



Executive Board Minutes 21/22-1

March 1, 2021–10:30 a.m.

Costa Rica—2021 Article IV Consultation and Request for an Extended Arrangement Under the Extended Fund Facility

Documents: EBS/21/17, and Cor. 1, and Sup. 1

Staff: Goretti, WHD; Rother, SPR

Length: 1 hour, 5 minutes

ISSUED: September 29, 2022

APPROVAL: October 6, 2022

CEDA OGADA
Secretary

TABLE OF CONTENTS¹

The Acting Chair’s Summing Up.....	3
Executive Board Decision.....	5
Executive Board Attendance.....	6
Discussion Record.....	8
Annex.....	26
○ Gray Statements	
○ Staff Responses to Executive Directors’ Technical Questions	
○ Constituency Codes	

¹ Minutes are the official record of a formal Board meeting in which the Board may adopt decisions and reach understandings related to the business of the Fund. Staff background documents issued before the meeting are the principal basis for the meeting. Preliminary “gray” or “buff” statements by Executive Directors and staff’s responses to Directors’ technical questions are circulated prior to the meeting. Adopted decisions and/or summings up—the Chair’s “sense of the meeting” or policy conclusions/recommendations—are issued after the meeting. The minutes include all these elements, as well as the discussion record (a verbatim transcript of the discussion lightly edited for clarity). Minutes are made public consistent with the IMF’s Transparency Policy and Open Archives Policy.

THE ACTING CHAIR’S SUMMING UP

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities’ prompt response to the pandemic, but recognized that the economic shock has still been significant, further weakening the country’s pre-existing fiscal vulnerabilities and generating large financing gaps.

Directors supported Costa Rica’s request for an Extended Arrangement under the Extended Fund Facility, underscoring its potential role as a catalyst for additional financing, and commended the authorities for the broad-based political and social dialogue that has underpinned their home-grown program. They agreed that policy efforts should prioritize equitable fiscal reforms, maintaining monetary and financial stability, and advancing key structural reforms to promote inclusive, green, and sustainable growth. Directors emphasized the importance of strong program ownership to achieve these objectives.

Directors noted that the fiscal position has weakened considerably due to the COVID-19 crisis, despite the ambitious 2018 reform. They welcomed the authorities’ commitment to achieve a primary surplus by 2023 to place debt on a downward path, while continuing to secure critical social and capital spending in response to the pandemic and over the medium term. Directors also welcomed the authorities’ plans to further strengthen social assistance programs, and, in the context of the ambitious Public Employment Bill, help improve the equity and efficiency of government spending. They noted that efforts to enhance medium-term fiscal planning and debt management, revenue administration, and public sector governance are critical to support the fiscal strategy and mitigate risks.

Directors agreed that the accommodative monetary policy stance remains appropriate. They emphasized the need to address remaining impediments to monetary policy transmission and noted that greater development of the foreign exchange market will help support effective risk management and intermediation in local currency. Directors also strongly supported the plans to further enhance the central bank’s autonomy and governance which should further support the inflation targeting regime.

Directors noted that the authorities’ temporary and well-targeted financial sector measures have provided needed crisis relief. While noting that the financial sector seems resilient, they emphasized that the credit portfolios in the banking sector will need to be carefully monitored and welcomed the ongoing efforts to step up monitoring and supervision.

Directors commended the authorities’ ambitious macro-structural agenda to lift potential growth and address inequality, including by promoting innovation and digitalization. They noted that increasing formalization, notably through greater female labor force participation, will help deliver broad-based improvements in productivity and living standards. Directors applauded the authorities for their pioneering efforts to further improve

resilience to climate change and fully decarbonize their economy, which will present tremendous opportunities for new jobs and sustainable growth.

It is expected that the next Article IV Consultation with Costa Rica will be held in accordance with the Executive Board decision on consultation cycles for members with Fund arrangements.

EXECUTIVE BOARD DECISION

The Executive Board took the following decision:

Costa Rica—Request for an Extended Arrangement Under the Extended Fund Facility

1. Costa Rica has requested an Extended Arrangement in an amount equivalent to SDR 1,237.49 million for a period of three years from the date of adoption of this decision.
2. The Fund approves the Extended Arrangement for Costa Rica set forth in EBS/21/7 and decides that purchases may be made under the arrangement.
3. The Fund waives the limitation in Article V, Section 3(b)(iii).
(EBS/21/7, 02/12/21)

Decision No. 16976-(21/22), adopted
March 1, 2021

EXECUTIVE BOARD ATTENDANCE²

M. Furusawa, Acting Chair

Executive Directors

S. Chodos (AG)

P. Moreno (CE)

R. von Kleist (GR)

S. Bhalla (IN)

P. Trabinski (SZ)

Alternate Executive Directors

O. Odonye (AE)

H. Andrianometiana (AF), Temporary

A. Grant (AP)

F. Fuentes (BR)

Z. Zhang (CC)

F. O'Brolchain (CO)

C. Just (EC)

P. Rozan (FF)

M. Massourakis (IT)

K. Chikada (JA)

C. Sassanpour (MD), Temporary

S. Geadah (MI)

Z. Zedginidze (NE), Temporary

J. Sigurgeirsson (NO)

L. Palei (RU)

B. Alhomaly (SA)

F. Mochtar (ST)

T. Chrimes (UK), Temporary

S. Senich (US), Temporary

S. Bhatia, Acting Secretary

V. Sola, Summing Up Officer

D. Alcantara, Board Operations Officer

M. McKenzie, Verbatim Reporting Officer

Also Present

Communications Department: M. Candia Romano, M. Soto Abril. Fiscal Affairs Department: M. Pecho Trigueros. Finance Department: L. Chidawaya, T. Krueger. Legal Department: N. Rendak. Monetary and Capital Markets Department: P. Kongsamut, A. Marina, J. Nelmes.

² For countries in each constituency, please see the Constituency Codes in the annex.

Strategy, Policy, and Review Department: R. Green, B. Rother. World Bank Group: B. Cunha, P. Rodriguez. Western Hemisphere Department: N. Geng, M. Goretti, M. Hadzi-Vaskov, M. Hengge, H. Lin, K. Srinivasan. Executive Director: A. Andrianarivelo (AF), L. Levonian (CO), M. Mahmoud (MI), M. Mouminah (SA), A. Mozhin (RU). Alternate Executive Director: A. Alhosani (MI), H. Azal (EC), M. El Qorchi (MD), A. Guerra (CE), Y. Indraratna (IN), R. N'Sonde (AF), J. Romero (CE), B. Saraiva (BR), F. Sylla (AF). Senior Advisors to Executive Directors: W. Abdelati (MI), M. Choueiri (MI), J. Garang (AE), P. Harvan (EC), B. Lischinsky (AG), M. Maidi (AE), F. Rivera Molina (CE), R. Velloso (BR), J. Weil (CO), M. Zhunusbekova (SZ). Advisors to Executive Directors: F. Al-Kohlany (MI), P. Al-Riffai (MI), A. Arevalo Arroyo (CE), S. Belhaj (MD), E. Cartagena Guardado (CE), M. Coronel (BR), J. Corvalan (AG), D. Fadhel (MI), T. Iona (AP), A. Korinthios (IT), T. Krahne (GR), K. Kuretani (JA), R. Lopes Varela (AF), A. Maciá (BR), M. Merhi (MI), R. Moral Betere (CE), B. Piasecki (SZ), D. Shestakov (RU), B. Singh (IN), D. Susiandri (ST), A. Tola (SZ), N. Vaikla (NO), L. Van Hoek (FF), Y. Zhao (CC), T. Abalala (SA), J. Al Saud (SA), F. Lopez (CE).

DISCUSSION RECORD³

The Acting Chair (Mr. Furusawa):

As you noted in your gray statements, the Costa Rican authorities' prompt policy response to the pandemic helped avoid a deeper crisis; yet the socioeconomic impact has been sizable, exacerbating pre-existing fiscal imbalances, and generating a large financing gap. Against this backdrop, at the time of the Rapid Financing Instrument (RFI) approval last April, the authorities had already expressed interest in exploring a longer-duration arrangement.

The authorities and staff have subsequently reached understandings on a homegrown reform program to safeguard macroeconomic stability, support the recovery, and advance the reform agenda to promote inclusive, green, and sustainable growth. The authorities' program has been built on a broad-based consultation process within the country to deliver strong ownership of the needed reform efforts.

The proposed 36-month extended arrangement under the EFF recognizes the structural nature of the program's objectives and the time required to achieve durable solutions. It will also support policy continuity through the next general elections due in early 2022. Some Directors took note of these features in their gray statements.

Mr. Moreno:

Let me maybe just highlight four broad elements at this stage.

First, I would like to express my Costa Rican authorities' deep appreciation for the timely and fruitful engagement with the authorities during the COVID shock, including the RFI last April and now the successful EFF. This is a very good example of the IMF's rapid and comprehensive engagement with the authorities. And I would like to express our gratitude to Ms. Manuela Goretti and her team, which have carried out very intense and effective work with the authorities in this new virtual format, which has made things a little bit more complicated, with very long working hours.

Second, the Acting Chair just highlighted the response of the authorities to the crisis. Like many other places, the pandemic has hit Costa

³ Edited for clarity.

Rica very hard. It is the largest economic contraction since 1982, with a 4.5 percent of GDP drop and a rise in unemployment, over 24 percent.

Now, in the case of Costa Rica, there was the particularity that the crisis has hit when the authorities were starting to bear the fruits of major macroeconomic and structural reforms in the country, including a new fiscal rule in 2019 and the alignment with OECD standards on the structural front, including the accession to the OECD last year.

The authorities have taken a swift response to the crisis, including increasing health-related spending in an already strong public health system, and a special transfer program to support the households most affected by the crisis and a number of other measures, targeted moratoria on income and VAT taxes, containing nonpriority primary spending, or prudential policies and lowering interest rates to support credit conditions.

Third, on the specificity of the program, the very large impact of the crisis, as Acting Chair has mentioned, has inevitably led to a drastic deterioration of public finances. We think that the EFF provides the anchor to foster a resilient recovery. It is designed around three main pillars. We have highlighted them in the buff statement.

First, a fiscal pillar of continued implementation of the fiscal rule and additional measures, expenditure and tax measures to ensure a gradual reduction in the fiscal deficit to put the debt on a downward trajectory over the medium-term, while protecting the most vulnerable.

Second, a commitment to low inflation and their inflation-targeting regime and their exchange rate flexibility.

Third, continuing with the structural reform agenda. The authorities will continue with the path already set with the OECD accession, with additional reforms, including innovation, skills mismatches, red tape, fostering foreign direct investment, and, importantly, I would also highlight climate change.

Here, we have been talking these past few days of capacity development. I would also like to highlight the importance of the example of Costa Rica in the capacity development. It has been widely used in the recent reforms on financial regulation and supervision, revenue mobilization, fiscal and national accounts statistics. And it will continue to be instrumental to the program's success. There has been a good involvement also of the mission

chief in the design of capacity development. Again, it's a good example for countries.

Finally, let me also highlight the strong ownership of these programs, which we think is also important. The Acting Chair mentioned the elections next year. There has been an intense social dialogue, even in the design of the program. There has been continued engagement with the stakeholders and civil society organizations, the private sector, and with congress to advance key reforms in the program.

Actually, the government has already submitted to congress the draft bills contained in the EFF. There is a very strong commitment to the EFF by the authorities. It is viewed as a program that would provide a strong policy anchor for macroeconomic stability and structural change to ensure a steady and socially and environmentally more sustainable recovery in the future.

The staff representative from the Western Hemisphere Department (Ms. Goretti):

In response to Directors' comments, I would like to take the opportunity to provide a brief update on some of the issues related to program design and implementation.

Over the past months, as also just mentioned by Mr. Moreno, the authorities have made significant progress in building a consensus on their economic reform program through a national dialogue with key social and political stakeholders. This was on the back of the initial social discontent last September, as they announced a policy package which was excessively front-loaded and reliant on taxes, including a sizable and potentially distortionary financial transaction tax.

The reform program resulting from the national dialogue, and agreed with staff, strikes a good balance in securing debt sustainability, while being mindful of the pandemic and protracted recovery, through a balanced mix of equity-enhancing measures, underpinned by the fiscal rule. As a result, the program is being endorsed by many representatives of political parties, private sector, and civil society. Protests have been mainly circumscribed to the new public employment bill. This is an important reform which was initiated by the authorities last year to improve efficiency and equity in the public sector and has the support of a large share of the Costa Rican society. However, it is encountering the opposition of the public sector unions. As a result, the authorities have decided to preemptively submit it for constitutional review to ensure it does not infringe with any acquired rights.

Overall, the authorities expect the required ratification of the EFF by the legislative assembly to proceed smoothly, and they have recently indicated to staff that the discussion may be even advanced from the original May/June timeline. In general, they expect all pending legislation to be approved in the first half of the year, well ahead of the upcoming electoral campaign in the fall.

This brings me to a few of the questions related to the electoral cycle and how to ensure continued public buy-in of the reform program.

As noted also in the report, the three-year duration of the arrangement will help ensure policy continuity across the elections. Building on their successful national dialogue, the authorities have created an economic and social council, which will ensure ongoing consultations with different stakeholders and help build consensus on public policies and reforms throughout the program period and beyond.

Moreover, the conditionality under the program will continue to be calibrated and phased, in line with the authorities' plans and implementation capacity. For example, mindful of the electoral cycle, all the key reforms which require legislation have been set either before or well after the elections. Other conditionality, like the structural benchmarks on the medium-term fiscal framework or the debt strategy, as discussed with the authorities, are not expected to be delayed, since most of the work is already advanced, with support from Fund and World Bank technical assistance (TA), and the intermediate steps will be already completed earlier this year.

Looking ahead, the staff will continue to follow a similar approach in setting conditionality in the latter years of the program, with a focus on macro-critical issues, building on the progress to date and synergies with other international financial institutions (IFIs). Moreover, in instances where the authorities are spearheading and steadily advancing the reform effort, like in their ambitious macrostructural agenda, conditionality will remain parsimonious and review-based, not to undermine program ownership.

Mr. Fuentes:

We issued a gray statement, supporting Costa Rica's request for the EFF and the completion of the 2021 Article IV consultation. We premise our support on the authorities' robust policy commitment through their homegrown program, which is very much in line with the EFF objectives and

the country's ongoing OECD accession process. I will make the following points for emphasis.

First, while the authorities' response to the crisis has been timely and comprehensive, the economy was hit harder than expected. The pandemic shock has exacerbated Costa Rica's pre-existing fiscal imbalances, generating larger-than-expected financing needs. Last year's RFI resources were critical to support the policy response to the pandemic; however, they proved to be insufficient to bolster medium-term fiscal sustainability and growth, indicating the need for an upper-credit tranche (UCT) program. This did not come as a surprise, as the possibility of Costa Rica requesting a UCT had been contemplated during the RFI Board discussion in April last year.

