agreement with the BCCR.

Mid-March.- Sign Agreement with BCCR and make initial disbursement not later than April .

First Week in April[1/] - Submit a PAAD Amendment covering funds and

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1/ To the maximum extent possible, the initial PAAD will be a comprehensive document covering the full FY 1984 ESF program. It will deal with the subject matter of the first Agreement, and it will indicate those specific conditionality items and uses of local currency which require further discussion and negotiation with GOCR agencies. These latter items will consequently be covered in the PAAD Amendment, which, it is hoped, will be limited to dealing with these topics.

conditions relating to an Agreement with the Central Government.

Mid-May - Sign Agreement with the Central Government and begin disbursing in June.

II. BACKGROUND TO THE 1984 NEGOTIATIONS:

The objectives of USAID strategy in 1983 were to stabilize the economy, and in the process, to halt the decline in Gross Domestic Product. USAID's strategy was to condition U.S. Economic Supporting Assistance for FY 1983 on compliance with the IMF Standby program. This program was successfully concluded December 19, 1983. Largely as a result of this approach, and the successful renegotiation of foreign debt, Costa Rica's balance of payments gap was closed, inflation dropped from near triple digit levels to less than 10%, the multiple exchange rates were unified, and the exchange rate stabilized, the public sector deficit was reduced, and larger amounts of credit were freed up for private sector uses. In short, a modicum of stability was achieved. There is also some evidence that the three year decline in GDP has been inhibited if not halted. The challenge in 1984, and indeed the objective of our strategy, will be to consolidate the economic stabilization effort and to bring about the enactment and execution of the major structural reforms required to begin a new period of sustained, export led, economic growth.

Unfortunately, the achievement of these objectives will be complicated by some disquieting signs on the horizon. One of the more serious of these is the public sector's fiscal year 1984 budget, which has a projected deficit of ¢15 billion. In part, this is due to the GOCR having accepted, during 1983, average wage increases for public sector employees of at least 35% in nominal terms, postponing some of the payments to 1984. These wage adjustments have permitted public sector employees to recuperate 50% to 60% of the drop in purchasing power incurred during the 1980-82 period. The projected deficit is three times the amount otherwise compatible with economic stability. As a result, the negotiations for another IMF Standby Arrangement, which, ideally, would have succeeded the recently concluded Standby without interruption, are in a state of suspension. The IMF reportedly is unwilling to discuss a new agreement until the GOCR programs the reduction of the projected deficit. Moreover, contrary to our expectations, and in spite of a hiring freeze, the Monge Administration has created over 6,000 new jobs in the public sector. Finally, many Costa Ricans believe there is no further need for continued austerity, a factor which will inevitably ensnarl the administration's effort to put its fiscal house in order.

III. USAID STRATEGY

In shifting from a relative emphasis on stabilization to stabilization plus economic recovery, with all that this implies in the way of structural reform, the Mission broadened the scope of its policy dialogue with the Government in August, 1983. It was agreed with key officials at that time, that it would be preferable if the GOCR would take the lead in formulating and proposing needed structural reforms and policy changes. AID could then support these proposals, rather than having them take the form of U.S. imposed conditions. As a result, the GOCR created an Interministerial Commission to prepare a concepts paper on economic policy strategy, and actions required over the next three years to implement the strategy. The Commission was made up of the President of the Central Bank, and the Ministers of Planning, Finance, and Exports and Investment. A technical level working party, in which AID participated in an advisory capacity, prepared recommendations for consideration by the Ministers on a program of structural changes needed to attain extra regional, export led growth. These were embodied in a document entitled "Strategy and Actions in Economic Policy, 1984-86." The document has been revised by the Ministers and submitted by them to the President. A translation of the version submitted is attached as Annex 1. The initial reactions at the level of the Presidency have been positive as concerns the substance of the document. Present plans are to submit the document to the full cabinet for consideration, with a view to issuing a final, public version by mid February. The Presidency has also indicated that it wants the document to be "dressed up" for public consumption.

Present USAID strategy is based on the assumption that the document in question will be approved and publicized without substantial modification as a GOCR economic policy framework. We can then relate specific conditionality requirements to this document. The psychological setting for negotiations, and their possible public relations implications, will be much more favorable if this assumption becomes reality. However, we are prepared to deal with the same substantive matters without a GOCR policy document to which we can relate.

Our strategy further calls for addressing as many of the structural reforms as is feasible in the context of the 1984 Agreements, at least in terms of seeing that initial steps (sometimes only a study) are taken in 1984. There are several reasons for this tactic, rather than one of singling out a small number of reforms where the analysis is more advanced and where conditionality can be more specific. These are: (1) the interaction of all macro-economic policy factors in achieving export led growth; (2) the fact that 1986 is an election year in Costa Rica and, therefore, delay in initiating movement towards needed reforms beyond 1984 could result in postponing such initiatives until 1987, and (3) our view that structural reform and policy change need to be viewed as a process over time, rather than as the achievement of a few changes at any one point in time, even if they are important ones.

The above statement of general strategy is not intended to signify that we attach equal weight and assign equal priority to all policy changes and structural reforms. Our first priority is a combination of improvements in the financial intermediation situation, exchange rate policy, agreement with the IMF, and passage of a law facilitating the opening of new free zones. This is followed by progress in removing taxes that are disincentives to export and production, and by measures relating to decreases in public sector expenditure. All other reforms fall into a third category of priorities. We propose to give effect to these priorities by the way in which we structure the conditions precedent and covenant aspects of the negotiations. The priorities and the manner in which the conditionality is formulated can be categorized as follows:

A. First Priority Items

1. Prior Actions to Signing Any ESF Agreement - Legislative approval of modifications to the Currency Law and the Central Bank Laws (see Section IV. D. 1. below); and of modifications to the Free Zone Law (see Section IV. D. 6. below).

