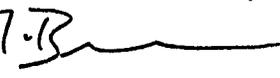


AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

JUN 19 1987

ACTION MEMORANDUM FOR THE ASSISTANT ADMINISTRATOR, LAC

FROM: LAC/DR, Terrence J. Brown 

SUBJECT: Costa Rica: FY 1987 Economic Stabilization and Reform (ESR) VI (515-0231) ESF PAAD

Action Requested: Your approval is requested to authorize \$84.85 million in ESF grant funds under the subject project.

Discussion: The ESR VI program has been reviewed at a series of meetings in Washington including the ESF Concept Paper review in mid-April and the PAAD review on May 6 and May 8. The PAAD has been revised since May 8 to reflect decisions made at those meetings and is ready for authorization.

The FY 1987 ESF program continues the USG's support for Costa Rica's economic stabilization and growth. It supports a macro-economic plan for 1987-88 framed by a proposed IMF standby agreement (mid 1987), a planned Paris Club rescheduling (Fall 1987), a possible commercial bank re-financing (late 1987) and a possible World Bank Structural Adjustment Loan (late 1987).

The \$84.85 authorization level is less than the \$85 million OYB level because \$150,000 is being reserved for CADO. If this reserved amount is not needed in FY 1987, we would expect to amend the ESR VI back towards \$85 million.

The transferred dollar funds will be deposited into a special account as legislatively required. The funds in the separate account will be released to finance imports of productive goods from the United States.

The policy dialogue will consolidate previous policy achievements; and encompass some new or expanded dialogue related to banking reform, public employment reductions and Customs Administration reform as summarized below:

Carryover Covenants

- 1) Exchange rate: Continue periodic exchange rate adjustments (mini devaluations) to keep the colon at a competitive level;
- 2) Interest rates: Continue to allow market forces to determine banking system interest rates;
- 3) Domestic credit: Restrict the amount of subsidized credit, and limit credit to the public sector in order to free resources for the private sector; and

4) Divestiture/privatization: Limit CODESA activities to prevent the creation, operation or financing of any new subsidiaries.

New Covenants/Other conditionality

- 1) Banking reform: Permit private banks to sell certificates of deposit with maturities over 90 days to mobilize resources in the private banking sector;
- 2) Public Sector Employment: Reduce public sector employment, and/or wages, to target levels established by the Government of Costa Rica (GOCR) [via a side agreement];
- 3) Export Promotion: Increase the efficiency of the Customs Administration by simplifying import/export procedures.

ESF-generated local currency will finance economic development activities including: credit for the private sector (\$6.0 million equivalent), agribusiness development (\$4.8 million), low-income housing bank (\$20 million), and privatization/divestiture (\$16 million). Some of the LC funds will be demonetized including \$32 million equivalent provided to reduce BCCR debt.

Significant conclusions from the PAAD review included the following:

a) Payment of External Debt: The PAAD proposed to permit the dollars in the special account to be used to service external debt. Arguments for debt service revolved around the extreme nature of the GOCR's external debt situation and the need to maintain the GOCR's international credit-worthiness. At a follow-up meeting on this subject in your office on May 8, it was decided that debt payments would not be an eligible use; rather, the funds would be utilized only for eligible imports from the United States. In tracking the use of dollars from the separate account, USAID will work with the BCCR to minimize new controls and reports.

b) Withholding \$10 million: The DAEC decided not to withhold \$10 million from the initial obligation, as suggested during the earlier ESF Concepts Paper Review. The \$10 million was to be withheld in response to the GOCR's Agricultural Production Law, which breached previous GOCR policy commitments to reduce subsidized credit.

In lieu of the \$10 million set aside, the mission will require that the GOCR study the impact of the law (on the credit system, interest rates, and credit programs financed by AID and other donors). This requirement will be tied to disbursement

of the second ESF tranche, i.e., approximately \$43.7 million. By attaching conditionality to a larger portion of the grant and permitting more time for GOCR reflection, the Mission can better register concern and encourage action to minimize the law's negative effects.

c) Public Employment: Limiting public sector employment may be one of the most important remaining structural adjustments in Costa Rica. The DAEC recommended that the Mission link public employment performance targets to the ESF program. The government employment and wage targets will be specified in a side agreement between the GOCR and the Mission.

d) Divestiture/Privatization: The DAEC raised questions about prospects for completing the divestiture process. The Mission agreed to a full evaluation beginning in early CY 1988 of the CODESA divestiture program.

e) Housing: Prior to committing local currency funds to the new housing bank, the Mission will advise AID/W whether support for the new housing bank is consistent with A.I.D. policies regarding the reduction of subsidies, increased private sector participation and savings mobilization.

f) Disbursement Strategy: The DAEC concurred with the two tranche disbursement strategy proposed (\$40 million in August 1987 and \$44.85 million later in 1987). The first tranche is tied to promulgation and start-up of the 1987/88 economic plan.

