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USAID IMPACT ON COSTA RICA'S DEVELOPMENT DURING THE LAST 50 YEARS

FINANCIAL SECTOR POLICIES AND INSTITUTIONS

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ABSTRACT

This chapter analyzes USAID's impact on the Costa Rican financial sector It includes a sector overview describing major financial developments over the last fifty years and driving forces behind the policy changes The study focuses primarily on the 1982-1992 period, in which the most relevant USAID financial sector projects were concentrated USAID's impact is analyzed from three different approaches policy reforms, institution building, and sector projects

The study concludes that USAID played a key role in fostering financial development in Costa Rica Its major impacts came from two sources 1) support to policies aimed at modernizing the financial system, and 2) sector projects to develop private financial intermediaries USAID's contribution through the creation of new institutions had limited impact

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1 INTRODUCTION

This paper analyzes the impact of USAID's programs and projects on the Costa Rican financial sector over the last 50 years The study focuses primarily on the 1982-1992 period, in which the most relevant financial sector programs of USAID in Costa Rica were concentrated The analysis is based on official documentation, project evaluations and interviews with USAID officers involved in the projects, public officers, policy-makers, and representatives of the financial sector community

Section 2 presents a sector overview It describes major developments of the financial sector from the mid 1940s up to 1995 and driving forces behind the policy changes It provides the background for understanding the institutional framework in which USAID placed its programs and projects

The next section describes and analyzes the most relevant USAID activities from both macroeconomic and microeconomic perspectives The macroeconomic approach focuses on USAID's influence on policy formulation through the conditionality included in the ESR (Economic Stabilization and Recovery Programs) The microeconomic analysis emphasizes financial institutions (supported by USAID) and sector projects

Section 4 evaluates the impact of USAID's support for policy reforms, institution building, and financial sector projects It also includes the study's major findings and conclusions

The last section summarizes major lessons for USAID (and other donors involved in financial sector projects/programs) and for the country

2 SECTOR OVERVIEW

This section summarizes the evolution of the Costa Rican financial sector over the last fifty years It describes the sector's structure and institutional framework, as well as major policy reforms This overview provides the background for evaluating USAID's involvement and impact on the sector

2 1 The Financial Sector

The Costa Rican financial sector consists of a large variety of intermediaries, which operate under different legal, institutional, and regulatory frameworks This situation has created a fragmented and dualistic market In the McKinnon (1973) sense, "fragmented financial markets" means that firms and households face different effective prices for financial resources and do not have access to the same technologies Fragmentation has been the consequence of lack of uniform rules for the financial intermediaries Duality means that regulated and unregulated intermediaries interact in the same market

The sector consists of the following institutions

i) The National Banking System, which includes the Central Bank, three state-owned banks[1] (SOBs), and private banks As of September 30 1995, twenty-four private banks were registered at the General Auditor of Financial Entities

ii) Non-bank private intermediaries, including finance companies ("Financieras"), Savings and Loan Associations ("Mutuales") and credit unions [2]

iii) Public-sector institutions with financial activities This group includes the Banco Popular y de Desarrollo Comunal (BPDC), Banco Hipotecario de la Vivienda (BANHVI), Instituto Nacional de Seguros (INS), Caja Costarricense del Seguro Social (CCSS), and Caja de Ahorro y Prestamo de la Asociacion Nacional de Educadores (ANDE)

iv) Unregulated private intermediaries, including offshore companies (known as "Caribeñas), local companies linking financial intermediation with other businesses (leasing, factoring, coffee production, warehouse facilities), unregulated Financieras, and "asociaciones solidaristas" (workers' associations)

v) The stock-exchange market, consisting of two brokerage institutions, Bolsa Nacional de Valores and Bolsa Electronica de Costa Rica

Table 1 shows the major Costa Rican financial intermediaries The following paragraphs describe the evolution of the sector (focusing on the national banking system and the Financieras), and driving forces and policy reforms [3]

2 2 The Early Years 1945-1960

During the 1940s Costa Rica received strong influence from European ideologies on social

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[1] The oldest Costa Rican bank, Banco Anglo Costarricense, created in 1863 and nationalized in 1948, was closed in 1994 after it became insolvent

[2] As of September 30, 1995, 21 Financieras were registered at the General Auditor of Financial Entities There are some 150 credit unions, of which 49 are associated with the Federacion de Cooperativas de Ahorro y Credito (FEDECREDITO) There are six "Mutuales", under the supervision of Banco Hipotecario de la Vivienda (BANHVI)

[3] For detailed analysis of particular sectors, such as pensions, the insurance market, and the stock exchange, see Loria (1992), Chevez (1990), Vogel et al (1993), and Weigel and Solera (1991)

justice and social democracy Some young Costa Ricans, who had gathered into a group for discussions about domestic issues, adopted these ideas This group, called *Centro de Estudios de los Problemas Nacionales,* merged with an existing party to create the *Partido Liberacion Nacional (PLN)*

Then, Costa Rica was a very small, open, rural economy, dominated by coffee exporters Private bankers, who had exercised strong economic and political power, controlled the banking system These overly-conservative and cautious bankers represented an obstacle for the members of the PLN to carry out their social democratic ideals (Mesalles, 1991)

2 2 1 The Banking Nationalization Decree of 1948 Philosophy and Consequences

A civil war took place in 1948 The incumbent administration was overthrown for not accepting the results of that year's election After that revolution, the PLN took control of the government The provisional government- the Junta- took some "socializing" measures, including the nationalization of the provision of electricity, the railroads, and the banking system The 1948 Decree that nationalized the commercial banks created a monopsony for the four State-Owned Banks (SOBs[4]) on taking deposits of any kind from the public

The nationalization Decree stated

> Private banking is nationalized Only the state will be authorized to mobilize, through its own institutions, the deposits of the public The shares of the Banco de Costa Rica, Banco Anglo Costarricense, and Banco Credito Agricola de Cartago are expropriated for reasons of public convenience The state, through its Ministry of Economy, will take over the banks immediately The form and conditions for payment of the shares will be regulated afterwards

The decree stated as legal the operations of private banks, but private bankers were not allowed to accept deposits from the public The decree did not expropriate Banco Lyon, a family bank mostly devoted to international transactions An argument for the nationalization was that the government must allocate resources with economic development criteria, rather than profit maximizing motivation Therefore, mobilization of the public's savings should not be in private hands According to Lizano (1977), the nationalization had the political purpose of transferring economic and political power from private shareholders to the State

The Central Bank was formally created as a separate institution in 1950 Previously, money-issuing functions were undertaken by the *Banco Nacional de Costa Rica,* a public institution

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[4] According to Mesalles (1991b), the expropriated banks were owned by Costa Rican citizens Therefore, this was not a true nationalization, but a process of creation of state-owned banks

created in 1914 After the nationalization, the Central Bank based its monetary policy on the administrative allocation of credit ("topes de cartera") and the setting of subsidized interest rates

The nationalization had some positive effects Credit facilities were open to economic activities considered as "too risky" by private banks Subsidized credit programs were very successful in providing credit to small farmers By 1952, 47 Juntas Rurales (rural lending boards created in 1937) of the Banco Nacional de Costa Rica (BNCR) had granted nearly 20,000 loans, compared to 12,641 loans given in 1947 by 30 Juntas (Echeverria, 1958)

The SOBs controlled the financial market during the 1950s and to the late 1960s The nationalization forced state banks to undertake social goals In practice this led them to distribute credit with social rather than economic criteria The resulting losses were considered as the state's "contribution" to economic development SOBs' financial viability, therefore, was not a matter of concern Because of their public nature, politicians argued, SOBs cannot go broke After social-criteria loans, political-criteria loans followed

Behind the SOBs' successful record in granting credit, there was evidence of poor banking performance During the 1947-1961 period loans in arrears increased, as well as lending transaction costs (Ortuño, 1963) The transfer of ownership from private bankers to the state eroded accountability and sound banking practices Later, banks became borrower-dominated and highly vulnerable to political pressures

2 3 Institutional Development and Financial Deepening 1960-1978

Between 1960 and 1978 many nonbank financial intermediaries emerged, but the financial services industry continued to be dominated by the SOB's monopsony Although the laws defined state banks as autonomous institutions, constitutional amendments and later reforms limited their autonomy from the Executive only to administrative matters On policy decisions, SOBs deferred to the executive branch The so-called Ley 4-3 allowed the President to name or remove four of the seven members of the autonomous institutions This assured political control by the Executive on the state banks' policies

The current legislation had created monopsonistic advantages in favor of state-owned banks The 1953 Banking Act stated that only state-owned banks could receive cash deposits from the public to invest in commercial and credit transactions This was an implicit prohibition for private banks to operate checking accounts In addition, The Central Bank Law (enacted in 1953) restricted Central Bank rediscount facilities to state-owned banks Since private banks were prohibited both from taking deposits from the nonbank public and from taking Central Bank credit, private banks' operations were to be financed through the banks' own capital, which must be on deposit in a special account at the Central Bank These regulatory constraints paved the road for private banks' later use of the **certificate of deposit (CD),** a legal loophole found by private banks that allowed them to capture funds from the public and circumvent the 1948 decree Private banks could issue CDs at maturities of 180 days and more Table 7 shows private banks' success in mobilizing deposits and the attractiveness of CDs to depositors

In 1969, the Bank of America established a wholly-owned subsidiary in Costa Rica, registered as a private bank Later, other foreign banks decided to operate in Costa Rica not as banks but as Financieras (finance companies) under the Finance Companies Legislation enacted in September 1972, which allowed Financieras to issue CDs Banco Santander was the only foreign bank that established a local private bank instead of a Financiera

This boom of foreign banks was complemented by the formation of about 50 locally owned Financieras during the 1970s, the creation of the Banco Popular y de Desarrollo Comunal (the Workers bank) in 1969, the Corporacion Costarricense de Desarrollo (CODESA)[5] in 1972, and the National Stock Exchange in 1976 In 1979 members of the chamber of commerce opened Banco del Comercio, the first locally-owned private bank since the family banks had been expropriated in 1948

