PN-AAR-998
ISN 33159

August 28, 1983

UPDATE OF ECONOMIC SITUATION

Julian Heriot

Introduction

The ROCAP economist was requested by USAID/Costa Rica to update the macroeconomic analysis of the Costa Rican economy. With the assistance of the resident USAID economist, Minor Sagot, an analysis was made of the major macroeconomic accounts during the week of 22-26 August, 1983.

The key issue in any discussion of economic performance in 1983 is the adherence to the IMF standby agreement. The principal conclusion that emerges from the following paragraphs is that the ceilings and targets specified in the agreement will be met, but at considerable cost. In order to maintain inflation and the exchange rate at present levels, the monetary authorities will soon consider a sharp cut in the rate of growth of credit to the private sector. This action will serve to reduce imports, possibly pushing the economy below the current forecast of a negative 3 percent growth in GDP in 1983.

Background to the Current Crisis

The Costa Rican economy continues to be buffeted by adverse conditions in the world economy and by the politcal uncertainty that has plagued the Central American region since the late 1970s. The slump in the world economy --principally the recession in the OECD countries-- triggered a fall in commodity prices (coffee, beef and bananas) and a reduction in demand for Costa Rica's growing trade in non-traditional items such as textiles and wood products. On the other hand, import prices (particularly petroleum prices) continued to rise well into 1982. This reversal in the terms of trade has depressed domestic income and has widened the deficit in the current account of the balance of payments.

For Costa Rica the fall in export revenues proved to be a disaster from which it has yet to begin a recovery. It became impossible to service its foreign obligations --public sector debt alone totalled some $2.5 billion at year end 1981-- and considerable pressure soon built against the colon. Beginning late in 1981 the colon was rapidly devalued against the dollar and an equally rapid period of inflation soon followed culminating in an 80% increase in the CPI during 1982. The growth rate in GDP turned negative in 1981 and the economy registered an 8.8% decline in 1982.

Political events in Central America have played their part in depressing the economy of Costa Rica. The insurgency in Guatemala, the civil war in El Salvador, and the tensions between Honduras and Nicaragua have resulted in a scarcity of foreign direct investment, a sharp reduction in short-term commercial credits and a flight of investment capital.

The Move Towards Stability

The IMF Program

The IMF standby program essentially underwrites attempts to reduce domestic economic activity to a level consistent with external balance. Specifically, its objectives are a reduction of the public sector deficit and the reduction in external arrearages. The former is to reduce the level of domestic expenditure consistent with new conditions in the world economy and the latter is to restore the confidence of the world financial community in the Costa Rican economy. These two objectives are closely linked.

The deficit of the consolidated public sector (the central government plus the autonomous public enterprises) is to be reduced to 9.5 and 4.5% of GDP in 1982 and 1983 respectively. On the revenue side, there are to be an income tax surcharge and increases in the prices and rates charged by the state enterprises. On the expenditure side, there are to be cuts in current and capital outlays and the sale of some of the companies controlled by CODESA, one of the largest of the state enterprises. Furthermore, the GOCR is to be restrained from borrowing abroad for unproductive, i.e., for consumption purposes.

Consistent with these objectives, the program specifies two ceilings and one target. There will be quarterly tests on net official international reserves and the ceiling on banking system net credit to the non-financial public sector and on net assets of the Central Bank apply at all times. The first ceiling limits credit to the public sector from the entire banking system; the second limits it from the Central Bank.

In the foreign sector, the government of Costa Rica has undertaken to improve the image of its economy abroad. To accomplish this it will reschedule its foreign debt and has agreed to allow no new accumulation of arrears in its foreign obligations. Additionally, it will offer no new exchange guarantees for domestic debt. Consistent with these conditions is the target on net official international reserves which serves as a test for any accumulation of new arrearages.

The government of Costa Rica has also agreed to several policy reforms. Adjustment of prices and wages will conform to market pressures and the uses of subsidies will be held to only a few commodities. In order to improve the supply of bank credit to the private sector, interest rates will be gradually adjusted to positive real levels. To increase export competitiveness the various exchange rates will be unified within a flexible exchange rate system.

