

ASSISTANT
ADMINISTRATOR

ACTION MEMORANDUM FOR THE ADMINISTRATOR

JUL 31 1984

THRU : AA/PPC, Richard Derham (Acting) *R. Derham*
FROM : AA/LAC, Marshall D. Brown (Acting) *M. D. Brown*
SUBJECT : Costa Rica Economic Stabilization and Recovery III
Program (Project No. 515-0192)

Action: Your approval is required to authorize a \$35.0 million grant from Economic Support Funds (ESF) to Costa Rica for the Economic Stabilization and Recovery III Program.

Background: The Economic Stabilization and Recovery III Program for FY 1984 was submitted March 2, 1984, reviewed by the DAEC on March 16, and approved by you on April 27. The original PAAD (copy attached) provided background, rationale and description for the overall \$70 million dollar ESF program for FY 1984, as well as a detailed description of conditionality requirements and objectives for local currency resources for the \$35.0 million loan portion of assistance. At that time, the PAAD requested authorization of the loan portion of assistance only. The PAAD indicated that the \$35.0 million grant portion of the cash transfer would be authorized based on a PAAD Supplement, which is the topic of this memo.

The purpose of the PAAD Supplement is to provide additional balance of payments support to AID stabilization efforts in Costa Rica, and to promote the objectives of USAID/Costa Rica's Caribbean Basin Implementation Plan by encouraging policy and structural reforms aimed at re-establishing dynamic growth in the economy through private sector export-led growth. The grant will be signed with the Government of Costa Rica (GOCR) and will provide balance of payments support via the Central Bank of Costa Rica. The GOCR will make an equivalent amount of dollars available for sale to private producers to allow for imports from the U.S. of raw materials, intermediate goods, construction materials, and spare parts. An equivalent amount of local currency will be deposited by the Central Bank in a special account. These funds will be used for development activities jointly agreed upon by the GOCR and AID.

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Since the signing of the December 1982 one-year IMF Standby Arrangement, the Costa Rican economy has evidenced several important accomplishments.

These include successful rescheduling of the external debt in 1983 with commercial banks and bilateral donors at the Paris Club; a decrease in the public sector deficit from its peak of 14.5% of GDP in 1981 to less than 5% in 1983; achievement of exchange rate stability (by the end of 1983 the Central Bank unified and stabilized the flexible rate, currently at 44.25 colones to the dollar); achievement of relative price stability as evidenced by a reduction in the rate of inflation from 81.8% in 1982 to 10.7% in 1983; an increase of 42% in real terms of credit provided to the private sector by the National Banking System; the creation of the Program for Investments and Exports within MINEX to promote exports and to attract new investments; and a bottoming out of the recession (real GDP grew by 0.8% in 1983 and the official forecast for GDP growth in 1984 is 2%).

These accomplishments have moved Costa Rica towards economic stability. If, however, Costa Rica is to begin and sustain an economic recovery led by an export growth strategy, the GOCR will have to adopt and adhere to a new set of policies which have been outlined in both the PAAD and the Mission's CDSS for FY 1986.

Discussion: The Mission strategy for ESF funds is to address as broad a range of policy and structural reforms as is deemed feasible to achieve the overall long-term objectives of the ESF Program. This involves both continuing efforts begun under previous Agreements, and seeing that important steps are taken in 1984.

The strategy has thus shifted away from an emphasis on short-term stabilization and towards longer-term conditionality and activities pertaining to, in particular, improved policy formation and administrative reform, strengthening of the financial system, and administrative and operational support for expansion of exports and investment.

There is also a political factor involved in the Mission's strategy: 1986 is an election year in Costa Rica. Delay in initiating movement towards necessary policy and structural reforms beyond 1984 could result in these being postponed and not reconsidered until 1987. The Mission, therefore, has considered it important to attack these issues on a broad front before the end of CY 1984.

There are three prior actions to A.I.D. obligation of the \$35 million grant. Meeting of the first prior action, (which was also a prior action to the \$35 million loan portion of our ESF Program), took place in April 1984 when IMF management sent a message to the GOCR indicating acceptance of the GOCR's Letter of Intent. The GOCR has achieved some success in reaching IMF macroeconomic targets; the process, however, is continuing and approval of the Letter of Intent by the IMF Board of Directors is still pending.