Favorable macroeconomic performance during the 1960s and most of the 1970s stimulated the entrance of many players in the financial market This contributed to the financial deepening process observed during that period Financial deepening is the accumulation of financial assets at a pace faster than the accumulation of nonfinancial wealth (Shaw, 1973)

A considerable amount of financial deepening took place over the period 1964-1979 Financial deepening, measured by the ratio of Total Liquidity (M2) with respect to GDP, increased from 20 percent in 1964 to 43 percent in 1979 (see Table 2)[6] This process was driven by the accumulation of non-monetary deposits (quasi-money) As inflationary pressures increased after the mid-1970s oil crisis, investors' preferences moved away from currency and checking account deposits Accumulation of financial assets, along with a growing network of financial intermediaries (SOB's branches and private finance companies), allowed a rapid expansion of domestic credit

Gonzalez-Vega (1988a) pointed out that despite financial deepening, Costa Rica continued to rely on foreign savings Some Financieras established by large foreign banks extended

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[5] CODESA was a government holding company engaged in development projects It had direct access to Central Bank credit to finance its activities Most of CODESA's projects failed and created financial problems for the Central Bank

[6] The ratio of M2 to GDP is commonly used as a measure of overall financial depth (King and Levine, 1991, Edwards, 1995) This coefficient has the limitation that it is affected by the behavior of the nominal GDP, which may distort the meaning of the ratio For example, during a recession the size of the GDP may decline and therefore the size of the ratio increases This suggests a financial deepening process that may not exist

significant amounts of dollar loans to private Costa Rican companies, to the Government, and to public autonomous institutions

By the mid 1970s the financial system showed evidence of financial repression [7] In 1975 deposit rates were negative in real terms Subsidized interest rates (below market levels) led to credit rationing and high transaction costs to small and riskier clients, while SOB's loan portfolios were concentrated in the hands of few large borrowers with privileged access to formal credit (Gonzalez-Vega 1976, Loria 1982)

In general, the financial deepening process observed between 1960 and the late 1970s occurred more as a result of favorable macroeconomic conditions, availability of foreign saving, and monetization of foreign earnings than through deliberate policies to promote sound and efficient financial intermediation

2 4 Financial Reforms, Economic Crisis, and Financial Repression 1975-82

In reaction to the crisis of 1975-76, during which real interest rates turned negative, there was an attempt to introduce financial reforms This occurred in October 1978, when the Government linked domestic interest rates to international rates This reform, however, was undermined by the much worse crisis of 1980-81

In the early 1980s Costa Rica suffered a severe economic crisis, characterized by a stagnant economy, growing unemployment, rampant inflation, rapid devaluation of its currency, and a large public sector deficit The crisis emerged as the result of long-term structural trends, short-term external shocks and unfortunate policy decisions in response to these shocks (Gonzalez-Vega, 1988b) The 1981-82 crisis put an end to a relatively long period of financial deepening and ushered in a period of financial disintermediation undoing much of the financial deepening that had occurred in the earlier period

By the early 1980s the import substitution and protectionist model adopted in the late 1950s was exhausted Therefore, it was unable to react to the external shocks High inflation in 1981 and 1982, fueled by the oil crisis, strong exchange rate depreciation and rapid growth of domestic credit, eroded purchasing power The Government borrowed heavily from foreign commercial banks in the late 1970s to cover the increasing import bill, instead of devaluing the currency

With the exhaustion of external creditworthiness, in 1981 the Government suspended

[7] McKinnon (1973) defines financial repression as a situation in which the failure of banks to earn high equilibrium rates of return from their privileged borrowers is reflected back in an unduly low return to depositors--one that may well be negative in real terms if inflation is at all significant

payments on its external debt Currency substitution (replacement of colon-denominated assets with foreign currency-denominated assets) took place and accelerated capital flight

The crisis caused a severe contraction of the financial sector Most foreign-owned banks and Financieras closed their operations and left the country Saving mobilization and loan portfolios decreased in real terms Large portions of the banks' credit became overdue, and crowding out of the private sector in loan portfolios was severe Measured by the M2/GDP ratio, financial deepening declined from 56 percent in 1981 to 37 percent in 1986 (see Table 2)

The need to finance a large fiscal deficit with domestic credit provoked a big reduction of credit for the private sector In 1981 the consolidated fiscal deficit (including Central Bank losses) represented almost 20 percent of GDP In the same year domestic credit for the private sector decreased nearly 50 percent in real terms

Inflation turned real interest rates negative during 1975 and 1976 To correct this distortion, and to increase national saving, in 1978 the Government introduced a financial reform by linking domestic interest rates to international rates Although designed to foster financial development, this reform had the opposite effect and dramatically contracted the financial sector (Loria, 1986)

The reform was based on the setting of both positive real lending and deposit rates according to international trends However, when international rates went up, domestic rates were not adjusted pari-passu While domestic inflation rose as much as 80 percent in 1982, deposit rates were set at 20 percent This led to a rapid "dollarization" or currency substitution process[8]

Other factors that contributed to the weakening of the reform were the following

i) **Political pressure** the Central Bank was unable to deter pressures from interest groups ("rent-seekers") to lower nominal lending rates, and to keep subsidized rates for specific activities

ii) **Lack of global approach** the authorities centered the reform on interest rates, but did not adjust relative prices (real wages and exchange rates) to changes in interest rates

iii) **Shock Treatment** the reform was non-gradual with respect to interest rates Gradual changes would have been more appropriated in a society characterized by a long tradition of government intervention The economic, political, and social establishment was not prepared to move quickly from state intervention to "free market" oversight

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[8] Camacho and Gonzalez-Vega (1985) analyze the Costa Rican experience of currency substitution and exchange rate determination during the crisis

iv) **Economic instability** the reform was undertaken in the midst of rampant inflation, stagnation, a huge fiscal deficit, and foreign exchange speculation

v) **Lack of credibility** as mentioned above, the Central Bank was unable to resist pressures to reverse the changes As a result, the credibility that the public had on the reform was severely undermined

Because of the failures in carrying out the reform, its results were poor The successful second round of financial reforms (1984-1989) clearly shows that the authorities learned the lessons from the 1978 experience

2 5 Economic Recovery, Structural Adjustment and Financial Reforms 1983-1989

After experiencing an economic and financial crisis in the early 1980s, Costa Rica began a program of economic stabilization and recovery This program was supported by international agencies, notably USAID with financial assistance (grant) of more than US$ 1 0 billion The USAID policy conditionality focused on, among other measures, developing the private financial sector

2 5 1 Economic Stabilization and Recovery

In response to a severe crisis in 1981 and 1982, Costa Rica began to carry out a comprehensive financial stabilization and structural adjustment program The stabilization program, backed by the IMF, was highly successful It combined fiscal austerity, a restrictive monetary policy, a sharp devaluation followed by periodic adjustments in the exchange rate (crawling peg), and liberalization of interest rates Foreign assistance, mostly from the United States, contributed in a mayor way to the success of the stabilization program

The stabilization program yielded positive results in 1983 and 1984 Real GDP increased during those years, while the average annual rate of inflation declined from a peak of 80 percent in 1982 to 14 percent in 1983-1984 The overall deficit of the nonfinancial public sector declined from an average of 13 percent of GDP in 1980-81 to 2 5 percent in 1993-94 In late 1982 and 1983, as confidence was restored and the value of the colon became more stable, the inflation rate subsided quickly and domestic interest rates became positive in real terms

The structural reform program, supported by USAID and the World Bank, included the following measures import tariff reduction, export incentives, privatization of some state-owned enterprises, tax reform, and financial reform USAID's conditionality focused on financial reforms

2 5 2 Financial Deregulation and Liberalization the Post-1982 Reforms

Once the economic stabilization was achieved, the Central Bank started the second round of financial reforms. The first task was to eliminate administrative credit allocation and interest rates setting. This process was completed in three years (1984-1987), under the leadership of Central Bank President Eduardo Lizano. Since its creation in the 1950s, the Central Bank exercised control over the financial sector by setting deposit and lending rates and credit ceilings for a wide range of economic activities.

Administrative credit ceilings ("topes de cartera") had been the main Central Bank's monetary tool. With the "topes" the authorities had attempted to influence both resource allocation and the rate of growth of domestic credit. This instrument had become increasingly vulnerable to political pressures, and very difficult to monitor (Lizano, 1987). In the early 1980s, for instance, the credit program included as many as 53 "topes" for the Central Bank to allocate and follow up. This reflected strong pressures from many "rent-seekers" to obtain banking credit for a particular activity[9]. After 1984 the Central Bank gradually eliminated the "topes," and in 1987 commercial banks had freedom to allocate credit according to their individual policies. The process, however, was temporarily reversed in 1988, as the urgency of the economy's financial disequilibrium forced the Central Bank to go back to credit ceilings (Loria, 1988).

Government intervention in setting interest rates was also progressively reduced. Up to 1983 the Central Bank set interest rates at below-market levels. The purpose was to subsidize "preferential" activities defined by the Executive. As credit ceilings were gradually reduced, the Central Bank steadily moved to a system of market-determined interest rates. The Central Bank also promoted the unification of interest rates to all borrowers in the same category.

Barriers to the banking industry were also reduced. A reform of the Central Bank Law approved in late 1984 allowed the private banks' access to rediscount facilities if funds were obtained by the Central Bank from international development institutions. Changes to the existing legislation also permitted private banks to reduce the minimum term of their Certificates of Deposits (CDs) from 180 days to 90 days.

Further reforms allowed private banks to develop new markets, such as interbank overnight funds and private pension funds. These developments gave private intermediaries access to short-term liquidity funds, and provided new financial alternatives for savers to invest.

The role of private banks expanded vigorously during the 1980s. Fifteen private banks were created in six years (1981-1987), while only five were established in thirty-three years (1947-1979). Private banks' share in total credit to the private sector rose from less than 2 percent in 1981 to 10 percent in 1986.

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[9] The "topes" were also a bad policy in the sense that they distorted relative prices and undermined an efficient allocation of financial resources.

