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A Report to

The Agency for International Development

and

The World Bank

Central American Capital Markets
Costa Rica: Macro-Financial Background

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Introduction

The purpose of this report is to analyze recent developments in the macro-financial situation in Costa Rica, with particular attention to their relevance for the continuing development of Costa Rican capital markets. Costa Rica has had an organized securities market for several years, and its growth in volume of operations and in number and types of instruments traded has been substantial. Nonetheless, short-term debt instruments, especially those issued by the Costa Rican Government and by public and private financial institutions, continue to dominate trading in the formal securities market. The following report indicates some of the reasons, especially the macro-financial reasons, why this has been the case and also suggests some macro-financial policy changes that could hasten the development of capital markets in Costa Rica.

During the five past years the Costa Rican economy has undergone substantial change. Structural adjustment has taken place in several sectors such as agriculture, industry and foreign trade, as well as in the financial sector. The general trend has been to liberalize, that is, to get prices right (eliminate distortions) and to foster competition (open up the economy by reducing protection).

In the financial sector, more autonomy and freedom have been given to financial intermediaries, so that they can now make their own decisions more freely (how much to lend, to whom to lend, how much to pay for funding, how much to charge customers). In particular, banks and other intermediaries are free to set interest rates and other charges to clients according to their own criteria and to allocate credit to whatever sectors and borrowers they prefer. In addition, piecemeal decisions by the Central Bank have largely been eliminated, and more extensive supervision of regulated financial institutions has been undertaken by the Auditoria General de Entidades Financieras (AGEF).

Although these changes in financial sector policies have clearly been important, their impact on the allocation of credit is difficult to judge because earlier figures do not reflect effective credit allocation but rather what was convenient to report in accordance with the Central Bank's directives. In addition, various significant constraints remain to financial sector reform. For example, private banks cannot issue instruments denominated in foreign currencies, and amounts issued in local currency are constrained by capital requirements that many private bankers find highly restrictive. In the case of public banks, the AGEF has little power to intervene even in the affairs of banks known to be technically insolvent because of the size and political power of these banks which can even undermine Central Bank controls (e.g., the creation of "float" to evade attempts to tighten liquidity).

In spite of the major changes in economic policies, aggregate figures for the Costa Rican economy do not display significant disruptions or even major changes. During the past five years, the growth of real GDP has ranged from 3 to 6 percent per year, and all sectors of the economy have shared in this growth (only construction showed negative real growth in any of the past five years). The service sector has continued to grow in relative terms and is by far the most important sector in the Costa Rican economy, accounting for more than 45 percent of GDP. The "productive" sectors have continued to decline in relative importance, with manufacturing now accounting for less than 20 percent of GDP and agricultural only slightly more than 15 percent. Moreover, in spite of policies of economic liberalization, the share of the central government has continued to grow and is now almost 15 percent of GDP. On the other hand, growth in foreign trade has been substantial, with imports now exceeding 40 percent of GDP and exports reaching approximately 35 percent. Continuing growth and the lack of major changes in the structure of production may suggest that economic reform has not been too painful for Costa Rica, but alternatively it may suggest that the process of adjustment is only beginning and that much remains to be done.

In the important area of saving and investment, there has been little further progress since Costa Rica's initial recovery from the economic crisis of the early 1980s. With the exception only of 1981 and 1990 when gross domestic investment increased to about 29 percent of GDP,[2] investment has ranged between 25 and 27 percent of GDP during the past ten years, and a significant proportion of this is accounted for by inventory accumulation (more than 7 percent of GDP in some years). Investment is mostly private, with public capital formation running between 4 and 5 percent of GDP during the last five years. As revealed by Table 1, Costa Rica's domestic savings performance is also a serious concern. Private saving has fallen from over 11.5 percent of GDP in 1986 to 9.5 percent in 1989, while public saving has fallen from 7.4 percent to only 5.1 percent over the same period. The increasing gap between investment and domestic saving has been filled by a growing use of external savings, which has risen from 3.8 percent of GDP to more than 9 percent.

The failure of Costa Rica's organized securities market to diversify significantly away from short-term debt instruments issued by the government and by financial institutions may reflect the same macro-financial conditions that have hindered saving and investment in Costa Rica. On the other hand, it may be that the failure of Costa Rica's capital markets to develop more fully has been a major factor in restricting investment and domestic savings performance in particular. The following examination of certain

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[2]These increases were accounted for by several private projects in the areas of tourism and banana production.

key aspects of the Costa Rican macro-financial situation will attempt to provide information and analysis that can shed light on this issue and thereby provide some useful recommendations for further policy reforms as well as for high-priority programs of institutional strengthening.

The main macro-financial topics to be covered in this report are:

- the fiscal situation, not only of the central government but also of the Central Bank and autonomous government agencies, as well as the financing of the deficit;

- changes in the foreign exchange regime and, briefly, the behavior of the exchange rate and the balance of payments;

- the behavior of monetary aggregates, inflation and interest rates, as well as changes in government monetary, credit and interest rate policies;

- instruments for carrying out monetary policy and for the further development of capital markets; and

- the effects of taxation on financial markets and instruments.

TABLE 1

COSTA RICA

SECTORIAL DISTRIBUTION OF NATIONAL SAVINGS

MILLIONS OF COSTA RICAN COLONES

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990*
NET NATIONAL SAVINGS	2688	5201	8174	13296	20518	30905	46579	45927	53525	61984	78423
% of total savings	30.5%	37.5%	40.5%	49.1%	63.8%	67.5%	83.1%	65.6%	69.2%	60.8%	56.4%
% of GDP	6.5%	9.1%	8.4%	10.3%	12.6%	15.6%	18.9%	16.1%	15.3%	14.5%	15.0%
PRIVATE SAVINGS	3106	4531	8981	428	6775	18498	28436	18969	30917	40352	
% of total savings	35.2%	32.7%	44.5%	1.6%	21.1%	40.4%	50.7%	27.1%	40.0%	39.6%	
% of GDP	7.5%	7.9%	9.2%	0.3%	4.2%	9.3%	11.5%	6.7%	8.8%	9.5%	
OFICIAL SAVINGS	-418	669	-807	12868	13743	12408	18166	26946	2260[illegible]	21633	
% of total savings	-4.7%	4.8%	-4.0%	47.6%	42.8%	27.1%	32.4%	38.5%	29.2%	21.2%	
% of GDP	-1.0%	1.2%	-0.8%	10.0%	8.4%	6.3%	7.4%	9.5%	6.5%	5.1%	
GENERAL GOVERNMENT SAVINGS	-672	-70	958	7331	9783	9800	14204	15968	14981	12561	
% of total savings	-7.6%	-0.5%	4.7%	27.1%	30.4%	21.4%	25.3%	22.8%	19.4%	12.3%	
% of GDP	-1.6%	-0.1%	1.0%	5.7%	6.0%	5.0%	5.8%	5.6%	4.3%	2.9%	
STATE OWNED ENTERPRISES	254	740	-1765	5537	3961	2607	3940	10937	7627	9072	
% of total savings	2.9%	5.3%	-8.7%	20.5%	12.3%	5.7%	7.0%	15.7%	9.9%	8.9%	
% of GDP	0.6%	1.3%	-1.8%	4.3%	2.4%	1.3%	1.6%	3.9%	2.2%	2.1%	
SAVINGS FROM EXTERNAL AGENTS	6134	8664	12009	13765	11623	14847	9453	24067	23844	39984	60674
% of total savings	69.5%	62.5%	59.5%	50.9%	36.2%	32.5%	16.9%	34.4%	30.8%	39.2%	43.6%
% of GDP	14.8%	15.2%	12.3%	10.6%	7.1%	7.5%	3.8%	8.5%	6.8%	9.4%	11.6%
NET TOTAL SAVINGS	8822	13864	20184	27061	32141	45752	56632	69993	77369	101968	139097
% of total savings	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
% of GDP	21.3%	24.3%	20.7%	20.9%	19.7%	23.1%	22.7%	24.6%	22.1%	23.9%	26.6%
CAPITAL DEPRECIATION	2181	2711	3887	4219	4862	5488	6130	7116	8919	10578	13740
GROSS INVESTMENT	11003	16575	24070	31270	37003	51240	62162	77107	86288	112546	152837
% of GDP	26.6%	29.0%	24.7%	24.2%	22.7%	25.9%	25.2%	27.1%	24.7%	26.4%	29.3%

SOURCE: BANCO CENTRAL DE COSTA RICA.

The Fiscal Situation

In any economy, the public-sector fiscal deficit is a crucial input for macro-financial stability in general and for the development of domestic capital markets in particular. Any fiscal deficit must be financed in some way, and the larger the deficit the greater the potential pressure on domestic financial markets. Even if a deficit can be financed externally, foreign borrowing must eventually be repaid, while foreign grants depend on a country's continuing ability and willingness to please external donors.

That part of the fiscal deficit that must be financed domestically can either be financed transparently (e.g., through the issue of securities that are purchased voluntarily by private-sector agents) or through various non-transparent means such as high reserve requirements on deposits at regulated financial institutions, forced purchases of government securities carrying below market rates of interest and/or rapid expansion of the monetary base to take advantage of the inflation tax. Non-transparent means tax and repress the formal financial system and are thus inconsistent with programs of financial reform and liberalization -- but are nonetheless widely employed, even by countries espousing programs of reform. The use of transparent means to finance a public-sector deficit can aid the development of domestic capital markets by providing a greater range and volume of securities to be traded, but even transparent financing cannot avoid crowding out credit to the private sector. Moreover, paying market rates of interest on outstanding government debt may further complicate a country's fiscal problems.