Rescheduling of the Foreign Debt

Rescheduling agreements have been conducted with Costa Rica's bilateral and commercial creditors (see table 1). This has resulted in a reduction in the 1983 debt service burden from $1.766 billion (interest and principal arrears of $1.107 billion plus interest and principal of $659 million contracted for 1983) to approximately $770 million ($275 million in arrears and $495 million in current payments). Although still high (90% of projected exports for 1983) it is manageable given the volume of compensatory flows.

1983
i ~~607~~
p ~~162~~
~~769~~

TABLE 1

COSTA RICA: DEBT RESCHEDULING

Interest in arrears through 12/31/82	447
Rescheduled	(244)
to be paid in 1983	(203)
Principal in arrears through 12/31/82	660
Rescheduled	(588)
to be paid in 1983	(72)
Interest contracted in 1983 (includes interest on past due principal)	437
Rescheduled	(33)
to be paid in 1983	(404)
Principal contracted in 1983	222
Rescheduled	(132)
to be paid in 1983	(90)

Repayment
203
72
404
90
769 repayment.
240 50% new
529 net repayment

Source: IMF

"capitalization"

res. i → 12/31/82	244
repaid p → 12/31/82	−72
	172
res. i 1983	33
	205
rep. p 1983	90
	115
	303 50% of i repaid
	418 Total capitalization

Recent Economic Performance

The Balance of Payments

Rescheduling of the public sector external debt has improved the balance of payments picture for 1983, although there is some doubt that the balance of payments test can be met without a reduction in the projected import level. In table 2 the balance of payments has been projected under two scenarios, one optimistic and one pesimistic. The format is that of the basic (or above the line) balance, with three below the line entries to arrive at the change in net reserves.

-- The current account deficit is likely to be between $285 and $415 million. The government's export projection of $840 million may be too optimistic given export performance through May 1983 (see footnote accompanying table 2). The projection of $80 million in net transfers may also be too high. Note the projected level of imports ($920) which represents some real increase over 1982, but is approximately 35% lower in real terms with respect to imports in 1981.

-- The capital account balance is likely to fall between $452 and $437 million. The only difference between the two scenarios is a somewhat lower estimate for net long term private investment.

-- The basic balance is thus likely to be between $167 million under the optimistic scenario and $22 million under the pesimistic.

Adjusting the basic balance projections with below the line items (payment of arrearages and IMF resources) we arrive at a fall in net reserves of between $48 and $193 million. Since the IMF agreement calls for no further decrease in net reserves, these shortfalls must be covered with new resources (such as foreign exchange loans), or by a reduction in the projected level of imports. A reduction of $100 million in imports -striking a balance between the two scenarios-- would mean an 8% real drop in the import level from 1982.

TABLE 2

COSTA RICA: BALANCE OF PAYMENTS, 1983

(US$ million)

	Optimistic	Pesimistic
Current Account	-285	-415
Trade balance	- 80	-170
Exports, FOB	(840)	(750)1/
imports, CIF	(-920)	(-920)
Services balance	~~-285~~ 205	~~-295~~ 245
Tourism	100	902/
Transportation	33	33
Factor services	-425	-425
Interest	(-404)	(-404)
Other	(- 21)	(- 21)
Other	7	7
Transfers, net	80	502/
Capital account	452	437
Private	250	235
Short-term, net	(215)	(215)
Long-term, net	(35)	(20)2/
Official	202	202
Short-term, net	7	-
Long-term	195	-
disbursements	285	-
ESF/DA	(107)	-
PL 480	(28)	-
IBRD	(1)	-
IDB	(4)	-
Other	(145)	-
Amortization	- 90	-
Basic Balance	167	22
Principal arrears	- 72	- 72
Interest arrears	-203	-203
IMF3/	60	60
Change in net reserves4/	- 48	-193

Source: Central Bank, IMF and ROCAP estimates

Footnotes

1/ A lower export level based on performance through May 83. Historically, exports through May accounted for 46-48% of annual exports. The optimistic level ($840) is a straight line projection based on exports through May ($353 million). The pesimistic figure is adjusted to account for the cyclical nature of annual exports ($353 - .47= $750)

2/ A previous estimate or a downward adjustment where it was felt that GOCR estimates were too optimistic.