Second, the structural nature of the EFF arrangement will support Costa Rica on multiple fronts. It will provide a boost to the policy efforts to bolster a recovery. It will help catalyze additional bilateral and multilateral resources to fulfill Costa Rica's external financing needs and will back efforts to remove the structural bottlenecks. Considering the risks to debt sustainability, we welcome the EFF's medium-term fiscal strategy, underpinned by a thorough mix of expenditure rationalization and revenue mobilization measures and a comprehensive reform of debt management to strengthen efficiency, transparency, and compliance with international best practices.

Third, the outlook presents important policy and reform challenges. We have to acknowledge that. On the fiscal front, a more disciplined and efficient policy approach is paramount to secure debt sustainability and support market expectations. For the medium-term, the development of a focused and well-managed capital spending plan is critical to close the infrastructure gap and boost potential growth.

Regarding the banking system, we take note of the supportive role of the monetary authorities to ensure a swift and comprehensive policy response to safeguard bank balance sheets and strengthen resilience. Moving forward, a closer monitoring of bank credit portfolio quality is needed as they continue to restructure loans in a low-growth environment.

Finally, despite the aforementioned challenges, we strongly believe Costa Rica is well positioned to successfully implement this program. We appreciate the authorities' strong ownership and commitment, as well as their efforts to build a consensus for its full implementation. Costa Rica has exhibited a remarkable commitment to implement a wide-ranging structural

reform agenda in recent years. The invitation extended by the OECD last May to become a member state is a testament to the government's commitment to sustainable policies, strong policy frameworks, and good governance.

Mr. von Kleist:

We issued a comprehensive gray statement, in which we expressed our support for the authorities' request for a Fund-supported program under the EFF. Thus, I can be very brief.

Costa Rica has entered the COVID-19 pandemic with an already elevated level of public debt, and it will take several years of fiscal efforts to revert the debt level back to the medium-term target of 50 percent of GDP. In this context, I join many of my colleagues in welcoming that care has been taken to develop a growth-friendly path to rebuilding fiscal buffers and securing debt sustainability, which will also be crucial for the ownership and, thus, the success of the program.

Like many of my colleagues have stressed, broad and durable political and social support for the program's objectives will be key. Tackling the high level of income inequality, thus, remains appropriate. The COVID-19 pandemic has been hitting the poorest particularly hard, not least due to vulnerabilities from a high level of labor market informality. Like Ms. Levonian, we support the EFF's focus on tackling high levels of informality and encourage the authorities to design labor market policies to take advantage of a likely upturn in tourist arrivals and to channel a larger share of job creation into the formal sector.

Mr. Just:

Allow us to make three more points.

First, Costa Rica ranks very high in democratization. This will require significant efforts to build the necessary domestic political consensus so that the objectives of the program can be supported on a sustainable basis. We would agree with Mr. Ronicle and Mr. Chrimes, that effectively communicating the objectives of the program so that they are well understood will be key. We also agree with Mr. Ronicle, that some of the trade-offs involved could have been addressed more explicitly in the program documents; most notably, the benefits of the fairly cheap financing conditions offered by IFIs, compared to issuing domestic debt either in colón or U.S.

dollars, or mitigating the possible risk of a tightening of external financing conditions from 2022 onwards.

Second, we supported the safe tourism concept developed by the authorities and presented in the annex--it also is quite striking--and think this could be useful also for other tourism-dependent countries.

Third, we agree with the staff's characterization of Costa Rica as a trailblazer in climate change. We commend the authorities also for their recent commendable efforts on biodiversity. We also thought the decarbonization plan highly instructive and would appreciate the staff's comments on whether it is intended to integrate those aspects of the plan that fall within the Fund's remit into bilateral surveillance going forward, such as more targeted advice on green budgeting, how to adjust the fiscal and regulatory framework, or options for carbon pricing.

Mr. Chodos:

We issued a gray statement, too. We also express our support for this venture by the Costa Rican authorities and people. We just wanted to emphasize a couple of points.

Costa Rica has always been an example on climate change, and we really would suggest that the program focus on the fostering and building upon that experience as a trademark and as a value added of this program. Maybe we can have the program enhance the capacity even further to show that we can mix climate change problems with the programs and have more effective joint lines of action between what we do at the Fund and the needs of Tokyo, Kyoto, and the climate arrangements. Costa Rica might be a very good opportunity for that.

Also, we wanted to emphasize the need for ownership. So, we take tranquility from the words of Ms. Goretti, in that there is very wide support, and the tackling of the reforms match the non-intense political cycles. We think that this is of paramount importance. We had seen problems regarding the support of the Costa Rican people regarding the programs. So, the enhancing and making sure that there is true ownership is the key element for success.

Mr. Mochtar:

We issued a joint gray statement with Mr. Chikada and Ms. Riach, supporting the country's request for an extended arrangement under the EFF. This program will help underpin the authorities' policies and their reform agenda to navigate a swift recovery, so as to promote sustainable, inclusive, and green growth over the medium term. We have two brief comments for emphasis.

First, while the program design is deemed well designed, we note that the risks to the program remain sizable, as the uncertainty surrounding the pandemic and the global outlook are still high. To this end, we associate ourselves with Mr. von Kleist, that pursuing prudent policy, as well as a strong program ownership by the authorities, would be essential.

As Costa Rica's fiscal position deteriorated over the last decade, we underscore the need to restore fiscal sustainability. We note that the 2018 fiscal reform has shown positive progress, but the shock has put the improvement on hold.

Once the crisis recedes, we support the authorities' plan to resume their reform efforts to rebuild a sound fiscal position to ensure debt sustainability. In this regard, the approval of the fiscal reform contemplated in the EFF is important, and we appreciate the staff's update on this at the beginning of the meeting.

Second, structural reforms are instrumental to boost competitiveness and inclusiveness, including reducing informality and inequality. The fact that the authorities have adopted wide-ranging structural reforms as part of the accession process to the OECD is encouraging, notwithstanding there is still much work that needs to be done. Given the very high level of inequality and informality, like other Directors, we agree that the reforms should focus on addressing those impediments, including by enhancing the social safety net, as well as reforming social security, and the minimum wage structure.

Mr. Odonye:

The COVID-19 pandemic continues to exert a heavy toll on Costa Rica, worsening inequality and informality related to women and youth. Let me emphasize our joint gray statement with several Directors, in which we endorse the authorities' timely response to contain the fallout of the pandemic and their request for an extended arrangement under the EFF.

Fiscal discipline remains critical to ensure debt sustainability. To this extent, we welcome the authorities' growth-friendly policy package and encourage a gradual fiscal consolidation to lift growth and support debt sustainability. In the context of the envisaged EFF, we endorse the staff's advice and look forward to a broader implementation of the structural reform agenda.

Two, the Central Bank of Costa Rica's (BCCR) swift response to mitigate the COVID-19 shock and preserve the banking sector is appropriate. And for us, this commendable effort came at an exceptional time. For this reason, we advise that the authorities should actually pay close attention to credit portfolios for households and businesses exposed to the banking sector, and they should also watch out for inflation movement, as emphasized by the staff and Directors alike, including Ms. Robitaille and Mr. Chikada.

Finally, we welcome the authorities' resolve to boost growth through an array of structural reforms, including by reducing inequality and informality on the path toward the OECD accession. Like Mr. Hilbers and others in their joint gray statement, we encourage further labor reforms, including by raising women's participation to support a durable accession.

We commend the authorities for embracing the new growth-enhancing economy and encourage persistence to ensure resilience against climate change.

Mr. Rozan:

We support the program. We published an extensive gray statement. I just want to limit my remarks to four points.

First, the program is well structured. It is flexible, with adequate contingency planning. Though the fiscal objectives are quite ambitious, we believe that the composition of the fiscal package is well designed. And we appreciate the staff's useful answer on social spending indicators and the importance of centralization and targeting of the social assistance program. We are looking forward to seeing progress in this area. However, I would like to echo Ms. Levonian's question regarding the possibility in the next reviews, to consider more structural conditionality to target more directly inequality and informality; we would be interested to hear from the staff on this issue.

Moreover, as the program is being rolled out, we would welcome further and more structural information on planned TA activity and outcomes, as well as that of other CD providers, to have a real understanding of how this will help to advance the objective of the program. I mean, this is not a Costa Rica-specific issue. We discussed that in the last CD's Boar discussion, but we believe it could be useful for the rollout of the program.

Second, and to ensure the program's success, as others have said, it is important to ensure political and public buy-in, which is nonetheless an easy task, as we know; and the legislative approval and then the implementation of the public employment reform will be key in this regard. Let me thank the mission chief, for the introductory remarks, in particular, on the communication campaign.

Third, I would like to underline the leadership role of Costa Rica regarding environmental policies. This is a perfect example of how these policies are conducive to growth. We probably could draw more lessons from this country, in particular, as it is one of the only tropical countries in the world that has been able to reverse deforestation. I am very happy, in this regard, that we are seeing the resilience issue being integrated into the conditionality of the program. I do not know if it is a first, but it is a very useful point.

Finally, let me commend the staff for the considerable work on the annexes and, in particular, in collaboration with the World Bank and the Inter-American Development Bank (IDB). Climate, inequality, and informality issues are definitely a good example of where synergies between institutions could help build a common vision and better policy recommendations. We would be happy to see more of this type of collaboration in the future.

Ms. Andrianometiana:

We welcome Costa Rica's engagement with the Fund and their strong ownership of the program. We have issued a joint gray statement with six other chairs, in which we supported the authorities' request for an EFF; therefore, we would like to emphasize only a few points.

First, the COVID-19 pandemic has hit the Costa Rican economy hard and has put additional pressure on public finances. Although the RFI disbursement has helped close the short-term gap, the country continues to face macroeconomic and structural vulnerabilities. Therefore, a UCT program

will be instrumental in anchoring the authorities' macroeconomic policies and structural reforms to secure macroeconomic stability and promote an inclusive and sustainable recovery from the pandemic.

Second, like many other Directors, we welcome the authorities' plan to gradually reinvigorate the fiscal consolidation process, consistent with the 2018 fiscal reform, while supporting the recovery and preserving debt sustainability. We take positive note of the measures to strengthen revenue mobilization and to promote an equitable tax structure. We also commend the authorities' commitment to reprioritize spending by earmarking additional spending for the vaccine rollout, while streamlining the public wage bill. In addition, a further increase in the fiscal space to accommodate the much-needed priority investment for infrastructure and social spending continues to be warranted.

Finally, we encourage the authorities to accelerate reforms aimed at boosting productivity, tackling inequality, and strengthening resilience to climate change. On the latter, we really welcome the authorities' commitment to climate change reforms and measures to reduce greenhouse gas emissions. We take positive note that Costa Rica is the first country to achieve zero emissions in electricity supply.

Mr. Massourakis:

We have issued a joint gray statement, and we have broadly concurred with the thrust of the staff appraisal and supported the request for the EFF arrangement. Today, I will focus on a few additional points.

First, we congratulate Costa Rica for the successful institutional transformation and the important wide-ranging structural reforms that the country has adopted since 2018. We also welcome the authorities' reiterated commitment to the structural reform agenda and to the EFF, as underscored in the buff statement.

The EFF, which follows the RFI approved last April, will be fundamental to support the reform efforts currently underway, while catalyzing additional support. Capacity development will be a key element to support the program's success, as emphasized in the buff statement. We are, however, concerned about the parliamentary approval of the EFF being undermined due to the likelihood of social unrest. We would appreciate an update on the situation.

We urge the authorities to make greater efforts to address the persistent income inequality, uneven access to opportunities, and low social mobility. These are pressing issues, further exacerbated by the pandemic, which hamper growth by reducing human capital accumulation and investment.

Mr. Sassanpour:

We joined six other chairs in issuing a gray statement, in support of Costa Rica's request for an extended arrangement under the EFF. Such an arrangement, in our view, is appropriate, given the country's projected sizable balance of payments and fiscal financing needs, as well as the need to implement an ambitious structural reform program.

I do not intend to go over the issues we covered in our gray statement but would like to follow up on an issue related to Costa Rica's commitments to OECD accession. According to the staff, the accession road map includes commitments, up to 2024, in a number of areas, including competition, state ownership, governance, and environmental policies. Technical reviews have already been concluded by 22 OECD committees. This is according to the OECD website.

I invite the staff to comment on the consistency of Costa Rica's OECD commitments with those planned under the structural component of the EFF program with regard to coverage, timing, and sequencing, and whether there are any risks of cross conditionality.

Related to that, informality and inequality in Costa Rica, especially among the low-skilled workers and women, are much higher than those of OECD and even higher than some of Costa Rica's peers. This was an issue raised by a few other Directors. Are there any specific tracks in the OECD's accession road map--and, for that matter, the EFF program--to help narrow the informality and inequality gaps appreciably over the next few years?

Mr. Mozhin:

We have cosigned a joint gray statement, together with six other chairs, so I can be relatively brief now.

Costa Rica is, clearly, a remarkable success story, certainly by regional standards but also in the global context. Its social achievements are truly amazing, with the literacy rate close to 100 percent and life expectancy at a

very high level. I would also underline the low level of crime, and I would welcome any comparisons in the crime rates between Costa Rica and neighboring countries. However, in the later periods, the generous social system apparently has become a little too generous, and this was reflected in the accumulation of fiscal deficits and public debt. Of course, this was significantly amplified by the COVID-19 crisis.

The question I have is, what are the sources of the high inequality in Costa Rica? I think Mr. Sassanpour also made this reference. Why is inequality so high, in a situation when parliament has been long dominated by supposedly left-of-center parties? It looks a little strange to me that, in a country like Costa Rica, with such a big emphasis on social protection, education, healthcare, it has such a high level of income inequality.

Regarding the EFF program, which we have supported, together with six other colleagues, I think the question I have is on the political side. The political system is prone to producing the so-called gridlock, a conflict between the presidency and parliament. In that connection, my question is simply, how would the staff describe the current political configuration? Does the president have significant parliamentary support, especially in light of the social tensions the country has experienced recently?

Mr. Zhang:

We fully support the authorities' request for the EFF. We have issued a gray statement. I would like to focus my intervention on three brief issues.

The first one is that containing the pandemic is a fundamental issue for continued reopening of the economy. We commend, the authorities have put us at enough money for the vaccine. However, I would like to know whether the authorities have had enough resources to buy the vaccines that are needed. The staff's comments are welcome.

Secondly, we support and commend the authorities for 2021, put aside targeted support and also have a very comprehensive contingency plan. However, we think it is important to contain the wage bill of the public sector and to reduce the currently high transfer of the money to the public sector, so as to save resources to support the vulnerable and reduce the poverty and inequality. This is also related to my third point, on the structural reform, especially on the public enterprise.

The staff report mentioned that Costa Rica's economy is mainly dominated by the public enterprises, but the governance reform is not moving ahead well. So, we support and encourage the authorities to use their membership in the OECD to move ahead the public enterprise reform, especially their corporate governance, to increase efficiency.

At the same time, we hope the authorities can continue to improve the Doing Business environment so as to fortify private entrepreneurship. This is also important to reduce poverty and inequality.

Ms. Senich:

We issued a gray statement, in which we supported the EFF, so I will focus my remarks on one topic.

