FOR INFORMATION

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To: Members of the Executive Board

From: The Secretary

Subject: **Costa Rica—Assessment Letter for the World Bank**

Board Action:	Executive Directors' **information**
Publication:	No*
Questions:	Ms. Otker, WHD (ext. 37810) Mr. Srinivasan, WHD (ext. 34589)

***The authorities have not consented to the publication of this assessment by the World Bank.**

COSTA RICA—ASSESSMENT LETTER TO THE WORLD BANK

March 10, 2020

This letter updates the assessment of macroeconomic conditions made in the staff report for the 2019 Article IV consultation, which was completed by the IMF Executive Board on March 27, 2019. Since then, the IMF team visited Costa Rica during February 18-24, 2020. The next Article IV Consultation is scheduled to take place in June 2020.[1]

1. **Macroeconomic conditions remain broadly stable, but growth continues to be subdued.** Following consecutive falls in growth from 2017 to early 2019, the economy has turned around since mid-2019, owing to a rebound in services, agriculture, and manufacturing, resulting in an overall estimated growth of 2.1 percent in 2019. Reflecting the subdued pace of economic activity, elevated unemployment, at around 12 percent, lower oil prices, and an appreciated domestic currency (the colón), inflation fell below the 2-4 percent target range of the Central Bank, while inflation expectations remained anchored to the mid-point of the target range. The current account deficit narrowed, from 3.3 percent of GDP in 2018 to an estimated 2.6 percent in 2019, and was financed fully by FDI inflows. Reserve cover is currently equivalent to about 5 months of imports, or 104 percent of the ARA float metric, within the range considered as adequate (100-150 percent). Growth is projected to pick up modestly to 2.5 percent in 2020, supported by an accommodative monetary policy stance, improvements in the terms of trade owing to continued low oil prices, and moderately higher public investment. However, significant downside risks exist, related to adverse shocks to global growth, including from the recent outbreak of the Coronavirus, a sharp rise in risk premia, intensification of economic and socio-political stress in Nicaragua, as well as the continued weakness in consumer and business confidence and uncertainty about the implementation of the fiscal reform.[2]

2. **Successful implementation of the fiscal reform approved in end-2018 and the fiscal rule that came into effect with the 2020 budget remain key to preserving macroeconomic stability and boosting confidence.** The successful issuance of a US$1.5 billion Eurobond in November 2019 helped reduce pressures on domestic interest rates even further, while implementation of tax measures enacted in the fiscal reform law led to higher revenues. However, the central government's primary deficit still rose to 2.8 percent of GDP in 2019, while the overall deficit rose to 7 percent, its highest level in more than 3 decades, owing to a growing interest bill, higher capital spending, and payment of some transfers owed in 2018. The central government debt reached 58.5 percent of GDP in 2019, up from 53.2 percent in 2018 and double its level a decade ago. The large fiscal deficit is the main risk to macroeconomic stability, with debt projected to exceed 60 percent of GDP in 2020.

3. **The authorities announced an additional fiscal adjustment package earlier this month, aimed at reducing debt and supporting economic growth.** The measures include efforts to improve tax administration, reduce tax evasion, review tax exemptions, replace expensive debt with cheaper financing, and reform the public sector—including through the consolidation of public institutions and the streamlining of public wage scales—as well as asset sales and using financial surpluses of decentralized public agencies toward reducing debt. Staff welcomes the authorities'

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[1] See IMF Country Report 19/101 issued on April 13, 2019, and press release issued on February 24, both posted on IMF country page (https://www.imf.org/external/country/CRI/index.htm).

[2] Staff projections are being revised in light of the recent developments related to COVID-19.

additional efforts toward fiscal consolidation, but considers that the projected yield of some of the measures could take longer to materialize than envisaged by the government and needed to boost market confidence and reduce funding costs in the short-term.

4. **Given this, a timely implementation of the already enacted reforms, clarity on the workings and strict implementation of the fiscal rule across the board (with the exceptions recognized by the fiscal reform law), and front-loading fiscal measures as much as possible will be key to reviving confidence and further lowering funding costs.** Front-loading fiscal measures as much as possible will also help put debt more quickly on a sustained downward path toward a level prudent for emerging economies and create buffers against future shocks.[3] Such measures could include additional cuts to the wage bill, higher property taxes/VAT rates (which are low in Costa Rica by regional standards), and the introduction of environmental taxes (including to support the government's target to decarbonize the economy by 2050), and should complement efforts aimed at reducing tax exemptions and improving tax administration. These measures will need to strike a good balance between spending cuts and revenue mobilization, while protecting growth and the vulnerable.

5. **The central bank's recent efforts to support growth, enhance the inflation targeting framework, and tackle financial vulnerabilities are welcome.** Staff commend the authorities' efforts to implement monetary policy oriented towards supporting economic activity, increasing exchange rate flexibility, and enhancing transparency and communication to strengthen monetary policy transmission and firmly anchor inflation expectations. Greater exchange rate flexibility, the move to differentiate the reserve requirement on domestic and foreign currency-denominated deposits, and the upcoming reversal of the reduction in provisions for FX loans to non-dollar earners should also help reduce the impact of high level of dollarization on financial stability. Continued monitoring and management of other sources of potential risks are also needed, including high exposure of the financial system to the public sector and a highly-indebted household sector.