The increasing role of private financial intermediaries did not match with lack of competition and over-regulation in the formal financial system As a result, an unregulated (informal) financial system emerged This parallel market included local unregulated finance companies and off-shore subsidiaries located in the Caribbean area[10]

Due to lack of a proper regulatory framework the number of unregulated Financieras increased very rapidly By 1987 their assets amounted to half of private banks' assets, and they were managing approximately 14 percent of quasi-money (World Bank, 1987) Most of these unregulated companies operated in a high-risk segment of the market They borrowed at rates exceeding the average market rate by 20 percentage points, and used these resources to finance unsafe projects of their own With the liquidity crisis that emerged in late 1987, some of these unregulated companies collapsed

The failure of unregulated companies caused damage to the regulated financial system, and undermined the general public's confidence in private financial intermediaries If private intermediaries were to play a more important role in the market, supervision had to be improved to foster financial prudence and discipline This led the Congress to approve the Financial Sector Modernization Law in 1988, which was included in the conditionality tied to the Second Structural Adjustment Loan (SAL II) agreed with the World Bank

2 5 3 The Financial Modernization Law the Main Accomplishments

By 1987 the Costa Rican financial system was highly inefficient It was characterized by over-regulation and lack of competition Banks became increasingly rigid while unregulated financial intermediaries grew rapidly Central Bank's regulations on term structure of deposits, leverage, and access to rediscount facilities discriminated private banks vis-a-vis public banks Prudential regulation and supervision was quite inadequate at all levels of financial intermediation (World Bank, 1987) Financial intermediation spreads were very large, especially in state banks (see Table 8)

In order to solve the above problems, in November 1988 the Legislative Assembly approved the Financial Sector Modernization Law The main features of the Law, which was part of the World Bank's Second Structural Adjustment Loan (SAL II) are

i) It requires the registration of all financial institutions at the General Auditor of

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[10] Both public and private banks established these subsidiaries, known as "Caribeñas", to provide foreign exchange transactions at lower cost Because Costa Rican income tax law defines as taxable only that income generated within the country's territory, interest earned in a Caribbean country is not taxable The financial reforms approved in October 1995 allowed "Grupos Financieros" to operate off-shore companies if they met the capital, disclosure, and supervision conditions set by the law

Financial Institutions (AGEF) This regulatory body is allowed to intervene financial institutions without obtaining prior Court authorization

ii) It contains a series of provisions designed to increase the solvency of state-owned banks by requiring higher capitalization and more realistic policies for dealing with non-performing loans

iii) It raises the loan authorization limits of banks' managers to improve efficiency of state banks

iv) It requires the establishment of deposit insurance to enhance the safety of deposits in private financial institutions[11]

2 5 4 Further Financial Sector Reforms under SAL II

SAL II was approved in December 1988 and became effective in November 1989 The financial sector component of SAL II included measures to improve SOBs' financial positions and mobilization of resources Some specific measures are the following

i) The Government will not promote any new generalized debt-rescheduling program with subsidized credit lines

ii) Penalty rates will be charged on all overdue loans

iii) Prohibition for banks to register as income accrued interest on loans overdue by more than 180 days

iv) Reduction of SOBs' arrears and subsidized credit in real terms

2 6 Financial Developments in the 1990s

2 6 1 Economic Background

After a successful economic performance in 1992-93, the macroeconomic situation deteriorated in 1994-95 The Central Bank projects the economy to grow by 2 5 percent in 1995, down from 4 5 percent in 1994 and 6 4 percent in 1993 Inflation rose from 9 0 percent in 1993 to 20 0 percent in 1994-1995 The fiscal position worsened from near balance in 1992-1993 to a deficit of 8 0 percent of GDP in 1994, of which 1 8 percentage points is explained by the losses of Banco Anglo Costarricense Costa Rica has also experienced

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[11] This insurance never came into operation, as the National Insurance Institute (INS) proposed very high insurance fees because of the volatility of the financial market

important structural changes These include the liberalization of the capital account of the balance of payments, further reduction of import tariffs, the abolition of the SOBs monopsony on checking accounts, and the access of private banks to rediscount facilities

2 6 2 Financial Developments

During the 1989-1992 period the Central Bank concluded the elimination of the "topes" and the liberalization of interest
rates These actions contributed to foster financial deepening Legal reserve requirements, however, were a repressive factor Because the use of open market operations (placement of Monetary Stabilization Bonds) increased its losses, the Central Bank heavily relied on the reserve requirements to control the money supply High reserve requirements are a key element in explaining the large intermediation margin in the Costa Rican banking system (Camacho and Mesalles, 1994) Regarding institutions, two new private banks started operations Banco Solidarista (1991) and Banco Panamericano (1992)

Additional reforms took place during the 1990s Both SOBs and private banks were allowed to grant loans and mobilize deposits denominated in foreign currency on their own account This is an important change, in agreement with the liberalization of the exchange rate regime In February 1992 the Central suspended the minidevaluations and adopted a "dirty float" exchange rate system Accordingly, exchange rate controls were removed and the capital account of the balance of payments was opened Large capital inflows followed and the colon rate appreciated Attempts to stop the appreciation of the colon complicated the design and management of monetary policy and were a source of financial repression

In order to moderate the real appreciation of the colon and its negative effect on exports, the Central Bank intervened in the foreign exchange market by purchasing dollars and therefore adding to the monetary base To sterilize the additional liquidity, the Central Bank increased the reserve requirements on demand deposits Also, in an attempt to discourage capital inflows, the Central Bank lowered interest rates on its Monetary Stabilization Bonds, which prompted a reduction in the banking system's interest rates This caused some financial repression as real deposit interest rates became negative

Also, in January 1992 the Central Bank reduced the minimum term of the CDs from 90 days to 31 days In August of that year the Bank authorized private banks to issue CDs at any term, which helps foster competition and reduce barriers to entry into the banking industry

In 1994 a new private bank (Bancrecen) entered the financial system, and two former Financieras became banks (Citicorp and Finadesa) The number of private banks increased in 1995, when two more former Financieras were transformed into banks (Promerica and Improsa)

The proliferation of entities, transactions, and financial innovations seemed to respond more to excessive regulation and lack of competition than to a natural development (Gonzalez-Vega,

1990) Intermediaries created many sophisticated instruments to circumvent Central Bank regulations, such as very high reserve requirements and credit ceilings

Financial innovations, such as Operaciones de Administracion Bursatil (OPAB), Investment Funds (Fondos de Inversion), Fideicomisos (trust funds), Cuentas de Administracion Bursatil (CAV), and overnight deposits have expanded very rapidly OPABs and CAV, which give investors the possibility of investing short-term at a guaranteed rate outside the SOBs, amounted to 30,585 million colones by June 1995 (Camacho, 1995a) This amount represented 22 8 percent of M1 (Money Supply) and 42 4 percent of total demand deposits Investment in OPABs allows commercial banks to reduce the amount of sight deposits subject to reserve requirements

On the credit side, Private banks created the Bankers Acceptances ("Aceptaciones Bancarias"), to expand the credit supply beyond the limits imposed by the Central Bank With the banks' guarantee, borrowers could obtain financing by selling the Acceptances in the securities market The banks registered the Acceptances as off-balance-sheet transactions

As surging financial intermediaries and innovations expanded and took larger shares of the market, they were eroding the power of the legal monopsony of the SOB Also, the emergence of unregulated intermediaries and financial innovations has undermined the effectiveness of Central Bank's monetary policy

2 6 3 Recent Financial Reform

Despite the efforts to improve financial intermediation, the system continued to suffer from a series of problems, which include 1) high reserve requirements which affect adversely financial intermediation, 2) both state and private banks continued showing high and increasing intermediation spreads (see Table 8), 3) high administrative costs, weak loan portfolios, and a low capital base in the SOB, 4) insufficient competition between public and private intermediaries, 5) weak enforcement powers and incomplete coverage of financial intermediaries by AGEF, and 6) limited autonomy of the Central Bank and AGEF

Reforms to foster competition and efficiency in the financial market, and to strengthen prudential supervision continued as a concern of the Costa Rican authorities In 1992 the Legislative Assembly set up a special commission to review the existing legislation on financial intermediation issues The commission, supported by USAID, prepared draft bills on financial reforms, which were approved on October 26, 1995

Major reforms included in the approved legislation are the following

- SOBs' monopsony on checking accounts is abolished and access to Central Bank rediscount extended to all financial intermediaries supervised by AGEF Private banks can offer checking accounts ten months after the laws are published

- The reserve requirement rate is to be gradually reduced from current levels (43 percent for sight deposits) to a uniform rate of 15 percent by December 1998, and extended to all institutions supervised by AGEF

- Autonomy of the Central Bank is increased by extending the term of members of the Board (excluding the Executive President and the Finance Minister) from four years to seven years

- The new legislation allows AGEF to impose penalties and strengthens its ability to exercise its supervisory function It also extends AGEF's supervisory responsibilities to all financial intermediaries

- The Central Bank guarantees free convertibility (removal of restrictions on foreign exchange transactions and contracts) The Bank also has legal authority to set up any foreign exchange regime

- The law restricts the Central Bank's use of instruments such as credit ceilings ("topes"), import surcharges, and interest rate setting

- The Central Bank's major responsibility is to keep internal and external stability All development-related objectives are considered as subsidiary

- New legislation is introduced to regulate the operations of the so-called "Grupos Financieros "

- The law eliminates the restriction on the number of shareholders required to establish a private bank It also eliminates the ceiling on individual ownership of the bank

The new Central Bank's law envisages important changes to increase financial sector efficiency, as it includes provisions to strengthen the Central Bank's autonomy, and to improve the capability of the supervisory agency (SUGEF) to exercise prudential supervision Regarding autonomy, the members of the Bank's Board of Directors (excluding the Executive President and the Minister of Finance) are named by the Executive Branch and ratified by the Legislative Assembly This reduces political intervention on the Bank's policies In addition, the former AGEF is transformed into SUGEF, a new regulatory body ruled by a Directorate, with power to intervene any financial intermediary, to set capital base requirements and risk standards, and to regulate the operations of the so-called "Grupos Economicos "