2. Conditions Precedent to Initial Disbursements Under Any ESF Agreement - Formal agreement with the IMF (see Section IV.B. below). To be included in the Agreement with the BCCR and, if still an open issue, in the Agreement with the Central Government.

3. <u>Conditions Precedent to the Second Disbursement to the BCCR</u> - Interest rate reform and credit allocation reform (see Section IV.C. below). To be included in the Agreement with the BCCR.

4. <u>Covenants in the BCCR Agreement</u> - Criteria and reporting requirements on exchange rate policy (see Section IV. C. 2. below).

B. <u>Second Priority Items Dealt with as Covenants</u> - Tax reform and actions relating to reduction in public sector expenditure (see Sections IV.D. 2. and 3. below).

1. Tax Reform on export taxes (see Section IV. D. 2. below). To be included in the Agreement with the Central Government.

2. Action plans for transfer of entities and functions from the public to the private sector (see Section IV. D. 3. a. below). To be included in the Agreement with the Central Government.

3. Action plans for reduction-in-force of public sector employment (see Section IV. D. 3. b. below). To be included in the Agreement with the Central Government.

C. <u>Third Priority Items Dealt with as Covenants</u>

1. Limitations on credit to CODESA, the GOCR holding company (see Section IV. C. 4. below). To be included in the Agreement with the BCCR.

2. Submission of legislation on Tax Administration Reform (see Section IV. D. 2. below). To be included in the Agreement with the Central Government.

3. Progress reports on revision of pricing policies (see Section IV. D. 4. below). To be included in the Agreement with the Central Government.

4. Progress reports and submission of draft legislation on external tariff reform (see Section IV. D. 5. below). To be included in the Agreement with the Central Government.

5. Progress reports on export and investment promotion activities (see Section IV. D. 6. below). To be included in the Agreement with the Central Government.

Finally, our strategy provides for continuing the practice of tranched disbursements, so that we can effectively monitor and seek compliance with agreed upon actions.

IV. CONDITIONALITY

A. General

Reference was made earlier to the GOCR Economic Policy document attached as Annex 1. In terms of economic ideology this document represents a marked departure from the traditional position of the National Liberation Party, the party in power. It will undoubtedly give rise to debate within party circles. Party leadership, is endorsing the concepts contained therein. If this group holds to its position, and manages to educate and convince other elements in the party of the advisability and, indeed, necessity for the stated changes, this may well mark a major turning point in Costa Rica's development.

The GOCR policy document sets forth a development strategy which we can accept. When it comes to specific measures and policy changes, it generally points in the right direction but lacks specificity. However, it does provide an adequate and useful framework within which to consider conditionality elements of the FY 1984 ESF program.

To a considerable degree, the version of the GOCR document that was prepared by the technical level working party for consideration by the Ministerial Commission did contain the needed specificity. The Ministers, who — as might be expected -- examined the technical recommendations not only from a substantive, but also a political viewpoint, were responsible for watering down of the proposed actions. We see the ESF Agreement as an instrument through which to reintroduce the necessary specificity. We will consider making the GOCR document an Annex to the ESF Agreements, and cross referencing specific conditionality requirements to the indicated sections of the Annex.

B. IMF/ESF Agreement Relationships

We propose to require as a condition precedent to any disbursement of FY1984 ESF funds the existence of a formal agreement for CY1984 between the GOCR and the IMF. Alternatively, we could, advise the GOCR that we are not prepared to sign any Assistance Agreements until they have reached agreement with the IMF. However, we believe that the incentive to conclude an agreement with the IMF is greater under a C.P. to disbursement. Furthermore, we prefer not to incur the delays and consequent time pressures that are implicit in waiting to prepare and negotiate an ESF Agreement until after the IMF Agreement is finalized. The Mission also proposes to continue requiring a special provision which permits suspension of ESF disbursements if it is determined that Costa Rica is in substantial non-compliance with the IMF.

We assume that any agreement between the IMF and the GOCR will deal adequately with limits on money supply, net foreign exchange reserves, exchange rate unification, credit to the public sector, the size of the public sector budget deficit, compliance with debt servicing obligations, the rate structure of public utilities, limits on external borrowing, and wages policy. Consequently, we will not deal in this paper with any of these items as conditionality elements to be considered for the ESF Agreement. However, if it is determined that the manner in which the IMF deals with any of the above topics does not fully reflect AID's developmental objectives, we would propose to supplement the IMF requirements.

C. Policy Changes to be Required of the Central Bank

There are two priority items to be dealt with: management of credit and interest rates; and exchange rate policy.

1. Credit and Interest Rate Management - Sections IV.1. b. and c) of the GOCR document provide a conceptual basis for a simplification and rationalization of the management of credit and interest rates. We propose to build on this, and to develop and negotiate both a condition precedent to a second disbursement to the BCCR and a covenant that set minimum standards and provide a basis for a continuing policy dialogue. Significant monitoring capacity will have to be developed. The C.P. and covenant would provide for as many of the following measures as prove negotiable, taking into account CY 1984 actions that the BCCR may have taken prior to the negotiations:

a. The total amount of subsidized credit, which is defined as credit provided at or under the 6 month savings certificate rate, shall not at any time during 1984, exceed the amount outstanding for this type of operation as of December 31, 1983. (This is estimated to be approximately 5% of the 1983 credit program.)

b. The financing of subsidized credit operations will be provided by the Central Bank, from resources other than those captured from the public by the commercial banks.