The Mission was asked to define the performance targets for disbursement of the second tranche. The Mission now proposes: 1) performance against macro-economic targets related to GOCR expenditures, banking system credit, BCCR assets, foreign exchange reserves, and external debt arrears; and 2) continued satisfactory progress by the GOCR in implementing ESR VI conditionality. Progress toward public employment and wage targets will also be considered. The macro-economic targets will be specified in the economic plan to be promulgated by the GOCR and accepted by the IMF.

Justification: This action falls within the \$150 million ESF program level for Costa Rica listed in the FY 1987 Congressional Presentation. No Congressional notification is needed.

Recommendation: That you sign the attached facesheet authorizing the obligation of \$84.85 million in ESF grant funds.

LAC/DR:GAdams:mh:5/27/67:X28110

Clearances:

State/ARA/ECP: WBarmon [draft]

State/ARA/CEN: FJones [draft]

GC/LAC: GDavidson [draft]

LAC/DP: CZuvekas [draft]

LAC/CEN: RNichols [draft] 6/74

LAC/DR: LKlassen [draft]

LAC/CONT: TTotino [draft]

PPC/EA: JHeriot [draft]

PPC/PB: DAdams [draft]

LAC/DP: WWheeler [draft]

LAC/DR: ILevy [draft]

DAA/LAC: MButler [draft]

CLASSIFICATION:

A/C 112D-1 PAAD	AGENCY FOR INTERNATIONAL DEVELOPMENT PROGRAM ASSISTANCE APPROVAL DOCUMENT	1. PAAD NO	515-0231- 515-K-608
		2. COUNTRY	Costa Rica
		3. CATEGORY	Cash Transfer
		4. DATE	May 1987
		5. TO	AA/LAC, Dwight Ink
		6. DVB CHANGE NO	N/A
7. FROM	LAC/DR, Terrence J. Brown	8. DVB INCREASE	
9. APPROVAL REQUESTED FOR COMMITMENT OF	\$ 84,850,000.00	10. APPROPRIATION -	Economic Support Funds (ESF) LESA-87-35515-KG31 (737-75-515-00-50-71)
11. TYPE FUNDING	12. LOCAL CURRENCY ARRANGEMENT	13. ESTIMATED DELIVERY PERIOD	14. TRANSACTION ELIGIBILITY DATE
<input type="checkbox"/> LDAN <input checked="" type="checkbox"/> GRANT <input checked="" type="checkbox"/> INFORMAL <input type="checkbox"/> FORMAL <input type="checkbox"/> NONE		FY 1987	
15. COMMODITIES FINANCED			

16. PERMITTED SOURCE	17. ESTIMATED SOURCE
U.S. only: _____	U.S.: \$84,850,000
Limited F.W.: _____	Industrialized Countries: _____
Free World: _____	Local: _____
Cash: \$84,850,000	Other: _____

18. SUMMARY DESCRIPTION

The purposes of the program are to provide balance of payments support to stabilization efforts in Costa Rica, and to encourage policy and structural changes aimed at re-establishing dynamic economic growth through increased exports. The \$84,850,000 grant will be provided in two tranches as a cash transfers to a special Central Bank account to finance private sector imports from the United States of eligible raw materials, intermediate goods, construction materials, capital equipment, and spare parts. An amount in local currency equivalent to the grant will be deposited by the Central Bank in a separate special account to finance development activities for purposes specified in the PAAD. The \$84,850,000 million authorized hereby will be subject to the Conditions, Covenants, and Special Provisions specified in Section IV.E of the PAAD.

With prior consultation with AA/LAC, the Mission is authorized to vary the disbursement plan contained in Section IV.C.2.b of the PAAD. The Central Bank of Costa Rica will provide the colon equivalent of each dollar disbursement at the highest rate of exchange not unlawful in Costa Rica on the date of the dollar disbursement.