Meeting of the second prior action took place in May, 1984, when President Monge formally issued a document titled "Economic Policy: Strategy and Actions 1984-86," which outlined the GOCR's export and investment policy strategy.

Meeting of the third prior action, which was also a prior action to the \$35 million loan portion of our ESF Program, requires modifications of the monetary law (Ley de la Moneda). Reforms to the monetary law which will make external borrowing in dollars feasible and a change in Article 62 of the Banking Act, a provision of Costa Rica's monetary legislation, is also required in order to allow the Central Bank to lend dollars directly to private banks are required. The bill to meet these important conditions has passed out of committee and is currently being debated by the Costa Rican assembly. The Mission expects the legislation to be approved by mid-August; however, the exact date of passage cannot be predicted with certainty.

In addition to the three prior actions and in accordance with its "broad front" strategy, the Mission proposes 22 covenants/activities to be worked on throughout the time period envisaged for the ESF Program. The covenants include, among other things, provision of funds for activities as well as approval and/or publication of a number of action plans related to policy and structural reform. Funds will be provided to increase operating capital for the Free Zone Corporation, to improve Central Bank statistical and price verification capacities, and for Ministry of Planning studies and other contracting requirements. Action plans will be published with respect to divesting or reorientating the majority of the Costa Rican Development Corporation's current holdings to the private sector, reducing distortions in the pricing system, and modifying the Free Zone Law to make it more responsive to export and investment promotion policies. In line with the Mission's ESF strategy, these covenants/actions will be the subject of on-going A.I.D. conditionality.

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Finally, the \$35 million grant attaches two special provisions for suspending AID disbursements: (1) GOOCR failure to remain in substantial compliance with the IMF Stand-by Arrangement; or (2) GOOCR failure to substantially comply with the Covenants in this Grant Agreement or in the Loan Agreement signed on May 7, 1984, or in the Agreement signed between AID and the Central Bank on December 13, 1982 or any of the amendments thereto.

The Mission's conditionality for the \$35 million grant sets the stage for a coordinated donor action program. The remaining \$23 million from the \$35 million loan funds was obligated on July 12, 1984. A portion of the grant funds is expected to be obligated and disbursed by the end of July or early August. This will assist the GOOCR to maintain net domestic assets at a level sufficient to obtain approval by the IMF Board of Directors of the 1984 Standby Arrangement with the GOOCR for SDR 50 million. The 1984 Standby Arrangement is in turn a condition required by the World Bank for a series of Structural Adjustment Loans planned to begin at the end of this calendar year.

The need for A.I.D. monies to foment a coordinated donor action program is pertinent given the GOOCR's immediate cash crunch, brought on mainly by the huge debt service obligation. Payments on outstanding debt have increased from \$276.5 million in 1982 (a debt-service ratio of 32%) to a forecasted \$480 million in 1984 (a debt-service ratio of 53%). The GOOCR faces a foreign exchange shortage of approximately \$30 million at present; this figure is expected to rise (net of ESF and other disbursements) to \$87.5 million by end-July, and to \$150 million by end-December.

An Advice of Program Change along with a new Congressional Notification was sent to Congress on June 7th as this PAAD Supplement requests grant funding and only loan funding was included in the FY 1984 Congressional Presentation. The waiting period expired on June 22nd.

In light of Costa Rica's urgent balance of payments crisis, it may be necessary to postpone or eliminate the remaining prior requirement to permit immediate obligation and disbursement of the first tranche of grant funds. Further, given the fluid nature of the political and economic situation, it may be necessary to modify some of the covenants/activities during the course of negotiation and implementation.

Hence, it is requested that you: (1) authorize the Mission director in consultation with the Acting Assistant Administrator (LAC) to postpone or eliminate the remaining prior requirement if necessary; and (2) authorize the Acting Assistant Administrator (LAC) to approve any changes in the covenants which may be requested by the Mission.

Recommendation: (1) That you sign the attached Program Assistance Approval Document (PAAD) authorizing \$35.0 million in ESF grant funds for Costa Rica for the Economic Stabilization and Recovery Program.

APPROVE FBK

DISAPPROVE _____

DATE 7.31.84

(2) That you authorize the Mission Director in consultation with the Acting Assistant Administrator, (LAC) to postpone or eliminate the remaining prior requirement to this \$35.0 million grant tranche, should it become necessary.