In their response to technical questions, the staff suggests that if an activity is weaker than the program baseline, there could be further monetary policy easing and supportive credit policies. We would ask the staff how possible further monetary policy loosening would be. In particular, do the staff judge that the current policy rate is at the effective lower bound? And how are the authorities weighing the benefits versus the risks to the central bank of taking a more aggressive expansion of the funding the lending programs.

The staff representative from the Western Hemisphere Department (Ms. Goretti):

Let me perhaps start from the question on climate change. This is, indeed, a key pillar of the program and of the macrostructural agenda of the authorities that they have spearheaded, even before our discussions started. It is a long-lasting legacy of the Costa Rican authorities. Of course, we will continue to ensure that the climate change strategy, both on adaptation and mitigation, is going to be fully integrated under the program.

With reference to the specific question on the decarbonization plan, we are working very closely--together with the IDB and the World Bank colleagues, where collaboration has been excellent--trying to leverage, as much as possible, on our expertise and mandate.

For what concerns the IMF, we have been working closely with our colleagues from the Fiscal Affairs Department, for example, in the development of a revenue-neutral fee-based scheme that would increase incentives for the use of low-emission vehicles. This is a revenue-neutral

measure that takes into account also the fact that we are in the middle of a crisis, of a pandemic. So, we are also being mindful of the impact on the lowest quintile of the population. To give an example, this is also one of the commitments included already into the program documents.

As the recovery takes hold, we will continue to explore other potential tax schemes and incentives to support the decarbonization plan with the authorities, as much as we are doing on the adaptation side with a structural benchmark, where, with support from the World Bank, the plan is to estimate what would be the cost of climate-proofing the Costa Rican economy. And, of course, we will need to be mindful and reflect these costs in the budgetary plans of the authorities going forward, consistent with their capital spending projections.

We also took note of the Directors' attention to the issue of informality and inequality. This, indeed, has been one of the key areas of focus of the program but also our Article IV discussion, as also reported in our annex, which we prepared jointly with our World Bank colleagues.

On the question on causes, as we note in the staff report, the drivers of this level of inequality, despite the well-established welfare system in Costa Rica, are both of a macro and micro nature. Among the macro ones, we note the still high degree of informality, as also highlighted by some of the Directors, including a widening pay gap between formal and informal workers and public and private sector employees; the still low degree of female labor force participation; and the fact that social spending is not as targeted as it could be, and as a result the distributional measures are not as efficient.

On the micro side, one key issue is the effectiveness of education and training. While the spending envelope is very high in Costa Rica, there are improvements needed in terms of efficiency, which are also being tackled by the public employment bill.

Now, all these areas are being tackled under the program. While we have been selective in terms of structural benchmarks, one will notice that in the program documents, in the memorandum of economic and financial policies, there are several commitments, not just the structural benchmark on centralizing and digitalizing social transfer programs but also the commitment with the World Bank to improve the targeting of social transfers and the commitments by the authorities, for example, to have a further adjustment in the social security contribution based on income levels and part-time work by end-December 2021. There are also plans towards a further rationalization of

the minimum wage system, which is very complex in the country and contributes to the high level of informality, as well, together with the other IFIs, the work which continues to advance on improving the efficiency of education and also the training programs, which is an issue which affects the entirety of the country since there are still several disparities between the urban and the rural areas in the country.

This is an area that will require time to be fully addressed. And we will continue to develop policy options and measures, together with other IFIs, throughout the duration of the program and reflect it in program commitments and conditionality.

As regards the CD integration, this is a vital aspect of every program. We need to rely on capacity development to develop our policy and, in fact, make use of ongoing capacity development to make our policy recommendation under the program as fast as possible. So, we will continue to do so. Also, we already have plans, as we have done in other programs, to include more specificity on the integration of capacity development also in the reports that we will be presenting to the Board in an upcoming review in terms of what is the country's strategy on capacity development. And we will start providing more details already at the time of the first review.

On the question on OECD accession, of course, this is an important achievement but is also an area where the authorities still have a very ambitious agenda post-accession. We have been in close contact with the OECD colleagues, indeed, to ensure that the program is consistent and complementary with the ongoing committees and work streams that are being pushed ahead by the OECD. This is not just in the area of governance, where we had the specific questions in one of the gray statements, but also in terms of taxation, the financial sector agenda, and the informality agenda. So, we will continue to ensure that there is complementarity, also based in our relative expertise on the topic.

There was a question, a specific question on the vaccine. The authorities have confirmed they preordered adequate doses of the vaccine for all the adult eligible population. In this sense, they have been very proactive. And they are quite ahead already, compared also to regional peers. They already started the vaccination in December, although there have been some delays in the delivery of the doses that have been preordered, but this is something we see other countries are also experiencing.

On the scope for more rate cuts or quantitative easing, the policy rates are already at the lower bound, but I think there will be scope, if needed, to rely on some of the quantitative easing instruments that the BCCR has available. So far, they have been very cautious to deploy the full armaments, the full tools, and mainly looking at the need for credit relief and liquidity in the system. For example, the access to a purchase program, which was recently approved last year by parliament, has been hardly used so far. And as regards the repo operation, there is scope to increase the size of the operation, if there was a need. We see scope for additional easing, if there was a need, which also will complement the fact that, on the fiscal side, the space is limited.

Let me now tackle the broader question on the parliamentary support. As I mentioned at the beginning in my own opening remarks, the president, the authorities have been conscious that they have only 10 votes in their own party to push ahead the reform, against about 38 votes that are needed for a qualified majority. This is what has also motivated this long dialogue with the social and political partners over the last months because, it was not sufficient to have an executive commitment to the program, but there was a need also to have a commitment, a more broad-based commitment, by other members of parliament.

We met with the president himself during the mission. He reiterated his confidence that this process has been successful. And he is hopeful that the ratification of the EFF and also of the underlying legislation should happen smoothly over the next months, possibly already in the spring and at the end of the half of the year. This seems also consistent, reportedly, with the interest of all political parties that are looking at securing a stable macroeconomic market environment in the second half of the year to be able to focus on the electoral campaign.

Again, as noted in the report, the implementation risks remain, but hopefully the process ahead, in terms of parliamentary approval, will proceed smoothly.

Mr. Moreno:

At this stage, let me convey to the Board members that we have taken good note of their comments, and we will convey them to the authorities.

I have heard, starting from the beginning, from Mr. Fuentes and reiterated by the rest of the Directors, the importance of ownership and

program management. Here, let me also echo what Ms. Goretti has just remarked. I mean, the authorities engaged in a very early and wide engagement strategy, including a public consultation before even program negotiations and a very strengthened engagement with congress to address Mr. Mozhin's concerns here. And there is confidence that they will be supported and conveyed precisely because of the early and wide engagement. And as Ms. Goretti has stressed at the beginning, the main reforms are left outside of the electoral cycle to facilitate the swift approval of the program.

I have also heard from Directors the importance of the gradual fiscal support and to consider building flexibility of the program, including on the monetary front. Ms. Senich's comment was also addressed by Ms. Goretti. Also, the importance of structural reforms, highlighted by most of the Directors, to build a growth-friendly recovery. As Mr. von Kleist has highlighted, this is also key to ownership. But, again, most of the Directors have also stressed the importance of addressing informality and inequality and climate change. This is also very high on the government's agenda, and we will convey those comments.

Finally, I appreciate and thank the management, the staff, and the mission team for the report. It has been very intense, intense work.

The Acting Chair (Mr. Furusawa) noted that Costa Rica is an Article VIII member, and no decision is proposed.

The Acting Chair (Mr. Furusawa) adjourned the discussion.

ANNEX

- Gray Statements
- Staff Responses to Executive Directors' Technical Questions
- Constituency Codes

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BUFF/ED/21/28

February 24, 2021

**Statement by Mr. Moreno and Mr. Cartagena Guardado on Costa Rica
Executive Board Meeting
March 1, 2021**

Our authorities want to express most gratitude to management and staff for the timely response to Costa Rica's request of a three-year Extended Fund Facility (EFF) for SDR 1,237.49 million (335 percent of quota). We also extend our especial appreciation to Ms. Manuela Goretti, the Mission Chief, and her team, for their excellent work and fruitful discussions with the authorities, as well as for their efforts to bring this request to the Board in a timely manner. The EFF will help fulfill part of the balance of payments gap and support budget needs derived from the exogenous COVID-19 shock, and it will be instrumental in catalyzing additional financial support from other official lenders and international capital markets. The EFF follows a disbursement of SDR 369.4 million (100 percent of quota) under the Rapid Financial Instrument (RFI), approved by the Board in April 2020. The combined RFI and EFF resources, in response to the pandemic, signal a historical step for the country, which last drew Fund resources in 1991 under an SBA.

Background information

Costa Rica is recognized for its strong institutions and long-standing democracy. For decades, its policies have focused on economic openness and investment in human capital. They have laid the foundation for a profound transformation from an agriculture-based economy to a knowledge-intensive, service-oriented one. Costa Rica is one of three countries in Latin America ranked as full democracy by the Economist Intelligence Unit's Democracy Index (21st in the world by same index). It also enjoys one of the highest human development indices in the region.

Since 2018, the authorities have adopted wide-ranging structural reforms, in line with the OECD accession process. The roadmap for structural reforms since 2018 has aimed to boost the economy's growth potential, reduce inequality and improve the living conditions of the population, with a strong commitment to decarbonization and building resilience to climate change. Acknowledging this process, OECD invited Costa Rica to become its 38th member in May 2020. Alongside the accession process, Costa Rica has taken decisive steps to align its legislation and public policies with international best practices and OECD

standards in areas such as competition, statistics, anti-corruption, corporate governance, financial markets, and tax transparency. The accession agenda enjoys broad political support and has also provided the building blocks for the dialogue with the IMF, particularly on the structural front.

The authorities took decisive steps to strengthen macroeconomic policies. Costa Rica's fiscal situation deteriorated sharply over the last decade. Recognizing the need to restore sustainability, the authorities promoted a comprehensive fiscal reform, approved in December 2018, to increase revenue, rein in spending, and put debt on a declining trajectory over the medium term. The reform included broadening the base for the value-added tax, higher income taxes, and a fiscal rule limiting expenditure growth underpinned by provisions to put a lid on public sector wages, one of main drivers of the fiscal deficit. The authorities also made substantive progress in strengthening the monetary and exchange rate policy framework and improve financial sector regulation and supervision.

The impact of the pandemic

The Costa Rican economy has been hit hard by the COVID-19 pandemic. According to preliminary estimates from the Central Bank (BCCR), 2020 ended with a 4.5 percent drop in GDP, the deepest economic contraction since 1982. The tourism industry, which accounts directly and indirectly for about 13 percent of GDP and employment, has been severely affected, but other sectors such as transportation and commerce have also taken a heavy toll. The unemployment rate doubled to over 24 percent, disproportionately affecting women and the young.

The economic and health crisis also led to a drastic deterioration in public finances, just when the benefits from the December 2018 reform were materializing. Tax collections tumbled due to the contraction of economic activity and the targeted moratoria on income and VAT taxes. The authorities increased health-related spending to address the pandemic, and introduced a special transfer program (Bono Proteger) to support households most affected by the crisis. To limit the fiscal impact, the authorities also contained non-priority primary spending, including current transfers to the public sector. However, the economic fallout from the pandemic entails that a new fiscal adjustment program, additional to the reform passed in 2018, will be necessary to keep debt at manageable levels over the medium term.

Monetary and financial authorities have taken support measures to mitigate the impact of the crisis. They have adopted a mix of monetary and prudential policies to lower interest rates, improve credit conditions, and ensure adequate functioning of financial markets. These measures have helped support cash flows to households and businesses, thereby protecting employment and the productive fabric.

Costa Rica’s strong health system and sanitary measures were instrumental to reduce covid-related fatalities. At 1.37 percent, the fatality rate ranks one of the lowest in Latin America. It was the first country in Central America and among the first in the entire region to begin vaccinations against COVID-19, and the process is advancing well with over 100k doses administered so far and supplies secured for the entire adult population.

The outlook signals a sustained recovery through 2022. BCCR projects GDP growth at 2.6 percent in 2021 and 3.6 percent in 2022. While subject to the unprecedented uncertainties of the pandemic, the outlook is anchored on better external conditions and reopening of economies globally. Supportive credit conditions and improvement in consumer and business confidence as vaccination continues will also aid the economic recovery to take hold.

Costa Rica has remained closely engaged with the Fund during the pandemic. At the outset of the crisis, the country requested Fund support through the RFI, which helped ease the economic consequences. The Letter of Intent (LOI) for the RFI, signed in April 2020, expressed the authorities’ desire to explore a longer-duration arrangement given the protracted impact of the pandemic and the need for additional fiscal consolidation. A close dialogue ensued and culminated with the formal request for an EFF program, intended for budget support purposes. The EFF will also help address the balance of payments and government financing needs, support the economic recovery, and provide a policy anchor to ensure macroeconomic stability.

The EFF Program

The program is structured around three pillars. As expressed in the authorities’ LOI, the program’s three key objectives are: (i) gradually implementing equitable fiscal reforms to ensure debt sustainability while protecting the most vulnerable; (ii) maintaining monetary and financial stability while continuing to strengthen central bank autonomy and governance, and addressing structural financial vulnerabilities; and (iii) on the structural front, advancing on key reforms to promote inclusive, green, and sustainable growth.

The program is designed with strong ownership, including a wide political and social engagement. The authorities carried out a broad public consultation process between October and November 2020. A report titled “Plan to Overcome the Fiscal Impact Caused by the COVID-19 Pandemic: Proposal to Start Negotiations with the IMF” was made publicly available as a basis for discussion. It also became the authorities’ baseline to start formal negotiations with the Fund’s staff mission in January 2021. Public dialogue continues, with authorities engaging with the private sector, civil society organizations and Congress to advance key reforms contained in the Fund staff-level agreement.

On the fiscal front, the required consolidation will be based on continued implementation of the fiscal rule as well as additional tax and expenditures measures to ensure a gradual reduction in the fiscal deficit and put debt on a downward trajectory over the

medium term. The fiscal program is anchored on two targets: a primary balance of 1 percent of GDP by 2023 and a debt-to-GDP ratio of 50 percent by 2035. To achieve these goals, the authorities are firmly committed to continue strict implementation of the fiscal rule, along with measures to contain expenditure beyond the mandate of the fiscal rule. A key element of the fiscal program on the expenditure side is a public employment bill, an ambitious reform to modernize and streamline the public administration while containing the wage bill, all in line with OECD recommendations. On the revenue side, measures include reduction of tax expenditures, adjustment of capital income rates, personal income tax reform, special tax on lottery prizes, overhaul of the tax on luxury homes, and mandated dividend distributions from state-owned enterprises. The fiscal program also envisages gains from reforms to public procurement, modernization of the tax and customs administration, and public financial management reforms. Finally, it contemplates protection of capital expenditure and well-targeted social spending to address critical infrastructure needs and support the most vulnerable.

Work with Congress on approval of the fiscal reforms contemplated in the EFF has started. The Government has already submitted to Congress all of the draft bills contained in the EFF policy commitments. To ensure adequate and timely progress with the fiscal reform package, the authorities are actively working with members of Congress to address any questions and secure support.