The public-sector deficit has always been an important problem for the Costa Rican economy, especially in recent years. During the 1980s, with the exception only of 1988 and 1989, the global public-sector deficit was over 5 percent of GDP each year (see Table 2).

There is a wide consensus that the Costa Rican fiscal deficit comes mainly from excessive expenditures instead of from a shortage of revenues. In fact, in comparison with the rest of Latin America, Costa Rica has a very high ratio of tax revenues to GDP, about 14 percent in 1990, with more than 15 percent expected for 1991.

Table 2 shows that the main sources of Costa Rica's fiscal deficits are the Central Government and the Central Bank. The Central Government's budgetary position has worsened during the last two years, especially in 1990. There are several important causes of this deterioration. Although most of them have to do with expenditure increases, there were also several reductions in revenues that severely damaged the fiscal finances during 1989 and 1990.

ABLE 2
OSTA RICA
VERALL PUBLIC-SECTOR DEFICIT
ILLIONS OF COSTA RICAN COLONES)

	1985	1986	1987	1988	1989	1990
ENTRAL GOVERNMENT	-3940	-8246	-5713	-8835	-17330	-22865
)eficit/GDP	-0.02	-0.034	-0.02	-0.025	-0.041	-0.045
ENTRAL BANK	-10226	-9260	-9916	-11656	-11570	-10067
)efeicit/GDP	-0.052	-0.038	-0.035	-0.033	-0.027	-0.02
EST OF NON FINANCIAL 1/						
JBLIC SECTOR	3027	3217	3549	3802	3522	5400
)eficit/GDP	0.015	0.013	0.013	0.011	0.008	0.011
JBLIC ENTERPRISES 1/	-2489	555	1259	3935	3741	946
)eficit/GDP	0.013	0.002	0.004	0.011	0.009	0.002
VERALL DEFICIT	-13628	-13733	-10822	-12754	-21637	-26586
)eficit/GDP	-0.069	-0.056	-0.038	-0.036	0.051	-0.052

A positive percentage means surplus.

urce: Ministerio de Hacienda y Banco Central de Costa Rica.

Certain structural problems promote automatic increases in government expenditures. In particular, there is a very complicated labor benefit schedule that automatically makes current government expenses grow. To some extent, moreover, public employee benefits are not under the control of the central executive authorities because, in practice, the court system is in charge of settling collective labor controversies. Furthermore, retirement benefits are excessive according to most standards and imply severe actuarial losses to the pension system.

Another structural problem comes from export promotion incentives. These appear to have been very effective in increasing Costa Rican sales to other countries, but at the same time they have been very costly to the national budget.

One of the most disturbing items among expenditures is the increase in interest on the public debt. In 1991, contractual interest payments by the Government accounted for almost one-third of total budget provisions. This is especially troubling because it is due in part to the process of financial liberalization which involves moving toward the payment of market rates of interest on the public debt.

The reduction or elimination of these structural factors is not an easy task. In large measure, they represent accrued benefits for public employees that, given the legal conformation of the Costa Rican labor market, cannot effortlessly be removed.

Not only did structural factors produce an increase in government expenditures in 1989 and 1990, but also some particular elements contributed at the same time, and those elements tend to reflect a certain lack of discipline in expenditure control. In the first place, 1989 was a pre-election year, and 1990 was a year in which a different political party took control of the government. Under these circumstances, the former administration did not do everything at hand to solve the main structural fiscal imbalances. Moreover, it is almost a rule that expenditures increase substantially in a pre-election year. In addition, the new government officials were somewhat slow in implementing corrective measures, at least during the time it took them to get acquainted with their tasks.

The most important reductions in fiscal revenues resulted from the deterioration in international coffee prices and the decrease in import duties that was undertaken in the context of the structural adjustment program sponsored by the World Bank. Lower coffee prices diminished export proceeds, thereby reducing the amount of tax revenues collected. In addition, in 1989 the National Assembly voted substantial rate reductions in the taxes on coffee production and exports, in part to alleviate losses suffered by coffee growers.

Under the conditions of the World Bank's second Structural Adjustment Loan, import tariffs were reduced to a maximum rate of 40 percent in 1990. This contributed not only to a fiscal deterioration but also to a worsening in the balance of payments as tariff reductions were not accompanied by compensatory adjustments (e.g., more substantial devaluation of the local currency). However, the negative fiscal effects of this measure were partially offset by an increase in the general basic rate for import duties (the tariff floor).

These circumstances together produced a significant deterioration in Central Government budget in both 1989 and 1990. While in 1988 the Central Government deficit was 2.5 percent of GDP, it increased to 4.1 percent in 1989 and to 4.5 percent in 1990.

The second major source of public-sector budgetary imbalance is the Central Bank. After 1981, Central Bank losses began to increase rapidly as a result of the sharp expansion in public-sector foreign debt. The Central Bank itself had in the past incurred major foreign indebtedness to sustain a fixed exchange rate. In addition, the Central Government and other public agencies further augmented the Central Bank's external debt, as the Central Bank had to make external payments to creditors while local debtors were responsible only for paying the Central Bank in local currency. These operations resulted in significant exchange rate losses. Furthermore, Central Bank losses have progressively increased as a consequence of increasing interest payments on Stabilization Bonds (financial instruments aimed at controlling monetary expansion) and Foreign Currency Certificates (bonds denominated in foreign currency) due to higher interest rates and the continuing accumulation of these Central Bank instruments in the hands of the general public.

Public-sector enterprises are a source of budget surpluses that help to offset a part of the deficits from the Central Government and the Central Bank. Some public enterprises, such as the Costa Rican Water and Sewage Institute (ICAA), the Railroad Company (INCOFER), the National Production Council (CNP)[3] and most of CODESA's[4] enterprises, have chronically unbalanced budgets. Others, however, such as the Costa Rican Electric and Telephone Institute (ICE) and the Costa Rican Petroleum Refinery (RECOPE) have traditionally run huge financial surpluses. For this reason, public enterprises as a whole have shown significant surpluses every year since 1986.

[3] The CNP is an agency in charge of price stabilization for basic foods.

[4] CODESA is the Costa Rican Development Corporation, the local version of a development bank.

In 1989 and especially in 1990, in contrast to prior years, the favorable budgetary situation of public enterprises eroded. Some of them experienced reductions in their budget surpluses, while for others, such as the CNP, the deficit position worsened. The main reasons for this general deterioration were, on one hand, delayed adjustments in utility tariffs and in the retail prices of oil products and, on the other hand, the increase in overall expenses of the CNP as a consequence of crop failures.

Another traditional source of budget surpluses in Costa Rica has been the "rest of the non-financial public sector," which includes most of the decentralized public institutions such as the Social Security System (CCSS), the Agrarian Development Institute (IDA), and the Costa Rican Coffee Institute (ICAFE), among others. Usually the most important source of this surplus is the CCSS which, in 1990, generated more than 60 percent of the total surplus of this group of governmental institutions.

The financing of public sector deficits has traditionally been transparent. The main sources of funds have been the sale of government bonds to the public through open market operations on the National Securities Exchange and credit from the banking system. In addition, some government bonds are placed directly with certain public sector entities as a means to balance the overall deficit.

Table 3 presents figures on the financing of the government deficit from 1987 through 1990. As can be seen from this table, the most important source of financing for the fiscal deficit has been the issue of Government Bonds which, in 1990, financed 87 percent of the deficit. Most of these bonds are sold to "the rest of the non-financial public sector (47 percent in 1989) and the banking system (16 percent in 1989), while the private sector bought 21 percent of the net increase in bonds during 1989 (see Table 4).

During 1990 some less transparent procedures emerged for financing the fiscal deficit, but these procedures nonetheless implied the payment of market interest rates by the government so that the degree of distortion in financial markets was minimized. However, this does not mean that these financing procedures are totally harmless. The increasing placement of public debt issues creates significant pressures on financial markets, thereby increasing interest rates in real terms. These pressures produce a significant crowding out of the private sector because investors cannot compete with the Government for the scarce funds available.

TABLE 3
COSTA RICA
GOVERNMENT DEFICIT FINANCING
(MILLIONS OF COSTA RICAN COLONES)

	1987	1988	1989	1990
FISCAL DEFICIT	5713	8835	17330	22865
INTERNAL SOURCES	4039	8035	14330	20675
Government Bonds	10678	7332	16347	19892
Property Titles 1/	4532	8384	6284	16672
Other Bonds	6146	-1052	10063	3220
Other Internal	-6639	753	-2017	783
EXTERNAL SOURCES	1674	750	3000	2190

1/ Property titles are a type of Government Bond that is issued to provide a financial instrument adapted to market conditions.

SOURCE: Ministerio de Hacienda and Banco Central.

TABLE 4
COSTA RICA
GOVERNMENT BONDS
ANNUAL NET INCREASE BY TYPE OF HOLDER
(MILLIONS OF COSTA RICAN COLONES)

	1987	1988	1989	1990
TOTAL	10678	7332	16347	19892
Central Bank	-88	-175	-56	
Commercial Banking System	4982	2463	2572	
Rest of Public Sector	4490	1802	7663	
CCSS	1671	1158	5891	
BANHVI	1580	244	1051	
Banco Popular	1365	-126	149	
Others	-326	526	572	
Private Sector	987	2339	3452	
External Sector	111	310	93	
Others	196	593	2623	

SOURCE: Banco Central.