c. The Central Bank will make funds for subsidized credit operations available to the commercial banks via rediscount lines, and at a rate which is at least equal to the cost of the funds to the Central Bank.

d. All other credit operations undertaken by the commercial banks will be made at real, positive rates, which are defined as a minimum of 2 points over the six months time deposit rate.

e. The six months time deposit rate shall also be positive in real terms, and shall reflect the following: domestic inflation, international interest rates, and the demand/supply situation for credit. The Central Bank will be required to report to AID on a monthly basis its analysis of the suitability of the six months time deposit rate, and its rationale for adjusting or not adjusting the existing rate.

f. In setting interest rates to the final borrower for non-subsidized credit operations, no more than two different rates will be used. (At present there is a multiplicity of rates. It would be preferable to unify all of these into one rate, but this is probably not negotiable. We can, perhaps, reach agreement that there should be one rate for agriculture and one rate for everything else. This would constitute a major step in the right direction.)

g. Allocation of credit by quantitative ceilings shall be limited to six categories as follow: agriculture, livestock, industry, exports, new activities, and other. For all categories except new activities, there will be no disaggregation by product or by activity. For new activities, credit allocation will be shown on a product by product and/or activity by activity basis. Such activities are defined as those for which there is not an established demand for credit, but for which the development of the product or activity is at a point where promotional credit is desirable.

2. <u>Exchange Rate Policy</u> - The statement in Section IV. 5. a. of the GOCR policy paper on this topic is acceptable if the term "the competitiveness of exports", is understood to include relationships between domestic prices and those of Costa Rica's principal trading partners. In any event, it would be unwise to attempt to establish any mechanical formula for achieving and maintaining parity. Instead, the Mission proposes to require the Central Bank to report monthly on their

rationale for adjusting or not adjusting the exchange rate. This requirement would serve to maintain a policy dialogue, and to permit AID to react when it seems indicated, rather than to take the initiative as is the case at present.

3. Improvement in State Bank Efficiency - In addition to the two priority items dealt with above, and other covenants that will deal with general reporting requirements, it may be desirable to require the Central Bank to provide progress reports on the Government's efforts to make the state banks more efficient and, possibly, to introduce specialization. The GOCR policy paper makes reference to such improvements (Section IV. 1. (d)); there is also a Commission which has been examining this problem for some time. However, we are not optimistic about the potential for improvement in the near future.

4. CODESA Credit - One final item that should be dealt with in the Agreement with the BCCR, concerns prohibiting the use of Central Bank credit and/or refinancing of credit obligations to the BCCR by the Costa Rican public sector development bank/holding company (CODESA). It may be desirable to impose some limitations on credit for CODESA subsidiaries. This issue will require more analysis before we can formulate a reasonable condition.

D. Policy and Structural Changes to be Required of the Central Government

1. Financial Intermediation

Proposals for modification of the banking law and currency law were sent by the Executive to the Legislative Assembly in mid 1983. These modifications would permit private bank access to Central Bank credit operations, and would facilitate dollar denominated lending by all credit institutions (See Section IV. 1. d. iii. of the GOCR paper). The banking law modification was sent in compliance with an ESR II covenant. Both modifications to the existing laws are important to improving the ability of the banking system to meet the needs of the private sector. There is, however, some opposition to the banking law modification on ideological grounds.

As indicated earlier, we propose to advise the GOCR that the signing of any FY 1984 ESF Agreement will be conditioned on approval by the Legislative Assembly of the two measures described above. This will permit both AID and the GOCR Executive to avoid the thorny political issue of the GOCR Executive signing an Agreement which makes commitments concerning legislative action. We could, of course, include such legislative action as a condition precedent to disbursement, but believe that a prior action to signing requirement will be found preferable by the GOCR.

2. Tax Reform

Section IV. 2. b. of the GOCR paper lists five changes in the tax structure which are designed to faciliate investment and exports. All would result in reductions in revenue. The revenue loss for 1984, if all measures were applied fully and simultaneously, would be in the range of ¢3.5 - 4.0 billion. It is not practical, therefore, to require a full reduction in 1984, but movement in the right direction is desirable. The degree of the reductions, and the form these will take, will need to be negotiated. Also, the manner in which the commitment for legislative action is expressed in the Assistance Agreement will have to be pursued with the GOCR. What is clear now is that whatever revenue loss is incurred in 1984 as a consequence of AID conditionality requirements would have to be offset — at least during 1984. These revenue reductions would not have been built into the calculations and measures designed to meet the IMF requirements concerning the public sector deficit. The Mission purposes to help offset such reductions by supporting the GOCR investment budget from ESF local currency generations.

Section IV. 2. b. of the GOCR paper also proposes to improve collections on existing taxes. Initial findings of an IRS technical assistance team indicate that any significant improvement in collections will be contingent on changes in tax law on such matters as the following: shifting from a judicial to an administrative collection procedure; payment of disputed tax as a requirement for judicial appeal; and interest rates on late payment that are adjusted automatically to market rates. The submission by the Ministry of Finance of suitable legislation to the Assembly by mid 1984 should be a convenant in the ESF Agreement.

3. Other Actions with Fiscal Policy Implications

a. The GOCR paper provides for transfer of entities and functions from the public to the private sector, and for the elimination of certain public sector programs (Section IV. 2. c.). The government could be requested to convenant that by June, 1984 it would provide AID with a list of entities and functions that would be examined between that date and the end of 1984, with a view to taking decisions reflected in the 1985 budget proposal or earlier, if feasible. It might also be possible to identify certain CODESA subsidiaries that should be offered for sale to the private sector, and to develop a covenant in this regard. However, we probably could not go beyond this within the negotiating time frame. Such a covenant would also have to provide for changes in the applicable law; this currently sets a minimum amount of equity which CODESA is required to maintain in any given subsidiary, unless specifically exempted by legislative action.

b. Another covenant could be considered which would require submission of an action plan by June or July 1984 to reduce public sector employment. This would relate back to the concepts set forth in Sections IV. 2. c. i. and iii. of the GOCR policy paper.

