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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/23-1

10:00 a.m., March 27, 2019

1. Costa Rica—2019 Article IV Consultation

Documents: SM/19/58 and Correction 1, and Correction 2; and Supplement 1; and Supplement 2

Staff: Balakrishnan, WHD; Kaufman, SPR

Length: 35 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	E. Sishi (AE), Temporary
	H. Razafindramanana (AF)
	J. Di Tata (AG)
	G. Johnston (AP)
	M. Coronel (BR), Temporary
	P. Sun (CC)
	J. Suazo (CE), Temporary
L. Levonian (CO)	
	S. Benk (EC)
	A. Castets (FF)
S. Meyer (GR)	
	M. Siriwardana (IN)
	P. Di Lorenzo (IT), Temporary
	Y. Naruse (JA), Temporary
	G. Nadali (MD), Temporary
	D. Fadhel (MI), Temporary
	M. Josic (NE), Temporary
	N. Vaikla (NO), Temporary
	L. Palei (RU)
	R. Alkhareif (SA)
	R. Pandit (ST), Temporary
	P. Trabinski (SZ)
	O. Haydon (UK), Temporary
	A. Grohovsky (US), Temporary

G. Bauche, Acting Secretary
H. Malothra, Summing Up Officer
E. Mannefred, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Communications Department: M. Candia Romano, H. Khang. Institute for Capacity Development: A. Lariau Bolentini. Legal Department: D. McDonnell. Strategy, Policy, and Review Department: M. Kaufman. Western Hemisphere Department: R. Balakrishnan, F. Di Vittorio, N. Geng, A. Husain, J. Sin. World Bank Group: K. Scott. Executive Director: L. Villar (CE). Alternate Executive Director: A. Guerra (CE), P. Moreno (CE), K. Tan (ST).

Senior Advisors to Executive Directors: Z. Abenoja (ST), M. Sidi Bouna (AF), A. Tolstikov (RU). Advisors to Executive Directors: W. Al Hafedh (SA), M. Albert (FF), S. Buetzer (GR), J. Corvalan (AG), P. Mooney (CO), M. Mulas (CE), A. Zaborovskiy (EC), Y. Zhao (CC), J. Montero (CE).

1. COSTA RICA—2019 ARTICLE IV CONSULTATION

Mr. Villar, Mrs. Del Cid-Bonilla and Mrs. Suazo submitted the following statement:

On behalf of the Costa Rican authorities, we would like to thank staff for the fruitful discussions held during the Article IV mission, which focused mainly on strengthening fiscal sustainability beyond the ongoing fiscal reform, enhancing the inflation targeting regime and financial sector resilience, and boosting structural reforms to increase potential and inclusive growth.

The authorities broadly share the staff´s appraisal but consider that the evaluation of the country's context and vulnerabilities needs to be more balanced. In particular, they think the statement that "significant macro and financial vulnerabilities persist" does not provide an accurate description of the country´s economic situation nor is it a conclusion that is borne out by the staff´s analysis. They also think that the assessment of the political environment requires qualification.

While fully aware of the fiscal vulnerabilities, the authorities highlight the country's significant strengths on the real, external and monetary sectors, and the resilience of the financial sector. Even though growth has slowed recently, the country has historically grown at reasonably high rates, and per capita income is catching up the OECD's average. Costa Rica continues to be a highly sought-after FDI destination due to its attractive business environment related to policy predictability, strong institutions, and a well-educated workforce. The country maintains one of the highest human development indices in Latin America and has one of the lowest perceptions of corruption in the region along with Chile and Uruguay. Costa Rica is, as staff mentions, on track in the process of joining the OECD, expected for 2020. The external sector is strong, with reserves comfortably above adequacy metrics; a narrowing current account deficit consistent with staff´s estimated norm and more than fully financed by persistently strong FDI inflows; an export sector that is dynamic and well diversified both in products and markets; and a moderate overall external debt position. Monetary policy is forward looking and data-driven and has succeeded in keeping inflation low and stable for several years bringing down expected inflation, while the current policy of greater exchange rate flexibility will help the country absorb shocks, thus constituting another important buffer. Finally, staff´s and the authorities´ stress tests show that, despite some exposures, the financial sector is resilient to significant shocks.