Monetary policy will continue to be underpinned by the authorities' commitment to low inflation under the inflation targeting framework. Maintaining low and stable inflation (with a target of 3 percent $\pm$ 1 percentage point) under a flexible exchange rate is critical to secure domestic and external stability. In the context of the current and forecast inflation well below target, and strong disinflationary pressures from a negative output gap and high unemployment, BCCR has cut its policy rate to a record low. The authorities are committed to maintaining this counter-cyclical stance for as long as necessary to bring inflation gradually back to target as conditions allow. They have also introduced a policy of greater exchange rate flexibility, which is proving effective in absorbing shocks and helping reduce financial dollarization. To further support this strategy, the authorities have put in place reserve requirements differentiated by currency, as well as prudential regulation measures to discourage foreign-currency lending to unhedged borrowers. In 2019, the authorities promoted reform to strengthen the autonomy of the central bank through amendments to the BCCR Law. These amendments tightened dismissal rules for the BCCR's Governor, de-linked the Governor's term from the political cycle, and removed the Minister of Finance's voting rights in the BCCR Board.

The authorities are committed to continuing with the structural reform agenda, including on climate change. As previously highlighted, Costa Rica has laid out a comprehensive roadmap for structural reform to align public governance and policies with international best practices, and foster transparency, efficiency, and growth while reducing inequality and protecting the most vulnerable. Many of these reforms have already been

completed as part of the accession process to OECD. The remaining ones are being implemented. Focus areas for the EFF include reducing skill mismatches, promoting innovation, incentivizing formalization, closing infrastructure gaps, cutting red tape, and continuing to attract FDI. Also, as part of the EFF, the authorities have reiterated their commitment to climate change reforms, with measures to reduce greenhouse gas emissions, for instance by promoting the electrification of the transport fleet, and to strengthen Costa Rica's adapting capacity, for example by assessing the medium-term investment needs for enhancing resilience of the country's physical infrastructure.

Fund capacity development will be a key element to support the program success. As outlined in the staff report's Informational Annex, Costa Rica has actively engaged in the use of Fund technical assistance, including on fiscal and national accounts statistics, financial regulation and supervision, customs efficiency, and revenue mobilization. Capacity building has been instrumental in the EFF design, and will continue to be critical for success of the policy agenda under the program.

We would like to emphasise the authorities' strong commitment to the requested EFF, which will help support a smooth economic recovery, boost green and inclusive growth over the medium term, and provide a strong policy anchor for macroeconomic stability while protecting the poor. They are confident that the policies outlined in the LoI, and further detailed in the Memorandum of Economic and Financial Policies, will ensure an effective use of the requested disbursement. The authorities will remain in close dialogue with the Fund, as mentioned in the LoI and its annexes, to ensure the successful implementation of the program.

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GRAY/21/560

February 25, 2021

Statement by Mr. von Kleist and Mr. Krahne on Costa Rica
(Preliminary)
Executive Board Meeting
March 1, 2021

We thank staff for its well-written report and Mr. Moreno and Mr. Cartagena Guardado for their helpful Buff statement. **We concur with the thrust of the staff appraisal and support Costa Rica's request for an EFF arrangement.** The strong reliance on the tourism sector and related services as well as pre-existing fiscal weaknesses rendered the Costa Rican economy particularly vulnerable to the economic fallout of the pandemic. While last year's RFI disbursement helped the country to bridge the situation when uncertainties peaked, the magnitude of the crisis and the resulting short-, medium- and long-term policy challenges are becoming increasingly apparent and point to significant structural adjustment needs upon which the authorities' economic reform program builds. While reserves are still at comfortable levels, financing needs are elevated and a Fund-supported program can anchor the authorities' reform efforts. Against this backdrop, the program design appears appropriate. Nevertheless, risks to the program are substantial, as the pandemic is not yet overcome and associated external uncertainties are still high. As staff rightly notes, downside risks would further weigh on the debt and financing outlook and thus underscore the importance of prudent policies as well as strong program ownership by the authorities.

Costa Rica has entered the COVID-19 pandemic with an already elevated level of public debt and it will take several years of fiscal efforts to revert the debt level back to the medium-term target of 50 percent of GDP. While the pandemic has exposed pre-existing fiscal vulnerabilities, the 2018 fiscal reforms were certainly very valuable, but still remain incomplete to restore buffers. We thus encourage the authorities to build on this reform momentum to re-establish a sound fiscal position that also allows for meeting spending needs during the recovery phase. We welcome the authorities' plans to earmark additional spending for the vaccine rollout.

With the DSA forecasting r-g to remain in positive territory over a medium-term horizon, budget consolidation is becoming ever more urgent and necessitate a

considerable improvement of the primary balance in the coming years. Maintaining a credible commitment to consolidation is also critical to improving subpar market perceptions and thereby easing tight external financing conditions in the face of large gross financing needs. With this in mind, we deem the fiscal program targets as broadly adequate and realistic. In fact, the projected improvement in the primary deficit is gradual and the realism tools of the DSA suggest a fairly mild consolidation strategy. Nevertheless, implementation challenges should not be underestimated, given the possible materialization of unaccounted risks and provided a broad political consensus can be upheld also beyond the electoral cycle. *In this context and with a view to the general election in early 2022, we would appreciate staff comments on the domestic political and societal support for the fiscal program parameters across party lines.*

Regarding the design of the fiscal strategy, we broadly agree with staff that a gradual reduction of the public wage bill is indispensable and we welcome the authorities' plans to rationalize the public employment framework. Furthermore, we appreciate that staff and WB estimates suggest that revenue measures not only help to mobilize resources but also are likely conducive to a fairer and more equitable tax structure.

We concur with staff that the monetary policy stance is appropriate and anchored in an overall adequate monetary policy framework. We encourage the authorities to address remaining issues regarding the effectiveness of the monetary transmission mechanism and to continue with closing gaps in the governance framework. To this end, we take positive note of the SB on amending the BCCR Law, and urge the authorities to ensure that this reform addresses outstanding weaknesses in the operational autonomy and the governance framework in line with findings of the recommendations from the latest safeguards assessments.

While taking note of staff's preliminary assessment that Costa Rica's external position in 2020 was stronger than the level implied by fundamentals and desirable policies, we express sympathy with the authorities' view on the EBA results. Besides the uncertainties in the current environment and the country's relative outperformance of an already weakened comparator group, we underscore that these results should not obscure the need to prevent a deterioration of external sustainability. More broadly, the conflict between a request for Fund financing assistance and staff's preliminary findings of a strong external position creates challenges for external communications and underscores that EBA results should be taken with a grain of salt. In particular, policy gaps are often driven – as in this case – by a relatively stronger fiscal expansion globally that might not necessarily be desirable domestically.

The authorities' primary objective in the area of financial sector policies is to safeguard stability when phasing-out forbearance measures. To this end, we join staff in welcoming the authorities' vigilance and proactive supervisory stance and encourage them to proceed with implementing the FSSR recommendations with due prioritization according to capacity

constraints. As the authorities have recently begun to gradually unwind some of the crisis measures, we would appreciate if staff could follow up on the experiences made and lessons-learned in the upcoming program reviews.

Despite scoring relatively well on competitiveness indicators, economic performance and access to opportunities suggest potential for improvement and highlight the need for a reinforced structural reform strategy to boost the nascent recovery and enhance job opportunities for all. The Covid-19 pandemic has been hitting the poorest particularly hard, not least due to vulnerabilities from a high level of labor market informality. We encourage the authorities to design labor market policies to take advantage of a likely upturn in tourist arrivals and to channel a larger share of job creation into the formal sector.

Moreover, we agree that the transition towards a greener economy offers significant opportunities to Costa Rica. While we take positive note of the national decarbonization strategy, the country's exposure towards the impact of climate change indicates a need to prioritize measures aiming at climate change adaptation and preparedness. To reduce the fiscal costs of investments in these areas, we encourage the authorities to explore avenues to crowd-in private investment.

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GRAY/21/561

February 25, 2021

**Statement by Ms. Levonian, Mr. O'Brolchain, and Mr. Weil on Costa Rica
(Preliminary)
Executive Board Meeting
March 1, 2021**

Thank you to staff for their report and to Mr. Moreno and Mr. Cartagena for their insightful Buff statement in which they stressed the importance of the Extended Fund Facility (EFF) to support a smooth economic recovery, boost green and inclusive growth over the medium term, and provide a strong policy anchor for macroeconomic stability while protecting the poor.

We support Costa Rica's request for an Extended Arrangement under the EFF for 335 percent of quota. We also support the staff appraisal and agree that the response to the crisis has been swift and comprehensive. However, a sharp contraction in tourism has opened up a balance-of-payments financing gap which requires catalytic Fund support to close. The three pillars proposed for the program appropriately balance supporting macroeconomic stabilization and securing a durable recovery from the COVID-19 crisis. We welcome that care has been taken to develop a growth-friendly path to rebuilding fiscal buffers and securing debt sustainability which will be crucial for maintaining public trust as Costa Rica recovers from this unprecedented health and economic crisis. This EFF will also support the authorities as they tackle preexisting challenges such as rising debt levels, vulnerability to climate change, informality, and inequality. We agree that risks and uncertainties are large, but see the deep and meaningful public consultation that underpins the reform agenda as an important mitigating factor. Staff identified a quick rebound in tourism as an upside risk. We would caution that despite Costa Rica's noteworthy competitive advantages in this sector (e.g., high-quality medical system, developed ecotourism), tourism may still face a longer-than-expected road to recovery which will depend largely on developments in key source markets. Staff appropriately made relatively conservative assumptions in the baseline, but we would welcome some elaboration on contingency measures in the event of a downside scenario. *Staff comments are welcome.*

The policy response to the crisis was appropriate, but fiscal discipline will be required to secure debt sustainability and reassure markets. As staff note, a loose fiscal stance, weak growth dynamics and increasing interest costs have contributed to steadily rising debt over the last decade which has increased debt vulnerabilities. This situation has only been compounded by the COVID-19 crisis. Therefore, we support planned fiscal reforms, underpinned by a prudent fiscal rule and a growth-friendly mix of revenue and spending measures. In particular, we support the public sector employment reform project to rebalance the competitiveness of the public and private sectors. As this project moves ahead, it will be important not to destabilize the public service while a major public health threat looms and higher-than-normal levels of state intervention are required. Given significant infrastructure gaps, it will be critical to ensure that the programmed reduction in capital spending is temporary, and that a medium-term capital plan is developed that can boost competitiveness and generate sustainable growth. To lock-in fiscal gains over time, the authorities should gain a clearer understanding of the contingent fiscal risks posed by major SOEs through increased transparency and reporting.

Crisis impacts on the banking sector will need to be monitored closely. We took note that almost half of banks' loan book has been restructured as a result of the relaxation of regulations to support loan restructuring as well as payment moratoria. *Can staff indicate whether the restructured and deferred loans are concentrated in any one sector and what proportion of deferred loans are now performing?* It will also be important for the authorities' potential loan guarantee fund to support otherwise viable businesses in need of liquidity support to avoid deferring the necessary restructuring of the real economy that follows such an acute shock. The wide-ranging monetary policy response to the crisis reinforces the importance of enhancing the central bank's governance framework. As such, we welcome plans to strengthen the central bank law to improve operational independence and governance. Lastly, we commend the authorities for their significant progress in adopting the recommendations of the 2018 Financial Sector Stability Review.

Tackling high levels of income inequality must be a priority. The crisis has exacerbated Costa Rica's inequality and informality challenge, in particular for women who already faced low labour force participation rates and material pay gaps, and we support the EFF's focus on tackling high levels of informality as a means to reduce persistent inequality. Planned fiscal reforms, including enhancements to the social safety net, are expected to improve income distribution and reduce poverty. However, given very high levels of inequality and informality relative to other OECD countries, structural conditionality could have targeted inequality and informality directly, leveraging advice regarding enhancements to the social safety net, reforms to social security, the minimum wage structure, or enhancements to childcare. We see this as something for staff and the authorities to consider for future reviews.

The authorities should be commended for their efforts to build resilience to climate risks and their ambitious climate targets including decarbonization by 2050. As staff highlight, Costa Rica is highly vulnerable to natural disasters and other climate related risks which can have significant economic impacts if left unmanaged. Given the macro-criticality of the issue, we strongly welcome the integration of climate issues in the Fund's surveillance as well as in the EFF itself via structural conditionality relating to infrastructure climate resilience. The Fund and World Bank will need to work in close partnership to help Costa Rica build resilience, advise on policy settings to meet climate goals, and to ensure that the EFF supports those objectives.

We welcome the authorities' efforts to strengthen fiscal governance and anti-corruption framework. In their letter of intent as part of the April RFI disbursement, the authorities indicated that they were committed to using the RFI resources transparently and through established governance mechanisms, including ex-post accountability and controls, to ensure the funds are used to address the COVID-19 related shocks. *Can staff provide an update on this commitment?*

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February 25, 2021

Joint Statement by Mr. Bhalla, Mr. Hosseini, Mr. Mohieldin, Mr. Mouminah, Mr. Mozhin, Mr. Odonye, and Mr. Sylla on Costa Rica
(Preliminary)
Executive Board Meeting
March 1, 2021

1. The COVID-19 pandemic is exacting heavy socio-economic costs in Costa Rica, particularly among women and the young. The authorities responded in a timely and proactive manner, leveraging Costa Rica's well-established universal healthcare system. This response, together with extensive access to clean water and sanitation in the country, is helping to fight the outbreak and mitigate fatality rates, as noted by staff in their well-written reports. Notwithstanding the Fund's emergency financial support provided in April 2020, the shock has weakened the country's fiscal position and generated a large financing gap. Accordingly, and given the authorities' commitment to the objectives of the Extended Fund Facility (EFF)-supported program as reflected in the authorities' MEFP and stressed by Messrs. Moreno and Cartagena Guardado in their helpful Buff statement, we support the proposed decision. Against this backdrop, we appreciate the authorities' strong ownership of the reforms, as evidenced in the inclusive consultation process aimed at garnering support for their program. We share staff's view that the structural nature of the program objectives and the time required to achieve durable solutions amid the gradual recovery from the COVID-19 shock support the use of an extended arrangement under the EFF.

2. The authorities' commitment to reprioritize spending and gradually return to fiscal consolidation over the medium term, as well as their plan to maintain space for adequate pandemic-related spending in 2021 and continue to support the most vulnerable is commendable. We take positive note of the contingency measures and adjustors in the program to augment COVID-related spending, if needed. We welcome the authorities' public employment reform agenda, including their efforts to contain the wage bill. We are pleased to note that the envisaged tax reforms include measures to broaden the tax base and enhance the progressivity of the tax structure, which will help reduce income inequality. Structural conditionality in the first year of the program adequately focuses on spending efficiency and

revenue mobilization, as well as fiscal governance and transparency measures, given the authorities' aim to ensure debt sustainability.