Conceivably, the covenant could go beyond the development of an action plan and commit the GOCR to achieve a specified reduction-in-force, e.g. 10,000 positions in CY 1984. If such a commitment proves negotiable, we would have to be prepared to offset the unbudgeted cost of the actions (separation pay, and retraining costs) by investment budget support.

4. Pricing Policy

Section IV. 3. of the GOCR policy paper provides for a revision by the Government of a series of measures relating to pricing policy. A covenant could be prepared which would require progress reports on this exercise, but which would also introduce some minimum terms of reference for undertaking the revision. Such terms might include prohibition of any subsidies in provision of goods and services by state enterprises, and a maximum limit on the number of retail goods and services subject to price control to the 31 items now included in the basic market basket.

5. Customs Tariff Policy

Section IV. 5. b. of the GOCR policy paper reflects a need for and a commitment to undertake a thorough going revision of the external tariff structure. Suitable criteria have been established and some of this work has already begun. A covenant could be prepared which would require quarterly progress reports from the Ministry of Economy on the topics listed in the policy paper, and the submission of a draft law to the Legislative Assembly by September of 1984 covering the desired changes. Such a covenant could also deal with a few items not mentioned in the GOCR policy paper, specifically, elimination of the BCCR controlled temporary surcharges on imports, and the use of selective consumption taxes, rather than customs tariffs, to control demand for luxury goods. The former apply equally to domestic and imported products.

6. Export and Investment Promotion

Section IV. 6. of the GOCR policy paper is quite exhaustive in detailing the problems that need resolution and, in some instances, the required actions in this area. It is not always clear, however, which items require legislative action and which problems can be resolved by other devices. A covenant requiring quarterly reports on the status of and actions being taken with regard to the totality of the items listed in the policy document would probably be the most useful way of dealing with this area of concern. One action of particular interest is a modification of the Free Zone Law which has been submitted to the Legislative Assembly by the Executive Branch. It would permit the Executive Branch to designate new installations or convert existing installations into Free Zones in any location in the country. The present law only authorizes two Free Zones, one on the Atlantic and one on the Pacific coast. There is little private sector interest in developing these two locations. The Mission proposes to make passage of the new law a "Prior Action to Signing any ESF Agreement."

V. LEVELS OF ASSISTANCE

Annex 2 presents a projection of the Balance of Payments situation for 1984. It is based on optimistic assumptions as regard the growth of exports, the government's ability to curtail imports, and other donor disbursements. Also, it assumes a zero GDP growth rate in 1984. Even with these optimistic assumptions, the projections show that there will be an unfinanced resource gap of approximately $124 million in the Balance of Payments for 1984, before ESF flows are taken into account. This situation is due to the large, $385 million requirement for debt service, which remains even after taking account of the 1983 rescheduling results. Further rescheduling of commercial and bilateral debt in 1984 is not feasible.

We believe it is in the U.S. interest to provide sufficient ESF resources in FY 1984 to cover this $124 million gap in the Balance of Payments. We also believe that all FY 1984 ESF assistance should be provided on a grant basis in order to avoid increasing Costa Rica's overall debt.

We recognize that the amount of ESF presently programmed for Costa Rica only comes to $70 million, and is split between grant and loan. We believe that our negotiating position will be much improved if all funds are made available on a grant basis, and if some way can be found by which we can indicate to the GOCR our willingness to help close their B/P gap if they will take the necessary policy measures looking to the future.

V. USES OF U.S. DOLLARS AND LOCAL CURRENCY

A. U.S. Dollar Resources

U.S. Dollars granted under both the Assistance Agreement with the BCCR and the Assistance Agreement with the GOCR, will be provided to the Central Bank, and made available for sale to private importers for the import of raw materials, intermediate goods and spare parts, and construction materials from the U.S. Such usage, and the procedures involved, including the cash transfer mechanism, will be similar to those involved under the previous ESR II program.

B. Local Currency Resources

The colon equivalent of the ESF dollars provided under the Assistance Agreement(s) will be used for one or more of the purposes listed below in order of priority. In determining the uses of local currency, the impact on the money supply of Costa Rica and any IMF requirements with respect to this will be taken into consideration.

1. Private Sector Credit Liquidity - The first priority for use of local currency will be to ensure that there is adequate credit liquidity for the needs of the private, productive sector, including any additional requirements for the private bank rediscount line created under previous ESF Agreements. The amount and form that the local currency allocations for this purpose will take will be determined by future analysis and reflected in the PAAD.

2. Investment Budget Support - Investment budget support is defined as the financing of items in the consolidated government budget which were already planned prior to the AID Agreement and which correspond to capital investments as opposed to expenditures of a recurrent cost nature. As indicated in Section IV. on Conditionality above, such use of ESF funds would be considered in 1984 only as a quid pro quo for foregone export tax revenue and/or for extraordinary costs involved in personnel reductions, such as severance pay and other lump sum benefits. Use of local currency to support investment budget items would have the added effect of ensuring, on a line item basis, that certain public investments needed to support the export strategy were in fact made. Investment by autonomous instituions as well as by Central Government entities would be considered, including counterpart commitments to projects financed by other donors

3. Special Activities - As was the case in the ESR I and II programs, a number of activities have been identified which the Mission

feels merit support. Illustrative of such activities, which do not qualify as investment budget items according to the definition above, are assistance to housing and construction, maintenance and repair of water and sewerage facilities, health facilities and roads, and construction of industrial parks/free zone installations. Housing and construction assistance funds would be channeled through INVU in 1984 (the National Institute for Housing and Urban Development) to private sector builders, and would be conditioned on improvement in the rent control laws. Maintenance and repair of water and sewerage facilities, health facilities and roads would also be channeled through public sector institutions, but, as in the case of the INVU program, private sector firms would be employed to carry out the work.