19. CLEARANCES	DATE	20. ACTION
LAC/DP: WWheeler (draft)	6/3/87	<input checked="" type="checkbox"/> APPROVED <input type="checkbox"/> DISAPPROVED
GC/LAC: GDavidson (draft)	6/2/87	 AUTHORIZED SIGNATURE Dwight A. Ink Assistant Administrator, Bureau for Latin America and the Caribbean
LAC/CEN: CCostello (draft)	6/2/87	
M/EM/CONT: CChristensen (draft)	6/29/87	
PPC/EA: KKauffman (draft)	6/5/87	
DAA/LAC: MButler		
ARA/ECP: WBarmon (draft)	6/10/87	DATE: 7/3/87

CLASSIFICATION.

Reference to June 19, 1987
memo

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON D C 20523

ASSISTANT
ADMINISTRATOR

JUN 26 1987

ACTION MEMORANDUM FOR THE DEPUTY ADMINISTRATOR

FROM: AA/LAC, Dwight Ink *WIB*

SUBJECT: Costa Rica FY 1987 ESF Program: Loan/Grant Split

ACTION REQUESTED: Approval of the \$85 million FY 1987 ESF Economic Stabilization and Recovery (ESR) VI program on a full grant basis.

BACKGROUND: Since the economic crisis which beset Costa Rica and the rest of Central America in the early 1980's, the Government of Costa Rica has instituted sweeping economic policy reforms and achieved good progress in restructuring its economy for sustained long-term economic growth. Foreign exchange rates and interest rates have been adjusted to reintroduce market pricing signals and other incentives for private sector investment and growth. The government role in the economy has been constrained by fiscal controls and by a program of divestiture of state enterprises. Private domestic investment increased by 12% in 1986 and amounted to 98% of the 1977 level. Moderate economic growth has resumed (3-4% in 1986). Exports increased by 16% in 1986 due to a rise in coffee prices and continued growth in non-traditional exports. A.I.D. has supported these economic policies and programs with ESF support of \$586.3 million.

AID
EXECUTIVE SECRETARIAT

JUN 26 9 45 AM '87

DISCUSSION: Under the ESR VI program for FY 1987, A.I.D. will provide \$85 million balance of payments (BOP) support (compared to about \$120 million per year in FY's 1984-86). The ESR VI will support a GOCR economic plan for 1987-88 framed by a planned IMF Standby (mid 1987), a possible commercial bank re-financing (late 1987) and a possible World Bank Structural Adjustment Loan (late 1987). The ESF policy dialogue will consolidate previous macro-economic policy achievements; and encompass new dialogue related to banking reform, public sector personnel reductions and Customs Administration reform.

Despite Costa Rica's success in restructuring its economy, additional BOP support will be needed for several years to offset the negative impact of the nation's extreme external debt service and to buy time for the growth of private sector production. Costa Rica's public sector external debt service

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is projected to consume about 60% of all commodity export earnings from 1988-1990. Servicing such debt leaves the nation with insufficient foreign exchange to import needed production inputs. Reducing the burden of this debt to a more manageable 35% requires annual debt relief of \$286 million. Given this debt service burden, maximum ESF grant financing is consistent with U.S. interests in Costa Rica. Grant rather than loan financing reduces the debt service burden and the rate of debt accumulation, thereby supporting our stabilization and recovery objectives.

Grant financing would coincide with long-term GOCR expectations for grant assistance. ESF assistance was provided as a grant to Costa Rica last fiscal year because of the country's economic and debt situation. In the Congressional Presentations for both FY 1987 and FY 1988, A.I.D. notified the U.S. Congress that ESF would be provided to Costa Rica on a grant basis in FY 1987. Also, ESF assistance is being provided on a grant basis this fiscal year to the other Central American core democracies (Guatemala, Honduras, and El Salvador). The imposition of loan terms at this late stage would provoke the Arias Administration's sensitivities that the USG is demonstrating less political support for Costa Rica.

AUTHORITY: The Bureau believes that full grant financing of the program is justified under the Guidelines on Terms of A.I.D. in that the ESF program is a politically sensitive activity in Costa Rica.

RECOMMENDATION: That you approve provision of \$85 million ESF in FY 1987 on a grant basis.

Approved 

Disapproved _____

Date 6-26-87

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