3. We commend the Banco Central de Costa Rica (BCCR) for ensuring a rapid, transparent, and well-communicated response to mitigate the impact of the COVID-19 shock on the banking system. Given the still weak inflation outlook, we agree with staff's assessment that the monetary policy stance remains appropriately accommodative. Steps to address remaining structural issues hindering monetary policy transmission, including high financial dollarization, are welcome. Further, we welcome progress made in advancing the implementation of the 2018 Financial Sector Stability Review recommendations. We also concur with staff that strengthening the central bank law can further enhance the BCCR's operational autonomy and governance, as well as enhancing supervisory and prudential regulations.

4. Owing to remarkable progress in implementing a wide-ranging structural reform agenda in recent years, in May 2020 Costa Rica was invited to become the 38th OECD member. This is a considerable achievement, with far-reaching implications. Nonetheless, informality and inequality, which remain very high, should be addressed to enable the authorities to achieve the full potential of OECD accession. Therefore, the authorities' structural agenda under the program appropriately aims to lift potential growth and address inequality, while advancing the fight against climate change. We note, with interest, the structural benchmark aimed at enhancing infrastructure resilience to natural disasters. *We would be interested to hear from staff in which structural reform areas they expect to have structural conditionality in the latter years of the program.* We encourage the authorities to enhance formalization, including through increased female labor force participation, access to childcare, proper education, financial inclusion, and digitalization, to enhance productivity and raise living standards.

With these remarks, we wish Costa Rica and its people every success.

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GRAY/21/563

February 25, 2021

**Joint Statement by Mr. Chikada, Ms. Grant, Mr. Mochtar, Mr. Iona, Mr. Kuretani, and
Ms. Susiandri on Costa Rica
(Preliminary)
Executive Board Meeting
March 1, 2021**

We thank staff for the comprehensive report, as well as Mr. Moreno and Mr. Cartagena Guardado for their insightful Buff Statement.

The COVID-19 pandemic is exacerbating Costa Rica's pre-existing economic imbalances. Despite the authorities' prompt policy response, and well-established universal healthcare system, the outbreak has generated socio-economic hardship, with a sharp economic downturn and increased unemployment and inequality. This has led to further substantial balance of payments and budget support needs. While the RFI in 2020 has provided temporary financial relief, financing needs remain sizeable. **Against this backdrop, and coupled with the assessment that Costa Rica's capacity to repay the Fund is adequate, we support the authorities' request for disbursement under the EFF amounting to 335 percent of quota.** We expect the program will help to anchor their policy and reform agenda as well as further catalyze financial support from other partners and international capital markets.

We welcome the authorities' plan to gradually resume their fiscal reforms to preserve debt sustainability, while supporting the recovery and the most vulnerable. The pandemic has put a hold on the positive progress of fiscal reforms launched in late 2018 to tackle large fiscal imbalances. While a higher fiscal deficit in 2020 is appropriate in response to the COVID-19 pandemic, fiscal consolidation efforts to bring public debt on a downward path should resume once the crisis abates. We cautiously note that while debt is assessed to be sustainable, the risks remain high. To this end, we support the authorities' goal of achieving a primary surplus by 2023. The authorities' strategy to pursue expenditure rationalization underpinned by a fiscal rule and equitable revenue mobilization is encouraging. Given the limited policy space, prioritizing expenditure for the most critical spending needs is important. Thus, we take comfort with the authorities' intention to address excess spending on the wage bill. At the same time, we encourage the authorities to strengthen coverage and targeting of social assistance given the high rates of inequality. In this regard, we welcome the support from IFIs, including TA from the

Fund, to help develop a medium-term fiscal framework and debt strategy to ensure fiscal sustainability, while strengthening social protection.

The accommodative monetary policy stance should be maintained, but it should be contingent on the inflation outlook. This is important to secure policy credibility given the adoption of an inflation targeting framework. We are encouraged by the authorities' commitment to strengthen the central bank's operational autonomy and governance as it could enhance the efficacy of inflation targeting framework. However, we note with concern that high financial dollarization could impede monetary policy transmission. Thus, we welcome the authorities' various initiatives to address this impediment, including by enhancing effective management of FX risk. As exchange rate flexibility remains key, FXI should continue to focus on addressing episodes of excessive volatility.

The financial sector seems to be resilient, but we encourage the authorities to closely monitor credit portfolios in the banking sector. This is instrumental to safeguard financial stability given the large share of restructured loans and the high uncertainty surrounding the pandemic's course. We also note that the authorities are considering the establishment of a US\$300 million fund to provide guarantees to companies and individuals affected by the pandemic, with the contingent liabilities assessed to be limited. *Could staff comment on the preparatory work that the authorities need to do, drawing lessons from other countries' experiences, to ensure effective implementation?*

Finally, the authorities' reform agenda to boost potential growth and foster economic inclusion, while enhancing the country's resilience against climate change, is commendable. Given existing structural impediments, especially the high degree of informality and inequality along with weak productivity, we support the authorities' ongoing efforts to strengthen the quality of education, close infrastructure gaps, reduce excessive red tape and promote formalization in line with OECD recommendations. We are also encouraged by the authorities' continued efforts to improve resilience to climate change and decarbonize its economy.

With these remarks, we wish the authorities success in their future endeavors.

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GRAY/21/564

February 25, 2021

**Statement by Mr. Zhang and Ms. Zhao on Costa Rica
(Preliminary)
Executive Board Meeting
March 1, 2021**

We thank staff for the informative report and Mr. Moreno and Mr. Cartagena Guardado for the helpful Buff statement. We broadly agree with staff's appraisal and would like to offer the following points for emphasis.

Costa Rica has been hit hard by the COVID-19 pandemic through the channels of trade, tourism, and foreign direct investment. We commend the authorities for their swift policy responses to address the challenges from the pandemic. We support the authorities' request of a three-year Extended Fund Facility (EFF) for 355 percent of quota to help meet its balance of payment and budget needs, and support the authorities' ambitious structural reform agenda.

On fiscal policy, we commend the authorities for their broad-based engagement with key stakeholders to build a fiscal consolidation plan to ensure debt sustainability. We welcome the authorities' plan to achieve a primary surplus of 1 percent of GDP by 2023 and agree with staff's proposal to include central government primary balance in the quantitative conditionality of EFF. The authorities' ongoing efforts to strengthen the coverage of social assistance programs is key to protecting the most vulnerable during fiscal consolidation. We encourage the authorities to fully implement the spending and revenue measures to address the country's high public-private sector wage premium, so as to reduce income inequality and improve incentives.

On monetary policy, we agree that accommodative monetary policy stance remains appropriate in a low inflation environment. However, we notice that monetary policy transmission is hindered by a still high dollarization. In this regard, we see value in the authorities' efforts of developing the FX derivatives market and discouraging unhedged FX borrowing. *Could staff elaborate what needs to be further done to deal with the challenges brought about by dollarization?* In light of the inflation targeting and flexible exchange rate

regime, we encourage the central bank to continue to limit FX interventions to disorderly market conditions. On financial policy, we welcome the authorities' efforts to enhancing supervision of credit portfolios given the large amount of restructured loans and high uncertainty. We commend the achievements by the authorities in implementing the 2018 Financial Sector Stability Review recommendations and take positive note of the role of the Fund's TA in the process.

On structural reforms, a broad array of structural reforms is needed to boost competitiveness and inclusiveness, including reducing informality and inequality, addressing weaknesses in transport infrastructure, and promoting female labor force participation. As SOEs play a dominant role in many key sectors of the economy, we wish to see more detailed discussion on how to improve the governance and efficiency of the SOEs in the structural agenda. We note that Costa Rica became a member of the OECD in May 2020. *How can OECD membership help the authorities advance ahead in the areas including, but not limited to, SOE governance and capital movement management? Staff's comments are welcome.* We take positive note that Costa Rica is the first country to achieve zero-emission in electricity supply and welcome the authorities' commitment to fully decarbonizing the economy by 2050.

With these remarks, we wish the authorities all the best in these challenging times.

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GRAY/21/565

February 25, 2021

**Statement by Mr. Bevilaqua, Mr. Fuentes, and Mr. Coronel on Costa Rica
(Preliminary)
Executive Board Meeting
March 1, 2021**

We thank staff for the report and Messrs. Moreno and Cartagena for their insightful statement which helps substantiate the case for upper-credit-tranche financial assistance to Costa Rica. **We strongly support the request for a three-year Extended Fund Facility (EFF) arrangement to help address the country's balance of payment needs and anchor the authorities' structural reform agenda.** We premise our support on Costa Rica's robust institutional framework, wide sociopolitical engagement on the proposed program and authorities' strong ownership and policy commitment, which are fully in line with the EFF objectives and the country's ongoing OECD ascension process.

The COVID-19 pandemic caused considerable disruption to the Costa Rican economy. Notwithstanding the government's proactive response to the pandemic and the country's widely renowned healthcare system, the two consecutive waves of COVID-19 cases hit Costa Rica hard. While authorities' strict lockdowns and fiscal and financial relief measures helped avoid a deeper socioeconomic crisis, economic activity and employment declined sharply. Job loss has been particularly high in the service and hospitality sectors, as well as for women and youth. Following last year's estimated 4.8 percent GDP contraction, the economy is expected to expand by 2.6 percent this year under heightened uncertainty and considerable downside risks.

The protracted pandemic shock has exacerbated Costa Rica's pre-existing fiscal imbalances. After a decade of widening fiscal deficits and rapidly rising debt, the authorities made laudable efforts to curb this trend through the implementation of a comprehensive fiscal reform in 2018, which featured the adoption of a fiscal rule. Nevertheless, the unexpected extent and scope of the pandemic shock increased public expenditure while fiscal revenue plummeted, generating larger than expected financing needs. The RFI resources approved in April 2020 have been effective to ensure an adequate response to the pandemic

and increase social spending, yet they were insufficient to buttress medium-term fiscal sustainability.

Monetary policy and financial sector support in response to the COVID-19 shock have remained appropriate. The BCCR provided credit relief to affected businesses and households through well-targeted temporary measures, with some being gradually unwound as conditions improve. Banks appears resilient, yet to ensure banks remain adequately capitalized the authorities have stepped up monitoring and supervision of credit portfolios, given the uncertain environment surrounding the crisis.

The EFF program seems well designed, comprehensive, and ambitious. The arrangement will help catalyze additional bilateral and multilateral financial support, essential to address Costa Rica's sizeable financing needs while keeping adequate foreign reserve levels. The program is appropriately focused on ensuring fiscal and debt sustainability while protecting the poor and the most vulnerable. The arrangement is also geared towards strengthening monetary and financial stability and advancing the authorities' reform agenda to foster stronger and more inclusive growth. The authorities and staff have made an effort to calibrate the program design for a broader acceptance by the Costa Rican society, which are expected to minimize immediate risks of a political setback.

A successful fiscal consolidation strategy within the program will require steadfast commitment and supplementary measures. The authorities' fiscal reform plan -already afoot with the legislative approval of the 2021 budget- aims at gradually achieving a primary surplus by 2023 and reducing the debt-to-GDP ratio to 50 percent by 2035. However, debt -albeit still sustainable- is expected to remain high beyond the program's conclusion. In this regard, Costa Rica's strong rule of law and institutional development stand as vital assets for medium-term fiscal sustainability. Still, measures to streamline public administration, contain the wage bill, reduce tax expenditures, and reform the personal income tax system will warrant proper sequencing, protracted consensus-building, and an effective communication strategy.

In closing, we wish the Costa Rican authorities success on their path to full recovery from the pandemic crisis, as well as on the program's implementation.

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GRAY/21/566

February 25, 2021

Statement by Mr. Just and Mr. Harvan on Costa Rica
(Preliminary)
Executive Board Meeting
March 1, 2021

We thank staff for the excellent report, and Messrs. Moreno and Cartagena Guardado for their helpful Buff statement. With large increases in debt of close to 40 percent of GDP since the global financial crisis, fiscal vulnerabilities were already elevated prior to the pandemic. The COVID-19 shock had a significant negative impact on the economy and society, generating a sizable financing gap of 6.4 percent of GDP over 2021-2023. Costa Rica has benefitted from the April 2020 Rapid Financial Instrument. We appreciate that the authorities have requested a follow-up UCT-program to help address structural balance-of-payments needs and fiscal imbalances, and to anchor reforms and **support their request for a three-year Extended Fund Facility (EFF)** for SDR 1,237.49 million (335 percent of quota).

We broadly agree with the program modalities and positively note the EFF's expected catalytic role in garnering additional financial support. While we see legislative approval of the program as important to ensure its broad ownership, we are concerned about possible political gridlock and the election cycle that could derail reform progress, in particular, relating to the medium fiscal and debt management framework. In this context, we wonder about the timing of Review dates and the target dates for structural benchmarks (SBs), and *would appreciate staff's comments on the underlying thinking. More specifically, could staff elaborate on how the risk of possible backtracking on program objectives in the run-up to the election is reflected in the program design?*

The medium-term **fiscal strategy** underpinning the EFF is broadly appropriate. Overall, we support the mix of expenditure rationalization and revenue mobilization measures, and highlight the importance of the public employment sector and state-owned enterprise (SOE) reforms, including closing existing data gaps on liabilities. A more frontloaded consolidation could have been considered, as the primary deficit is expected to contribute to debt reduction only from 2023, while a return to the market is already expected in 2022. Given the large risks to debt sustainability, we would have welcomed a three-zone assessment utilizing the new MAC DSA framework. *Staff's comments on whether this would materially change the assessment are welcome.* We highlight the importance of improving public debt management, as recommended by the 2018 Financial Sector Stability Review, and welcome

the associated structural benchmark on the Medium-term Debt Management Strategy. We positively note the contingency measures contained in the EFF, and would have welcomed greater detail on the fiscal impact of the identified measures in 2022 and 2023.

We positively note resilience of the **banking sector** in staff stress tests, and concur with the proposed structural benchmarks aimed at enhancing the Central Bank of Costa Rica's (BCCR) operational autonomy and governance. The accommodative **monetary stance** remains appropriate, as weak demand and subdued import prices are expected to keep inflation low until recovery takes hold. We highlight the need to continue to monitor financial sector stability and steps to further reduce dollarization, while maintaining FX flexibility. *Does staff expect that the BCCR will continue to take care of all SOE FX transactions during the EFF program?*

We take positive note of the authorities' ownership of the **reform program**, and broadly agree with the focus on addressing inequality and informality in the labor market, tackling obstacles to boosting productivity and competitiveness, and improving resilience to climate change. *We would be interested whether the SB on infrastructure resilience will be a joint effort with the World Bank, as we would see only the financing options aspect as within the remit of the Fund.*

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GRAY/21/567

February 25, 2021

**Statement by Mr. Sigurgeirsson and Mr. Vaikla on Costa Rica
(Preliminary)
Executive Board Meeting
March 1, 2021**

We thank staff for the comprehensive report and Mr. Moreno and Mr. Cartagena Guardado for their informative Buff statement. The COVID-19 pandemic has seriously impacted Costa Rica's public health situation, raised unemployment level and weakened public finances. We commend the authorities for their effective response to the pandemic resulting in one of the lowest fatality rates in the region. At the same time the deteriorating fiscal position and tight financial conditions have created a sizable financing gap. **We support the authorities' request for Extended Arrangement under the Extended Fund Facility (EFF) in the amount of SDR 1,237.49 million.** We encourage the authorities to use any program ownership momentum, based on the wide political and social engagement, to implement the planned fiscal consolidation measures to secure macroeconomic stability and provide resilience. This will be particularly important in view of the election cycle.