2 6 4 Agenda for Further Reforms

The Legislative Special Commission's next task is to draft additional legislation for the financial system as a whole Further competition and market integration are topics of high priority In particular, the Commission is preparing legislation to authorize foreign banks to set up and operate branches in Costa Rica At present foreign banks can only operate through subsidiaries established as Costa Rican private banks Regarding financial market integration, the Commission is working on a financial code to harmonize, as much as possible, all the existing institutional and legal framework

2 7 Concluding Remarks

Over the last fifty years the Costa Rican financial sector has experienced important changes From the banks' nationalization in 1948 to the pre-crisis years, the sector evidenced financial deepening Later, financial repression emerged with the crisis and the sector started moving toward structural reforms During the 1980s private intermediaries proliferated and captured larger shares of the market through financial innovations This process seemed to respond to excessive regulation and lack of competition Important reforms have taken place since the mid-1980s, including the recent abolition of the SOBs' monopsony on checking accounts The process, however, has been very slow Market fragmentation, lack of competition, insufficient supervision, and inefficient (costly) financial intermediation are still pending issues Political opposition to policy reforms seems now to have diminished, and prospects for further reforms are favorable

Among the many Costa Ricans that supported the financial sector reform, two of them deserve special consideration, Claudio Gonzalez-Vega and Eduardo Lizano Professor Gonzalez-Vega, now at the Ohio State University, provided the theoretical and empirical foundation to support new ideas and concepts on financial reforms As President of the Central Bank of Costa Rica, Dr Lizano took the leadership in setting up important reforms that paved the road for further discussions on financial issues

3 USAID'S INVOLVEMENT IN THE FINANCIAL SECTOR POLICY AND INSTITUTIONS

USAID's intervention in the Costa Rican financial sector can be analyzed on two levels initiatives at the micro level and programs at the macro level At the micro level USAID developed a series of projects that dealt with specific financial institutions These projects had the common purpose of developing private financial intermediaries At the macro level, USAID's intervention was related to policy reforms aimed at enhancing the financial sector's efficiency This section reviews USAID'S major projects, programs, approaches and goals in the financial sector

3 1 Involvement at the Macro Level Stabilization and Recovery Programs and Policy Reforms

Most of USAID's intervention in the financial sector was concentrated in the 1982-1992 period (the stabilization and restructuring phase) After the crisis the country experienced in the early 1980s, USAID supported the Costa Rican Government (GOCR) through the Economic Stabilization and Recovery Programs (ESRs) These programs provided dollar funds for balance of payment support Disbursement of dollar funds generated local currency counterpart funds (HCLOC), part of which were devoted to financial sector projects As stated in the ESR agreements, dollar disbursement were conditioned on the adoption of policy reforms, most of them related to financial sector issues

USAID's conditionality on financial policies started in 1982, with the second ESR program The ESR II stated as a condition precedent to disbursement that "an amendment to the Central Bank Law to permit the participation of the private banks in the Central Bank's rediscount and other lending programs on an equal basis with the public banks must be submitted to the Legislative Assembly "

The conditionality included in the third (1984), fourth (1985), and fifth (1986) ESR programs focused on interest rates and credit policies It stated that the average deposit rate ("tasa basica pasiva") was to be positive in real terms, lending rates were to be unified to only two major categories, and rates were to be adjusted regularly taking into account inflation, international rates, and supply and demand for credit In addition, a program was to be developed to reduce costs and intermediation margins of SOBs, and transaction costs for their clients

Regarding credit policies, financing for two major money-losing public enterprises, CODESA (a holding development company), and the CNP (the basic-grains marketing board) were to be limited Also, loans at subsidized rates (below the "tasa basica pasiva") were to be limited to specific activities, such as small farmers, rural women, forestry, and others specified by particular laws The Central Bank was required to announce and maintain a credit program and to report and explain any deviations between programmed and realized amounts

The sixth ESR program (1987) continued the conditionality of previous programs and added two new components First, the GOCR was required to analyze the impact of a law to reschedule agricultural loans (Ley FODEA)[12] on the operations and profitability of the domestic banking system, on levels of subsidized credit, on availability of credit and the cost of financial intermediation Secondly, ESR VI required the GOCR to adopt measures to facilitate the access of private and cooperative banks to the financial market

The conditionality included in the seventh ESR (1988) insisted on positive and market-determined interest rates and limited subsidized credit New covenants included the following to maintain a credit program that eliminate detailed allocative categories for the

[12] The law authorized the Ministry of Finance to issue five billion colones in bonds which would be used to buy the delinquent loans of small and medium-sized farmers in state-owned banks A moratorium decree issued by President Monge and extended by President Arias forced the banks to reschedule the loans with a 12-18 year repayment period, including 4 years of grace and at subsidized interest rates This episode of political interference is analyzed by Mesalles (1991b) from a political economy perspective

provision of credit, to prepare a rural credit program based on an analysis of demand, costs, and administrative practices responsive to market forces, and to develop a deposit guarantee program for private financial institutions

The next program's conditionality (ESR VIII, 1989) introduced a quantitative limit on subsidized credit (7 7 billion colones including all sources of funds) The covenants also included an action plan to improve and rationalize the pension system This condition opened the discussion on private pension funds as financial intermediaries

ESR IX (1990) included aspects of financial conditionality carried over from prior programs The program gave special consideration to reducing the inequality of treatment between public and private banks, by permitting private bank access to rediscount facilities, insurance deposits, and issuance of short-term Certificates of Deposits (CDs) The 1991 Program (ESR X, Trade and Investment Program) focused primarily on trade liberalization and public sector efficiency Financial policies dealt with reducing the Central Bank's losses and with measures to enhance the Bank's autonomy

The last program (ESR XI, 1992, Trade and Investment II) continued to support structural reforms, and had no explicit financial sector conditionality Areas of concern were macroeconomic stability, exchange rate liberalization, tariff reduction, decontrol of prices, and public sector efficiency

General Assessment

The conditionality associated with program lending raises a number of problems to consider In program conditionality the relationship between conditions and outcome is much theoretical and even ideological, its mode of operation less clear than project conditionality, and its effect subject to long delays and uncertainty (Lele and Nabi, 1991) Another issue is the distinction among policy dialogue, advice, and imposed conditionality It is widely recognized that policy dialogue is a better way to improve policies than to impose conditionality that is unwanted by the host country Implementation of program conditions may be unlikely as it may conflict with sovereignty of the recipient government

USAID's intervention in the Costa Rican financial sector was a combination of policy dialogue and imposed conditionality USAID supported the thinking of the Executive President of the Central Bank, Eduardo Lizano, which concurred with the "Washington consensus"[13] in favor of shifts toward more market-determined interest rates to allow a

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[13] The "Washington consensus" includes the U S Congress, senior members of the U S Administration, technocrats of the international financial institutions, the economic agencies of the U S Government, the Federal Reserve Board, and the think tanks "Consensus" on policy reform includes the following ten beliefs fiscal discipline, priorities for public expenditure, tax reform, financial liberalization, exchange rates determined by market forces,

flexible allocation of resources within developing countries (Zank, 1990)

Lizano s policies, however, did not necessarily reflect the GOCR's point of view on financial sector issues By the time ESR programs started, restricting financial services and market entry, administrative credit allocation, and interest rates controls were policies supported by key members of the economic cabinet (Loria, 1992) Compliance of most of the USAID s conditionality helped Mr Lizano to launch the reforms and force the politicians to endorse them

What was the rationale for the policy changes? The crisis made evident that the "inward looking" development model of the 1950s was insufficient to provide an adequate basis for sustaining suitable economic development The solution, Lizano argued, was an "outward looking development model" For this model to be successful, the Central Bank should promote competition to reduce intermediation costs to finance export-oriented projects

USAID supported Lizano s ideas through ESR conditionality As stated in the ESR IX,

> A previous history of burdensome procedures, lack of private banks competition, and political interference had impeded an efficient response to the credit needs of the productive private sector In this regard, the Mission will seek to support key decision-makers as they seek to further reduce the inequality of treatment between public and private banks

Because private banks did not have access to rediscount facilities from the Central Bank, USAID established and funded five lines of credit within the Central Bank to provide liquidity and long-term financing to private banks (and public banks in some cases) The purpose of the lines, which amounted US$ 169 5 million, was to finance private, local enterprises which produced primarily, but not exclusively, for the export market A reform to the Central Bank Law enacted in August 1984 made possible the operation of the credit line system for the private banks [14] As pointed out by Lanza (1994), the origin of the money was important for political appearances As long as the origin of the funds is external, politicians could claim that they are not part of the "national patrimony " In other words, the Central Bank is not using public domestic funds to give credit to private institutions

Backed by USAID, the Central Bank was successful in carrying out most of the reforms described in the Sector Overview Section The financial liberalization was temporarily reversed in 1989, and surged again in 1992 Then, the conditionality diminished as ESR programs ended, but USAID's support continued through technical assistance provided by the

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trade liberalization, direct foreign investment, privatization, deregulation, and property rights (Williamson, 1990)

[14] The Law established that the Central Bank can grant loans to all commercial banks if the funds are provided by multilateral or bilateral institutions

3 1 1 Technical Support for Policy Changes The Financial Services Project

The Financial Services Project (FSP) is a US$ 5 46 million project designed to promote the development of efficient financial market systems It was approved by USAID in June 1990 and includes three components policy analysis and reform, prudential supervision, and financial management and innovation

At request of the GOCR USAID provided technical support to a special legislative commission created to develop financial reforms With the support of USAID, the Commission drafted three bills covering stronger financial sector supervision, greater Central Bank autonomy and global financial sector reform The first two bills were recently approved by the Legislative Assembly Major reforms include rediscount facilities to private banks, abolition of the SOBs' monopsony on checking accounts, and limited Central Bank financing to the Government According to bankers, policy-makers, and deputies interviewed for this study, there is no doubt that USAID was pivotal and instrumental in the process of financial reforms in Costa Rica

Outputs of the Policy Analysis and Reform component include research, local and international advisors, training, publications, seminars, conferences, and study tours A recent evaluation of the FSP indicated that