Regarding the political environment, there is a significant and unprecedented cross-party consensus in Congress on a broad agenda of reforms. A major fiscal reform was enacted by Congress in December 2018 after nearly two decades of gridlock and notwithstanding a three-month strike of public sector employees opposed to the reform. There is also broad support to the OECD accession agenda, including the passage in February of a bill to strengthen autonomy of the central bank and swift progress on another bill strengthening the national statistical system. Moreover, the Legislative Assembly already passed a crucial reform making legislative procedures more efficient by reducing the scope for filibustering. Additional critical bills related to adopting dual education and narrowing the scope for strikes in elementary public services have broad political support in Congress.

Outlook

The economy is expected to rebound in 2019, supported by stronger consumption and public investment, and by base effects as the impact of the 2018 strikes dissipates. These factors, along with reduced uncertainty and lower financing costs from the fiscal reform, would offset the impact of spending restraint and tax increases. As expected, with approval of the fiscal reform, consumer confidence has improved. Also, the rise in unemployment in the fourth quarter of 2018 resulted from a sharp increase in participation rates as many high school students –whose schools closed because of the strike during that quarter– started looking for jobs, with only partial success. Part of this rise is therefore expected to be temporary. In the medium and long term, the authorities project growth to return to potential, estimated conservatively at 3.5 percent.

Fiscal policy and reform

The fiscal reform passed in December is sufficient to put public debt on a sustainable footing. On the revenue side, the reform includes conversion of the sales tax into a value added tax, as well as higher income taxes. On the expenditure side, it includes wage restraint and a fiscal rule that ties down spending growth. The expected total yield of the reform is estimated at 4 percent of GDP by 2023, with government debt peaking at about 62 percent of GDP that year and declining gradually thereafter. After passage of the fiscal reform, the EMBI spread has tightened faster for CR’s debt than for other Latin American debt and is currently close to its historic low, while domestic financing conditions for the government have significantly improved, with about two-thirds of the gross financing needs for 2019H1 already covered.

The authorities are committed to full implementation of the fiscal reform. They are taking steps to ensure a smooth introduction of the VAT, thus limiting implementation risks. They are also seeking legislative approval for external financing from both multilateral sources and international bond placements to meet financing needs on more favorable conditions, ease pressure on local markets, reduce private sector crowding out, and improve debt dynamics. Staff recommends additional frontloaded tax measures of 0.7 percent of GDP to ensure faster debt reduction; however, passing the reform left the country strained, and further tax measures do not seem politically feasible this year. Instead, the authorities are focusing on reforms to public employment, organizational changes to the state and overall government streamlining. They would consider further adjustment measures contingent on the evolution of the fiscal deficit and of other fiscal reforms already being evaluated by Congress. Crucially, the recent fiscal reform removed all legally-mandated earmarked spending. Staff noted that constitutionally-mandated spending rigidities persist, such as transfers to public education and the judiciary. However, these transfers will not trigger additional spending increases, as a share of GDP, as spending is already above the mandated floors.

Progress is being achieved on improving the sustainability of special pension regimes. Benefits were reduced in 2018 for the Retirement and Pensions Regime for the Judiciary. Several parametric changes are being considered to the special pension regimes that are funded out of the government´s central budget.

Monetary and exchange rate policies

The authorities have continued strengthening the inflation targeting regime. Data-driven monetary policy has kept inflation low and stable for several years and succeeded in bringing down expected inflation to within the target band. More recently, monetary policy has become explicitly forward looking. The central bank (CB) estimates that VAT implementation should only lead to a temporary and modest increase in inflation, with the central estimate for forecast inflation remaining well within the target band in the next two years. It will continue to monitor risks to forecast inflation and adjust readily the policy rate when needed. Exchange rate policy has become more flexible, with the IMF´s de facto XR regime classification recently shifting from “crawl like” to “floating”. A bill passed by Congress in February 2019 enhanced CB independence by de-linking the appointment of the CB’s governor from the political cycle, establishing clear causes for her/his dismissal, and taking away the voting power of the Finance Minister in the CB Board, all long-standing IMF recommendations.

Financial sector

The authorities recognize that still-persistent financial dollarization represents a vulnerability, but staff's stress tests show that the financial sector is resilient to different types of shocks, including exchange rate shocks and their impact on unhedged borrowers. Going forward, the authorities are committed to discouraging dollarization through continued exchange rate flexibility and a recalibration of prudential measures. They note that the June 2018 reduction in provisions on dollar loans to unhedged borrowers was adopted following a sharp deceleration of FX credit, and was designed as temporary with the provision increasing from 1 percent to 1.25 percent in June 2019 and returning to its original 1.50 percent in June 2020. Currently, the supervisory authority is considering a faster pace for the increase in the provision. It is also revising the definition of unhedged borrowers to make it stricter.