6. **The authorities are making progress in implementing a broad array of structural reforms, underpinned by the OECD accession process.** In this context, 19 of the 22 accession review committees have been completed, with a range of environmental, education, and financial sector reforms (including through the passage of the laws on deposit insurance and consolidated supervision), with the accession expected to be achieved by mid-2020. The reforms should support competitiveness and financial stability and boost medium-term potential growth. Staff, however, recommends caution regarding ongoing discussions on introducing lending rate limits, for their negative impacts on financial inclusion, financial intermediation, and monetary policy transmission. Staff recommends addressing the underlying causes of high interest rates, particularly those related to distortions on the operation of public and private banks. Tackling these distortions would also contribute to strengthening monetary policy transmission and supporting economic activity.

7. **Fund relations.** Staff conducted a staff visit on February 18-24, 2020, to discuss recent economic developments, progress with the fiscal reform, and the overall macroeconomic outlook, and published a press release at the end of the visit. The Article IV Consultation discussions are scheduled for June 2020.

[3] Under the baseline, the debt-to-GDP ratio would peak around 68 percent in 2023/24, from 58.5 percent in 2019.

Table 1. Costa Rica: Selected Social and Economic Indicators, Baseline Scenario

I. Social Indicators

Population (2018, millions)	5.0	Human Development Index Rank (2018)	63 (out of 188)
Per capita GDP (2018, U.S. dollars)	12,570	Life expectancy (2017, years)	79.6
Unemployment (2018, percent of labor force)	12.0	Literacy rate (2018, percent of people ages > 15)	96.7
Poverty (2018, percent of population)	21.1	Ratio of girls to boys in primary and secondary education (2018, percent)	101.4
Income share held by highest 10 percent of households	37.3		
Income share held by lowest 10 percent of households	1.5	Gini coefficient (2017)	51.4

II. Economic Indicators

						Proj.	
	2015	2016	2017	2018	2019e	2020	2021
	(Annual percentage change, unless otherwise indicated)						
Output and Prices							
Real GDP growth	3.6	4.2	3.9	2.7	2.1	2.5	2.9
Output gap (percent of potential GDP)	-0.2	0.6	1.1	0.6	-0.4	-1.1	-1.5
GDP deflator	3.8	2.0	2.6	2.5	1.9	2.0	3.9
Consumer prices (end of period)	-0.8	0.8	2.6	2.0	1.5	2.7	3.0
Money and Credit							
Monetary base	9.2	6.4	10.8	2.3	-5.2	5.6	7.1
Broad money	10.7	7.5	8.6	5.0	5.5	4.3	7.0
Credit to private sector	11.8	12.8	8.5	6.3	-1.4	3.2	5.4
Monetary policy rate (percent; end of period)	2.3	1.8	4.8	5.3	2.8	...	...
Exchange rate (national currency per US dollar, average)	528	538	563	574	584	...	...
REER	115	114	109	106	107	...	...
	(In percent of GDP, unless otherwise indicated)						
Savings and Investment							
Gross domestic investment	18.4	18.4	19.3	19.6	18.4	18.4	18.7
Gross domestic savings	15.0	16.2	16.0	16.3	15.8	15.6	15.8
External Sector							
Current account balance	-3.5	-2.2	-3.3	-3.3	-2.6	-2.8	-2.9
Of which: Trade balance	-8.3	-7.7	-7.4	-7.2	-6.3	-6.3	-6.2
Financial and capital account balance	-4.7	-2.5	-3.6	-3.1	-2.5	-2.7	-2.8
Of which: Foreign direct investment	-4.6	-3.7	-4.4	-3.6	-3.6	-3.6	-3.7
Change in net international reserves (increase +)	623	-260	-424	357	1,417	150	350
Net international reserves (millions of U.S. dollars)	7,834	7,574	7,150	7,495	8,912	9,062	9,412
Net international reserves (months of next year's imports)	5.2	4.8	4.3	4.6	5.1	4.9	4.9
Public Finances							
Central government primary balance	-3.0	-2.4	-3.0	-2.3	-2.8	-1.4	-0.9
Central government overall balance	-5.6	-5.3	-6.2	-5.9	-7.0	-6.1	-5.8
Central government debt	40.9	44.9	48.3	53.1	58.5	61.1	63.6
Consolidated public sector overall balance 1/	-5.8	-4.7	-5.3	-5.1	-6.3	-5.5	-6.5
Consolidated public sector debt 2/	45.4	49.8	50.5	55.5	59.6	61.3	62.8
Of which: External public debt	11.3	11.3	10.9	12.7	14.7	15.6	17.7
Memorandum Item:							
GDP (US$ billions)	55.4	57.8	59.0	60.9	62.3	66.5	70.6

Sources: Central Bank of Costa Rica, Ministry of Finance, and Fund staff estimates.

e - Estimated figures.

1/ The consolidated public sector balance comprises the central government, decentralized government entities, public enterprises, and the central bank, but excludes the Instituto Costarricense de Electricidad (ICE).

2/ The consolidated public debt nets out central government and central bank debt held by the Caja Costarricense del Seguro Social (social security agency) and other entities of the nonfinancial public sector.

Note: Growth projections are being revised in light of recent developments related to COVID-19.