> Substantial success was achieved in improving the policy and regulatory environment for financial sector performance during 1992 and 1993, primarily through assistance to the GOCR in developing policy and regulatory changes implemented through Central Bank administrative actions Significant progress on the legislative front was also achieved [15]

The Central Bank's autonomy is an issue of intense debate The question is to what extend a central bank should be independent from the Executive branch In Costa Rica, as in other Latin American countries, the central banks have been unable to resist pressures to finance fiscal deficits or to carry on public sector liabilities This situation led central banks to suffer heavy losses caused by "quasi-fiscal" deficits ESR X requested the GOCR to submit a plan to reduce the Central Bank's losses Since that plan did not appear, USAID, with the collaboration of the Central Bank, designed a plan to reduce such losses by using local currency counterpart funds

The FSP also provided technical assistance to create a modernized settlement and clearance

[15] Costa Rica Financial Services Project, Midterm Evaluation, Nathan Associates Inc , AG International Consulting Corporation, January 1995

system In 1993 a Costa Rican delegation of bankers and deputies visited the Federal Reserve of Boston to see the Fed's systems and policies With the assistance of the Federal Reserve of Boston, the Central Bank of Costa Rica and the National Banking Association (ABC) have been working together in designing a new clearance system in Costa Rica, which is expected to start in 1996

3 1 2 Central Bank's Losses and the use of Local Currency Counterpart Funds (HCLOC)

In the past the Central Bank accepted non-performing bonds in exchange for financing the losses of public institutions Since the Bank's interest-paying assets were much smaller than its interest-paying liabilities, the Bank experienced losses Among the non-interest paying assets issued by public institutions and owned by the Central Bank were the bonds issues by the Consejo Nacional de Produccion (CNP), the Costa Rican grain marketing board

To "clean" the Central Bank's balance sheet of some of its non-performing assets and to strengthen the Bank's financial position, USAID, in cooperation with the Central Bank, designed a "cleansing" mechanism to convert "bad assets" into "good assets " The basic idea was to increase the Central Bank's revenues through the use of previously non-programmed local currency generated from past USAID programs CNP bonds were selected as a first step in this cleansing

Encouraged by assurance of USAID's support, the Ministry of Finance agreed to issue and sell bonds with a face value of 6 2 billion colones to the Central Bank in exchange for non-performing bonds, of equal face value, held by the Central Bank and issued by the CNP USAID agreed to transfer 4 0 billion colones of previously non-programmed local currency to the Ministry of Finance to be used to pay the Central Bank's interest charges HCLOC covered much of the cost of this scheme, which could be used to replace other non-performing assets in the future

Although the CNP transaction was relatively small compared to the size of the Central Bank's losses, it made clear to politicians and policy-makers the pervasive effect of non-performing public bonds on the Central Bank's financial position The recently approved financial reforms request the Ministry of Finance to issue new bonds at market rates in exchange for its non-performing liabilities with the Central Bank

3 2 Involvement at the Micro Level Institutions and Sector Projects

At the micro level USAID's involvement focused on institution building and resource orientation USAID-funded entities developed a large variety of financial products and covered a wide range of activities, such as export promotion, agriculture, investment, venture capital, housing, microenterprise, and credit union development The rest of this section discusses both institutions and sector programs separately

3 2 1 Institution Building

USAID was instrumental in the creation of three export credit institutions, a mortgage housing bank, and two private cooperative banks

3 2 1 1 COFISA, BANEX, PIC

USAID supported export promotion by supporting the creation of three private sector institutions the Corporacion Costarricense de Financiamiento Industrial **(COFISA)**, the Banco Agroindustrial y de Exportaciones **(BANEX)**, and the Private Investment Corporation **(PIC)**

COFISA was founded in 1963 following an initiative by the U S Government to establish a Costa Rican private financial institution to promote private sector development in Costa Rica The financial performance of COFISA was successful until 1981, when the exchange rate crisis in Costa Rica left COFISA insolvent and in default with the international banking community The crisis also affected Costa Rican traditional and non-traditional exports severely

To assist COFISA in this crisis situation, in 1982 USAID and COFISA signed a loan agreement for US$10 million plus US$5 million equivalent in local currency funds (generated by ESR programs) The objectives of the program were 1) to assist in the liquidity of the productive private sector in Costa Rica, 2) to enhance the capacity of the private sector to generate foreign exchange, and 3) reestablish COFISA as a development-oriented financial institution

The recapitalization of COFISA was to be based on the future profitability of the institution and on the sale of new preferred shares With subsidized loans from USAID and market rates to be charge on the loans, COFISA was expected to be profitable private financial institution when the project was completed The borrower was the Corporacion Costarricense de Financiamiento Industrial, Internacional (COFISA International), which was incorporated in Panama in 1974 as a wholly-owned subsidiary of COFISA S A , the private finance company incorporated in Costa Rica in 1963

An evaluation covering the period 1982-1986 concluded that the project apparently achieved its objectives of bolstering Costa Rica's private sector and foreign exchange generation (Quiros and Quiros, 1986) The evaluators pointed out that "much remains to be done in terms of bank operations and planning to permit COFISA greater viability as a commercial bank once it is chartered " They also found that COFISA's financial situation improved as it was able to preserve significant equity during debt negotiations with external commercial banks COFISA's major challenge, the evaluators indicated, was to obtain additional debt

By 1989 the COFISA project had financed 57 projects amounted US$ 17 5 million

COFISA's loan portfolio, however, showed a high percentage of non-performing assets, which reflected poor credit policies and an inadequate project selection process (Porges, et al, 1990) The new administration that took office in 1990 improved some of the unsound lending practices by reducing the risk exposure The institution, however, continued to be highly dependent on USAID funds In 1990, 33 percent of consolidated assets derived from USAID funds, 40 percent of consolidated liabilities were due to USAID, and 35 percent of gross consolidated income arose from USAID-sponsored funds, including USAID trust funds managed by COFISA (Price Waterhouse, 1991)

After COFISA had loaned out the US$10 million AID fund, a question was how COFISA will continue to be a development institution by only making loans from reflows of the original dollar fund Without additional dollar financing COFISA would grow as a normal commercial bank but would decline as a development bank (Porges, et al, 1990)

The consolidated 1993-94 financial statements reflected a sound financial position, and the credit portfolio was concentrated on long-term financing for non-traditional exports As a percentage of total assets, outstanding loans increased from 47 percent in 1990 to 61 percent in 1994 Most of the loans have been granted from the reflows of the original AID loan, since no additional dollar financing has been achieved

The local bank, Banco de COFISA, started operations as a local private bank in 1986 Its assets represented 2 6 percent of private banks' total assets in June 1990, and 1 42 percent as of September 1995 The Bank's activities include lending operations, issuance of guarantees, stock exchange transactions, and management of USAID's funds It should be noted that, according to the USAID/COFISA agreement, the bulk of the lending operations are undertaken by the off-shore company COFISA International (Panama)

To summarize, the COFISA project has been successful in achieving the intended objectives There are, however, some shortcomings to point out 1) high dependence on USAID's funds, 2) the recapitalization came mainly through debt forgiveness (COFISA still owes US$ 7 million to USAID), 3) it involved subsidized interest rates and directed credit, which were inconsistent with USAID's conditionality, and 4) it subsidized private bankers who were clearly not among the low-income groups that USAID was supposed to benefit (Vogel, et al, 1993)

In 1982 USAID started the Private Sector Productivity Project, a US$10 million project implemented through **BANEX** The project's purpose was to overcome the liquidity shortage after the crisis and to develop a private-sector alternative to the public banks for non-traditional export financing BANEX was to engage in export management and promotion through the creation of a trading-company subsidiary BANEX did not succeed in export promotion so it moved to export banking services (Camacho, 1995b) As BANEX developed as a banking institution, it engaged in a variety of activities besides export services These included foreign investment attraction, development lending, and private pension funds

Today BANEX is a leading private bank in Costa Rica It was a pioneer in developing private pension funds and the "cuenta maestra," a financial innovation providing interest-earning sight deposits outside the public banks BANEX is the third largest private bank out of 24 operating in Costa Rica as of September 1995 Its assets and loan portfolio represent 10 1 percent and 10 3 percent of the total for all private banks, respectively

The Private Investment Corporation **(PIC)**, the first private venture capital company in Central America, was established in 1984 to fill a gap in services not provided by the banking system PIC is organized under the laws of the Republic of Panama In Costa Rica the company's activities are carried out mainly through its subsidiary Saip Inversiones S A PIC is domiciled in Panama and it is registered in the Central Bank of Costa Rica as an international financing institution Its accounting and subsidiary records are kept in US dollars

At the beginning, PIC worked as a merchant bank in developing projects aimed at fostering export earnings and employment To do so, PIC concentrated on providing investment packaging services, medium and long-term credit and equity financing for export-oriented ventures The PIC received a US$20 million USAID loan for lending capital, a US$1 million grant for technical assistance, and US$5 million in local currency (generated by ESR programs) for equity capital

One year after its creation, PIC experienced large losses from its development financing activity Lack of expertise, inadequate project evaluation, and unsound managerial practices accounted for this situation

A recent evaluation about PIC's performance stated the following

> It is clear that PIC was not able to take advantage of the ten-year grace period for repayment of the AID soft loan by building up a solid loan portfolio managed with low administrative costs The loss of this opportunity means that the future of the developing lending function within PIC may be uncertain As such, it is necessary to redefine the objective, strategy and direction of the development lending function within PIC [16]

Given this situation, PIC's Managing Director proposed to USAID to move away from the objectives set forth in the project paper and loan agreement in favor of engaging in lower-risk and less-costly activities As a result, equity investment and merchant banking activities were discontinued

Despite its initial failures, PIC made important contributions to financial development in Costa

[16] Price Waterhouse, Management Evaluation of the Private Investment Corporation, 1993, page 14

Rica It introduced new financial instruments and activities, such as leasing, underwriting, joint ventures, and equity investments PIC has also obtained external funding from Germany (DEG), the United Kingdom (CDC) and the World Bank (IFC) Currently, PIC's portfolio is concentrated in long-term loans for non-traditional exports PIC also provides working capital loans (with own or external resources) to supplement long-term projects Currently, PIC has requested AGEF authorization to establish and operate a local finance company to enlarge its financial services in local currency