To enhance financial sector resilience, the authorities are implementing a comprehensive package of reforms consistent with FSSR and OECD recommendations. In September 2018, with effect from January 2020, Conassif adopted the IFRS for the financial sector (not just IFRS 9 on asset valuation methods, as mentioned in ¶9 of the staff report). Progress is also being made in adopting a risk-based supervision approach in all four superintendencies. The CB introduced an Emergency Liquidity Assistance Mechanism (ELA) in 2018. Moreover, in early March 2019 the authorities submitted to Congress draft bills to: (i) allow the operation of foreign bank branches (currently only subsidiaries are allowed); and (ii) strengthen the framework for information exchange (IOSCO memorandum), provide legal protection to financial regulators, and increase the contribution of supervised entities to cover the cost of supervision–all FSSR or OECD recommendations. They will submit a bill to strengthen consolidated supervision in early April and are working on a bill to introduce deposit insurance and strengthen bank resolution. To reduce vulnerabilities and foster diversification of pension funds, in October 2018 the limit for their overall exposure to sovereign debt was reduced from 90 percent to 80 percent of assets.

The authorities will continue to enhance financial deepening and inclusion, one of the priorities in their economic program. The intended measures include deepening of the electronic payments system, passing of a financial consumer protection bill, and a financial education campaign. Staff recommended lowering electronic transaction costs to strengthen financial deepening. However, Costa Rica has one of the highest bank penetration rates among emerging markets, precisely due to the low cost and widespread use of electronic transactions.

Structural Reforms

The authorities have developed a broad structural reform agenda, including under the OECD accession process. The creation of a special legislative committee for OECD accession reflects broad political support for the process, which aims at aligning public administration and policies with best practices to foster transparency, efficiency, and growth. The authorities are also working on reforms to remove red tape, reform the energy sector, expand child care coverage to improve female labor force participation, and strengthen dual education to tackle high youth unemployment. These reforms should boost potential growth beyond the current estimate (by staff and the authorities) of 3.5 percent. The authorities thus see their (and staff's) long-term growth projections as conservative.

With regards to infrastructure, the government is implementing or planning an ambitious array of already financed projects to improve roads and reduce congestion in the country's road network. They are also working on projects to build an urban rail service in the capital, expand port infrastructure and build an electric freight train on the Caribbean coast.

Overall, most of the policy actions suggested by staff in the fiscal, monetary, financial and structural reform areas are in line with the authorities´ Economic Policy Program, and the majority of them are already being implemented.

Ms. Pollard and Mr. Grohovsky submitted the following statement:

The Costa Rican economy faces significant near-term challenges. Slower growth, weak public finances, high unemployment, and unhedged foreign currency borrowing weigh on the outlook. However, the authorities have recently undertaken some important steps, in line with past Article IV recommendations and the goal of building buffers. Further measures will be needed to reduce near-term risks while placing the economy on a better future trajectory.

We commend the authorities for the passage of the recent fiscal reform, which is an important step towards restoring fiscal sustainability. We recognize that accomplishing the fiscal reform that the prior government had been unwilling to undertake required a significant political undertaking. At the same time, however, the authorities still face serious near-term financing pressures and debt is set to continue to rise from already high levels for the next several years. We encourage close monitoring by the IMF on whether Costa Rica's deficit and debt are evolving in line with the authorities' expectations and urge the government to continue to work with Congress on more ambitious reforms that may be necessary to definitively address Costa Rica's financing challenges. We also agree that there is substantial scope to improve the efficiency of public sector spending to reduce earmarking and rebalance expenditure toward capital spending.

The public sector's large interest bill is also adversely impacting debt dynamics. Given the authorities' need to reduce their reliance on high-cost local capital market financing, it is reasonable for a near-term strategy to seek approval from Congress for Eurobond issuances. There is also a role for official financing to support Costa Rica's ambitious policy reforms to date, with the size of the official sector's support calibrated to the strength of the authorities' reforms. We are pleased that the authorities are taking steps to improve debt management—including through Fund TA—which should improve fiscal sustainability through better rollover of expiring debt and lower debt servicing costs.