APPROVE FBK

DISAPPROVE _____

DATE 7.31.84

(3) That you authorize the Acting Assistant Administrator, (LAC) to approve changes in the covenants to this \$35.0 million grant tranche, should they become necessary.

APPROVE FBK

DISAPPROVE _____

DATE 7.31.84

AID 1122-1 PAAD AGENCY FOR INTERNATIONAL DEVELOPMENT PROGRAM ASSISTANCE APPROVAL DOCUMENT	1. PAAD NO.	Project No. 0192	515-K-604
	2. COUNTRY	Costa Rica	
	3. CATEGORY	Cash Transfer	
	4. DATE	June 20, 1984	
5. TO:	6. OYB CHANGE NO.	N/A	
A/AID, M. Peter McPherson	7. OYB INCREASE	NONE	
7. FROM:	TO BE TAKEN FROM:		
AA/LAC, Victor M. Rivera (Designate)	Economic Support Funds (ESF)		
8. APPROVAL REQUESTED FOR COMMITMENT OF:	10. APPROPRIATION -		
\$ 35,000,000	Budget Plan Code LESA-84-35515-KG31		
11. TYPE FUNDING	12. LOCAL CURRENCY ARRANGEMENT	13. ESTIMATED DELIVERY PERIOD	14. TRANSACTION ELIGIBILITY DATE
<input type="checkbox"/> LOAN <input checked="" type="checkbox"/> GRANT	<input type="checkbox"/> INFORMAL <input type="checkbox"/> FORMAL <input type="checkbox"/> NONE	FY 1984	
15. COMMODITIES FINANCED			
N/A			

16. PERMITTED SOURCE	17. ESTIMATED SOURCE
U.S. only:	U.S.: \$35,000,000
Limited F.W.:	Industrialized Countries:
Free World:	Local:
Cash: \$35,000,000	Other:

18. SUMMARY DESCRIPTION

The purpose of this PAAD Supplement is to provide additional balance of payments support to AID stabilization efforts in Costa Rica, and to promote the objectives of USAID/Costa Rica's Caribbean Basin Implementation Plan by encouraging policy and structural reforms aimed at re-establishing dynamic growth in the economy through private sector investment-led growth. The grant will be signed with the Government of Costa Rica (GOCR) and will provide balance of payments support via the Central Bank of Costa Rica. The GOCR will make an equivalent amount of dollars available for sale to private producers to allow for imports from the U.S. of raw materials, intermediate goods, construction materials, and spare parts. An equivalent amount of local currency will be deposited by the Central Bank in a special account. These funds will be used for development activities jointly agreed upon by the GOCR and AID.

19. CLEARANCES	DATE	20. ACTION
ARA/ECP: R. Bash		<input checked="" type="checkbox"/> APPROVED <input type="checkbox"/> DISAPPROVED
LAC/DP: J. Olesen	6/25	Frank Belmont AUTHORIZED SIGNATURE July 26, 1984 DATE
GC/LAC: R. Meighan	6/25	
PPC/PDPR: P. Hullander	7/20	
Acting AA/PPC: R. Derham		
M/EM: C. Christensen		
LAC/DR: D.B. Johnson		TITLE
GC: H. Fry	5/30/84	
DAA/LAC: M.D. Brown		

CLASSIFICATION:

ATTACHMENT
TAB A - PAAD Document

Clearances:

PPC/PDPR:EHullander EH Date 7/23/84
GC:HFry MNFY Date 7/30/84

MSD
LAC/DR:MSDugan:msd:07/17/84:(0561B):ext. 28126

ATTACHMENT
TAB A - PAAD Document

Clearances:
PPC/PDPA:EBullander EB Date 7/30/84
GC:EPry MP Date 7/30/84

[Handwritten signature]
LAC/DR:MSDugan MS Date: 07/17/84: (0561B): ext. 28126

Clearances:
LAC/DR:LKlassen LK Date 7/26/84
LAC/DR:SESmith ES Date 7/26/84
LAC/DR:ILEvy IE Date 7/26/84
LAC/DR:DBJohnson DB Date 7/27/84
LAC/DP:JOLeson JO Date 7/26/84
LAC/CEN:PAskin PA Date 7/26/84
GC/LAC:RHeighan RH Date 7-26-84
ARA/ECP:RBash RB Date 7/30/84
PPC/PB:JWilkinson JW Date 7/30/84