As shown in Table 5, PIC is comparable to a medium-sized private bank in Costa Rica, and it has the potential to succeed as a financial intermediary The big challenge for PIC is to survive when it pays back the loans to USAID Prospects seem favorable, as PIC is taken measures to increase its financial viability

General Assessment

USAID's promotion of the creation of COFISA, BANEX, and PIC had two clear objectives to support non-traditional export projects and to give the private sector financial options outside the public banks These objectives were achieved However, in doing so, USAID provided subsidized loans to private bankers and designed directed credit schemes These mechanisms were against the philosophy of the new model that USAID was supporting in Costa Rica

BANEX was a very successful experience Over the years it developed financial innovations that enabled it to prosper after paying its debt to USAID In this sense, PIC and COFISA were less successful PIC had poor results during the early years Then, it transformed itself into a more innovative institution Over the years, however, PIC lost its competitive advantage and now it has to compete with other intermediaries that offer the same products PIC developed in the past COFISA, on the other hand, remains highly dependent on USAID funds, and the local bank shows no evidence of major actions to strengthen its competitive position in the financial market

The Costa Rican financial community seems to agree that USAID's promotion of private institutions was positive for the country However, interviews with local bankers raised two issues First, why did USAID not work with existing private financial intermediaries, instead of creating new ones? The second issue deals with ideology USAID, some bankers claim, did not give public banks the opportunity to participate in the scheme They were excluded because of their public nature, no matter what they were willing to do While the first issue may have merit, the second seems dubious It was clear that, in the early 1980s, public banks were not prepared to be the engine to support new export activities Secondly, although public banks were willing to improve their banking practices, political intervention represented a handicap very difficult to remove

USAID took the right approach in excluding state banks from export financing programs, because of practical considerations State banks were very conservative entities with no expertise in lending to nontraditional export projects Although some state banks were willing to improve their banking approach, their learning process would have been very slow and probably highly susceptible to intervention by politicians

3 2 1 2 The Housing Mortgage Bank (BANHVI)

By 1985 USAID developed the concept of a central mortgage bank operation The bank, which would be controlled by the private sector, would be empowered to issue bonds or mortgage certificates and to rediscount mortgages to facilitate reinvestment of housing financing in new operations USAID also planned to provide local currency financing to assist home financing institutions to improve their financing planning and administrative capacities

Later, the concept of a private mortgage bank changed, and USAID supported the passage of legislation to create a public second-story housing bank (Banco Hipotecario de la Vivienda, BANHVI) The change came from the existing large housing deficit and the need to establish a system for mobilizing a constant flow of resources for housing construction USAID provided local currency funds to strengthen private savings and loan associations ("Mutuales") and to establish BANHVI as the regulatory and supervisory body The savings and loan associations had been established in the early 1970s with seed capital and technical assistance from USAID

Law 7052 (1986) created the Sistema Financiero Nacional para la Vivienda (SFNV) It consists of BANHVI as the regulatory entity and a number of institutions (savings and loans associations, cooperatives, commercial banks) authorized by the Law 7052 to mobilize resources under the SFNV

In 1987 the GOCR and USAID signed an agreement calling for collaboration in the development of a more effective national system for housing finance, including financial support for BANHVI Between 1988 and 1994 USAID directed US$ 47 million (under ESR local currency programs) to the housing sector Conditionality included better credit policies for loan recovery, BANHVI's role in discounting mortgages rather than direct lending, and better definition of the role of different public housing institutions

USAID funds played a key role in remodeling the SFNV In 1991 the loan portfolio discounted by BANHVI with USAID funds accounted for 40 percent of the total portfolio (Robbins, 1992) This had a significant impact on the Mutuales' development Although most of the Mutuales were created in the early 1970s, their faster growth started after the creation of the SFNV in 1986 In 1993 the SFNV accounted for 45 percent of the housing credit market This percentage increased to 56 percent in 1994, with the Mutuales representing 36 percent (Meza and Thompson, 1995)

A major issue in housing finance in Costa Rica has been the conflict between short-term social programs versus the creation of a strong and stable national housing finance system The key point is the level of interest rates In the past BANHVI fixed the Mutuales lending rates at subsidized levels The Mutuales, on the other hand, paid market rates for their deposits This caused the Mutuales financial problems

USAID played an important role in promoting a policy dialogue between Mutuales and the GOCR on interest rates On April 1995 the GOCR agreed to change the interest rate policy for the SFNV Instead of fixing the lending rate, the GOCR now sets the intermediation margin for the Mutuales

The development of a Savings and Loan (S&L) system had been under consideration by the Costa Rican government and USAID since the early 1960s Then, Costa Rica's national banking system had very little housing credit available to meet demand for new houses by Costa Rica's growing middle class Therefore, USAID provided technical assistance to explore the possibility of developing an S&L This paved the road for the Legislative Assembly to approve a 1969 law which authorized the creation of an independent S&L Since the new system lacked adequate seed capital to begin lending and to attract savings deposits, USAID granted a US$1 million loan to finance the establishment of the S&L More recently, USAID provided the government with technical assistance to draft legislation transforming the S&L into private savings and housing banks under the supervision of the General Superintendent of Financial Institutions (SUGEF), a recently-established regulatory body also created with USAID technical assistance

General Assessment

USAID played an important role in the development of the housing financial system in Costa Rica USAID's funds provided the needed liquidity to finance housing construction USAID also contributed to strengthening BANHVI's control and supervision capabilities, to improving its management, and to facilitating the policy dialogue regarding interest rates policy As a result, the major institutions within the SFNV, the Mutuales, increased their share in the housing credit market

Although the Mutuales operates now with low delinquency rates and intermediation margins, their financial base is still weak and they are heavily dependent on BANHVI's resources (Meza and Thompson, 1995) Also, the Mutuales sector is concentrated in two large institutions, which accounted for nearly 80 percent of the sector's profits in 1994

3 2 1 3 The Cooperative Banks (Banco Federado and Bancoop)

Banco Federado is the successor of Banco Cooperativo de Alajuela, which was founded in 1984 and collapsed in 1986 because of an inadequate level of capitalization After the collapse, the Banking General Auditor approached Fedecredito (a federation of credit unions created in 1963 with USAID financial support) to take over the Banco de Alajuela With technical support of the Confederacion Latinoamericana de Cooperativas de Ahorro y Credito

(COLAC) and financial support from USAID (through PL 480, section 108 funds), Fedecredito acquired the Banco de Alajuela and transformed it into Banco Federado R L

Fedecredito realized that Banco Federado could not play an important role as a financial intermediary if it were not properly capitalized, especially after the 1987 financial crisis Then-President Oscar Arias supported Banco Federado with a 300 million colones donation from ESR VI local currency funds Fedecredito contributed to Banco Federado's capital with an additional 100 million colones According to the agreement, the donated funds were to be devoted to finance production by small and medium farmers and industries, and for construction and repair of low-cost housing In addition, the agreement provided for the establishment of a "guarantee fund" covering the deposits and savings of the members of the credit unions affiliated to Fedecredito

With a stronger capital base, Banco Federado started operations in 1988 as a private bank Fedecredito could mobilize the resources directly, without Banco Federado However, only through a bank Fedecredito could leverage the 400 million colones in capital up to a maximum of 10 1 according to the existing banking rules through the issuance of investment certificates Also, as a private bank Banco Federado had access to Central Bank lines of credit, including those supported by USAID funds

USAID also used local currency counterpart funds generated by PL 480 to capitalize the Banco Cooperativo Costarricense (Bancoop) The bank was organized by a group of cooperatives to fulfill the sector's needs of credit It started operations as a private bank in 1982 In addition to creating Bancoop, the cooperative movement sponsored new legislation which legally authorized the bank as a true cooperative bank

In 1989 USAID made available to Bancoop 260 million colones from PL 480 for on-lending The bank was required to be in good standing with the General Auditor of Financial Entities (AGEF) In 1990, Bancoop faced a financial crisis and was intervened by AGEF in 1991 Non-performing loans, use of working capital to acquire an expensive building, extreme disorder in the international department, and inefficient credit follow-up procedures accounted for the bank's financial distress (Vogel and others 1993, Hairston, 1987)

General Assessment

USAID's experience in providing seed capital to cooperative banks has been mixed Bancoop had a poor performance while Banco Federado has a better record Their impact on the whole financial sector has been modest Together, they represent 6 percent of private banks' total loan portfolio as of June 1995, up slightly from 5 percent in June 1990

As part of the Sistema Fedecredito, Banco Federado has developed expertise in providing financial services to the cooperatives, such as credit-card, savings-plan, and foreign-exchange operations The financial legislation recently approved opens opportunities and challenges for small private banks such as Banco Federado and Bancoop Banco Federado seems in better position to face the coming competition, by combining efforts and products with its partners within the Sistema Fedecredito (stock brokerage, offshore operations, housing financing) Prospects for Bancoop are uncertain It is doubtful that a small bank like Bancoop can survive in a more competitive market by itself

3 2 1 4 Microenterprise Financing (ACORDE)

USAID support to microenterprises emerged as an attempt to provide technical assistance and financial services not available to small-scale borrowers and savers In 1982 USAID created the Asociacion Costarricense para Organizaciones de Desarrollo (ACORDE) as a branch of the Coalicion Costarricense de Iniciativas de Desarrollo (CINDE) As CINDE dealt primarily with large projects, in 1988 ACORDE was transformed into an independent nonprofit umbrella organization providing credit and technical assistance to non-bank, private financial intermediaries (NGOs) The NGOs, in turn, would provide credit, training, and technical assistance to small and microenterprises

In the beginning ACORDE provided the NGOs with credit at subsidized interest rates Neither ACORDE nor the NGOs had real concern for their self-sufficiency and long-term financial viability ACORDE's role was just to distribute USAID donations among the NGOs without any development vision