The authorities' reliance on domestic markets for public sector financing needs has left the banking sector highly exposed to sovereign lending. Could staff provide more details on what percent of total credit is going to the public sector? The combination of high public sector borrowing plus sharply growing household borrowing implies that the productive sector is being increasingly crowded out. Additionally, while we welcome the increased move toward exchange rate flexibility, the authorities should complement this effort by reversing the measures passed last June to relax foreign exchange lending requirements, which has contributed to a larger share of foreign currency credit going to unhedged borrowers.

Looking ahead, we applaud the authorities' efforts to implement structural reforms in line with the OECD accession process. These reforms should help boost potential output over the medium-term and introduce more flexibility into the economy. We particularly welcome the authorities' prioritization of promoting female labor force participation.

Finally, we commend the authorities for removing the two capital flow management measures last December, in line with staff's advice and the institutional view on capital flows.

Ms. Levonian, Ms. McKiernan and Mr. Mooney submitted the following statement:

We thank staff for their report and Mr. Villar and Mrs. Suazo for their informative buff statement. Living standards in Costa Rica continue to improve while the poverty rate has declined. In addition, the financial sector is more resilient to shocks. Nevertheless, Costa Rica faces a persistently high fiscal deficit and rising public debt. In addition, unemployment remains elevated and the banking sector is highly concentrated. We broadly concur with staff's findings and add the following points for emphasis.

It is crucial that authorities fully implement fiscal reform. We agree with staff that, in addition to the restoration of fiscal sustainability and the improvement of tax policies, the reform would likely reduce inequality. We also agree that the reform will assist in the rebuilding of fiscal space. We welcome the steps taken by authorities to establish a fiscal council and agree with staff that the implementation of a medium-term expenditure framework (MTEF) could be an effective tool to control public expenditure over this period.

On the financial sector, we note the result of the stress tests indicating that the banking system is sufficiently capitalized to absorb sizeable shocks. Nevertheless, there are risks to the financial system in the form of rising NPLs, high dollarization and large increases in household borrowing. In addition, the Costa Rican financial sector is highly concentrated – Annex III of the report sets this out in detail. We agree with staff that implementing the outstanding FSAP/FSSR recommendations would enhance the resilience and inclusiveness of the financial sector, and note the progress made by authorities in terms of legislation pertaining to deposit insurance, bank resolution and securities market law.

We welcome the authorities' development of a broad structural reform agenda. We agree with staff that the promotion of female labor force participation and addressing weaknesses in transport infrastructure are key priorities. However, we also note the work being undertaken in areas such as enhancing the quality of the education system, promoting innovation and strengthening competition. We agree with staff that the implementation of these reforms should lead to potential growth beyond the current estimate. We welcome the policy response to adverse climatic conditions contained in the

Risk Assessment Matrix which involves building a consistent framework with investment in resilience and appropriate ex-ante financing.

Mr. Doornbosch, Mr. Psalidopoulos, Mr. Di Lorenzo and Mr. Josic submitted the following joint statement:

We thank staff for their informative report and Mr. Villar and Mrs. Suazo for their helpful buff statement. We welcome staff's views that Cost Rica has made significant progress with improving the OECD living standard and reducing the poverty rate. However, considering the fiscal risks stemming from increasing public debt as well as a range of risks stemming from the external environment and the identified vulnerabilities in the financial sector, the available window of opportunity is a great opportunity to improve resilience, build buffers and speed up the implementation of the ambitious set of reforms. We broadly agree with the thrust of the staff appraisal and will therefore focus on the following specific issues.

Fiscal consolidation remains an imperative. Large fiscal deficits have contributed to a significant rise in public debt, which almost doubled since 2010, while interest rate payments increased by almost 1 percentage point in the last three years only. Consequently, fiscal sustainability came under strong pressure and put fiscal space 'at risk'. Against this background, we welcome the implemented as well as planned fiscal consolidation efforts, as highlighted by Mr. Villar and Mrs. Suazo. If the authorities will fully and timely implement these measures, additional fiscal consolidation actions might not be necessary, also taking into account the still relatively high poverty rate and the broadening output gap. However, we agree with staff that the authorities should closely monitor the effects of the planned measures and implement additional measures if necessary to bring public debt levels on a downward path. In this context, we see room for further revenue mobilization measures, considering the low tax revenues to GDP ratio. Considering the high dollarization of the financial system, staff's comments on the pros and cons of the planned Eurobond issuance are welcome.