4. Special Account - A special account in the BCCR similar to that established under ESR II and with the same objectives, e.g. taking advantage of unplanned targets of opportunity, may be set up with part of the grant funds provided. The amount of local currency reserved for this use would be based on availability after the above priorities are met, and the need for and potential use of such funds.

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ANNEX No. 1

MINISTRY OF NATIONAL PLANNING AND ECONOMIC POLICY

MINISTRY OF FINANCE

MINISTER OF EXPORTS AND INVESTMENT

COSTA RICA CENTRAL BANK

Special Commission

ECONOMIC POLICY: STRATEGY AND ACTIONS

1984 - 1986

San José, Costa Rica
December 21, 1983

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ECONOMIC POLICY: STRATEGY AND ACTIONS

1984 - 1986

I. INTRODUCTION

1. The effects of the worst economic crisis of the past fifty years have been apparent since 1981: GDP contracted dramatically (4.6% in 1981 and 8.8% in 1982), in the latter year, inflation reached an all-time high of 90%, exports dropped by 13%, and unemployment rose to 10%.

2. Starting in mid-1982, the Government undertook a stabilization program which, with some adjustments, was incorporated (in December of that year) into an agreement with the International Monetary Fund (IMF). This program has had significant favorable results: in the current year, inflation has dropped considerably to under 10% a year, the Government has managed to arrange for a satisfactory restructuring of the public sector external debt, and the exchange rates have been unified.

Nevertheless, it is still necessary to consolidate the stabilization program. The problem of public sector finances, both for the Central Government and for the rest of the public sector, has not yet been adequately resolved, and this jeopardizes the important achievements and results obtained so far. Furthermore, the unemployment rate is still high, exports -- both traditional and non-traditional -- continue to drop, and domestic production is barely starting to show signs of a slight recovery. At the same time, the Central American area is still economically depressed and politically unstable. According to forecasts, prices of traditional export products will remain at low levels during the next few years. All of this is serious for a small and open economy like Costa Rica's. When to this is added the effect of the heavy burden that service of the foreign debt will mean to the country during the next few years, the situation looks even more worrisome.

Consequently, it is absolute essential to increase traditional exports to the maximum extent possible, and to establish a basis for penetrating new markets by reorganizing the present productive set-up and by stimulating investment in new economic activities mainly aimed at exports. The Central American market and the domestic market simply do not have the required potential to reactivate the national economy.

3. In view of the imperative need to consolidate the stabilization program and to reactivate the economy as soon as possible, Costa Rica must urgently adopt an economic policy program to be carried out during the next thirty months, which will provide a foundation for the achievement of these results.

4. The measures proposed in this paper have the following features:

a. They cover economic policy actions that are considered indispensable and which are compatible with the current status and the characteristics of the Costa Rican economy.

b. All are inter-related and are aimed at one and the same goal, for which reason they must be implemented in their totality.

5. Costa Rica is a paradigm of development for a peaceful and free Central America, and it must continue to be so. The viability of the democratic form of government requires that the growth process be geared to a greater economic democracy and a better distribution of wealth. The achievement of the economic reactivation goals included in this paper implicitly assume foreign financial support, in order to supplement the internal saving effort that must necessarily be made. External financing will come both from direct investment and from donations and long-term loans that will be used preferentially for strengthening directly productive sectors.

6. Lastly, it should be noted that when this paper indicates that certain actions or measures must be compatible with the "stabilization program", it is assumed that a new agreement will be signed with the International Monetary Fund and that the stabilization program will continue through 1984.

II. STRATEGY AND OBJECTIVES

In the medium term, the objectives of economic policy are to recover the standard of living which the Costa Ricans had reached prior to 1980, and to set up the basis for the re-establishment of a sustained development process like that which the country achieved in the post-war period. For that, it is necessry to consolidate stability without reducing social progress, and increase employment, stimulating the formation of an economically viable exportation.

In order to consolidate stability, the strategy consists of: (i) maintaining the deficit of the Government at a low level (e.g. less than 5 percent of GDP) and (ii) orienting monetary policy in such a way that no new disequilibriums occur either in internal prices, or in the balance of payments. This has been the stabilization strategy in the short run, but the form (tactic) for executing it is distinct in the medium term. This is due to making it congruent with employment and revenue objectives.

The reduction of the fiscal deficit needs to be achieved on the basis of a significant reduction in the size of the public sector, and improved collection of existing taxes. With respect to credit, monetary policy needs to be concerned with the growth of the money supply, and not only with regulating the expansion of credit. At the same time credit must be used to progressively improve the efficiency of production.

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To increase production is essential in order to reduce unemployment and to begin to recover the ground lost in per capita income. The strategy is: (i) to maintain internal demand at the maximum consistent with external equilibrium, (ii) in the short run, to increase traditional exports to the maximum congruent with demand in international markets, and (iii) in the medium term, to develop exportable production of non-traditional articles to non-traditional markets (e.g. the United States) assigning them the highest priority in the overall production policy. Although the results will not be seen for some years, it is necessary to begin now to take the measures that will establish the basis for this achievement.