The Foreign Exchange Regime

Consideration of the exchange rate and the foreign exchange regime is essential for an adequate understanding of the macro-financial situation in any country, as well as of the prospects for capital market development. An over-valued exchange rate creates expectations of devaluation in a fixed-rate regime and of depreciation of the domestic currency in a floating-rate regime. In either case, economic agents will find it less attractive to hold assets denominated in the domestic currency and will, therefore, require higher rates of interest on bank deposits and on debt instruments traded in domestic capital markets. The result will be higher interest rates for borrowers and a reduction in the real size of the banking system and domestic capital markets.

The choice between a fixed-rate regime and a floating-rate regime is a much debated topic in economic literature for both developed and developing countries. Nonetheless, a consensus has emerged that, under either type of regime, it is usually a mistake to impose foreign exchange controls such as requiring exporters to surrender foreign exchange earnings or importers to purchase foreign exchange only through official channels. Such controls are not only very difficult to enforce but also discourage economic agents from holding domestic assets because of fears that it may suddenly become more difficult to convert these assets to foreign exchange when needed. Although many countries have such controls (usually stemming from attempts to maintain an over-valued exchange rate), foreign exchange controls -- like an over-valued exchange rate -- penalize the holding of bank deposits and domestic debt instruments and thereby impede the development of the banking system and domestic capital markets.

Costa Rica has experienced intense exchange rate problems during the past decade, and this exchange rate instability has come primarily from fiscal disequilibria. The Government has frequently resorted to the banking system, seeking funds to finance its deficits. The Central Bank has then had to increase the amount of credit available to the banking system and, with this support, the banking system has provided the necessary funds to the Government. This situation has produced monetary disequilibria that have weakened the balance of payments and increased domestic inflation and thereby distorted the nominal exchange rate.

After the severe 1980-82 crisis, Costa Rica adopted a more flexible exchange rate policy. Initially this was just a system of periodic devaluations in response to specific circumstances, but in 1985 the Central Bank implemented a more formal crawling peg policy. The basic rule of this policy was to compensate for the difference between the domestic inflation rate and a weighted average of the inflation rates of Costa Rica's major trading partners. However, the authorities have not always strictly followed this policy, and the real exchange rate has frequently become overvalued relative to the US dollar. In fact, the overvaluation of the Costa Rican colón -- and the resulting loss of export competitiveness -- may have been one of the main reasons for the deterioration in the balance of payments experienced during the last two years.

As can be seen from Table 5 and Figure 1, Costa Rica's real exchange rate experienced a major appreciation during the last two years, at least until August 1990. After that date, the Central Bank substantially accelerated the weekly rate of devaluation, and in fact on several occasions there have been two devaluations in the same week. The more rapid pace of devaluation led to a readjustment in the real exchange rate, but not by enough to return the index to its level of January 1987.

TABLE 5
COSTA RICA
BILATERAL REAL EXCHANGE RATE INDEX
(JANUARY 1987 = 100)

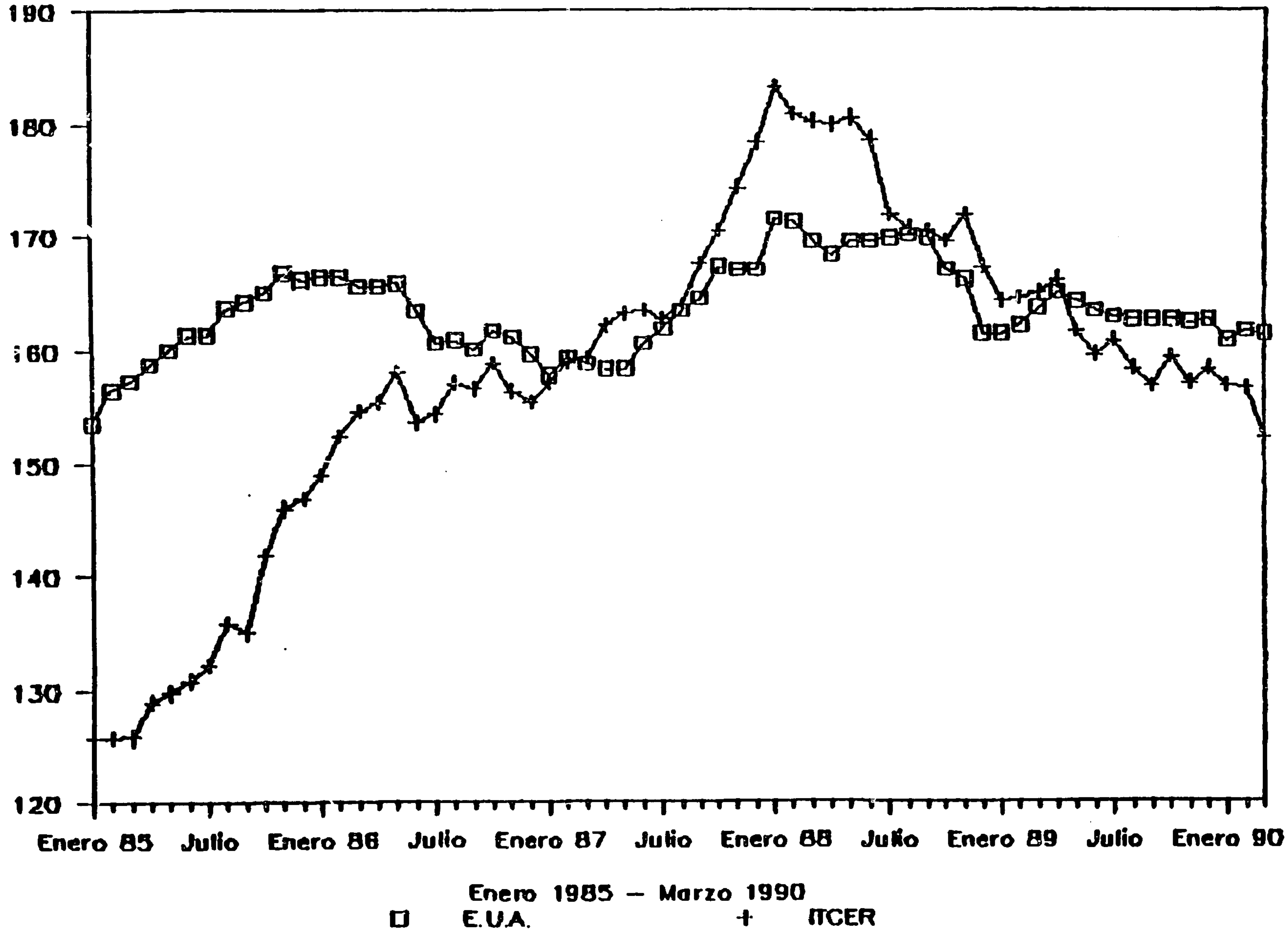
	1988	1989	1990
JANUARY	94.9	89.8	88.7
FEBRUARY	94.3	90.5	88.3
MARCH	93.3	91.3	87.5
APRIL	93.0	92.2	86.3
MAY	93.9	91.7	87.0
JUNE	94.3	90.9	86.6
JULY	94.5	90.4	85.8
AUGUST	94.5	89.7	86.6
SEPTEMBER	93.8	89.7	89.5
OCTOBER	92.0	89.4	90.7
NOVEMBER	91.6	89.0	90.3
DECEMBER	89.4	89.2	91.0

Based on the Costa Rican Consumer Price Index and the US Wholesale Price Index.

Table 5 gives only the bilateral real exchange rate index between the Costa Rican colon and the US dollar, while Figure 1 also gives the multilateral index published by the Consejo Monetario Centroamericano. Although the long-run trend of these indices is similar, there are significant differences in some periods, especially before 1987.

INDICE DE TIPO DE CAMBIO EFECTIVO REAL

(1980 = 100)



The multilateral exchange rate index is distorted by the inclusion of Central American exchange rates for periods in which exchange rate policies where highly different among the Central American countries. This is corroborated by the fact that, after January 1989, when most of the Central American countries adopted more similar exchange rate policies, the difference between the two indices was greatly reduced. For this reason, the bilateral exchange rate index may better reflect the competitiveness of Costa Rican trade in extra-regional markets. In addition, the multilateral index is not always available on a timely basis.

The major components of the current account of Costa Rica's balance of payments deteriorated in 1989 after several years of sustained improvement. The deficit in the trade balance doubled in 1989 with respect to 1988, and in 1990 it doubled again.

The trade balance deteriorated mainly as a result of a rapid increase of imports in 1989. In 1990 not only did imports continue to grow rapidly, but exports also became much less dynamic. Both events, the increase of imports and the sluggishness of exports, are at least partially consequences of the local currency overvaluation. Other events that contributed to the deterioration in the balance of trade were the fall in the terms of trade, especially the effect on exports of the plunge of international coffee prices, and the decrease in demand caused by the slowdown in the United States and other industrial economies.

As can be seen from Table 6, the worsening of the trade balance (the deficit increased from US$165 million in 1988 to US$590 million in 1990) together with a significant reduction in official capital inflows (such inflows, including both loans and official transfers, decreased from US$312 million in 1988 to US$261 million in 1990) produced a sharp fall in the international reserves of the banking system (-US$285 million). This caused an increase in external arrearages and in the availability of foreign exchange for imports and other external payments.[5]

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[5] At the end of February 1991, it took more than 60 days to obtain foreign currency through the banking system for external payments. Moreover, beginning in December 1990, each importer was required, at the moment of the solicitation, to deposit 70 percent in local currency of the amount of foreign currency requested. Previously, the requirement had been only 1 percent.