While we recognize the recent progress, banking sector vulnerabilities should be addressed. The banking system is well capitalized, and the overall institutional framework has improved. We particularly welcome the recent improvement in the central bank's independence and the increase in FX flexibility. At the same time, vulnerabilities stemming from high dollarization and high sovereign exposure continue to exist. In this vein, we were surprised to read that measures introduced by CONASSIF in June 2018 to relax FX lending requirements were adopted shortly after the MCM mission providing

Technical Assistance aimed at reducing credit dollarization, and recalibrating macroprudential regulations that encourage de-dollarization. Staff's comments are welcome. In the context of a highly concentrated and state-dominated banking sector, we support staff's recommendation to move forward with establishing a deposit guarantee fund, the implementation of a risk-based supervisory approach, as well as Basel III standards.

We endorse staff's recommendation to encourage more competitive behavior in the economy, particularly in the banking sector. Costa Rica has reached a remarkable achievement in creating a dynamic and diversified economy, evidenced by strong and continued inflow of FDIs as well as a high ranking in the doing business and competitiveness indicators. Considering the productivity slowdown, nota bene present in many other countries as well, we share staff's recommendation to revisit the competition law and liberalize certain sectors and professions where deemed beneficial. Increasing banking sector competition could decrease the currently high interest rate gap, and thus provide a boost to the private sector, but also decrease the interest rate payments for the public sector.

Lastly, Costa Rica should be commended for their model of sustainable development and climate change adaption. With nearly all of its electricity generated from renewable sources, and the initiative and steps made to decarbonize the transportation sector, the authorities and people of Costa Rica have proven to be among the global leaders in green development and pursuing the objectives of the Paris agreement. For countries that are highly vulnerable to natural disasters and climate change, these issues should be more prominently covered in Article IV reports. Staff's comments why this report is entirely void of climate change actions are welcome.

Mr. Tan and Ms. Pandit submitted the following statement:

We thank staff for the insightful paper and Mr. Villar and Mrs. Suazo for their informative buff statement. The Costa Rican economic transformation has yielded higher per capita income and a falling poverty rate thus far. Looking ahead, significant vulnerabilities remain, particularly in the form of high youth unemployment and income inequality, elevated fiscal deficits and sizeable dollarization. The recent slowing growth trend is likely to persist in the near-term with further downside risks in the horizon. Against this backdrop, we agree with the broad thrust of staff's appraisal and would like to offer the following comments for emphasis.

Effective and timely implementation of fiscal reform measures is warranted to restore fiscal sustainability. While we welcome the recent fiscal reform bill and the authorities' commitment to its implementation, Costa Rica continues to face material funding needs and liquidity challenges, with persistently elevated fiscal deficits and high domestic interest rates creating a vicious circle. We concur with staff on the need for a full and timely implementation of fiscal reform and front-loading of additional fiscal adjustments to reduce near-term financing pressures and rebuild fiscal space to manage potential shocks and contingent liabilities. We also agree with the recommendations on raising and improving the composition of tax revenue, enhancing spending efficiency and quality, and better targeting government transfers to help reduce informality and support equitable growth.

Enhancing financial sector resilience would augment efforts toward long-term economic growth. We take positive note that Costa Rica's banking system is generally sound and sufficiently well-capitalized. However, high dollarization and exposure to unhedged forex lending heighten vulnerabilities in the system, which is also facing fast-rising household leverage, significant net foreign liabilities and high sovereign exposure. Concrete steps are warranted to expedite the implementation of outstanding FSAP/FSSR recommendations including the risk-based supervisory approach and Basel III standards. In this regard, we welcome the authorities' plan to put in place a comprehensive package of reforms comprising a lender of last resort mechanism, a crisis management protocol, as well as legislation on deposit insurance and bank resolution, consolidated banking supervision, etc.

The monetary policy stance should remain data dependent and inflation-targeting. We note that the current accommodative monetary policy is appropriate given subdued inflation and a sizeable output gap, and there has been significant progress in enhancing the inflation targeting framework. Nonetheless, ongoing efforts to improve the transparency of monetary policy decisions should continue. In this vein, we welcome the passing of the bill for safeguarding central bank independence and facilitating greater exchange rate flexibility. We also encourage the authorities to adopt staff recommendations on publishing the calendar of monetary policy meetings and their corresponding meeting minutes.

Structural reforms are crucial to improve competitiveness and inclusiveness. Despite notable progress in poverty reduction and various business indicators, income disparity continues to be high in Costa Rica, and tight domestic financial conditions and uncertainty surrounding the fiscal reform continue to weigh on economic growth and inclusion. As rightly pointed out by staff, broad based structural reforms including those under the OECD accession process are needed to boost competitiveness and reduce inequality. To this end, we take positive note of the authorities' Economic Policy Program for development of a broad structural reform agenda and creation of a special legislative committee for OECD accession that aims to foster transparency, efficiency and growth.