In 1992 USAID, under the Financial Services Project, evaluated ACORDE's financial position, policies, and administrative structure The evaluation recommended that ACORDE make its own self-sufficiency and long-term viability its most important goal It also recommended that ACORDE provide credit at market lending rates in order to recover operational costs, including loan losses (Vargas and others, 1992) Some NGOs adopted the new policy guidance and had relative success, like the Fundacion Integral Campesina (FINCA) NGOs highly dependent on donations did not accept the new policies and were excluded from ACORDE's portfolio

General Assessment

A recent evaluation of the USAID Financial Services Project (Nathan Associates Inc , 1995) reports improvements in ACORDE's performance over the last few years ACORDE increased its average lending rates, reduced its administrative expenses and diminished its portfolio from 40 NGOs in 1991 to 26 at present Prospects for ACORDE are positive as it continues working with those NGOs willing to follow ACORDE's technical recommendations and also have the potential to become self-sufficient in the next few years

3 2 2 Financial Sector Programs

USAID also developed a series of projects dealing with the financial sector The most important are the Agricultural and Industrial Reactivation Project (AIR) and the Special Lines of Credit (SLC)

The Agricultural and Industrial Reactivation Project (AIR)

The AIR project started in 1987 It was designed to provide financing to private banks through a rediscount facility at the Central Bank AIR departed from other USAID initiatives in not focusing on particular institutions, as happened with PIC, BANEX, and COFISA The project provided US$19 6 million for long-term loans to support non-traditional agricultural and industrial exports to third markets outside Central America

Although US$12 million were deobligated, the project contributed to strengthening the private banks' lending capability and to channeling scarce long-term funds into the financial system The deobligation responded to borrowers' reluctance to have dollar debts, borrowing limits imposed by the Banking System Law, and difficulties with USAID procurement policies (Garrett, 1988) Once private banks learned the "rules of the game" they were able to mobilize the funds rapidly At the beginning of 1990, there was less than US$1 million available in the AIR project In this sense, if the project had been extended by another year, the deobligation would have not been necessary and all funds would have been allocated (Zuñiga, et al , 1991)

3 3 2 2 The Special Lines of Credit (SLC)

USAID introduced the Special Lines of Credit (SLCs) in 1982 The purpose was to provide loans to the private productive sector through the National Banking System The funds came from ESR local currency generation Since private banks had no access to rediscount facilities, the Central Bank transferred them the funds through the Corporacion Costarricense de Desarrollo (CODESA) ESR II conditionality required the Government to submit legislation giving private banks equal access (compared to public banks) to Central Bank rediscount

In August 1984 a change in legislation opened the Central Bank rediscount window for the private banks, and intermediation through CODESA was discontinued Since then, the Central Bank has channelled the funds directly to the private banks Covenants of successive ESR programs created different SLCs to finance private local producers which produce primarily for the export market An additional purpose was to supply funds to strengthen the private banks as financial intermediaries

The amount of the SLC increased over the years to the colon equivalent of US$169 5 million (8,871 million colones calculated at the exchange rate at time of disbursements of ESR funds to the Central Bank) The funds came from local currency generations of ESR I, ESR II, ESR VI, and ESR VII, divided among five specific lines as follows

Line	Amount	Intermediary
SLC 1	US$ 105 million (C4,469 million)	Private banks (US$ 66 m) State banks (US$ 39 m)
SLC 2	US$ 21 million (C1,219 million)	Private banks
SLC 2A	US$ 25,5 million (C1,989 million)	Private and state banks First-come, first-serve basis
SLC 3	US$ 8 million (C530 million)	Private and state banks First-come, first-serve basis
SLC 4	US$ 10 million (C664 million)	Banco Nacional de Costa Rica (small farmers)

Private banks were very aggressive in placing the SLC funds For the SLC2, the Central Bank exceeded the loan limit by 79 million colones In the case of SLC 2A (first-come, first-serve basis) the private banks allocated 97 2 percent of total funds (Auditoria General de Entidades Financieras, 1994)

The Central Bank, with the concurrence of USAID, used the interest spread on subloans (funded with the reflows) to support non-profit institutions such as ACORDE, CINDE, and FUNDEX (export fund) The interest spread was also used to establish a guaranty fund (a kind of deposit insurance) to protect private investors in case of a private bank failure The fund, managed by the National Banking Association (ABC), contributed to maintaining financial stability after the collapse of several private banks (Banco Germano Centroamericano, Banco Weeden, and Banco BIESA), and also helped to the financial recovery of Bancoop

The SLCs played an important role in the economy in several respects They channeled liquidity into the economy during the economic crisis of the 1980s Also, the SLCs were the major source of financing for the private productive sector (over 600 private-sector companies benefited from the SLCs) This helped to expand and diversify Costa Rica's export base, which was the leading contributor to faster economic growth after 1982

General Assessment

The AIR project, and especially the SLC, played a major role in the development of Costa Rican private banks With the support of USAID, the private banks took advantage of the opportunities provided by the new economic model, based on non-traditional export growth (Coto, 1988) Access to Central Bank rediscounts and the provision of a guaranty fund were major actions that paved the road for the private banks development

The following facts illustrate the private banks' growth

- Sixteen banks were founded during the 1981-1987 period, for an average of two new banks per year (see Table 3)

- In December 1982, only ten banks existed, with an equity of only US$5 5 million and total assets of US$ 36 7 million As of June 1995 there were 22 banks with a total equity of US$127 7 million and total assets of US$786 million

- In 1982 the private banks represented 2 93 percent of total credit granted by the National Banking System That percentage rose to 32 4 percent in 1991 and to 40 percent in 1994, as shown in Table 4

Despite that impressive record, the private banks did not improve their efficiency, measured by the intermediation margin or "spread " The banks spread, defined as the difference between an average lending rate and the net cost of funds, rose from 7 7 percentage points in 1987 to 10 2 in 1992 (Camacho and Mesalles, 1994) This margin is well above international standards of 2-3 percentage points As price-takers, the private banks took advantage of the large spread resulting from the public banks' inefficiency Private banks, however, have contributed to fostering competition in the Costa Rican financial sector, and to introducing a variety of financial innovations

USAID intervention through financial sector projects (like AIR and the SLCs) seemed more effective than targeting particular institutions (COFISA, BANEX, PIC) BANEX had a good performance as it is today the third largest private bank However, the second largest bank, Interfin, developed without direct financing from USAID (see Table 5) Neither Banco Federado nor Bancoop, which received substantial support from USAID, are among the eight top Costa Rican private banks

It is important to mention that Banco Federado, through Fedecredito and with financial support of the USAID Financial Services Project, is developing a structural strengthening fund to improve the managerial capabilities and financial viability of the credit unions in Costa Rica This project represents an opportunity for Banco Federado to develop its potential in the future

3 2 2 3 The Financial Services Project

The last financial sector project developed by USAID is the Financial Services Project (FSP) Its three components are policy reform, credit-union strengthening, and increased access to financial services by small and microenterprises The FSP started in 1992 and concluded in December 1995 At this point it is difficult to evaluate the project's impact on the Costa Rican financial sector Major outputs achieved so far are the regulatory framework for the credit unions, and the recently approved financial reforms The former will contribute to improving the cooperatives' safety and soundness as financial intermediaries in the future The financial reforms, including the elimination of the SOBs' monopsony on checking accounts, will foster competition and modernization of the financial system

4 IMPACT OF USAID INTERVENTION IN THE FINANCIAL SYSTEM

This section evaluates the USAID's intervention from three points of view policy reforms, institutions building, and sector projects The general conclusion is that USAID's major impact on the Costa Rican financial sector concentrated in the 1982-1992 period (the "stabilization and restructuring phase") through sector projects

4 1 Policy Reform

Regarding USAID conditionality, the issue is whether it was a policy dialogue process, or a "reform package" imposed by the Washington consensus It is clear that USAID had strong financial leverage to impose the "Washington consensus" on financial liberalization through the ESR programs However, in most cases USAID supported, instead of imposing, initiatives of the Central Bank's Executive President, which concurred with the Washington consensus This was the case, for example, of interest rates determined by market forces After the crisis of the early 1980s, the Central Bank recognized that the financial system needed deep structural reforms This should include more competition and deregulation to increase the sector's efficiency to supplement the lacking external financing

The new economic model, based on the non-traditional exports growth, required a very dynamic and efficient financial system The existing SOB, highly inefficient and risk averse, did not provide the financial arm to support the new economic model Political intervention on state banks, on the other hand, was an obstacle to modernize the financial sector rapidly The only way to cope with political intervention was some "forced conditionality" agreed upon with the Central Bank and supported by the ESR funds

What difference did USAID make? Without USAID's intervention it would have been very difficult to pass legislation to remove entry barriers to the banking industry and to reduce the utilization of monetary policies that proved inefficient and source of distortions, such as administrative setting on interest rates, and credit ceilings ("topes de cartera")

The Central Bank used the USAID conditionality and ESR funds to press politicians to approve the reforms In this sense, accomplishments under the ESR conditionality had the appearance of an imposed "package" from Washington This was a clever device the Central Bank utilized to circumvent political opposition to financial liberalization

USAID promoted financial reforms since 1982 It was, however, until 1995 when the major changes took place This long process reflects a great deal of political interference and the influence of pressure groups looking for their particular interest When ESR funds ended in 1992, and USAID had no longer financial leverage, its intervention changed The reform initiatives moved from the Central Bank to the Legislative Assembly Then, USAID supported the reforms through technical assistance, field trips, and seminars to disseminate "the state of the art" in financial reforms worldwide

USAID provided the legislators financial experts and advisors to facilitate the policy discussion Without the policy advice, the legislators would have to deal directly with pressure groups lacking a global approach on financial reforms Instead, most of the initiatives came from independent advisors with expertise in financial issues Once the deputies understood the technical rationale of the reforms, it was easier for them the achieve the political consensus

4 2 Institution Building

USAID's intervention by creating financial institutions is highly controversial Some Costa Rican bankers claim that excluding state banks from the USAID agenda because of ideology considerations was a wrong approach Their argument is that public banks dominate the financial system and therefore it is very difficult to improve the system's efficiency without targeting the public banks