TABLE 6
COSTA RICA
BALANCE OF PAYMENTS
(MILLIONS OF US DOLLARS)

	1987	1988	1989	1990*
CURRENT ACCOUNT BALANCE	-257	-179	-382	-570
Trade Balance	-227	-165	-314	-590
Exports of Goods (FOB) 1/	1158	1245	1404	1433
Imports of Goods (CIF)	1385	1409	1717	2023
Services and Transfers	-30	-14	-68	20
Tourism	68	105	129	135
Factor Services	-297	-352	-342	-309
Interest	-272	-319	-297	-255
Others	-25	-33	-45	-54
Current Transfers, net	226	255	161	185
Private	39	40	40	59
Official	187	215	121	126
Others	-27	-23	-16	-45
CAPITAL ACCOUNT BALANCE	261	408	529	285
Official Capital, net	69	97	182	135
Private, Including errors and omissions	192	311	347	150
CHANGE IN RESERVES	5	229	147	-285

* Preliminary figures.

1/ Includes exports of the temporary admission regime.

SOURCE: Bancc Central.

Although the Central Bank formally maintains a monopoly over all foreign exchange reserves, in practice there have not been tight controls on the functioning of the parallel foreign exchange market.[6] While there has been significant foreign exchange scarcity in the banking system for over a year, the parallel market

[6] All exporters are required to turn over their foreign exchange proceeds to the Central Bank, and the Central Bank is committed to provide foreign currency at the official exchange rate to importers and other approved agents.

has not reflected any significant pressure. In fact, the gap between the banking system exchange rate and the parallel exchange rate was less than 3 percent early in 1991 and reached at most 6 percent during 1990 and then only for very short periods of time.

Given the fragile net official reserve position of the banking system, the authorities have emphasized more strongly the devaluation process during first months of 1991, thereby trying to keep better control over the external trade gap. This approach has been complemented by a temporary 10 percent surcharge on import tariffs.

The dichotomy between the official and parallel markets reveals how difficult it is to enforce capital controls in Costa Rica. In fact, the existence of an official "dollarized" component of the financial system prevents the authorities having from any kind of effective jurisdiction. With increasing dollarization, the Costa Rican financial system becomes more integrated into world financial markets, so that the Central Bank has less control over the domestic financial system and must, in particular, continually take into account the effect of its monetary and interest rates policies on the possible transfer of colon-denominated financial assets into dollars.

At the end of 1990, Costa Ricans had time deposits in the banking system denominated in foreign currency that amounted US$566 millions. In addition, a portion of the credit operations of the financial system are conducted in foreign currency. The Central Bank also has an Official Capital Register for investors bringing external capital into the country. Registration guarantees that, after a 5 year period, the Central Bank will provide foreign exchange at the official exchange rate for interest, royalty and dividend payments as well as for capital repatriation.

The current situation suggests that, in the near future, Costa Rica may need to consider total exchange rate openness, leaving both trade and capital operations to a free parallel market. Although this often appears risky in countries such as Costa Rica that have not been able to achieve satisfactory internal and external stability, it may nonetheless be advantageous to have a parallel foreign exchange market that is totally free from possible vagaries in Central Bank exchange control policies. This may be even imperative considering the major constraint that Costa Rica's external debt imposes on its financing of any gap in the balance of payments.

Currently, Costa Rica has an external debt that amounts to more than US$3,000 million.[7] Under present contractual terms, the country needs more than $220 million for interest payments and about $250 millions for principal payments on the external debt each year. Debt service required almost one third of total export proceeds in 1990.

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[7] In 1990 the country undertook an important buying operation of its external debt at discounted prices. Costa Rica repurchased US$1,116 million (US$882 million of principal and US$234 million of interest in arrears) of its external debt with commercial banks at a price of US$0.16 for each dollar of debt. Considering that Costa Rica had to obtain about US$253 million of external credit to complete the transaction, external debt was reduced by about US$863 million. In addition, the balance of the commercial bank debt was restructured at a fixed interest rate of 6.25 percent, with extended terms and certain other conditions favorable to Costa Rica.

Inflation, Interest Rate Policies, and Domestic Credit Policies

Domestic capital markets are impacted in a number of significant ways by inflation, interest rate policies and domestic credit policies. Inflation in itself does not necessarily impede the development of capital markets, but the uncertainty that surrounds expectations of future inflation in countries with anything more than moderate inflation tends to make it quite difficult for borrowers and lenders to agree on interest rates for longer term contracts. Contracts with variable interest rates may solve some of these problems, but only if some reference rate can be agreed on and only if borrowers and lenders do not need to know future nominal cash flows with a high degree of certainty. The more problematic aspects of inflation arise when governments attempt to deal with inflation by introducing various types of controls that distort relative prices and thereby undermine the ability of economic agents to predict the relative profitability of different activities.

The most common government policies that influence the development of capital markets, especially in the context of inflation, are interest rate policies. Controlling nominal interest rates under situations of high and variable inflation is likely to make real interest rates unpredictable and possibly far from equilibrium levels for extended periods of time. If interest rate controls are applied to capital market instruments, this is likely to distort the development of capital markets. However, if such controls are applied only to regulated financial intermediaries (e.g., banks) or are universally applied but can more easily be evaded in capital market transactions than in transactions involving regulated intermediaries, capital market development may in fact be promoted through the greater opportunities for regulatory avoidance. Nonetheless, capital market development under such circumstances may lead to a lack of transparency as effective interest rates on transactions in capital markets are disguised.

Domestic credit policies are also likely to distort the development of capital markets, especially if, as is typical, they involve the provision of central bank funds for longer term loans at below market interest rates based on the assumption that longer term funds will otherwise be unavailable. Assumptions of this type often become self-fulfilling prophesies, as prime borrowers gravitate to these subsidized funds, thereby reducing the demand for longer term loans at market rates of interest and thus impeding the development of competitive capital markets. At the same time, financial intermediaries with access to these subsidized central bank funds will not be inclined to pay the market rates of interest required to mobilize longer term funds in the open market. In addition, governments are often tempted to tap the funds generated by insurance and pension funds to deal with their fiscal problems, with the result that the main potential sources of longer term funds that could flow to domestic capital markets are instead absorbed to finance government fiscal deficits.

In Costa Rica, average inflation rates have been quite high during the last four years, ranging from 16 to 21 percent as measured by the consumer price index. The main price indicators are presented in Table 7.

TABLE 7
COSTA RICA
PRICE INDEXES

	1987	1988	1989	1990
Consumer Price Index (1975=100)	920	1153	1267	1613
Annual Average Rate	16.9%	20.8%	16.5%	19.0%
Annual Rate (Dec. - Dec.)	16.4%	25.3%	9.9%	27.3%
Wholesale Price Index (1978=100)	947	1134	1255	1579
Annual Average Rate	11.3%	15.5%	14.8%	18.6%
Annual Rate (Dec. - Dec.)	10.9%	19.6%	10.7%	25.9%
GDP Deflator (1966=100)	2630	3123	3595	4308
Annual Average Rate	10.1%	18.7%	15.1%	19.8%

Lack of discipline in the control of monetary and fiscal variables has been the main cause of this price instability. However, the impact of domestic monetary disequilibria on Costa Rican inflation has been less important than their effects on the main external variables. In fact, these disequilibria have mainly affected the balance of payments by inducing increased imports. Part of this negative effect has been offset by the nominal devaluation of the exchange rate, which then produces price increases, but as already indicated the devaluation adjustment may have been insufficient.

The Costa Rican economy is small and open, and this openness produces the result that monetary disequilibria pressure the external balance more than domestic prices. This is the main reason that the exchange rate has to be adjusted frequently according to the difference between external and internal rates of inflation. An example of this is the experience of 1990. The money supply increased only 7.2 percent, while the inflation rate, as measured by the consumer price index, was 27.3 percent. The apparent insignificance of the increase in the money supply does not mean that there was not a monetary disequilibrium, but rather it shows the effects of the loss of international reserves. As the Central Bank expanded domestic credit, economic agents used the resulting expansion of the money supply to purchase foreign currency, thereby offsetting most of the increase in the money supply. In fact, the loss of international reserves was US$285 million, a record reserve loss for a single year.

One of the important consequences of inflation is its effects on nominal interest rates. These rates have increased substantially during the last three years, and this effect has been especially important since the second half of 1990. Tables 8 and 9 show the behavior of interest rates, in both nominal and real rates, during the last three years.

For many years, interest rates in Costa Rica were set directly by Central Bank authorities without any consideration of what market rates might be. Credit policy was consequently based exclusively on quantitative and qualitative controls, and interest rates on loans did not play any significant role in allocating funds to investment projects according to efficiency considerations.

Since 1986, however, the Central Bank has followed a more market oriented policy of interest rate determination and has given progressively greater autonomy to banks in the allocation of funds and the determination of interest rates. In 1988, moreover, a major financial reform was initiated, and a process of complete interest rate liberalization began. Private banks could then assume a more active role in interest rate determination, as they were permitted to charge and pay market rates.

During 1989 interest rates on both loans and deposits fluctuated in a narrow range, thereby making the differentials between state owned banks and private banks especially clear. Interest rates for term deposits of private banks are typically higher than those paid by stated owned banks due to the perceived greater riskiness of private banks, while for finance companies (both regulated and non-regulated) deposit rates are reported to range even higher.