3 Only $60 million of the approximately $100 million in disbursements under the standby program can be used to cover arrearages not accounted for by rescheduling. The other $40 million must be used to increase gross reserves.

4/ The IMF agreement calls for no decrease in net reserves. Accordingly this is the amount by which the GOCR would miss the net reserves test and which would have to be covered by resources such as additional foreign exchange loans.

The Fiscal Accounts

Table 3 summarizes the fiscal operations of the nonfinancial public sector which includes the central government and the major public sector enterprises. The point that must be underscored is the improvement in public sector finances. The consolidated public sector deficit has been reduced from ¢9.3 billion (about 9.5% of 1982 GDP) to ¢5.7 billion in 1983, a figure that will represent about 4.8% of 1983 GDP. This will be very close to the goal set out in the IMF agreement.

This improvement is due almost entirely to an increase in the current surplus of the state enterprises. An increase in rates and prices charged for petroleum products and other services was largely responsible for an increase in the collective surplus from -¢3.5 billion in 1982 to ¢2.4 billion in 1983. On the other hand there was very little improvement in central government finances during 1983. The savings of the central government registered virtually no change from 1982.

Financing of the deficit will not violate IMF ceiling on banking system net credit to the public sector. Of the ¢2.9 billion that will be financed domestically, over ¢1 billion will be covered by the sale of debt bonds to the non bank public leaving about ¢1.9 billion to be financed by the banking system, an amount well below the ceiling.

TABLE 3

COSTA RICA: OPERATIONS OF THE NONFINANCIAL
PUBLIC SECTOR, PROJECTION FOR 1983

(Millions of Colones)

	1982 1/	1983 2/
Central Government	- 2,747	- 4,325
Total Revenues	17,520	20,000
Total Expenditures	-20,267	- 24,325
Current	(-17,973)	(-20,630)
Capital	(- 2,294)	(- 3,695)
State Enterprises	- 6,574	- 1,349
Current Account Surplus	- 3,495	2,416
Capital Revenue	139	346
Capital Expenditures	- 3,218	- 4,111
Overall Deficit	- 9,321	- 5,674
Financing	9,321	5,674
External	2,130	2,085
Domestic	2,552	2,900
Banking System	(1,872)	(1,900)
Non-bank Financial Intermediaries and Private Sector	(680)	(1,000)
Other 3/	4,639	689
GDP	97,366	

1/ Preliminary.
2/ Based on flows recorded through June
3/ Includes change in floating debt, interest in arrears and residual.

Source: GOCR estimates

Money and Prices

Table 4 presents the accounts of the consolidated banking system. It is interesting to note that total credit of the banking system has grown during the first five months of 1983 at a rate almost equal to that of all of 1982, about 2.4% monthly. The composition of this growth has shifted dramatically, however. The monthly growth in credit to the private sector has grown from 2.7% in 1982 to 3.4% through May 1983. Credit to the public sector, however, has fallen from a monthly average in 1982 of 2.3% to 1% for the first five months of 1983.

The growth in credit so far during 1983 has, unlike the case in 1982, not lead to rapid increases in the money supply (MI). During 1982 the money supply (MI) grew at a monthly rate of 4.4%. So far this year it has grown at .2% monthly, a dramatic contraction in real terms. Quasi money, on the other hand, has grown at a monthly rate of 5% compared to 3.6% for 1982.

These developments have had three general consequences for the economy. First, the government has had no difficulty meeting the IMF ceilings on net domestic assets of the Central Bank and on banking system net credit to the public sector (see table 5). Note that the margins have actually increased as the liquidity of the public sector institutions has been transferred to deposits in the banking system.

Second, the very slow growth in the money supply has, so far, effectively braked inflation in 1983. For the first 6 months of 1983 the CPI has increased 9.8% (compared to 40% for the first six months last year) an annual average of less than 25%

Lastly, if the rate of credit creation continues, there will be a very large liquidity overhang to be carried into next year. Much of this will surely disappear as public and private enterprises begin paying arrearages on foreign debt. But it is likely that a sufficient amount will be available to finance a good part of 1984 public sector deficit through the purchase of debt bonds.