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

Mr. Trabinski and Ms. Wehrle submitted the following statement:

We welcome the authorities' comprehensive structural reform plan to pave the way to OECD accession. Nonetheless, we encourage the authorities to proceed decisively with their fiscal reform efforts and broader structural reform agenda, despite the challenging political and social environment. Bold steps are urgently needed to restore consumer and market confidence, as well as to reduce vulnerabilities. We broadly share the thrust of staff's appraisal and would like to highlight the following points.

We agree with staff that the authorities should consider additional fiscal measures. We commend the authorities for recently passing the fiscal reform bill. The fiscal rule in particular will help reduce the growth of spending. Nonetheless, we take note that the staff sees the need for an additional frontloaded fiscal adjustment to restore sustainability. We support staff's fiscal recommendations aimed at improving spending efficiency and quality, implementing better debt management practices in line with recent TA recommendations, and introducing a medium-term expenditure framework. The importance of reforming the state-run defined-benefit pension schemes, as noted in the previous Article IV report and the recent FSSR, should also be emphasized. There is also room to raise tax revenue, given Costa Rica's low revenue-to-GDP ratio relative to peers, and we agree that increasing property taxes and recalibrating the personal income tax could also help better target the highest income quintiles and reduce inequality.

Progress on outstanding FSAP and FSSR recommendations needs to be accelerated to enhance financial sector resilience. We urge the authorities to strengthen the regulatory and supervisory frameworks, with the help of Fund technical assistance. The high concentration of FX lending, the strong reliance of banks on foreign borrowing, the low efficiency and profitability of the sector, the sharp increase in household borrowing, and the banks' high exposure to the sovereign are increasing Costa Rica's vulnerability to shocks.

This holds true even most banks seem adequately capitalized. We note the slow progress in implementing crisis management mechanisms and are concerned that FX lending requirements were relaxed by CONASSIF. We also concur that promoting more competition in the banking sector to reduce the dominance of state-owned banks could help reduce lending rates. Ultimately, this could positively impact growth.

Mr. Johnston and Mr. Amor submitted the following statement:

We thank staff for their report and Mr. Villar and Mrs. Suazo for their helpful buff statement. Despite shocks, the public sector strike and spillovers from unrest in Nicaragua, Costa Rica’s economy continues to grow, albeit at a reduced level. We welcome the country’s progress in converging towards OECD living standards, and on accession to that organization. Despite reform efforts, unemployment and income inequality remain elevated, and a high fiscal deficit and rising public debt call for continued strong commitment to reform implementation.

We welcome the passage of the fiscal reform bill, which the authorities expect will re-establish fiscal sustainability when fully implemented. A durable commitment to contain expenditures should help preserve public debt sustainability. We appreciate the authorities’ commitment to containing wages and expenditure growth, and their plans to introduce a multi-year expenditure framework and create a fiscal council. We also see merit for performance-based reforms in areas where efficiency of public spending is considered low, such as education and social protection. While additional front-loaded fiscal adjustment would help reduce funding needs in the short term and further improve debt dynamics, it may be asking too much of the minority government to get political and public support for further consolidation in the current environment. With risks of social unrest still lingering, it will also be important to properly sequence the reforms by first improving the quality of public spending and enhancing social safety nets before imposing additional fiscal adjustment measures.

We welcome structural reforms geared toward increasing competitiveness and potential growth. Joining the OECD will likely boost investor’s confidence and attract additional FDI, so we welcome the strong political support put behind the accession process, and encourage continued progress on the measures outlined in Annex V. We also stress the need for measures like expanded access to early childhood education, to further enhance the provision of equal opportunities across all segments of society in Costa Rica and facilitate female labor force participation.

We note on the Risk Assessment Matrix that adverse climate conditions are a high risk for Costa Rica. However, the report did not discuss the need to strengthen ex-ante resilience. Was this an issue that was discussed with the authorities and do they have plans to address it?

Mr. Saraiva and Mr. Coronel submitted the following statement:

We thank staff for the well-written report, and Mr Villar and Mrs. Suazo for their insightful and informative statement. Staff's report appropriately focuses on Costa Rica's most sensitive macroeconomic issues, such as restoring fiscal sustainability, building up the banking system's resilience, and strengthening the monetary policy framework. In spite of a notable difference of tone, we are glad to see that there is a lot of convergence between the authorities and staff regarding the policy recommendations.