For the same year, interest rates charged by private banks show almost no variation among different categories of loans, but range between 5 and 10 percentage points higher than the rates charged by state owned banks for the same categories.[8] It is said, however, that the lower interest rates charged by the state owned banks tend to be offset by poorer service (e.g., longer delays) and by the costs incurred by borrowers in securing loans (e.g., in obtaining required documents and in making more trips to the bank).

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[8] For construction and other activities, this differential was only about 4 percentage points, as the state owned banks give these categories less favorable treatment. On the other hand, the differential was almost 10 percentage points for housing because of the especially favorable treatment given by the state owned banks, and this is even more pronounced in the case of small farmer lending in which private banks do not even participate.

TABLE 8
COSTA RICA
LENDING INTEREST RATES
NOMINAL AND REAL 1/
(YEARLY AVERAGE)

	1988 2/		1989		1990	
	SOB	PRB	SOB	PRB	SOB	PRB
AGRICULTURE						
Nominal rates	30.5%	36.3%	30.4%	35.3%	37.7%	37.9%
Real rates	8.0%	12.8%	11.9%	16.1%	15.7%	15.9%
CATTLE RAISING						
Nominal rates	30.0%	36.3%	30.0%	35.3%	33.6%	38.0%
Real rates	7.6%	12.8%	11.6%	16.1%	12.2%	15.9%
INDUSTRY						
Nominal rates	31.5%	37.8%	30.9%	35.3%	33.9%	39.7%
Real rates	8.8%	14.1%	12.4%	16.1%	12.4%	17.3%
CONSTRUCTION						
Nominal rates	31.5%		31.7%	35.6%	35.7%	38.3%
Real rates	8.8%		13.1%	16.3%	14.0%	16.2%
HOUSING						
Nominal rates	26.0%	37.8%	26.9%	35.5%	31.8%	38.3%
Real rates	4.3%	14.1%	8.9%	16.3%	10.7%	16.2%
SMALL FARMERS						
Nominal rates	15.0%		15.0%		15.0%	
Real rates	-4.8%		-1.3%		-3.4%	
OTHER ACTIVITIES						
Nominal rate	31.5%	38.0%	31.8%	35.6%	35.8%	39.7%
Real rates	8.8%	14.2%	13.1%	16.4%	14.1%	17.3%

1/ (1+ average nominal interest rate)/(1+ average inflation rate)
2/ Calculated using December interest rates.
SOB = State Owned Banks.
PRB = Private Banks.

TABLE 9
COSTA RICA
6 MONTH DEPOSIT INTEREST RATES
NOMINAL AND REAL 1/
(YEARLY AVERAGE)

	1988 2/	1989	1990
BASIC RATE			
Nominal	23.5%	23.2%	27.0%
Real	2.2%	5.7%	6.7%
MONETARY STABILIZATION BONDS (Central Bank)			
Nominal	23.0%	23.0%	27.3%
Real	1.8%	5.6%	6.9%
GOVERNMENT BONDS			
Nominal	23.2%	23.3%	28.3%
Real	2.0%	5.8%	7.8%
TERM DEPOSITS (STATE OWNED BANKS)			
Nominal	23.2%	22.9%	26.8%
Real	2.0%	5.5%	6.5%
TERM DEPOSITS (PRIVATE BANKS)			
Nominal	29.8%	27.7%	31.4%
Real	7.4%	9.6%	10.4%

1/ (1+ average nominal interest rate)/(1+ average inflation rate)
2/ Calculated using December interest rates.

During 1990 both deposit and lending rates increased substantially, but maintained the same pattern of spreads among institutions. In recent years, moreover, it has not been just nominal rates that are increasing but also real rates.

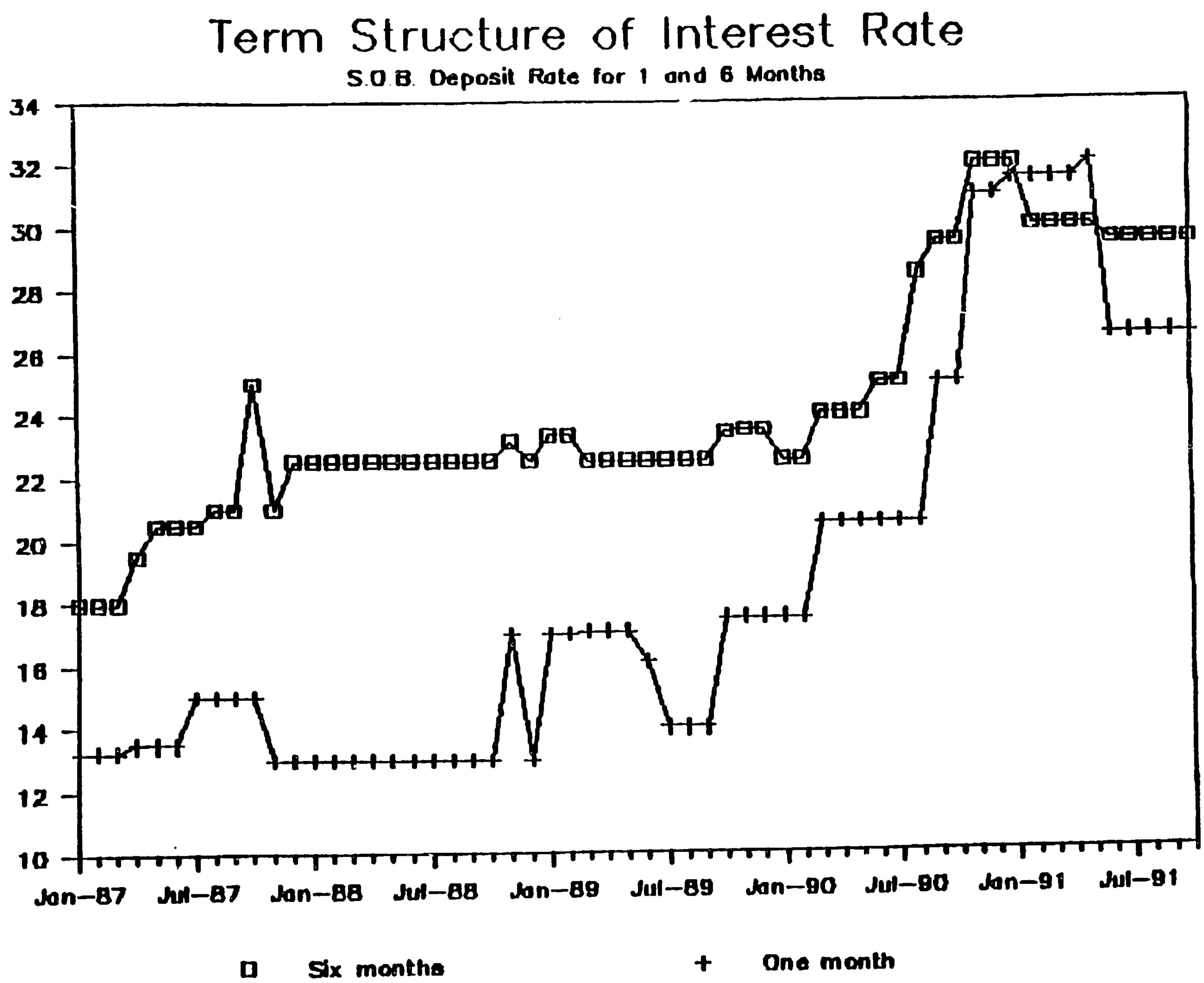
These interest rate increases are caused by several factors. Most importantly, the government has continually been resorting to open market operations with the selling of significant amounts of securities to fill its financing gaps and with the Central Bank also selling "bonos de estabilizacion monetaria," thereby competing not only with the private sector but also with each other to capture the public's savings. These competing sales have not only increased the demand for savings but may also have created a speculative trend in interest rates.

In 1988 the monetary and fiscal authorities had agreed to share the market. The fiscal authorities assumed the medium and longer run market (six months or more), while the Central Bank concentrated on short term operations (less than six months). This practice has, however, caused a significant narrowing in the term structure, as can be seen in Figure 2.

In addition, as part of monetary policy, the authorities have introduced tighter controls over credit expansion, which in turn restricts the money supply. Although the program was not applied with total success last year, it was effective enough to create further interest rate pressures.

The need of the Central Bank to capture increasing amounts of short term deposits in order to sterilize the perverse effects of fiscal imbalances have pushed short term interest rates upwards. Until recently, the difference between interest rates on six month deposits and one month deposits has typically been over 9 percentage points (e.g., from December 1987 to October 1988), but by October 1990 that difference had virtually disappeared and during several months (January to April 1991) one month interest rates were actually higher than six month interest rates. This result was a direct consequence of the aggressive monetary policy pursued by Central Bank to control the money supply.

While this policy has been effective in reducing excesses in the money supply, it has also been caused serious distortions in the term structure of financial markets. High short term interest rates, together with exchange rate risks and credit tightness, have greatly increases firms' preferences for short term financial assets.



Term Structure of Interest Rate
S.O.B. Deposit Rate for 1 and 6 Months
34
32
30
28
26
24
22
20
18
16
14
12
10
Jan-87
Jul-87
Jan-88
Jul-88
Jan-89
Jul-89
Jan-90
Jul-90
Jan-91
Jul-91
Six months
One month

Another important source of pressure on interest rates is the more dynamic and predictable devaluation policy implemented by Central Bank during the past year. This practice has impacted colon interest rates significantly, as people can easily move their savings from domestic financial assets to those denominated in foreign currencies. In order to remain competitive, the Costa Rican banking system has had to offer depositors highly positive real interest rates to make up for both the risk of devaluation and the interest rates paid on foreign currency deposits. This is also one of the reasons that foreign currency deposits in the banking system have been increasing more rapidly during the last two years than local currency deposits, even though real interest rates on colon denominated deposits are positive.