The monetary authorities have recently become concerned with the rate of credit creation. It is felt that the present rate of expansion threatens exchange rate stability and a higher rate of inflation. If steps are taken to slow credit expansion to the private sector, the result could be a fall in the level of imports from the projected $920 million and possibly, a further decline in GDP.

TABLE 4

COSTA RICA: PANORAMA FINANCIERO

NATIONAL BANKING SYSTEM

(Millions of Colones)

		1980 Dec.	1981 Dec.	1982 Dec.	1983 May
I.	Net International Reserves 1/	- 1,141.8	- 6,783.8	- 2,082.2	- 240.0
II.	Total Credit	21.011.2	24.068.1	32,401.9	36,367.4
	Domestic Credit	20,971.0	23,967.5	32,292.5	36,327.2
	a) Central Government net	5,541.8	6,555.1	6,417.1	6,032.2
	b) Other Public Sector	3,380.2	4,162.8	7,606.6	8,715.4
	c) Private Sector	12,049.0	13,249.6	18,268.6	21,579.6
	External Credit	40.2	100.6	109.4	40.2
III.	Other net assets	2,524.9	39,567.4	50,201.9	55.000.2
	TOTAL (I+II+III)	22.394.3	56.851.7	80,521.6	91.135.6
IV.	Total Liquidity	17,559.3	31,383.6	49,690.0	58,698.0
	Quasimoney	10.455.3	20.574.7	31,585.8	40,377.4
	Of which stabilization bonds		- 1,634.9	5,561.7	6,893.6
	Money Supply	7,104.0	10,808.9	18,104.2	18,320.6
	Currency in circulation	2,255.0	3,500.9	5,436.0	5,226.9
	Demand Deposits	4,849.0	7,308.0	12,668.2	13,093.7
V.? -	Foreign Debt (arrears)	4,835.0	25,468.1	30,831.6	32,437.6
TOTAL (IV + V)		22,394.3	56,851.7	80,521.6	91,135.6

1/ Does not include arrears on external payments

Source: Central Bank

TABLE 5

Costa Rica: Performance Under the Stand-By Program

	1982 Dec. 31	1983 Mar. 31	1983 June 30
Net International Reserve Position of the BCCR			
1. Target (floor)	\$- 1,234.2	- 1,234.2	- 1,234.2
2. Net Int'l Reserves	- 1,207.4	- 1,176.6	- 1,158.9
a. Net Official Int'l Reserves	- 104.4	- 46.9	- 54.5
b. Arrears	- 1,103.0	- 1,129.7	- 1,104.4
3. Margin (or Excess)	26.8	57.6	75.3
Net Domestic Assets of the BCCR			
1. Ceiling	¢ 69,710	69,510	69,650
2. Actual	67,307	65,135	64,331
3. Margin (or Excess)	2,403	4,375	5,319
Banking System's Net Credit to Non Financial Public Sector			
1. Ceiling	¢ 11,090	11,290	11,590
2. Actual	11,090	10,052	8,544
a. Net credit from BCCR	11,857	12,295	11,803
b. Net Credit from Banks	- 767	- 2,243	- 3,259
3. Margin (or Excess)	0	1,238	3,046

Source: USAID/Costa Rica estimates based on Central Bank data.

The Cost of Economic Stability

The government of Costa Rica will likely achieve the goals under the standby program, but the cost in terms of economic activity and unemployment will be high. The government has recently estimated real GDP growth in 1983 to be .6% (the IMF estimates 0). We feel that these estimates are very optimistic. Based on 4-5 months of data, agriculture will likely achieve a 0 rate of growth, industry may fall as much as 9%, commerce may decline 5%, and government services perhaps fall 5%. Using 1982 sectoral weights, these projections translate into a 3% decline in GDP for 1983. If the contemplated slowdown in credit to the private sector results in a cut in imports below the $920 million level, the fall in economic activity could be even greater.

Seen in the context of the last 3 years, a 3% drop in 1983 GDP will mean that real per capita incomes will have fallen approximately 25% since December of 1980. With an annual population growth of 2.6% and a 4.6% real rate of growth beginning in 1984 (very optimistic for any Latin American country according to recent IDB studies) it would take 12 years, until 1995, to reach the level of real per capita income that the country enjoyed in December of 1980.