Longstanding political stability in Costa Rica alongside consistent economic policies have led to strengthened institutions and solid development results. Costa Rica has one of the lowest poverty rates in Latin America and ranks high in the UN Human Development Index. Moreover, it enjoys the 5th highest per capita income in Latin America (in market exchange rates) and has earned solid and widely recognized environmental credentials. Due in no small part to these factors, Costa Rica continues to enjoy a highly favorable investment climate and as an upper-middle-income country is in the process of acceding to the OECD. These achievements notwithstanding, Costa Rica still faces several challenges, such as the high levels of income and wealth inequality, rising unemployment, and gaps in gender equality and women's labor force participation.

However, the most pressing challenge for Costa Rica has been the rapid deterioration of the fiscal accounts since the aftermath of the great global recession. Yearly deficits climbed sharply to unsustainable levels while the central government's debt more than doubled. By the end of 2017, after two failed attempts to produce a reform, the fiscal deficit had reached 6.2 percent of GDP—albeit improving slightly by the end of 2018. Moreover, the financing constraints had compelled the national treasury to resort to borrowing from the central bank.

In a highly opportune turn of events, the new authorities elected in May 2018 were able to break the political gridlock in congress, which managed to finally approve the first substantial fiscal reform in Costa Rica in twenty years. State workers responded with a three-month long strike, which together with intra-regional trade disruptions caused by roadblocks in neighboring Nicaragua, took a toll on growth. Despite the rocky start, the reform is expected to reduce the primary deficit to 0.8 percent of GDP by 2023. However, given the still elevated interest payments on a debt that will be peaking at around 62 percent of GDP, the overall fiscal deficit will be reduced more modestly to about 3.8 percent of GDP by that year.

Costa Rica's favorable medium-term economic prospects hinge on the successful implementation of the fiscal stabilization plan. Notwithstanding the recent progress, the government deficit financing stress may continue in the immediate future and, without fiscal buffers, staff's recommendation for an additional front-loaded adjustment could, at some point, be considered a practical option by the authorities. We also agree with staff that Costa Rica's debt management framework calls for an update, and that the functionality of the recently approved fiscal rule may become challenging, unless associated to a medium-term expenditure framework (MTEF).

We welcome the progress made towards strengthening monetary policy, namely, enhancing the independence of the central bank and its inflation targeting framework. The banking system has, in general, remained robust and relatively resilient to shocks. That said, increasing household debt and historically high sovereign exposure warrant close monitoring. Finally, we applaud the authorities' steps to follow up on the FSSR recommendations and encourage them to further improve Costa Rica's supervisory framework, financial inclusion, as well as the overall banking system's robustness by adopting BASEL III standards.

Mr. Benk and Mr. Zaborovskiy submitted the following statement:

We thank staff for the well-written report, and Mr. Villar and Mrs. Suazo for their helpful buff statement. Economic growth in Costa Rica remains subdued, as vulnerabilities mainly resulted from the weak fiscal position and the high dollarization weighs on the economic outlook. We concur with the thrust of the staff's appraisal and offer the following comments for emphasis.

Fiscal reforms, underpinned by a front-loaded consolidation and improved spending efficiency, need to be accelerated to put debt on the downward trajectory. Financing stress in the second half of 2018 against the overall fiscal deficit of 6 percent of GDP and elevated public debt underlines the urgency of front-loading fiscal consolidation to restore budget sustainability and reduce financing needs. We welcome the recently approved tax reform bill and echo staff's advice to proceed with its implementation.

Going forward, revenue-based measures and public financial management reform are warranted to sustain the fiscal adjustment. Given the upcoming election, we wonder whether the fiscal consolidation strategy advised by staff is feasible. What would be the second-best solution? The much-needed fiscal structural reforms should go hand-in-hand with expanding the targeted social safety nets to protect the poor. We strongly encourage the authorities to take staff's advice to advance debt management practices and reduce debt market fragmentation.