Implementation of equitable fiscal reforms will be key to ensure debt sustainability. We support and welcome the authorities' commitment to the proposed fiscal consolidation plan targeting a primary adjustment of nearly 5 percent of GDP over 2021-23. Strict implementation of the new fiscal rule, reduction in the public sector wage bill and implementation of measures to contain expenditure beyond the mandate of the fiscal rule will be crucial. We note that further structural reforms to enhance medium-term fiscal planning and debt management, to strengthen revenue administration and further enhance the governance and transparency of SOEs will also be critical to mitigate fiscal risks. Meanwhile, we encourage authorities to maintain adequate social and capital spending over the medium term to secure broad program ownership and to reduce inequality.

The BCCR's accommodative monetary policy stance remains appropriate. We welcome the authorities' commitment to maintain low and stable inflation under a flexible exchange rate to secure domestic and external stability. We also welcome measures to reduce the high-level of dollarization in the financial system and the introduction of greater exchange rate flexibility to absorb shocks. We encourage the authorities to enhance the BCCR's governance framework to advance the inflation targeting regime by further strengthening the

central bank's operational autonomy. We note that while the financial system appears resilient, financial stability can be further secured by implementing the 2018 Financial Sector Stability Review recommendations with a focus on strengthening the risk-based supervisory framework and monitoring of systematic risk.

We share staff's assessment that implementation of structural reforms will be important to address high level of unemployment, inequality and informality. Given that a large share of employment remains concentrated in the informal sector, we call on the authorities to foster formalization by introducing targeted reductions in social contributions. We also call for further efforts to reduce inequality by addressing wide income gaps and limited social mobility. In particular, we urge to continue with ongoing initiatives to expand childcare services and promote parental leave in the public and private sector to strengthen female labor force participation.

We strongly commend the authorities' ambitious steps to further improve resilience to climate change and fully decarbonize its economy by 2050. Given Costa Rica's high exposure to climate change risk, we welcome the authorities' work towards developing a roadmap to strengthen infrastructure resilience to climate change, considering both implementation costs and financing options, and disaster risk management. Finally, we look-forward to measures to integrate climate change considerations into monetary and financial sector policies, which are currently under evaluation by the authorities. *Costa Rica appears to have a strong policy intent towards addressing the threat of climate change and we would like to ask staff whether there may be lessons to be learned for other member countries from how the authorities approach this challenge?*

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GRAY/21/569

February 25, 2021

**Joint Statement by Mr. Hilbers, Mr. Massourakis, Ms. Korinthios, and Mr. Zedginidze
on Costa Rica
(Preliminary)
Executive Board Meeting
March 1, 2021**

We thank staff for the informative report and Mr. Moreno and Mr. Cartagena Guardado for the helpful Buff statement. The COVID-19 pandemic continues to severely affect Costa Rica's economy. We welcome the authorities' measures to counter the pandemic, and recognize the important strides Costa Rica made in its fiscal and structural reform agenda in line with Fund advice and as part of the OECD accession process. We share staff's assessment of the economy and support the request for the EFF. We emphasize the following points:

- **We welcome the main pillars of the program and the efforts to support inclusive, green, and sustainable growth.** We appreciate that, building on the ambitious 2018 fiscal reform, the authorities are gradually resuming their fiscal efforts while supporting the most vulnerable and economic recovery. The pandemic has created significant healthcare, social, and economic challenges in Costa Rica, a country highly dependent on tourism. The government's planned targeted social assistance and reprioritization of expenditure will be critical to counter the pandemic.
- **Fiscal consolidation supported by fiscal reforms will be key to support debt sustainability in the medium-term.** According to the recent DSA, public debt is sustainable but subject to high risks. The baseline assumes that debt will increase over the next 2 years, further eroding fiscal buffers. The government's gross financing needs remain high in the medium term. Continued efforts to improve expenditure control and mobilize revenue will be critical to debt sustainability. We also note that data coverage in the DSA is limited due to availability constraints on broader public sector data and welcome the authorities' efforts to tackle this issue and improve the fiscal risks analysis. We are concerned of the likelihood of parliamentary approval of the EFF being undermined due to social unrests. *We would appreciate staff's update on the situation.*
- **Informality and gender gaps are among the key drivers of Costa Rica's persistent income inequality, which remains high compared to OECD and LAC standards.** Addressing this issue is critical to boost equitable growth. In addition to reforms focusing on improving the business environment, ongoing tax and labor policies to reduce informality and increase labor participation

among women are of the utmost importance. We welcome the authorities' commitment to improve SOE's governance, enhance central bank independence and cut red-tape.

- **We welcome the authorities' focus on climate resilience.** Staff's analysis indicates that Costa Rica is particularly vulnerable to climate change risks. We commend the authorities for stepping up their climate adaptation efforts guided by the National Policy on Adaptation. Similarly, the target to fully decarbonize the economy by 2050, set out in the National Decarbonization plan, is commendable.

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GRAY/21/570

February 25, 2021

Statement by Mr. Buissé, Mr. Rozan, and Ms. Albert on Costa Rica
(Preliminary)
Executive Board Meeting
March 1, 2021

We thank staff for their detailed and well-written report, including its very relevant annexes. We also thank Mr. Moreno and Mr. Cartagena for their useful Buff statement. We share the thrust of staff's appraisal and believe the EFF will help support the welcome reform efforts currently underway in Costa Rica, and catalyze external support. We wish to make the following comments:

We welcome the swift and well-targeted reaction from the authorities to mitigate the impact of the sanitary and the economic Covid-19 crisis, and we support the 36 months EFF request to 335 percent of quota. After the emergency financing provided at the beginning of the Covid-19 crisis, the move toward a structural, multi-year engagement will be an instrumental to support the macro adjustment, build a sustainable, green and inclusive recovery, and to catalyze other financing to reach this goal. The program appears well-sequenced and the flexibility integrated in the conditionality of the program appears warranted to the current high uncertainty. As the program is being implemented, we would welcome further and more structured information on planned TA activity and outcome, as well as other CD providers, to have a real understanding of how this will help advance the objectives of the programs.

We very much welcome the authorities' efforts to build consensus, including through the planned legislative approval of the program, as we note that legislative elections will occur in one year. However social tensions are an important risk to monitor. In this sense, while we are very much looking forward the approval of the wage bill reform by end-May, a key structural benchmark in the program, good communication strategy and dialogue will be key, to show the benefits of this reform and more generally the other benefits of the program to protect the most vulnerable to help mitigating social tensions. *Does staff have specific recommendations on the communication strategy to ensure a political and public buy-in?*

We share staff's view on the need to implement equitable fiscal reforms to ensure debt sustainability while protecting the most vulnerable. The fiscal situation had already deteriorated sharply before the Covid-19 crisis, as the public debt increased by 40 percent of GDP since the GFC. *What is staff's assessment and recommendations on the risks associated to the foreign currency denominated debt, which reached about 42 percent of the total in*

2020 and should continue to increase? The ambitious 2018 fiscal reform contributed to correcting fiscal imbalances and also helped limit the fiscal slippages due to the crisis. However, continued fiscal consolidation is necessary to ensure debt sustainability, as risks associated remain high, and it would also prevent deterioration in external sustainability (as in the EBA model, we understand the importance of the policy gap driven by a strong fiscal expansion).

While we consider the composition of the fiscal package to be well-designed in the program, the 3.7 percent of GDP in structural terms over 2021-2023 remains rather ambitious. On the expenditures side, the wage bill reform will be a critical step. We note also the contribution of the 0.9 percent of GDP of capital spending cuts, and we therefore underline the importance of keeping these cuts temporary, in order to deal with the infrastructures gap also in the long term, and to improve the climate-resilience of infrastructures. Moreover, we welcome the structural benchmark to target better social protection, as well as the social spending increase of 0.1 percent of GDP. While we consider this increase limited, it should help the poorest income deciles and reduce inequalities. *Did staff look into integrating specific social spending indicators or conditionality, for example coverage of the cash transfer programs for lower income families, as quantitative performance criteria or indicative targets?* On the revenue side, we strongly welcome the measures proposed, and in particular regarding the PIT and the property tax which will help increase fiscal progressivity and reduce inequalities. Annex VI was particularly useful in this regard. We also welcome the efforts dedicated to improving governance and transparency for the SOEs, in particular the structural benchmark associated, and the contingency measures described in the section 14.

The management of monetary policy appears appropriate. We welcome the more forward-looking approach as well as the plans to reinforce the central bank operational independence and the greater exchange rate flexibility. We note that the financial systems appear resilient to a range of shocks. We welcome the implementation progress of the 2018 Financial Sector Stability review recommendations, and we encourage the reinforcement of the regulatory and supervisory frameworks, as well as greater financial inclusion.

We fully support the ambitious authorities' structural agenda, and in particular its climate and inclusive dimensions. The OECD accession is already a significant and positive step underlying the reforms progress, and we strongly support the plan to decarbonize the economy, which should be considerate as a model, as well as the strengthening of the climate-resilience. The Annex IX is very useful in that respect. Integration of a specific climate resilience conditionality is strongly welcome and could represent a very useful example for similar countries vulnerable to climate change. We are therefore looking forward to seeing the development of the roadmap to enhance infrastructure resilience. *The country is characterized by a well-thought model of ecotourism, but does staff see a need to have a more diversified economy?* Moreover, as informality and gender gaps are key determinants to explain the high inequalities, we encourage greater attention to education and child-care policies.

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GRAY/21/571

February 25, 2021

**Statement by Mr. Chodos, Mr. Lischinsky, and Mr. Corvalan Mendoza on Costa Rica
(Preliminary)
Executive Board Meeting
March 1, 2021**

We thank staff for the informative set of documents and Mr. Moreno and Mr. Cartagena Guardado for their comprehensive Buff statement.

We support Costa Rica's request for a 36-month arrangement under the Extended Fund Facility (EFF) to buttress the authorities' home-grown reform program that was assembled through a broad-based political and social dialogue. In addition to the program supporting the response to the Covid-19 pandemic, the economic recovery will help close balance-of-payments and budget financial gaps. It will also catalyze financial support from official partners and international financial markets. Costa Rica's significant progress towards converging to OECD standards paid off, and in May 2020 the country was invited to become its 38th member and it is the 4th LAC country member.

Costa Rica seems well positioned to move ahead with an ambitious agenda to raise potential growth, deal with inequalities, and address climate change and decarbonization. The program is buttressed on strong ownership, its favorable social and political stability, and comparatively high human capital. 72 years ago, after the civil war, the country abolished its armed forces and is one of the few countries in the world that has done so.

Costa Rica, as other countries in the region, has been hit hard by the pandemic. The authorities' swift sanitary measures and its well-established health system reduced the impact of Covid-related fatalities. At the same time, economic and financial measures were taken to avoid major consequences and mitigate the impact of the crisis. Among these measures, interest rates were lowered, credit conditions were eased, and the functioning of the financial system was ensured. The real economy was supported by delivering cash-flow to households (Bono Proteger) and firms to protect demand, employment, and production.

The response to the pandemic and the economic deterioration struck public finance. Tax collections fell and health-related expenditures increased. In order to avoid a further fiscal impact, non-priority primary spending was contained, and a Fund RFI was requested. Nowadays, the EFF will help implement fiscal policies to ensure debt sustainability, protect the more vulnerable, and promote green, inclusive, and sustainable growth. Among these fiscal policies, the implementation of the fiscal rule will continue, along with tax and expenditure measures related to capital and personal income, tax on luxury homes and lottery prizes, enhanced public procurement, tax and custom administration,

and PFM. All these measures, as mentioned in the Buff statement, would benefit from the Fund's capacity development, which is critical for the success of the policies under the program.

The Central Bank of Costa Rica (BCCR)'s swift actions to promote eased financial conditions during the Covid-19 pandemic shock was critical to support the economy. On the one hand, the monetary policy rate was reduced to a historical record low, from 2.25 percent in March 2020 to 0.75 percent in June 2020. On the other hand, the BCCR purchased sovereign and other liquid securities in the secondary market (authorized by law) to expand the level of liquidity and back households and firms' needs. The extensive use of these monetary tools did not have an impact on the level of inflation, which remained low and stable.

We take note that the central bank law amendments in 2019 strengthened the inflation-targeting regime. These amendments disconnected the dismissal of the central bank governor's term from the political cycle and removed the minister of finance's voting rights in the central bank board. The new institutional arrangements most likely would add value to the monetary and financial decision-making process. Nevertheless, we also believe that autonomy gained, granted by the law, should be balanced with further transparency and a wide communication strategy of monetary policy decisions to the public and a follow up of its impact on employment and the real economy. Therefore, the preestablished calendar of monetary meetings and subsequent publication of minutes are welcome.

The banking system entered the Covid-19 pandemic on a strong footing. Capital ratios and liquidity levels were sufficient to mitigate the shock. This situation further improved with a synchronized policy implementation, permitting an easing of credit conditions to households and firms. For instance, the reduction to zero of the minimum accumulation of countercyclical provisions, the temporary relaxation of loan restructuring while providing emergency funding to small and medium-sized enterprises, send the right signals to the financial market to grant additional room for maneuver to fix or resolve pockets of risks. Given the high level of dollarization (around 40 percent of deposits and loans) the development of foreign exchange derivative markets could be appropriate. Finally, we welcome the progress made to implement the 2018 FSSR recommendations to strengthen the regulation and supervision of the financial sector.

We commend the authorities for their strong commitment to the EFF. The policy agenda supported by the program will include enhancing skills, innovations, formalization of employment and the economy, closing the physical infrastructure gap and cutting red tape, while continuing to attract FDI. In the medium term, we hope that it will boost an inclusive and green recovery, while providing an anchor for macroeconomic stability and diminishing income inequality and poverty. If income inequality and poverty do not diminish, a program could not be considered successful.

With these comments, we wish the Costa Rican authorities every success in these challenging times.
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GRAY/21/572

February 25, 2021

Statement by Ms. Robitaille and Ms. Senich on Costa Rica
(Preliminary)
Executive Board Meeting
March 1, 2021

We thank staff for their informative report and Mr. Moreno and Mr. Cartagena Guardado for their very helpful Buff statement. The pandemic has taken a large toll on the economy, and the loss of tourism income has been brutal given the sector's importance as a source of employment for lower income groups. Furthermore, the pandemic struck just as the authorities were in the midst of a multi-year effort to address the country's fiscal imbalances and stabilize the path of public debt. **We welcome the Costa Rican authorities' engagement with the Fund, and we support the request for a three-year Extended Fund Arrangement (EFF).** The EFF builds upon the Rapid Financing Instrument approved last April and should unlock financing from other IFIs and further the goals of promoting economic recovery, strengthening public finances, and fostering inclusive and green growth.