Credit policy has been constrained by fiscal needs and monetary controls. As can be seen from Table 10, in 1987 and 1990, as the government took a larger share of the additional funds available for lending, the private sector was crowded out from financial markets and its potential for investment was thereby restricted. In 1988 and 1989, on the other hand, the overall increase in domestic credit was tightly controlled by the monetary program, so that, although the increase in credit to the private sector was greater than the increase to the public sector, it was nonetheless lower than the increase in credit to the private sector in 1987 and 1990.

In short, the need to control monetary expansion has forced the Central Bank to restrain overall credit growth, so that total credit has expanded by less than the rate of inflation during the last three years. This restriction of credit has resulted in a smaller increase in credit to private sector than to the public sector, especially during 1987 and 1990. In this way, the private sector has been to some extent crowded out by the public sector.

TABLE 10
COSTA RICA
MONEY AND CREDIT
(Millions of Costa Rican Colones)1/

	1987	1988	1989	1990
Money plus Near Money	126563	172738	218437	249082
Annual Growth Rate	20.0%	36.5%	26.5%	14.0%
Money Supply	43863	53329	63057	67597
Annual Growth Rate	4.6%	21.6%	18.2%	7.2%
Currency in Public Hands	14777	18049	21922	25985
Annual Growth Rate	11.6%	22.1%	21.5%	18.5%
Demand Deposits	29086	35280	41135	41612
Annual Growth Rate	1.3%	21.3%	16.6%	1.2%
Quasi Money	82700	119409	155380	181484
Annual Growth Rate	30.1%	44.4%	30.1%	16.8%
Domestic Currency Deposits	56535	80888	100712	117853
Annual Growth Rate	23.9%	43.1%	24.5%	17.0%
Foreign Currency Deposits	26165	38521	50226	63631
Annual Growth Rate	45.8%	47.2%	30.4%	26.7%
Total Credit	74920	82687	89797	107349
Annual Growth Rate	25.3%	10.4%	8.6%	19.5%
To the Private Sector	54465	62103	69051	82064
Annual Growth Rate	23.3%	14.0%	11.2%	18.8%
To the Public Sector	20456	20584	20746	25284
Annual Growth Rate	30.9%	0.6%	0.8%	21.9%
To Central Government	9758	8516	9338	12100
Annual Growth Rate	149.0%	-12.7%	9.7%	29.6%
To Rest of Public Sector	10698	12069	11407	13184
Annual Growth Rate	-8.7%	12.8%	-5.5%	15.6%

1/ Figures as of end of December.

SOURCE: Banco Central

Instruments for Monetary Policy and Capital Market Development

There is potentially a close link between the development of new instruments of monetary policy and the development of capital markets. In countries where central banks have been able to embark on programs of greater monetary stability and structural reform for the financial sector, they have not only removed certain impediments to the development of capital markets but they have also typically found it useful to initiate open market operations as the primary instrument to control liquidity in the financial sector. Open market operations are clearly superior to the traditional monetary instruments of reserve requirements (which are often excessively high in order to finance fiscal deficits) and rediscounts (which are usually associated with directed credit lines), and for capital market development they have the further advantage of requiring the trading of financial instruments for implementation.

During the past few years monetary and credit policies in Costa Rica have been dominated by two main issues: the quest for stability and structural adjustment in the financial sector.

<u>The quest for stability.</u> At the beginning of the 1980s Costa Rica suffered a severe crisis. Inflation and exchange rate instability reached previously unknown levels. From this point on, among the most important aims of the Central Bank have been to control inflation and to reduce exchange rate fluctuations. The obstacles to attaining these goals are well known: first, the fiscal deficit has forced the Central Bank to print money, either directly (treasury bills) or indirectly (commercial bank reserves) to finance the Government; and, second, the Central Bank has suffered continuing losses (i.e., deficits), a consequence mainly of the interest it has to pay on the external debt. The situation has improved remarkably since 1982 when the consolidated public deficit (including the Central Bank) represented between 17 and 19 percent of GDP, whereas now it is 5 percent of GDP. Nevertheless, the problem has not been completely overcome.

<u>Structural adjustment in the financial sector.</u> Adjustment has been aimed at reducing the costs of financial intermediation by increasing competition and consolidating the formal and informal financial markets. In addition, efforts have been made to improve the supervision of the financial sector. The main obstacles to achieving these objectives have been:

- a highly interventionist Central Bank that has traditionally tried to apply its policies through piecemeal direct controls;

- a highly inefficient commercial banking system in which the four state owned banks have had overwhelming importance;

- an underdeveloped private financial sector consisting of banks and financieras; and

- an underdeveloped supervisory body, the Auditoría General de Entidades Financieras (AGEF).

These issues forced the Central Bank to change both its aims and its instruments. With respect to aims, more emphasis was placed on economic stability and on the microeconomic management of financial intermediaries, while less was placed on promoting faster economic development and the expansion of production. With respect to instruments, the changes were also substantial.

Traditionally, the Central Bank had established general quantitative limits (límites generales de crédito) and specific quantitative restrictions (topes de cartera). Each year the Central Bank issued a credit program in which an overall credit limit and specific credit restrictions (as many as 50) were fixed for each bank. The commercial banks could neither lend more nor lend for other purposes. In addition, the Central Bank fixed the interest rate for each lending activity, as well as the rate of interest that commercial banks could pay to obtain funds from the public. The Central Bank also regulated the rediscount rate (loans to commercial banks) in ways to force the commercial banks to lend for certain specific activities and not for others. In short, the Central Bank was attempting to determine the quantity, price and allocation of all available credit. Moreover, the Central Bank also had to approve individually each of the new branches (sucursales) that commercial banks wanted to establish.

To achieve the new aims that emerged after 1982, these traditional instruments and policies largely had to be scrapped. Fragmented financial entities and activities had to be integrated into a single, unified financial system, and banks had to learn to operate as banks (make decisions and take risks). Major changes in controls over state owned commercial banks were initiated in the mid-1980s:

- banks were allowed to lend amounts that they thought reasonable;

- banks were allowed to decide to whom to lend (sectors, activities);

- banks could decide how much to charge to their customers (interest rates plus other fees); and

- banks could decide how much to pay for their funding.

The Central Bank progressively abandoned direct measures and began to rely more and more on indirect measures. The objective was no longer to determine amounts and allocation of credit but rather to influence overall liquidity. The Central Bank came to realize that the financial sector is, for practical purposes, a single entity. As a consequence, if the Central Bank tries to control the formal financial sector too much, then funds will be transferred to the informal financial sector, and Central Bank policy will become ineffective, if not totally useless.

With the main objective being to influence liquidity, open market operations became the most useful instrument. The Central Bank began by selling its own paper (Bonos de Estabilización Monetaria), and afterwards it also created an overnight market. In addition, the rate of interest rate for rediscounts was increased so that each time a commercial bank asks for funds from the Central Bank it would be unprofitable for the bank. Thus, rediscounts would only be used only to cope with liquidity problems and not to increase lending capacity. By trading its own paper, the Central Bank now influences the amount of liquidity and its price, the rate of interest.

The Central Bank has had to face certain major obstacles to put its new policies into effect, and the main ones have been:

- o the public deficit;
- o the losses (deficit) of the Central Bank; and
- o severe problems in the four state owned banks, especially in two aspects:
    - o The state owned banks are extremely inefficient, and their high costs imply that they have to operate with wide financial margins, i.e., high costs for their customers.
    - o They have significant political influence, not only with various high Government officials but also with certain producer groups. Under certain circumstances they can therefore neutralize and circumvent the policies of the Central Bank.
- o obvious weaknesses in the Auditoría General de Entidades Financieras that presented serious obstacles if more freedom were to be given to the commercial banks, both state owned and private.

Because of these obstacles, new legislation had to be enacted in the mid-1980s that accomplished the following:

- o More autonomy was given to the Central Bank, as the number of ministers on the Central Bank's Board of Directors was reduced from three to one.

- o The AGEF was given enough power to intervene, and even to close, financial institutions.

- o Commercial banks could no longer accrue interest on loans more than 180 days overdue, which helped to "clean" bank financial statements, especially those of the state owned banks.

These financial sector reforms have not only provided instruments to be traded in Costa Rica's capital markets, but they have also begun the process of strengthening Costa Rica's financial intermediaries. It has sometimes been argued that the inefficiency of Costa Rica's state owned banks and the small size of its private banks has promoted the development of capital markets as a substitute for adequately functioning financial intermediaries. It might therefore be supposed that the aspects of financial sector reform that strengthen Costa Rica's financial intermediaries will hinder the continuing development of its capital markets. On the other hand, however, the services of financial intermediaries and capital markets may largely be complementary, as indicated by the importance of trading in instruments issued by both state owned and private banks. In any case, there are a number of other aspects of financial sector reform that may impinge specifically on capital markets.

In a monetary economy there is always a capital market in the sense that some economic agents have an excess of funds and other agents have a need for them, and many of these agents will somehow get in touch so that a transfer will take place at some rate of interest. Such transfers can take place in a formal capital market (a stock exchange, for instance) or in an informal capital market. From this point of view a capital market has been functioning in Costa Rica for many years. For example, the Government has sold its bonds to the public, and lawyers have often played an important role as moneylenders. From a more formal point of view, however, it was only after the creation of the Bolsa Nacional de Valores (BNV) that it could be said that a formal capital market exists in Costa Rica.