There are other important components of the strategy. The first is to also elevate to the maximum and by various methods, the savings coefficient, in order to finance the increase in the various categories of production without compromising internal stability. The second is to stimulate said increase based on a continuing improvement in efficiency. With respect to production for the internal market, to maintain congruency with a policy of non-inflationary prices. With respect to exportable production, to be able to compete in the international markets.

One must emphasize three tactical considerations. On one side, it is necessary to adopt a wage policy which prevents a major deterioration in real wages and which restitutes the loss which has been suffered, pari-passu with the increase in production. On the other hand, it is necessary to give emphasis to the role of the private sector as a motor for the process of economic recuperation. Finally, it is essential to resolve the very grave problems of decapitalization which hundreds of Costa Rican firms have suffered, and to finance them by appropriate means to re-establish debt-equity ratios which would again give them access to the internal and external financing systems.

III. PROGRAM IMPLEMENTATION

Given the importance of assuring an orderly implementation of the various activities involved in the execution of this program, an Executive Council will be formed, made up of the Ministers of Planning and Economic Policy, Finance, Economy and Commerce, Export and Investment, and the Executive President of the Central Bank. At the same time, a working group will be formed, made up of top-level specialists, conforming to the area of interest of each of the institutions, to plan, assign tasks, and provide follow-up for the actions required for the effective implementation of the program, as well as report, in due course, on progress made and problems encountered.

IV. SPECIFIC MEASURES

1. Monetary and Credit Policy

Monetary policy plays a role of prime importance in economic policy. The criteria for allocating credit and the interest rate structure will be simplified so that it will be possible to channel available resources more effectively. In addition, it is considered urgent to improve and strengthen the national financial system. In this effort, the private finance and banking entities will play an important role together with the State banks, whose modernization and efficiency warrant special attention.

Consequently, the following measures will be put into effect:

a. Monetary Program

i. Only in exceptional cases will any exchange rate guarantees which could result in exchange losses be given.

ii. The credit which the commercial banks provide to the private sector (credit program) will, as a general rule, be financed from savings captured by the banks and from external funds; the direct or indirect credit provided by the Central Bank to the public sector will be limited to the maximum amounts derived from the stabilization program.

iii. The action of the Central Bank will continue to be centered on attention to the volume of credit and the interest rates, but will also attend to related aspects of the money supply.

b. Credit Policy

i. Overall credit limits will be fixed for the banking system, compatible with the stabilization program.

ii. For sectors where there is already an established demand for credit, the number of quantitative credit limits (portfolio ceilings) will be reduced to the following global categories with no disaggregation by activities and products: agriculture, livestock, industry, exports and others. There will be a special program to finance new activities that it is desired to stimulate.

iii. Mechanisms will be established, that will gradually lead to a situation where credit granted by the State banks will be supplementary to private effort, so that all of the risk will not be placed on the banks and, also, so that it will more effectively contribute to the economic and financial viability of the projects.

iv. The Central Bank will make use of the instruments that the law affords it, in order to ensure that the Commercial Banks have the necessary resources to satisfy seasonal demands for bank credit, in accordance with the established credit program.

c. Interest Rates

In regard to interest rates:

i. The attainment of the objective of reducing the rate of internal inflation will allow the banks to charge and pay interest rates that will be positive in real terms. For this purpose, the Central Bank will fix the rates, taking into account internal inflation, the rates of interest prevailing in international markets, and the relationship between supply and demand of credit.

ii. The existing interest rate structure for credit operations will be simplified.

iii. The Costa Rica Central Bank will maintain the volume of subsidized credit at the lowest possible figure, consistent with the basic objectives of economic and social policy.

iv. It will be up to the Central Bank to determine the source of resources for subsidized credit. These resources will be used to improve the profile of Costa Rican production, so the small- and medium-sized entrepreneur and producer will have access to these facilities. Subsidized interest rates shall be understood to mean such rates as are equal to or lower than the basic passive rate.

d. Banking System

With regard to the banking system, the policy of promoting a mixed banking system will be continued. To this end attempts will be made to increase the participation of private banks in the financial market in such as way as:

i. To contribute to an improvement in the efficiency of the financial system in its totality. Simultaneously the necessary actions will be taken to increase the productivity of the state banks.

ii. Specifically, emphasis will be placed on the transformation of the State banks so that they participate more actively in the process of attracting and channelling savings. In this sense, the concept of specialized banking will be promoted in order to discriminate clearly between commercial banking functions and development banking functions.

iii. Active lobbying before the Legislative Assembly will undertaken for:

- Amendment of the Organic Law of the Costa Rica Central Bank so that private banks have access to rediscount operations of and to foreign resources obtained by the Central Bank.

- Amendment of articles 6 and 7 of the Currency Law so as to allow the banks, under certain conditions, to make loans denominated in foreign currency and to transfer the exchange risk to the borrower. This will facilitate the capture of external savings.

2. Fiscal Policy

The economic policy program contemplates a series of measures intended to place public finances on a sound basis. Specifically, it is intended to constrain growth in public sector spending and prevent the public sector deficit (viewed as a proportion of the GNP) from growing any further. In addition, it is intended to attempt to finance the deficit by non-inflationary means.

The measures set forth below are based on the criterion that any elimination of sources of income for the public sector must be compensated by a reduction in expenditures, by new taxes, or by the transfer of additional resources. The objective is that such revenue reductions be neutral as regards the size of the fiscal deficit, while promoting other objectives, such as stimulating production for export. At the same time, the Budget Authority must have greater legal authority so that it can bring about an integration of the finances of the decentralized institutions with those of the Central Government into a fully coherent public sector financial operation.