Promoting economic recovery and protecting the most vulnerable remain the most pressing objectives. Costa Rica's universal health care system and widespread access to clean water and sanitation have been instrumental in enabling the health response to the pandemic, but we agree with staff that the authorities need to develop a broader policy response to address the root causes of high unemployment among vulnerable populations. Staff note that COVID-related spending in 2020 was only 1.3 percent of GDP, which seems low for a middle-income emerging market, although that figure does not include lost revenues from the COVID-19-related tax breaks. *How has Costa Rica's discretionary fiscal response to the pandemic compared with those of other emerging markets (EMs), particularly with respect to support for the most vulnerable?*

We welcome that the authorities are pressing on with fiscal reforms that aim to stabilize the path of public debt and reduce the high level of inequality. The expansion in the public sector wage bill over the past decade has undermined fiscal stability but also contributed to a worsening in income distribution because most public workers are in higher income groups. Further, taxes and transfers play a limited redistributive role in Costa Rica. We therefore welcome the authorities' plans to rein in the public sector wage bill. The tax reform of 2018 will institute a progressive tax regime and contribute to an improvement in income distribution. We believe spending to support the vulnerable could have been more ambitious,

however, as the authorities' planned increase of social spending for the most vulnerable by 0.1 percent of GDP would lift only 12,000 people out of poverty. *Staff comments would be welcome.*

Strengthening public finances will require a medium-term fiscal framework as well as broader coverage of the public sector. Costa Rica's public debt is judged to be sustainable, but the level is high, at over 65 percent of GDP, and importantly does not include State-owned Enterprises (SOEs). We therefore welcome the inclusion of a structural benchmark on a medium-term fiscal framework and welcome that the program requires SOEs to adopt International Financial Reporting Standards so that the authorities have a complete understanding of the fiscal position.

The monetary policy response to the crisis has been appropriate. Costa Rica's move in recent years to a more flexible exchange rate regime under an inflation targeting (IT) framework enabled the central bank (BCCR) to use monetary policy to attenuate the economic weakness, but, as is the case for several EM central banks, the policy rate has reached the effective lower bound. The BCCR's response to being at the effective lower bound strikes us as having been appropriately cautious through their introduction of a repo arrangement that aims to improve credit availability and with BCCR purchases of government and other liquid bonds to improve market functioning used very selectively. The program appropriately includes a Monetary Policy Consultation Clause, given Costa Rica's inflation targeting framework. We strongly support the program's plan to strengthen the BCCR's governance structure, bolstering the institution's operational independence.

We are encouraged by the finding that the staff's high level bank stress test found the banking system to be adequately capitalized. We urge the authorities to continue to monitor banks carefully so that bank credit will be available as the recovery takes hold. We also support the authorities' efforts to reduce the high degree of dollarization in Costa Rica which requires the central bank to remain committed to promoting low inflation, so that people do not feel a need to protect themselves from exchange rate risk by moving to dollar-denominated assets. *Can staff please comment on the likely effectiveness of the authorities' prudential measures to reduce dollarization?*

Finally, we welcome staff's coverage of climate risk in the proposed program. Costa Rica has been proactive in addressing climate risk and has a well-earned reputation for its attention to the environment, especially in tourism. We were also pleased to see the inclusion of a structural benchmark on devising a road map for strengthening infrastructure resilience to climate.

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GRAY/21/573

February 25, 2021

Statement by Mr. Ronicle and Mr. Chrimes on Costa Rica
(Preliminary)
Executive Board Meeting
March 1, 2021

We thank staff for the helpful papers and Mr. Moreno and Mr. Cartagena Guardado for their informative buff statement. We broadly agree with staff’s assessment, and we support the authorities’ request for a 36-month arrangement under the Extended Fund Facility at 335% of quota (SDR 1.237bn).

COVID-19 and the associated economic shocks have had a significant impact on Costa Rica, as elsewhere in the region. Costa Rica was the first country in central America to record a COVID-19 case, back in March 2020, but a proactive policy response and the strength of institutions and policy frameworks (including the established universal healthcare system) have helped contain the spread of the virus. Nevertheless, the health impacts have been significant, and the economic consequences of the pandemic have been severe, weighing on activity, employment, the fiscal position and the financial sector.

Pandemic-related difficulties are layered on top of pre-existing challenges which Costa Rica must address, building on the progress the authorities had already made. Substantial fiscal changes were needed (and had begun) prior to COVID-19; the necessary fiscal response to the pandemic has increased financing pressures further. Despite loosening monetary policy, inflation is towards materially below the lower bound of the target band. Meanwhile, despite positive steps in recent years, Costa Rica still faces a suite of structural challenges inhibiting it from fully delivering on its plentiful economic potential. The staff report rightly picks out climate change, weak productivity and high inequality as crucial longstanding substantive issues to tackle – and also points to a variety of reform priorities, including to deliver better monetary policy transmission, reduced dollarization and improved governance and transparency. Ensuring continued financial stability will also be important as the recovery progresses.

A sustainably growing Costa Rican economy therefore hinges on a careful policy balancing act, supporting the population (and in particular the most vulnerable) through the COVID-19 shock while also addressing fiscal sustainability issues *and* important longer-term

macro-critical objectives. The combination of challenges explains why we believe a Fund-supported arrangement – and in particular an EFF – is the right way forward for Costa Rica. We generally support the authorities’ reform objectives, including as set out in the Letter of Intent. We welcome their continued commitment to fiscal responsibility and reform, building on the 2018 efforts. We also applaud their important climate and biodiversity ambitions. Costa Rica has well-established leadership credentials on climate issues, and – with its biodiversity a macro-critical advantage – has been taking innovative approaches to help preserve it, for example through urban bio-corridors. Timely implementation of green policies and plans will be crucial, and it is important that a Fund-supported program does not crowd this out, given the estimated \$41bn that decarbonization could be worth over the next three decades.¹ In addition, we are pleased that the BCCR is developing a roadmap to integrate climate change considerations into the design of monetary and financial policy.

The staff report helpfully sets out three sensible core pillars for the program, but could be more explicit in addressing the trade-off between debt sustainability objectives and returning inflation to target (and in the process reducing unemployment). Staff and the authorities prioritize fiscal measures – reflecting Costa Rica’s pre-pandemic fiscal challenges, debt sustainability concerns, and the potential role of enhanced confidence in reducing financing costs. Yet global financial conditions have presumably also helped keep bond yields down; too much fiscal consolidation could weigh on aggregate demand, with knock-on spending and revenue effects that may in turn undermine consolidation efforts; and a large output gap looks set to persist. *We would have liked to have seen this trade-off addressed more explicitly, supported by more empirical evidence, and would welcome staff comments.*

Broad and durable political and social support for the program’s objectives will be key. The staff report and the buff statement both convey optimism, highlighting efforts to build consensus on the authorities’ economic reform package. However, despite both Costa Rica’s track record of political stability and a growing sense within Costa Rica that a Fund-supported program is the right way forward given fiscal challenges, continued widespread backing will be difficult to maintain. Getting to this stage has not been straightforward, and securing congressional approval may not be easy (despite staff’s expectation of “smooth ratification”), while the upcoming elections could put further pressure on the fragile domestic consensus. The risk assessment matrix acknowledges “widespread social discontent and political instability” as “high likelihood, high impact”. That underscores the particular importance of staff and the authorities communicating the program’s objectives clearly and effectively, ensuring that they are well-understood.

Uncertainty around baseline economic projections also call for a pragmatic approach as the program progresses. The authorities’ Memorandum of Economic and Financial Policies highlights that they have “built in flexibility to deal with unforeseen shocks”. However, the

¹ <https://publications.iadb.org/publications/english/document/The-Benefits-and-Costs-Of-Decarbonizing-Costa-Ricas-Economy-Informing-the-Implementation-of-Costa-Ricas-National-Decarbonization-Plan-under-Uncertainty.pdf>

adjustor allowing for increased COVID-19 emergency spending for up to 0.3 percent of GDP in 2021, while helpful, may not cover all eventualities. Similarly, while the quantitative performance criteria and indicative targets under the proposed Fund arrangement seem appropriate as things stand, depending on how circumstances unfold, they may need to be revisited at future reviews. We expect this to be a common challenge across most post-pandemic upper credit tranche programs. Flexibility should not detract from the primary objective of sustainably resolving balance of payments issues – but it should be invoked to *support* ultimate delivery of that objective where necessary.

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GRAY/21/575

February 25, 2021

Statement by Mr. Trabinski and Mr. Tola on Costa Rica
(Preliminary)
Executive Board Meeting
March 1, 2021

We support the request for an arrangement under the Extended Fund Facility (EFF).

The pandemic crisis has hit Costa Rica's tourism-dependent economy hard, exacerbating the fragile macroeconomic conditions. It has also reversed some gains from the fiscal reform program initiated in 2018. The authorities' swift and decisive response helped to contain the pandemic and to mitigate its negative spillovers on the economy. The use of an EFF arrangement is justified by the need to support the authorities' ambitious structural reform agenda. At the same time, we would like to point out that its size is significant, also considering the already disbursed emergency funding, while international reserves are at a comfortable level and projected to grow. We note that capacity to repay the Fund is assessed to be adequate but that program implementation risks are significant.

Achieving the primary surplus target by 2023 will be key in reversing the negative debt dynamics. We agree with staff's view that the higher fiscal deficit was justified in the context of the needed pandemic response. Going forward, it will be essential that fiscal consolidation in the context of the fiscal rule advances as planned to ensure medium-term debt sustainability. In this regard, we welcome that the program has built-in flexibility to allow for any needed recalibration through additional fiscal space and contingency measures.

Strong program ownership will be key for addressing existing macroeconomic vulnerabilities. The three policy and reform pillars aiming at (i) equitable fiscal consolidation to ensure debt sustainability, (ii) maintaining monetary and financial stability, and (iii) advancing structural reforms to promote inclusive, green and sustainable growth will address both pre-pandemic vulnerabilities as well as the disruptions caused by the Covid-19 shock. It is encouraging to see that the authorities have gained substantial homegrown support for their reform agenda, which should further help mitigate risks. However, further progress will depend on the continued resolve of legislators to endorse the Fund supported reform program, in particular considering the next year's general elections. *In this context,*

could staff inform on the reasons for the delay in approving the Public Employment Bill by the Legislative Assembly? Furthermore, to maintain a broad-based consensus supporting these structural reforms, it will be particularly important to mitigate their impact on the most vulnerable segments of the population. In this context, addressing informality and gender gaps should be among the high priorities of the authorities.

Improving governance and transparency in state-owned enterprises (SOEs) will help raise productivity and mitigate fiscal risks. We welcome the acceleration of full adoption of IFRS reporting standards by SOEs. This should help eliminate weaknesses in data availability and allow to have an accurate and comprehensive account of the public debt situation. We also see merit in the ongoing reforms to advance digitalization, and we encourage the authorities to continue these efforts.

Costa Rica

Responses to Technical Questions Posed by Executive Directors in Advance of
EBM/21/22 – March 1, 2021

Staff's responses to technical and factual questions are below. Broader policy questions on program design and implementation risks will be addressed in staff's oral intervention at the Board meeting.

Outlooks and Risks

1. **Staff appropriately made relatively conservative assumptions in the baseline, but we would welcome some elaboration on contingency measures in the event of a downside scenario. Staff comments are welcome.**
 - The program baseline expects the economy to grow by 2.6 percent this year, reflecting a gradual recovery in domestic and external demand. Pre-COVID output levels are expected to be reached only by late 2022. Activity in the tourism sector is expected to recover even more gradually, returning to pre-crisis levels by 2023.
 - In the face of adverse shocks, the authorities stand ready to reprioritize non-critical spending or propose to the Legislative Assembly temporary tax measures (e.g. through a solidarity tax) as needed, complemented by additional financing, including through readily available contingency lines from CAF (US\$500 million) and CABEL. Further monetary accommodation and financial sector policies could also help support the economy.
 - The program also builds flexibility to augment COVID-related spending, through an adjustor to the fiscal primary target allowing for additional spending of up to 0.3 percent of GDP in 2021, for health services, targeted support to households and businesses (including those in the tourism sector), or additional allocations to social assistance programs.

Fiscal Policy and Debt Issues

2. **How has Costa Rica's discretionary fiscal response to the pandemic compared with those of other emerging markets (EMs), particularly with respect to support for the most vulnerable?**
 - Costa Rica's total discretionary fiscal spending or foregone revenues to the pandemic amount to about 1.5 percent of GDP, also considering the budgeted spending of 0.2 percent of GDP including on COVID vaccine in 2021. This is lower than the EM average of 3.8 percent of GDP (according to the latest FAD Fiscal Response to COVID dataset), partly due to lower health-related spending in Costa Rica (about 0.3 percent of GDP compared to 0.7 percent in EMs), given that the country already has a universal health care system in place.

- The majority of Costa Rica's discretionary fiscal spending to the pandemic—at about 1.2 percent of GDP—has been devoted to supporting the most vulnerable via the Bono Proteger cash transfer program, significantly higher than the EM average of about 0.5 percent of GDP (or global average of 0.9 percent of GDP, according to October 2020 Fiscal Monitor). The program is well-targeted, with temporary subsidies to vulnerable households, including both formal and informal sector workers who meet the eligibility criteria.

3. Did staff look into integrating specific social spending indicators or conditionality, for example coverage of the cash transfer programs for lower income families, as quantitative performance criteria or indicative targets?

- While the program does not include an indicative target on social transfer programs, the TMU includes data reporting obligations regarding the level of social safety net spending, on a quarterly basis. The data will be provided by IMAS and FODESAF and will be monitored under the program.
- Further improvements in social spending coverage and targeting are also explicitly envisaged under the program. One of the program's structural benchmarks considers centralization and digitalization of the payment system for all the cash transfer social assistance programs at the MOF's National Treasury by end-December 2021, with support from FAD. Moreover, the authorities are committed to enhancing the targeting accuracy of social safety nets and strengthening the role of SINIRUBE (Sistema Nacional de Información y Registro Único de Beneficiarios del Estado) as the main instrument to target social protection benefits and services, with support from the WB.

4. We believe spending to support the vulnerable could have been more ambitious, however, as the authorities' planned increase of social spending for the most vulnerable by 0.1 percent of GDP would lift only 12,000 people out of poverty. Staff comments would be welcome.

- As mentioned in the staff report and reviewed in close coordination with colleagues from the WB Poverty and Equity Team, Costa Rica's current level of social assistance spending (at about 1.9 percent of GDP) is already broadly on par with countries at similar development level, although still below OECD average.
- Aside from the structural increase of 0.1 percent of GDP to support the most vulnerable (which increases total programs by about 5 percent), the fiscal package proposes a temporary allocation for an additional 0.1 percent of GDP in social spending for 2021 to avoid an otherwise budgeted decline in social assistance spending due to lower earmarked revenue (MEFP ¶12).
- The program envisages two important actions to centralize and improve the targeting and coverage of the social assistance programs (see previous answer), including a structural benchmark. Further proposals to expand coverage can be assessed, in

coordination with the WB, in future reviews once these reforms are completed to ensure the most efficient allocation of resources.