New legislation was enacted in 1990 to improve institutional aspects of the capital market by establishing the Comisión Nacional de Valores (the Costa Rican version of the U.S. Securities and Exchange Commission). One of the most important aspects of the new legislation is that it gives better protection to minority shareholders, and this should be a potential incentive for many savers to buy shares traded on the BNV. Nonetheless, it has to be recognized that the BNV is still a rather small and rudimentary institution, and three main characteristics are especially worth mentioning:

- o Trading in shares is insignificant among total transactions on the BNV. Shares do not even represent 1 percent of the total value of transactions, as can be seen in Table 11. On the other hand, bonds and certificates of deposits (CDP) account for almost 80 percent of all transactions.

- o As can be seen in Table 12, private sector instruments are relatively unimportant, accounting for less than 20 percent of total transactions, while public sector instruments predominate. In fact, the development and growth of the BNV has been closely linked to the public deficit.

- o A high proportion of all instruments traded are short term paper, as can be seen in Table 13. In fact, paper with a maturity of over 180 days is hardly traded at all. The main reason for this pattern is the lack of confidence of savers in the stability of the colon. Inflation and devaluation are important obstacles to generating medium term savings in colones.

Among the main remaining issues that continue to impede the development of capital markets are:

- o The "dollarization" of the economy has been substantial, as an important proportion of national savings is held in foreign currency, while the "parallel" market also handles a sizable amount of US dollars.

- o The relative underdevelopment of certain aspects the economy represents another obstacle, as most enterprises are still relatively closed family concerns. These enterprises do not go to the capital market to get additional funds by selling shares, but rather by selling short term commercial paper, so that the supply of shares is limited. On the other hand, large institutional investors (insurance companies, pension funds) do not participate in the purchase of shares, so that the demand of shares is also limited.

- o The lack of participation by the Caja Costarricense de Seguro Social (CCSS) and the Instituto Nacional de Seguros (INS) in capital markets is a particularly serious shortcoming since both these institutions typically run large surpluses and are conceptually ideal sources of longer term funds. Under prevailing law, however, these institutions are not permitted to invest in or lend to the private sector (except for certain special programs, such as housing finance, that are specifically authorized by law). Instead, the surpluses generated by these institutions are devoted to financing the public sector fiscal deficit.

TABLE 11.

VOLUMEN DE TRANSACCIONES POR TIPO DE TITULO
EN EL CORRO REGULADO
Cifras en millones de colones

	82/83	83/84	84/85	85/86	86/87	87/88	88/89	89/90
Acciones	16.6	21.7	20.3	72.1	181.8	133.1	230.5	378.5
Acep Banc	48.9	447.6	882.1	589.1	1,935.3	6,808.1	9,099.6	7,743.8
Bonos	3,435.4	6,975.7	20,418.5	39,906.3	47,785.3	55,456.8	69,764.5	85,249.7
C.A.T.	384.2	505.6	886.3	1,530.2	2,852.4	4,005.7	8,276.6	7,600.5
C.D.P.	6,672.8	12,193.6	13,803.7	16,711.8	27,256.0	47,150.4	87,372.4	112,015.4
Cert.Presa	776.0	1,107.7	1,210.8	339.8	321.7	717.9	676.4	109.0
Cert.Inversión	858.3	1,923.6	4,033.2	7,115.6	11,015.7	13,985.9	16,594.7	20,302.3
Otros	218.9	862.7	6,953.2	15,832.4	11,570.1	17,288.3	16,878.8	14,910.1
Total	12,411.1	24,038.2	48,208.1	82,097.3	102,918.3	145,544.2	208,893.5	248,307.0
Estructura %								
Acciones	0.1	0.1	0.0	0.1	0.2	0.1	0.1	0.2
Acep Banc	0.4	1.9	1.8	0.7	1.9	4.7	4.4	3.1
Bonos	27.7	29.0	42.4	48.6	46.4	38.1	33.4	34.3
C.A.T.	3.1	2.1	1.8	1.9	2.8	2.8	4.0	3.1
C.D.P.	53.8	50.7	28.6	20.4	26.5	32.4	41.8	45.1
Cert.Presa	6.3	4.6	2.5	0.4	0.3	0.5	0.3	0.0
Cert.Inversión	6.9	8.0	8.4	8.7	10.7	9.6	7.9	8.2
Otros	1.8	3.6	14.4	19.3	11.2	11.9	8.1	6.0
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Nota: periodo octubre/setiembre de cada año.
Fuente: Dirección de Proyectos, Bolsa Nacional de Valores, S.A.

TABLE 12
VOLUMEN DE NEGOCIACION POR SECTOR EN EL CORRO REGULADO
Cifras en millones de colones

	Periodo 88/89				Periodo 89/90			
	Monto	% Sector	% Total	Var %	Monto	% Sector	% Total	Var %
A. Sect Público	171.973.3	100.0	82.3	53.8	212.184.1	100.0	85.5	23.4
A.1 Gob Central	69.781.2	40.6	33.4	31.5	82.373.4	38.8	33.2	18.0
Titulos de propiedad sobre Bonos								
Deuda Interna	69.764.5	40.6	33.4	31.6	82.234.6	38.7	33.1	17.9
Otros Bonos Fiscales	0.0	0.0	0.0	(100.0)				
C.A.F.	16.7	0.0	0.0	—	138.8	0.1	0.1	736.1
A.2 Sist. Banc Nac.	102.192.1	59.4	48.9	73.9	129.808.1	61.2	52.3	27.0
Bonos Est Monet	3.217.4	1.9	1.5	31.0	3.014.8	1.3	1.2	(6.3)
C.A.T.	8.276.6	4.8	4.0	106.6	7.600.5	3.6	3.1	(8.2)
Cert Presa	676.4	0.4	0.3	(5.8)	109.0	0.1	0.0	(83.9)
C.D.P. ¢	34.778.8	20.2	16.6	112.3	21.769.7	10.3	8.8	(37.4)
C.D.P. $	52.593.6	30.6	25.2	70.9	90.245.7	42.5	36.4	71.6
Cupones	1.283.3	0.7	0.6	223.6	806.5	0.4	0.3	(37.2)
Cert Inv Hipot	1.044.7	0.6	0.5	(71.3)	365.0	0.2	0.1	(65.1)
Cont Part Hipot	8.0	0.0	0.0	(98.0)	2.4	0.0	0.0	(70.0)
Otros	313.3	0.2	0.1	3.033.0	5.891.5	2.8	2.4	678.8
B. Sector Privado	36.920.2	100.0	17.7	9.5	36.121.4	100.0	14.5	(2.2)
B.1 Empresas	28.135.2	76.2	13.5	12.5	30.225.6	83.7	12.2	7.4
Acciones	220.5	0.6	0.1	73.2	376.9	1.0	0.2	63.4
Ac Bancarias	9.099.6	24.8	4.4	33.7	7.743.9	21.4	3.1	(14.9)
Bonos	0.0	0.0	0.0	(100.0)	0.0	0.0	0.0	0.0
Cert Inversión	16.594.7	44.9	7.9	18.7	20.202.0	56.1	8.2	22.3
Letras de Cambio	1.656.4	4.5	0.6	(50.6)	1.294.0	3.6	0.5	(21.9)
Pagarés	2.2	0.0	0.0	(45.0)	0.0	0.0	0.0	(100.0)
Cupones	13.4	0.0	0.0	9.8	25.7	0.1	0.0	91.8
Cert Inv Fideic	538.7	1.5	0.3	(23.8)	477.0	1.3	0.2	(11.4)
Otros	0.0	0.0	0.0	(100.0)	6.1	0.0	0.0	100.0
B.2 Mutuales	8.784.9	23.8	4.2	0.9	5.895.8	16.3	2.3	32.9
C.D.P.	118.5	0.3	0.1	66.2	111.6	0.3	0.0	(5.7)
Cont Part Hipo	8.666.4	23.5	4.1	0.4	5.776.2	16.0	2.3	(33.3)
Cert Inv Hipo	0.0	0.0	0.0	(100.0)	8.0	0.0	0.0	100.0
TOTAL	208.893.5		100.0	43.5	248.305.4		100.0	18.9

Fuente: Dirección de Proyectos. Bolsa Nacional de Valores. S.A.

