

3. The Costa Rican Debt Deal: Is Small Beautiful?

Stephany Griffith-Jones

A. Introduction

One of the most interesting deals agreed in principle within the Brady Plan is the Costa Rican one. Its two main features are: a) the deal has only the options of debt/debt service reduction (and *not* a new money option) and b) the level of debt/debt service reduction agreed is very large, being estimated at around two-thirds of contractual obligations. As regards the latter point it should be stressed that the deal will bring Costa Rica no easing of its cash flow in the short run, because the country has *not* been servicing its commercial debt in full for several years. However, the agreement of such a deal will imply that Costa Rica has — to an important extent — overcome the serious debt overhang problem, with which it has been struggling since 1981. (The Costa Rican debt crisis started a year earlier than that of the rest of Latin America!) A major reduction of Costa Rica's debt overhang — if quickly finalised — should have a beneficial effect on private sector expectations and confidence, as the danger arising from disruptions and continuous negotiations disappears. Costa Rican senior policy-makers would also see a highly demanding and time-consuming activity such as payment debt negotiations disappear from their busy agenda with more time and energy available for them to concentrate on national economic management.¹

B. The Background

Costa Rica has several distinctive features which affect its debt position. It is a small country; therefore, though its debt is large in proportion to its own economy (with its per capita ratio amongst the highest in the world, and with a debt/export ratio that peaked at around 300 per cent in the mid-1980s), the total sum of its debt is relatively small for its creditors; therefore, the potential damage of arrears or even losses on banks' balance sheets is infinitely smaller than similar steps taken by Mexico or Brazil. This is one of the ways in which Costa Rica's smallness is advantageous to it.

Furthermore, Costa Rica has other special features. It

¹ For an interesting account of how time-consuming and distracting debt negotiations could be for a small debtor, see an account by the former Debt Minister of Costa Rica: E. Rodriguez, 'Costa Rica: A Quest for Survival' in S. Griffith-Jones (ed) *Managing World Debt*, Wheatsheaf (UK) and St. Martin's Press (USA).

has a democratic regime (being unique in this sense in Central America); it neighbours with Nicaragua and Panama, which implies that the US government had particular motives to maintain friendly relations. Costa Rica also has a highly skilled debt bargaining team. At the same time the Costa Rican government has implemented fairly successfully an acceptable adjustment programme; the budget deficit has been sharply reduced, inflation declined from above 80 per cent in 1981 to a rate between 10 and 20 per cent in recent years, the exchange rate has become competitive, leading to a strong expansion of non-traditional exports. In the last four years GDP growth has been relatively good, though per capita GDP is still below its 1981 level. These features have allowed the Costa Rican government to obtain valuable concessions from the international financial institutions. For example, Costa Rica was the first country in Latin America to get credit from the IMF (under a stand-by) while having quite large arrears with the commercial banks. The diplomatic way in which arrears were accumulated (without any use of radical rhetoric, and, on the contrary, with permanent emphasis by the Costa Rican authorities on their wish to reach an agreement with the commercial banks) was noteworthy. Indeed Costa Rica followed the strategy of 'conciliatory default', — or perhaps a more mild form of 'conciliatory debt arrears' — advocated by people like Anatole Kaletsky, without shouting it from the roof-tops. As a result, it was able to continue attracting fairly significant new flows from bilateral aid agencies and multilateral agencies while limiting service payments on its bank debt. Partly also because of the smallness of its economy, such official flows were not interrupted as a result of commercial debt arrears.

The fact that Costa Rica was in partial arrears to the commercial banks led to the sharp decline in the price of its debt in the secondary market (to a level below 20 per cent since December 1987). In turn this made it easier for Costa Rica to obtain such a favourable deal within the Brady context.

C. The Costa Rica Deal in the Context of the Brady Plan

The agreement reached between Costa Rica and its Banks' Advisory Committee in November 1989 covered US\$1.5 bn of medium-term bank debt and

US\$325 mn of arrears dating back as far as 1986. As pointed out, this agreement provides for only two options: reduction of the debt or of the service thereon; no provision is made for fresh funds without a write-down. In essence, this agreement gives the banks the opportunity to sell their debt back to Costa Rica at a price of about US\$0.16 on the dollar. Banks choosing to sell 60 per cent or more of their portfolio will receive an offer to exchange the remainder of the debt for a 20-year bond (including a 10-year grace period) at a fixed below-market interest rate of 6.25 per cent. As an incentive for commitments to undertake large-scale buy-backs, these bonds will include a renewable guarantee of at least 12 months on interest payments. In contrast, banks selling less than 60 per cent of their loans will receive longer-term bonds (25 years, with 15 years grace) at a fixed interest rate of 6.25 per cent with no such guarantee as that provided for in the former case.

Arrears in respect of the debt remaining after the repurchase operation are to be settled by means of a 20 per cent cash payments and the reprogramming of the balance over 15 years (with no grace period) at 0.81 per cent over Libor. Again, in order to encourage the banks to undertake large buy-backs, banks selling 60 per cent or more of their portfolio will receive a renewable guarantee on three years of interest payments.

The Costa Rican bonds will also contain a contingency clause whereby the banks will be entitled to additional payments if Costa Rica's GDP exceeds 120 per cent of its 1989 level in real terms. However, such additional

payments may under no circumstances be in excess of 4 per cent of the aggregate value of the bonds and the loans involved in the rescheduling of arrears in interest. Once these latter loans have been paid, the ceiling for additional payments will drop to 2 per cent.

As part of this package, Costa Rica will also set up a debt/equity conversion programme involving a minimum of US\$20 mn per annum for the next five years.

About US\$253 mn will be needed to finance the Costa Rican agreement, of which over US\$100 mn will come from the World Bank and the IMF in the form of loans. The remainder is to be obtained from bilateral sources, such as Japan, Taiwan and the USA.

D. A Brief Assessment

The special features of the country and the negotiating skill of the Costa Rican authorities have been combined for this country to get the best deal in the context of the Brady Plan. Furthermore, the fact that the country was already in rather substantial arrears for several years with the commercial banks *and* that it did *not* insist on new money as part of the package clearly seems to have contributed to it being able to negotiate such a large discount on its debt. There are clear lessons here for other debtors, even though some account needs to be taken of Costa Rica's special features, such as its smallness and its geo-political importance to the US. However, other governments should also learn from the Costa Rican government the skill to argue that theirs is a 'special case'.