5. Could staff inform on the reasons for the delay in approving the Public Employment Bill by the Legislative Assembly?

- The approval of the Public Employment Bill is proposed as an end-May structural benchmark to allow time before approval by the Legislative Assembly for its Constitutional review to ensure it does not infringe on acquired rights. Given the relevance of this structural reform for the equity and efficiency of the public sector, the constitutional review is a critical step to ensure full buy in and ownership of the reform, especially among public sector unions and employees.
- Please note that, while the reform will entail a gradual rationalization of the wage bill over the medium to long term, with average annual savings during the first 10 years preliminarily estimated at around 0.5 percent of GDP for the central government, these yields are not built yet under the program baseline projections.

6. The staff report helpfully sets out three sensible core pillars for the program, but could be more explicit in addressing the trade-off between debt sustainability objectives and returning inflation to target (and in the process reducing unemployment). Staff and the authorities prioritize fiscal measures – reflecting Costa Rica’s pre-pandemic fiscal challenges, debt sustainability concerns, and the potential role of enhanced confidence in reducing financing costs. Yet global financial conditions have presumably also helped keep bond yields down; too much fiscal consolidation could weigh on aggregate demand, with knock-on spending and revenue effects that may in turn undermine consolidation efforts; and a large output gap looks set to persist. *We would have liked to have seen this trade-off addressed more explicitly, supported by more empirical evidence, and would welcome staff comments.*

- Perceived debt sustainability risk is particularly important in the context of Costa Rica, where widening fiscal imbalances and lack of progress in fiscal reform led to severe market stress in 2018 and a significant slowdown in economic activity and low inflation.
- Although market conditions have eased in the second half of 2020, the EMBI spread for Costa Rica remains elevated at about 550 bps as of end-January, the second highest in the Central America region.
- To mitigate the impact of the fiscal adjustment, the design of the program focuses on securing debt sustainability through an equity-enhancing fiscal reform plan. About two-thirds of the fiscal adjustment envisaged under the program is based on expenditure cuts, largely on public wages, and revenue measures are supported by removing tax expenditures (instead of introducing new taxes) and growth-friendly immovable property taxes and SOE dividends.

- Please also note that fiscal multipliers tend to be smaller for small open economies and countries with high sovereign default risk due to confidence effects, like Costa Rica (e.g., 2018 Spring WHD REO). These results are found to hold for Latin American and the Caribbean countries even during periods of economic slack. In the staff report for the 2019 Article IV Consultation, staff estimated fiscal multipliers in Costa Rica as ranging from about 0.3 for current spending to 0.8 for public investment. Within current spending, adjustments in public wages are found to have a lower multiplier effect than cuts in other transfers.
- While inflation is expected to return to the 3 percent mid-point target gradually, inflation expectations have remained anchored around 3 percent. The authorities' macro-structural reform agenda is expected to further support job creation and inflation, amid a gradual recovery in credit growth.

7. Given the large risks to debt sustainability, we would have welcomed a three-zone assessment utilizing the new MAC DSA framework. *Staff's comments on whether this would materially change the assessment are welcome.*

- The rollout of the new debt sovereign risk and debt sustainability framework for market access countries (MAC SRDSF) is expected in Q4 2021 or Q1 2022, after a staff guidance note and new template have been finalized. Three-way debt sustainability assessments would be shared with the Board only after the rollout takes place. Before the MAC SRDSF rollout, the internal application of the new tools to debt sustainability assessments would help staff identify any issues that surface, including on the use of judgment to arrive at the final signals from the new framework. During this period, staff will use the full battery of tools available, including the new tools, to inform staff's judgment on debt sustainability during the review process. This procedure has been applied to this program request by Costa Rica.

8. *What is staff's assessment and recommendations on the risks associated to the foreign currency denominated debt, which reached about 42 percent of the total in 2020 and should continue to increase?*

- While foreign-currency denominated debt as share of total debt is estimated to have reached about 42 percent in 2020, and continue to rise thereafter until 2024, vulnerabilities and risks related to foreign-currency denominated debt remain moderate. First, the share of FX debt will remain below the high-risk of debt distress threshold of 60 percent. Second, the rising share largely reflects financial assistance from the Fund and other IFIs at favorable rates to respond to the COVID-19 shock and support the recovery efforts. In the absence of financial assistance from IFIs and the gradual return to Eurobond issuances in 2022, the Central Government would need to issue debt in colones or US dollars in the domestic market. Aside from crowding out private investment, these domestic issuances would likely be at significantly higher interest rates and shorter maturities. For example, debt issuances in the domestic market in 2020 were mainly at 5 and 7 years and had interest rates of over 8 percent, compared to an average rate of about 4 percent and typical maturities of over ten years for IFI loans

and interest rates of 6.25 and 7.15 percent for Eurobond issuances with 10-year and 26-year maturities back in November 2019.

Governance

9. We welcome the authorities' efforts to strengthen fiscal governance and anti-corruption framework. In their letter of intent as part of the April RFI disbursement, the authorities indicated that they were committed to using the RFI resources transparently and through established governance mechanisms, including ex-post accountability and controls, to ensure the funds are used to address the COVID-19 related shocks. *Can staff provide an update on this commitment?*

- The Planning Ministry launched a COVID-related Transparency Portal, which consolidates information from eight public authorities –Joint Social Welfare Institute (IMAS), Ministry of Labor and Social Security (MTSS), National Emergency Commission (CNE), Integrated Public Procurement System (SICOP), Costa Rican Social Security Fund (CCSS), Ministry of Health, Ministry of Finance. The Portal aims at making available procurement contracts and other information on public purchases, key information on central government spending, geographical distribution of key emergency social assistance programs, and details of donations received.
- The Comptroller's Office has also a separate COVID-related Transparency Portal with key information on public purchases, results of procurement and spending audits (for instance, audits to emergency procurement process performed by the CCSS and the "Bono Proteger" program), status of emergency legislation and extraordinary budgets and supporting material to public sector entities on institutional risks and business continuity.
- The Ministry of Labor and Social Security also manages a specific Transparency Portal on the emergency cash transfer program "Bono Proteger," which publishes the list of beneficiaries, progress reports, and aggregated statistics.

10. How can OECD membership help the authorities advance ahead in the areas including, but not limited to, SOE governance and capital movement management? *Staff's comments are welcome.*

- Costa Rica's post-accession roadmap with the OECD includes several commitments up to 2024 in the areas of competition, state ownership and privatization practices, public governance, and environmental policy. On state ownership and privatization practices, by the end of 2021 and thereafter if required, Costa Rica shall provide a progress report on the implementation of the following priority recommendations: (i) full implementation and compliance with IFRS, (ii) development and implementation of a system for establishing and monitoring the achievement of financial and non-financial performance objectives, (iii) enactment of legislation to remove the Minister of Agriculture from the board overseeing FANAL, (iv) pursuing public procurement reforms to monitor and limit the use of exceptions for direct public procurement between public entities including

SOEs, (v) making further progress on implementing initiatives to strengthen the functioning of boards, including the implementation of board evaluations, and effective risk management and control systems, and (vi) reviewing SOE board remuneration and developing recommendations to support competitive remuneration and incentives that are aligned with good board practices.

- Costa Rica has an open capital account. We are not aware of concerns related to its accession to the OECD Codes for Liberalization of Capital Movement.

Monetary Policy and Financial Sector Issues

11. Could staff elaborate what needs to be further done to deal with the challenges brought about by dollarization?

12. Can staff please comment on the likely effectiveness of the authorities' prudential measures to reduce dollarization?

- Supported by MCM TA, the authorities have taken measures to discourage dollarization, including higher risk weights and general provisions on FX loans to unhedged borrowers, as well as higher reserve requirements on FX deposits. As discussed in the 2019 Article IV and shown in Figure 4 of the staff report, there has been some gradual progress in reducing the dollarization of both credit and deposits over the last years.
- Looking ahead, a MCM TA mission was recently completed to assist the BCCR in developing the FX derivative market to facilitate effective risk management. MEFP (¶27) also notes further steps to reduce dollarization, such as reviewing the definition of an unhedged borrower, more stringent reporting requirements, and a higher categorization of risk for certain unhedged household FX loans such as automobiles and mortgages.
- Ultimately, de-dollarization is a gradual process and its long-lasting success hinges on strong macroeconomic policies to engender confidence in the national currency, prudential policies to discourage unhedged borrowing, and deepening of the foreign exchange market to provide hedging opportunities. The three pillars under the EFF-supported program are expected to help foster these elements.

13. Can staff indicate whether the restructured and deferred loans are concentrated in any one sector and what proportion of deferred loans are now performing?

- The largest share of restructured loans is concentrated in housing loans (29 percent), reflecting high unemployment. Around 24 percent of restructured loans is in consumer loans, which also encompasses financing of businesses of individuals, and therefore likely includes some of the tourism sector which has been disproportionately affected by the pandemic. Other affected sectors include related industries of services and trade. The authorities estimate that 58 percent of restructured loans are being repaid. Staff will continue to monitor developments in restructured loans, including changes in sectoral composition and loan repayment.

14. We also note that the authorities are considering the establishment of a US\$300 million fund to provide guarantees to companies and individuals affected by the pandemic, with the contingent liabilities assessed to be limited. *Could staff comment on the preparatory work that the authorities need to do, drawing lessons from other countries' experiences, to ensure effective implementation?*

- The guarantee fund is currently under the consideration by the Legislative Assembly for approval. The proposed features are broadly in line with guidance laid out in the Special Series on COVID-19 note on "[Legal Considerations on Public Guarantee Schemes](#)". The fund's US\$300 million size (½ percent of GDP) places a limit on the fiscal contingent liabilities. Moreover, to curtail moral hazard and to provide the correct incentives to both lenders and borrowers, the proposed maximum coverage of the public guarantee is 60 percent (across countries, the coverage ratio commonly varies between 50 percent to 80 percent).

15. *Does staff expect that the BCCR will continue to take care of all SOE FX transactions during the EFF program?*

- By law, the BCCR is required to service larger FX transactions for SOEs (greater than US\$100K). As discussed with MCM experts, a move away from this practice, which is common to other countries and aims at mitigating sudden excess FX volatility, would need to be gradual and carefully considered, given the need to first meet some preconditions, such as deeper FX markets (including derivatives) and stronger risk management practices in SOEs. An MCM TA on FX derivatives development took place this week in Costa Rica.

Macro-Structural Measures

16. *We would be interested whether the SB on infrastructure resilience will be a joint effort with the World Bank, as we would see only the financing options aspect as within the remit of the Fund.*

- The team has collaborated extensively with the WB and the IDB in the design of the climate change strategy under the program, based on the respective expertise (see also Annex IX to the staff report coauthored with IDB and WB colleagues). The WB is also supporting Costa Rica on the SB under the program for the development of the roadmap to enhance infrastructure resilience, as noted in the staff report and MEFP ¶36.

17. *The country is characterized by a well-thought model of ecotourism, but does staff see a need to have a more diversified economy?*

- Despite its relatively large tourism sector (directly accounting for about 5 percent of GDP and 19 percent of exports in 2019), the Costa Rican economy can also count on a strong manufacturing base (11.7 percent of real GDP and 42 percent of exports in 2019) and other services, such as education and ICT. For example, medical instruments alone account for almost the same share of exports as tourism and grew by 7.6 percent in

2020. The more diversified structure of the economy compared to other tourism-dependent economies has allowed to mitigate the severity of the shock.

- Nonetheless, the authorities are implementing measures to further promote investment in other sectors of the economy, including through efforts to promote digitalization and reduce red tape. The Strategy for an Inclusive and Decarbonized Economy 2020-2050 also focuses on the transition to the production of 3D (decarbonized, digital, decentralized) goods and services.

18. Costa Rica appears to have a strong policy intent towards addressing the threat of climate change and we would like to ask staff whether there may be lessons to be learned for other member countries from how the authorities approach this challenge?

- An important lesson from the Costa Rican experience is that tackling climate change can also create opportunities for new jobs and sustainable growth. For example, reforestation programs have contributed to achieving mitigation and adaptation goals and provided livelihoods for rural communities through ecotourism.
- In addition, the Costa Rican experience suggests that climate change considerations can be mainstreamed into several policy areas. For example, the Strategy for an Inclusive and Decarbonized Economy 2020-2050 combines policies to address climate change vulnerabilities with measures to promote the transformation of the economy (see response to previous question).

CONSTITUENCY CODES

OEDAE

Angola, Botswana, Burundi, Eritrea, Eswatini, Ethiopia, The Gambia, Kenya, Lesotho, Liberia, Malawi, Mozambique, Namibia, Nigeria, Sierra Leone, Somalia, South Africa, South Sudan, Sudan, Tanzania, Uganda, Zambia, and Zimbabwe

OEDAF

Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Comoros, Democratic Republic of Congo, Republic of Congo, Côte d'Ivoire, Djibouti, Equatorial Guinea, Gabon, Guinea, Guinea Bissau, Madagascar, Mali, Mauritania, Mauritius, Niger, Rwanda, São Tomé & Príncipe, Senegal, Togo

OEDAG

Argentina, Bolivia, Chile, Paraguay, Peru, and Uruguay

OEDAP

Australia, Kiribati, Korea, Marshall Islands, Federated States of Micronesia, Mongolia, Nauru, New Zealand, Palau, Papua New Guinea, Samoa, Seychelles, Solomon Islands, Tuvalu, and Vanuatu

OEDBR

Brazil, Cabo Verde, Dominican Republic, Ecuador, Guyana, Haiti, Nicaragua, Panama, Suriname, Timor-Leste, and Trinidad and Tobago

OEDCC

China

OEDCE

Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Mexico, and Spain

OEDCO

Antigua and Barbuda, The Bahamas, Barbados, Belize, Canada, Dominica, Grenada, Ireland, Jamaica, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines

OEDec

Austria, Belarus, Czech Republic, Hungary, Kosovo, Slovak Republic, Slovenia, and Turkey

OEDFF

France

OEDGR

Germany

OEDIN

Bangladesh, Bhutan, India, and Sri Lanka

OEDIT

Albania, Greece, Italy, Malta, Portugal, and San Marino

OEDJA

Japan

OEDMD

Afghanistan, Algeria, Ghana, Islamic Republic of Iran, Libya, Morocco, Pakistan, and Tunisia

OEDMI

Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Maldives, Oman, Qatar, United Arab Emirates, and Yemen

OEDNE

Andorra, Armenia, Belgium, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Georgia, Israel, Luxembourg, Moldova, Montenegro, Netherlands, Republic of North Macedonia, Romania, and Ukraine

OEDNO

Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, and Sweden

OEDRU

Russian Federation and Syrian Arab Republic

OEDSA

Saudi Arabia

OEDST

Brunei Darussalam, Cambodia, Fiji, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Nepal, Philippines, Singapore, Thailand, Tonga, and Vietnam

OEDSZ

Azerbaijan, Kazakhstan, Kyrgyz Republic, Poland, Serbia, Switzerland, Tajikistan, Turkmenistan, and Uzbekistan

OEDUK

United Kingdom

OEDUS

United States