TABLE 13.
VOLUMEN DE OPERACIONES POR MERCADOS EN EL CORRO REGULADO
Cifras en millones de colones

	Período 88/89				Período 89/90			
	Monto	% Merc	% Total	Var %	Monto	% Merc	% Total	Var %
Merc. Primario	**161.[illegible]55.1**	**100.0**	**77.3**	**46.8**	**211.395.2**	**100.0**	**85.1**	**30.9**
Acciones	81.1	0.1	0.0	1612.0	212.5	0.1	0.1	162.0
Bonos	62.344.0	38.6	29.8	41.3	77.468.8	36.6	31.2	24.3
C.D.P. Colones	23.944.7	14.8	11.5	96.8	18.221.2	8.6	7.3	(23.9)
C.D.P. Dólares	50.902.2	31.5	24.4	70.4	88.160.2	41.7	35.5	73.2
Cert.Inversión	9.856.4	6.1	4.7	26.3	13.775.2	6.5	5.5	39.8
Cont.Part.Hipot.	8.262.9	5.1	4.0	4.4	5.476.0	2.6	2.2	(33.7)
C.D.P. Mutuales	36.3	0.0	0.0	170.9	4.0	0.0	0.0	(89.0)
Cert.Inv.Hipot.	259.3	0.2	0.1	(89.5)	74.3	0.0	0.0	(71.3)
Pagarés	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Acep.Bancarias	5.341.0	3.3	2.6	20.1	5.422.7	2.6	2.2	1.5
Otros	427.2	0.3	0.2	(12.2)	2.580.3	1.2	1.0	504.0
Merc. Secundario	**47.438.4**	**100.0**	**22.7**	**33.5**	**36.910.2**	**100.0**	**14.9**	**(22.2)**
Acciones	149.5	0.3	0.1	12.7	164.4	0.4	0.1	9.9
Bonos	10.637.9	22.4	5.1	(6.3)	7.780.9	21.1	3.1	(26.9)
C.D.P. Colones	10.824.1	22.8	5.2	157.1	3.548.5	9.6	1.4	(67.2)
C.D.P. Dólares	1.691.4	3.6	0.8	87.2	2.085.5	5.7	0.8	23.3
Cert.Inversión	6.738.3	14.2	3.2	9.0	6.526.8	17.7	2.6	(3.1)
Cont.Part.Hipot.	411.5	0.9	0.2	4.5	302.6	0.8	0.1	(26.5)
C.D.P. Mutuales	82.2	0.2	0.0	42.0	107.6	0.3	0.0	30.9
Cert.Inv.Hipot.	785.4	1.7	0.4	(32.5)	298.7	0.8	0.1	(62.0)
Pagarés	2.2	0.0	0.0	(45.0)	0.0	0.0	0.0	(100.0)
Acep.Bancarias	3.758.6	7.9	1.8	59.1	2.321.1	6.3	0.9	(38.2)
C. A. T.'s	8.276.6	17.4	4.0	106.6	7.600.5	20.6	3.1	(8.2)
Certif. Presa	676.4	1.4	0.3	(5.8)	109.0	0.3	0.0	(83.9)
Letras de Cambio	1.656.4	3.5	0.8	(50.6)	1.294.1	3.5	0.5	(21.9)
Otros	1.737.9	3.7	0.8	152.0	4.770.5	12.9	1.8	174.5
TOTAL	**208.893.5**		**100.0**	**43.5**	**248.305.4**		**100.0**	**18.9**

Fuente: Dirección de Proyectos; Bolsa Nacional de Valores, S.A.

- The tax system does not encourage the development of the capital market. Dividends are taxed twice (the company and the shareholders), while interest on debts is treated as a cost of production, so that companies prefer to have liabilities (loans) instead of increasing their own capital (shares). In addition, the cost of increasing capital is high for companies in terms of legal fees and stamp taxes.

- There is a lack of protection for small shareholders. Some improvements were made in the recent legislation, but not enough, so that it continues to be difficult to convince savers to take the risk of becoming shareholders.

- Lack of information is perhaps the most serious obstacle to expanding the capital market and, more specifically, the market for shares. To obtain adequate and reliable information on the companies is difficult. Sometimes no information is available, and when it is the quality may not be good enough, so that it is difficult for potential investors to make decisions.

Taxation of Financial Markets

In many countries the tax system retards or distorts the development of capital markets through differential taxation of certain types of financial instruments. The most common examples involve different treatment of dividends and interest with respect to their taxation as income and their deductibility as expenses, and additional complications can arise in countries with significant inflation. The main characteristics of the Costa Rican tax system as it relates to capital markets are as follows:

- The corporation income tax has a maximum marginal rate of 30 percent when gross revenues of a corporation are greater than 6 millions colones; at lower gross revenues, the marginal rate fluctuates from 10 percent to 30 percent.

- Corporations can depreciate their assets every year and then adjust the value of their assets based on the inflation rate.

- Corporations can reinvest up to 50 percent of their profits and not have to pay income tax on the amount reinvested.

- Corporations involved in priority activities (i.e., non-traditional exports) receive special tax treatment. In particular, they do not have to pay any income tax during a period of 10 to 15 years; they do not have to pay customs duties on imports used to produce their exports; and they receive Certificados de Abono Tributario (CATs), an export subsidy that can be as high as 15 percent of the gross value of exports.

- There is a tax on physical assets such as buildings, equipment, machinery and land, but this tax is a rather low one because it has not been adjusted for inflation.

- There is no tax on the implicit profits that a corporation obtains from the reduction in the real value of its liabilities due to the inflationary process.

- Interest payments on bonds, certificates of deposits, etc. are subject to a tax of 8 percent that has to be withheld by the entity making the interest payment. This represents an effective reduction in the rate of interest.

- On dividends distributed by corporations there is a tax of 5 percent that has to be withheld by the corporation.

- Finally, it is important to note that the Central Bank does not pay interest on the compulsory reserve requirements of commercial banks. This makes reserve requirements equivalent to an implicit tax on banks and consequently leads to an increase in the cost of financial intermediation.

The present tax system has two main shortcomings: it subsidizes certain types of profits, and it imposes an extra tax on certain types of losses. Corporations do not have to pay a tax on the gains they obtain from the reduction in the real value of their liabilities (loans) due to inflation, in spite of the fact that this reduction in the real value of loans implies a net profit. On the other hand, those corporations having assets in the form of outstanding loans do not receive any tax benefits even though such assets have lost real value due to inflation. A similar distortion is present with interest income and payments. Corporations receiving interest have to pay income tax on the nominal value of the amount received, while corporations obtaining the benefits of the reduction in the real rate of interest due to inflation can still deduct the full nominal value of interest payments as a cost.

In general, the present tax system provides incentives for companies to become more indebted (obtain more loans) rather than increasing their capital. As already explained, there is double taxation of dividends, while in the case of loans there is a potential profit as the real value of principal and interest payments falls with inflation. In addition, as also noted above, an increase in capital implies further costs of 1 to 2 percent of the amount of the increase.

In view of this situation certain changes in tax legislation would be appropriate:

- o Income tax should be paid not on nominal interest income, but on real interest income.

- o The amount of nominal interest paid should not be deductible from taxable income, only the amount of real interest.

- o For depreciation purposes, the nominal value of the assets should be increased in line with the price index.

- o The double taxation of dividends should be eliminated, so that either the corporation or the shareholder should pay, but not both.

These changes would make the tax system more neutral and thereby tend to foster the development of Costa Rica's capital markets.

Concluding Comments and Major Recommendations

To a certain extent stability has been restored since 1980-1982. The situation today is generally much better in that inflation, exchange rate fluctuations, the fiscal deficit and unemployment have all largely been brought under control. Nonetheless, serious weaknesses remain. To make further progress toward a stable economy has proven elusive because of the impact of external shocks on a small economy and because of the difficulty of imposing fiscal and monetary discipline in a highly politicized economy such as Costa Rica's. To pursue stability so that the internal rate of inflation is in line with the international rate remains an aim of the utmost importance that has yet to be attained.

Substantial progress have been made toward structural adjustment in the financial sector, especially with respect to:

- new legislation (Central Bank, commercial banks, AGEF);
- institutional improvement;
- new policies, especially involving the Central Bank; and
- new instruments, with a shift toward open market operations.

Nonetheless, much remains to be done to increase efficiency and competition in financial markets, to reduce the costs of intermediation, and to offer more and better services to customers.

The two main obstacles that still block the road are:

> The public sector is much too large for the Costa Rican economy. Under these circumstances the crowding out of the private sector becomes unavoidable, and it is not possible to achieve a high rate of growth. This is not just a question of how to finance the public deficit. The problem is also the size of the public sector even if the deficit were financed in a "sound" way, e.g., through taxes. The amount of resources that the private sector has to transfer to the public sector (either through taxes or buying government bonds) is simply too large, so that not enough resources remain to allow for rapid growth in the private sector.
>
> The four state owned banks still enjoy a monopoly of sight deposits, and they also continue to have a predominant influence on the financial sector as they are by far the largest credit institutions in the country. Thus, there is no way to improve the financial system significantly without taking the necessary measures to deal with the state owned banks. Their obvious lack of efficiency and poor performance in general means that they have to operate with large

financial spreads just to cover their high costs -- which increases intermediation costs throughout the financial system. In addition, the state owned banks have enough political influence to be an obstacle to carrying out Central Bank policies.

Major modifications of the foreign exchange regime are also necessary, including allowing transactions in foreign currencies. It is important to open up the capital account of the balance of payments now that the opening up of the trade account is well underway. This would help the "dollarization" of Costa Rican financial markets in the favorable sense (i.e., the local currency, the colón, would have to compete with other currencies) which would create new opportunities for the capital market development. Allowing transactions in foreign currencies would allow Costa Rican financial intermediaries and corporations to issue paper and shares denominated in foreign currencies as well as forcing greater stability of the colón. In addition, it is important to avoid inflation in order to increase confidence in the local currency, so that a medium term market for financial paper in local currency could also be developed.

In summary, to continue with improvements in the financial sector, action is needed in at least six main areas:

- maintain financial stability;
- reduce the size of the public sector;
- resolve the problem of the four state owned banks;
- eliminate the unnecessary powers of the Central Bank;
- increase the capabilities of the AGEF; and
- improve the foreign exchange regime.

It would be important to accomplish all of this in order to strengthen the financial sector to facilitate the development of new financial institutions, including Costa Rica's capital markets.