Based on these considerations, the following measures will be put into effect:

a. Deficit

The policy of holding the overall deficit of the public sector to a reduced percentage of the GNP, and of limiting the financing thereof by means of the banking system, in accordance with the stabilization program, will be continued. In the event that the deficit is financed through the capital market, the actions should be programmed so as to reduce to the utmost any distortion that might be produced in said market.

b. Revenues

The corresponding actions will be taken in order to eliminate the taxes indicated below in a gradual manner, starting no later than January 1984. Simultaneously, compensatory sources of revenue will be created, such as new taxes or transfers, where the entry into force will coincide with the repeal or expiration of the following taxes:

i. The tax on exchange rate differential.

ii. The ad valorem tax on exports.

iii. The surcharge on port tariffs.

iv. The surcharge on income tax deriving from non-traditional exports. For 1985, the surcharge will be eliminated altogether.

The present tax system for traditional exports will be modified, so that a mechanism similar to the one now being used to tax coffee exports, will be applied.

Ways of improving preparation of the national budget will be sought, including steps to have the proposed budget submitted to the Legislative Assembly well in advance of its going into effect. Furthermore, technical consultation procedures will be set up between the Legislative Committee entrusted with the study of the proposed budget, and the Executive Power.

The tax administration office will be provided with the necessary elements (material, human, and procedural) in order to improve collection of existing taxes, particularly income, excise and sales taxes.

c. Expenditures

The following actions will be taken in this connection:

i. Freeze the creation of positions in the public sector as a whole. Similarly, the filling of vacancies will be forbidden for decentralized institutions of the non-financial public sector and Central Government agencies that have not submitted, to the satisfaction of the Budget Authority, a rational program to reduce the number of employees, which will take into account dispositions and agreements on labor matters.

ii. Transfer enterprises and functions from the public sector to the private sector in activities where the latter is comparatively more efficient.

iii. Set up training programs (as required) and programs for the payment of severance pay to employees of the public sector, for the purpose of inducing them to relocate in the private sector, offering them facilities for the change-over.

iv. Eliminate and reduce programs wherever they are not essential or have lost priority, rather than under-executing fixed percentages of individual line items in the budget.

v. Strengthen the Budget Authority by means of provisions enabling it to exercise more effective controls in the drawing up and implementing of the budgets of the public sector. For this purpose, technical assistance will be given to its personnel, as well as more training.

vi. In order to make better use of the resources of the public sector, develop a portfolio of a sufficient number of investment projects, improve evaluation methods and, in addition, implement the projects in accordance with a scale of priorities to be established by MIDEPLAN, and in conformity with determinations of the Budget Authority concerning the availability of resources. Public investment projects will be oriented to contribute to the reactivation efforts.

3. <u>Price Policy</u>

The basic strategy of the reactivation program consists of increasing exports outside of Central America. This means that the economy will have to penetrate more deeply into the international economy. In order to be able to compete successfully in those markets, the costs and prices of Costa Rican goods will have to be competitive. Therefore, the Government will examine:

i. The number of goods and services whose prices are fixed by the State.

ii. The procedures (speed and method) used to fix such prices.

iii. Prices of goods and services provided by the public sector.

iv. The criteria used to fix support prices and promotional prices.

4. <u>Wage Policy</u>

Wages constitute the main source of income for most of the population. Thus the creation of productive employment is the best way to maintain and increase personal income. At the same time, wages are one of the most important factors in production cost and in the size of the fiscal deficit. Thus, wage policy must take into account the inflationary process and, at the same time, not interfere either with increases in employment or in national production, without losing sight of the need to maintain the stability of the economy.

The actions to be taken in this connection are:

a. Adjust minimum wages and the wages of the employees of the public sector in accordance with the relative increase in the inflation index, in order that they remain constant in real terms. For the purposes of this adjustment, not only wages, but fringe benefits will be taken into account. Exceptions to these limits will be granted to decentralized institutions and the agencies of the Central Government that have submitted, to the satisfaction of the Budget Authority, a program for reorganization and increases in productivity, which will compensate for any wage adjustment over and above the one described above.

Additionally, as economic recovery is achieved, efforts will be made to gradually make up for the loss of real wages recorded during the past few years.

5. Foreign trade Policy

Improving the competitive situation of Costa Rican products in foreign markets is a fundamental task for the forthcoming months. Hence it is indispensable to adopt an exchange rate policy that will allow exporters to receive enough colones to meet increases in local production costs and thus maintain the profitability of their activities. Similarly, it is necessary to rationalize protectionism, not only to permit exporters to obtain the raw materials and inputs they need for their production at international prices, but also to improve the productivity of their firms.

Consequently, the following measures will be adopted:

a. Exchange Rate Policy

i. Maintain a flexible exchange rate policy, taking into account basically but not exclusively, three elements: supply and demand of foreign exchange; prospects for the balance of payments; and competitiveness of exports.

b. Tariff Policy

This policy should lead to a reduction and rationalization in the level of effective protection, so that the competitiveness of Costa Rican products in international markets will improve, and also, so that it will not hamper extra-regional exports.

