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IMF Staff Statement at the Conclusion of the Article IV Discussions with Costa Rica

An International Monetary Fund (IMF) staff mission led by Mr. Dominique Desruelle, Chief of the Central America Division in the Western Hemisphere Department, issued the following statement on December 14, 2007:

“An IMF mission visited San Jose during December 3-14 for the 2007 Article IV discussions with Costa Rica to review economic developments and policy prospects. The mission met with Minister of the Presidency Rodrigo Arias, Central Bank Governor Francisco de Paula Gutiérrez, Finance Minister Guillermo Zúñiga, Minister of Foreign Trade Marco Vinicio Ruiz, other senior government officials, parliamentarians, representatives of the private sector, and think tanks. The mission thanks the authorities for the very close cooperation and warm reception it received during its stay in San Jose.

“Benefiting from the authorities’ sound economic policies, Costa Rica’s economy has continued to grow rapidly over the past 12 months but headline inflation remains high, partly caused by high international oil and food prices. The strong economic performance has been driven by both private consumption and investment as well as external demand. Exports have increased substantially despite some appreciation of the real exchange rate, indicating that the economy remains competitive. However, there are signs that the economy may be overheating such as labor market pressures, rapid growth of consumer goods imports, and persistently high inflation of non-tradable goods.

“The near-term outlook is favorable, and has been strengthened by the ratification of the Central America Free Trade Agreement with the United States (CAFTA-DR). For 2008, economic growth is expected to revert to a rate of around 5 percent, in line with potential growth. This growth outlook is predicated on a U.S. slowdown and a moderate reduction in world growth. The authorities and the mission concurred on the need to pay close attention to changes in the global outlook, which has become subject to greater risks.

“The mission congratulated the authorities on advances made in strengthening economic fundamentals and noted that the coming year provided a great opportunity to consolidate this progress. The authorities and the mission agreed on the main elements of the reform agenda, namely passage of legislation associated with CAFTA-DR, a further strengthening of public

finances, additional steps toward the adoption of inflation targeting, and improvements in financial regulation and supervision.

“The mission welcomed the continued improvement in public finances, which has resulted in the best fiscal position in over a decade. Revenue performance has been strong as a result of both administrative measures and the economic expansion. This has allowed for a substantial reduction in the public debt-to-GDP ratio. The mission agreed with the fiscal stance envisaged in the 2008 budget, which would continue to support the authorities’ disinflation efforts and bring down public debt levels further.

“The mission noted the steps taken this year to reorient spending toward priority areas, including social spending, which is already having a positive impact on poverty reduction. It welcomed the measures envisaged in the 2008 budget to continue in this direction. The mission strongly supported the authorities’ intention to pursue tax reform in 2008 to finance additional priority spending in later years. It congratulated the authorities on the introduction of multiyear scenarios in the 2008 budget documents. Building on this first step, the mission discussed moving toward a full-fledged medium-term budget framework, which would link policy objectives, spending levels, and the need to raise additional revenue.

“The mission fully shares the authorities’ medium-term objective of bringing inflation down to that of Costa Rica’s trading partners and concurs with the planned move to an inflation targeting regime. In that context, it will be important to make further progress toward lowering underlying inflation over the next twelve months. Given external price shocks, which could adversely impact inflationary expectations, and domestic price pressures, the authorities and the mission agreed on the need to make monetary policy more effective in order to curtail demand and meet the inflation objectives. The mission welcomed the authorities’ plan to proceed speedily with a recapitalization of the central bank.

“The mission agreed with the authorities on the need for further financial sector reform. It also shared the authorities’ concern about rapid credit growth, which will require continued close monitoring. Further efforts would be needed to raise the regulatory and supervisory regime to international standards. Passage of the law on strengthening financial supervision would be an important first step. In addition, the adoption of an inflation targeting regime, which will imply greater exchange rate flexibility, should go hand-in-hand with the issuance of financial derivatives’ regulation, development of currency hedging instruments, and improved monitoring of foreign-exchange and interest risk in the financial system.

“The IMF will maintain a close policy dialogue with the authorities as they continue implementing their reform agenda. In the coming weeks, the mission will prepare a report to the IMF’s Executive Board, as a basis for a Board discussion in early 2008.”