In defense of USAID's approach other experts argue that it was necessary to create new private institutions given the poor performance of public banks and the political intervention they face Against this argument, private banks's representatives claim that USAID could have used the existing private institutions instead of creating new ones Another critic is that USAID used public funds (from US tax payers) to create private banks and to benefit a few bankers This is a valid complaint that seems contradictory with USAID policy reform advice, which is intended to improve the lives of the majority of the population, especially of the families at the low end on the income distribution The key issue here is what is the opportunity cost (for the country) of the resources transfered to private bankers used to benefit

This position should be analyzed vis-a-vis the role private bankers took in the Costa Rican financial development Some private bankers made important contributions by introducing financial innovations, taking the leadership to push politicians to approve financial reforms, and reducing transaction costs for non-traditional export producers excluded from the public banks' portfolio The development of private banks also allowed a division of political power, as new influential groups (bankers, exporters) entered the political arena

Another matter of consideration is to what extend it is valid to develop private financial intermediaries with domestic debt This position argues that USAID converted local counterpart funds into Central Bank bonds to back some institutions' equity and working capital

This study concludes that USAID's intervention in the financial system through institutions building had limited impact Leading Costa Rican bankers believe that Banex was a positive experience, but it would developed with or without USAID financial support Although, they recognize that USAID contributed to accelerate Banex's growth COFISA (excluding its international affiliates) had little success and today is one of the smallest private banks

Bancoop became insolvent and had to undergo a major rehabilitation to survive ACORDE, BANHVI, and Banco Federado improved their performance over the years but are not leading institutions in the Costa Rican financial sector

4 3 Financial Sector Projects

The main impact of USAID on the financial sector was through the Special Lines of Credit, which contributed to accelerate the development of private banks By the mid 1980s private bankers had a clear picture about the potential of the export-oriented model However, private banks were not able to provide the needed financing for export projects Through the SLC private banks had access to Central Bank rediscount facilities This mechanism leveled the playing field between the SOB and the private banks and introduce more competition in the system as a whole

Private banks played a major role in financing the export-promotion process, which was the economic engine during the second half of the 1980s Most bankers agreed that USAID was instrumental in changing the structure of the Costa Rican exports during that period Without USAID support, it would have been difficult for the private banks to grow as fast as they did

It is undoubtedly that USAID had a significant impact in improving the savings mobilization process Also, USAID contributed to foster competition in the financial system Increased competition, however, was not sufficient to reduce the intermediation margin in the banking system Most private banks relied on USAID credit lines and had few incentives to capture deposits and improve their efficiency The SOB's inefficiency allowed the private banks to operate with very high profitability This stimulated the proliferation of private banks, some of them concentrated in small markets or "nichos", others created to provide credit to enterprises related to their owners

Competition among private banks has not been uniform A few banks experience intense competition for customers, while the majority behave as followers As a result, the most aggressive banks took the leadership and gave the market an oligopolistic structure At present, the largest five banks control almost the 60 percent of the total loan portfolio of the twenty banks operating in the market

In opinion of former USAID officers in Costa Rica, the delays encountered with ratification, coupled with the long and complex USAID project development cycle, was one of the reasons why the Mission went to local currency financing of projects Although the local currency scheme was very much criticized because of its inflationary effects, it was essential to the Costa Rica program's flexibility and effectiveness

From a macroeconomic perspective, the SLC complicated the management of monetary policies The ESR agreements forced the Central Bank to lend the reflows, which expanded the money supply[17] This, in turn, added inflationary pressures into the system, which contradicted the economic stabilization objective that USAID financial support was supposed to achieve

Although USAID contributed to financial deepening through the SLC, at the same time provoked financial repression through inflationary pressures generates by the use of the SLC On the other hand, if the Central Bank raises the reserve requirement to sterilize the excess of liquidity caused by the SLC, it would penalize private consumers through higher banking intermediation spreads and lending rates An issue of further consideration is to what extend the inflation caused by the SLC monetization was temporal, compared to the ultimate objective of promoting non-traditional exports and supporting the balance of payment in the short run

5 Concluding Remarks

During the 1982-1992 period the Costa Rican financial sector experienced major improvements in policies, savings mobilization, and provision of financial services There is no doubt that USAID was instrumental in supporting these improvements USAID allocated about US$ 300 million to the financial sector, for an average of US$ 30 million per year (see Table 6) This financing had two major impacts 1) it contributed to support policies modernizing the financial system, and 2) it helped private intermediaries to develop These achievements had long-run effects, as Costa Rica is moving ahead in setting up further financial reforms and private intermediaries' share in the financial system increased over time

USAID's major contribution came from support to financial reforms, which emerged from the Central Bank's initiative The reforms were backed by the "Washington consensus" and in agreement with the economic growth model supported by the Costa Rican Government The Central Bank used the USAID program conditionality as a leverage to negotiate with politicians opposing the reforms Without USAID support, the process of financial reforms in Costa Rica would have been even longer than it has been so far

Regarding institutions, they were successful in providing credit for non-traditional exports

[17] The SLC monetization issue is discussed in more detail in Vargas (1995)

projects Some of them, however, became highly dependent upon USAID money and did not develop as dynamic and sound financial intermediaries Therefore, their potential to survive when they pay back their loans to USAID is not clear Beneficiaries of USAID funds working in microenterprise, cooperative, and housing activities were less successful, and their current role in the financial system as a whole is marginal

USAID's intervention did not contribute to improve the efficiency of the financial sector as a whole After 15 years of USAID financial support, the financial system still shows a high degree of inefficiency Intermediation margins in the banking system are far from international standards A subject of future research is to explore why private banks did not take advantage of their profitable position to improve their efficiency and exercise better competition to state banks

At present, private banks, which received substantial financing from the SLC, operate an oligopolistic, urban-biased, and fragmented market Few of them have branches in rural areas, and some have been intervened and closed by the General Auditor It is quite difficult to evaluate the true contribution of private banks in expanding the local financial system a whole, since they have important off-shore transactions not included in the official records collected by the monetary and banking authorities

Apparently, the use of the SLC mechanism was the only way to support private intermediaries and provide credit for development projects In doing so, however, USAID showed some inconsistency between its approach and the programs'conditionality For example, USAID conditionality supported the abolition of subdidized interest rates across the financial system, but allocated funds to targeted institutions at below-market rates

On the other hand, microeconomic activities created macroeconomic distortions that undermined the general objective of promoting economic stability The monetization of the SLC expanded the money supply and provoked inflationary pressures This complicated the monetary control and contributed to financial repression

To summarize, USAID intervention had positive effects on the Costa Rican financial sector However, USAID's impact could have been even larger, as the system still shows a great deal of inefficiency and lack of competition Without USAID, on the other hand, the sector's performance would have been less satisfactory

6 LESSONS

USAID's program in Costa Rica shows that projects with wide coverage, involving the overall system, seem more effective than targeting specific institutions USAID should avoid the practice of concentrating large amounts of resources in few institutions, especially if they have not been properly evaluated

Before creating new financial institutions to promote efficiency, USAID should evaluate technically the existing ones Donors must consider to what extend new institutions with limited expertise can be instrumental in promoting efficiency in wide and fragmented markets

USAID must exercise a practical and flexible approach to modify or eliminate projects/programs when they show inefficiencies or high dependance on USAID funds When money is just given as a donation or gift, institutions have no incentive to develop or improve their intermediation capabilities In this sense, competition is much better than donation in developing financial institutions Another issue to consider is to what extend USAID-funded institutions can survive as financial intermediaries without USAID money Projects and programs should emphasize the process of "learning to fish", instead of just "given the fishing rod "

USAID must avoid micro and macro inconsistencies among its policy approach, conditionality, and the procedures to allocate the funds among financial intermediaries USAID conditionality supported the elimination of subsidized interest rates and directed credit However, USAID utilized these policies in allocating funds to targeted institutions This is a clear contradiction between USAID's philosophy and its approach

On the other hand, USAID used the SLC to foster financial intermediation, but the monetization of the SLC provoked an excess of liquidity, which led to inflationary pressures and financial repression These unintended results are clearly in opposition to USAID's objectives of promoting economic stability and financial deepening When monetization of SLC expands the money supply, the Central Bank is forced to react by impossing sterilization mechanisms such as higher reserve requirements, which are a source of financial repression and crowds private consumers out of the banks' credit portfolio

USAID should focus on few activities of large impact on the financial system as a whole, and avoid dispersion in activities with null or very little impact Some programs may have little impact because they are carried out by institutions working in specific "nichos", lacking broader vision of the system as a whole USAID should compare its ideology versus the country's political environment This is useful to distinguish whether "soft covenants" (the Government is expected to do things) or "firm conditions precedent" are more appropriate

Donors' conditionality may be a useful device to resist political opposition to financial reforms As long as donors have enough financial leverage and their approach concur with the government's point of view, conditionality can be used to convince politicians to accept the reforms Instead of fighting directly with strong and influential politicians, the government presents the reforms as a "forced conditionality" tied to funds disbursement

The host country, on the other hand, must take the initiative in designing its projects, instead of waiting for proposals from abroad that may or may not fit into the country's environment Local authorities should resist the temptation of developing financial institutions by transfer them donations, instead of promoting competition and efficiency The country must support projects that benefit the system as a whole, and avoid those that concentrate the benefits in a few hands

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ANNEX

List of People Interviewed

Luis Solera, Chief of Office of Private Enterprise Development, USAID, Costa Rica

Eduardo Lizano, former Executive President of Banco Central de Costa Rica

Luis Liberman, General Manager of Banco Interfin

Felix Delgado, former Deputy Manager of Banco Central de Costa Rica

Minor Sagot, former USAID Economist

Ronulfo Jimenez, Director of ACORDE

Juan Belt, former Chief Economist USAID, Costa Rica

Alexander Arias, Financial Analyst, USAID, Costa Rica

Oscar Delgado, former Engineer, USAID, Costa Rica

Guillermo Zuñiga, former Vice-Minister of Finance

Vincenz Schmack, former Banking Advisor, USAID, Costa Rica

Leonel Zamora, Executive Director of ACORDE

Dennis Melendez, General Manager of BANHVI