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Therefore, action will be taken, or whenever required, bills will be submitted to the Legislative Assembly for the purpose of:

i. Thoroughly revising the Foreign Tariff Schedule in order to rationalize it and reduce its dispersion, that is, the existence of tariffs that discriminate between goods, using as a reference SIECA's proposal on this matter. This reduction will have to be studied and negotiated immediately in order to start applying it gradually as of January, 1985.

ii. Eliminate the tariff exemption system (Reifaldi) on the importation of raw materials, intermediate goods and capital goods. This measure will have to be executed gradually, beginning in January, 1985, and in coordination with the tariff revision, by means of equivalent percentage reductions. The only exceptions to this measure are imports of raw materials and intermediate goods used in the production of goods for export, in order not to weaken their competitive position in international markets.

iii. Negotiate the elimination of customs surcharges, which are imposed pursuant to the San José Protocol.

iv. Maintain Costa Rican producers in a position of equality with respect to Central American producers.

c. Foreign Indebtedness

In this connection, the following actions will be taken:

i. Initial negotiations to contract for foreign loans by the non-banking public sector may not be undertaken without the prior authorization of the Budget Authority, consistent with planning that will take into account, among other aspects, the social usefulness of the projects and the country's debt capacity, as well as that of the pertinent institutions.

ii. The Budget Authority will see to it that updated information is available on the status of the consolidated foreign debt of the public sector, as well as by institutions.

iii. The commitments resulting from the rescheduling of the public sector foreign debt will continue to be honored punctually, in consonance with the process of economic recuperation.

6. Promotion of Exports and Investment

The promotion of exports outside Central America is the essential element in the program to reactivate production. The measures listed in the foregoing sections are, in the final analysis, part of the

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export promotion policy. A number of additional measures are required. These are:

a. General Measures

i. Continue expediting and simplifying export procedures.

ii. Grant preferential and expeditious treatment to requests for foreign exchange for importing raw materials required for the export process.

iii. Expedite customs administrative paperwork both for exports and for imports of raw materials used to produce goods intended for export.

iv. Administer policies related to use of the domestic products in such a way that they will not undermine exporters' efforts.

v. Improve information on export and investment opportunities.

vi. Activate existing bilateral trade agreements and attempt to establish others, particularly with countries in the Caribbean, Mexico, Colombia and Venezuela. Furthermore, attend to exchange and payment problems in Central America.

vii. Take necessary steps to adjust port rates so that they conform to international prices governing this type of service.

viii. Prepare and submit to competent organizations, the necessary laws and regulations, including the export contract, in order to promote exports and investment.

b. Measures Regarding Drawback Industries

i. Eliminate the guarantee requirement (promissory notes).

ii. Establish one single body of regulations and one single decision making entity for the entire system.

iii. Provide a rapid and flexible mechanism for control and for disposal of waste material.

iv. Full tax exemption on import of inputs, as well as of other domestic taxes levied on production, consumption and distribution of inputs, in order to give the producers the greatest possible flexibility in the selection of domestic and imported inputs required for the drawback industries.

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v. Define the technical terms of the law more clearly.

vi. Resolve existing problems which inhibit the expeditious importation of spare parts and samples.

vii. Adjust the periods fixed for the permanence of raw materials in the country to conform to the characteristics of the production and marketing processes.

viii. Adjust the periods fixed for the permanence of samples in the country in order to conform to the characteristics of the production processes.

c. Measures Regarding Free Zones and Industrial Parks

The present coverage of the system will be expanded so that it will be possible to authorize the operation of other free zones.

d. Measures Regarding Fiscal Incentives

i. Maintain the present benefits which accrue to investors in free zone operations, and study the possibility of increasing, from 6 years (as at present) to 12 years, the effective life of the 100% exemption on income tax, conditioned on the domestic value added to the drawback product.

ii. Revise the present provisions for income tax credits related to investment, so as to favor investment for extra-regional export made by national enterprises.

e. Measures Regarding Foreign Investment in General

i. Establish a suitable legal and institutional framework to protect foreign investors against possible risks in repatriation of capital and remittance of profits.

ii. Determine the types and scope of applicable fiscal incentives.

f. Measures Regarding Tax Credit Certificates (CAT)

The present system will be revised so as to use it exclusively as an instrument to open and consolidate export markets in any country. Specifically:

i. Calculate the amount of the incentive on the basis of the value added, instead of calculating it on the export value, and by kinds of goods exported instead of by companies.

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ii. Operate the system so as to expedite the granting of the CATs.

g. Measures Regarding Substitution of Incentives

Study and propose new incentives that will replace existing ones and promote the sustained development of non-traditional exports.

h. Measures Regarding Financing for Exporters and Investors

i. Assure exporters of a "financial package" that will include, among other things, adequate local credit resources and facilities for obtaining foreign exchange financing and export credit insurance, so that such financing will be prompt and timely for the various stages involved in the productive process culminating in foreign sales.

ii. Promote the setting up of a financing program for national investors who can participate, together with foreign investors, in activities the object of which is principally exportation to foreign markets.

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ANNEX 2

CY1984 BALANCE OF PAYMENTS PROJECTION

I. CURRENT ACCOUNT	**-408**
Trade Balance	-135
Exports, FOB 1/	851
Imports, CIF 2/	-986
Services Balance	-288
Tourism	95
Transportation and Other	32
Factor Services	-415
Official Interest	(-385)
Other	(-30)
Transfers Net	15
II. CAPITAL ACCOUNT	**121**
Private Net	100
Official Net, Non-Compensatory	21
Disbursements (project assistance and other) 3/	(156)
Amortization	(-135)
III. OVERALL DEFICIT	**-286**
IV. FINANCING OF DEFICIT (Non-Project Assistance)	**163**
PL 480	20
Commercial Banks Revolver	43
IMF	100
V. UNFINANCED GAP	**-124**

1/ Exports are estimated to grow by 6.4%

	% Growth
Traditional Exports	4.5
Exports to the CACM	8.0
Non-Traditional Exports to the Rest of the World	
Weighted Average	6.4

2/ Imports are estimated to grow by 6%, corresponding to anticipated world inflation rates.

3/ Represents estimated disbursements as follows: AID/DA, $10 million; IBRD, $16 million; IDB, $50 million; CABEI, $30 million, and other, $50. million.