Strengthening the monetary policy framework and enhancing resilience of the financial system remain critical to anchor inflation and ensure financial stability. We commend the authorities for safeguarding the central bank's independence. Further improving the monetary policy framework requires increased transparency, data-based decision-making, sustained de-dollarization, and careful communication. Exchange rate flexibility should be the first line of defense against external shocks. We note that according to staff's assessment, Costa Rica's external position is broadly in line with fundamentals and desirable policies. Considering staff's call for a front-loaded fiscal adjustment, we welcome further comments on the desirable policy settings in the EBA CA model and their impact on the model's results. The stress tests conducted by staff suggest that the banking system can absorb sizable shocks; however, we caution the authorities against complacency, as important pockets of vulnerabilities remain within the financial system. The progress in the implementation of the outstanding FSAP/FSSR recommendations is vital to safeguard financial stability.

Structural reforms should be advanced to boost growth potential. High unemployment and income inequality point to the structural rigidities which need to be addressed by a growth-enhancing reform package. We note that the new government realizes the existing challenges and plans a broad array of measures to boost growth potential, including those required for OECD accession. We encourage the authorities to press ahead with their implementation and wish them every success in their reform efforts.

Mr. Meyer and Mr. Buetzer submitted the following statement:

We thank staff for their detailed report and Mr. Vilar and Mrs. Suazo for their insightful buff statement. We broadly agree with the thrust of staff's appraisal and would like to offer the following comments.

Costa Rica continues to be a positive example in the region for sustainable development, sound institutions, and overall robust macroeconomic frameworks. While the long strike and uncertainty associated with the recent comprehensive fiscal reform may have dampened growth and confidence in 2018, the passage of the fiscal reform bill was an important and timely step to stave off fiscal sustainability concerns against the backdrop of the steep rise in public debt and debt servicing costs over the past few years. Going forward, we agree with staff that the authorities should intensify their efforts to increase tax revenues from their current relatively low level, improve spending efficiency, and strengthen institutions further.

Against this backdrop, we have sympathy for Mr. Vilar’s and Mrs. Suazo’s call for a somewhat more balanced overall assessment of the current situation. That being said, the vulnerabilities which staff points to warrant vigilance and need to be addressed.

Reforms should aim at further improving the business climate, promoting competition, and raising educational outcomes. In this regard, we welcome the authorities’ plans to address high youth unemployment through strengthening dual education, which is a model that has, for instance, served Germany’s labor market very well in the past.

We agree with staff that enhancing resilience of the financial sector by implementing recommendations from the FSSR should be a policy priority. In particular, measures should be taken to reduce unhedged FX lending and the associated high level of credit dollarization, including through the deepening of domestic financial markets. Moreover, we encourage the authorities to reinforce AML/CFT frameworks and determinedly pursue the projects that are currently underway to this end.

We take positive note that the OECD accession agenda and associated structural reforms appear to have broad political support. We particularly welcome the recent passage of a bill that enhances central bank independence in line with long-standing IMF recommendations. In conjuncture with the fiscal and monetary reforms undertaken by the authorities, the ambitious structural reform agenda and planned infrastructure investments are expected to promote sustainable and inclusive growth over the medium to long term.

In this vein, we appreciate the country’s ambition and demonstrated global leadership in clean development and pursuing the objectives of the Paris agreement. Given the prominence of this issue in the country, as also reflected in the government’s recently released “Decarbonization Plan” and the hosting of the pre-COP25 meeting later this year, we are wondering why any reference to it was curiously absent from the document.

Mr. Geadah and Ms. Fadhel submitted the following statement:

We thank staff for the informative report and Mr. Villar and Mrs. Suazo for the useful buff statement. Costa Rica’s economy is steadily converging to OECD living standards while transforming into a service-oriented from an agricultural-based economy. However, the economy is facing macro and financial vulnerabilities mainly related to its fiscal deficits and public debt. There are also external sources of risk, including rising protectionism, potential changes in key trading partner policies, and tightening global financial conditions.

We commend the authorities for the recent enactment of the fiscal reform bill and look forward to its effective implementation. Staff recommends additional front-loaded fiscal measures. As the authorities consider that further tax measures do not seem politically feasible this year, we would welcome staff comments on whether the authorities should instead focus on spending measures. Enhancing the efficiency and quality of public spending, especially in social protection and education, together with performance-based reforms, could help generate economic and social dividends and support growth. We join staff in welcoming the rolling out of debit cards for transfers to low-income households. Effective targeting of social security programs will be important to help protect the poor.

We agree that the current accommodative monetary policy is appropriate and should remain data-dependent. The output gap is currently projected to be negative and inflation is at the floor of the target range. We take note of the progress in enhancing the inflation targeting framework and welcome the passage of the bill on central bank independence as well as the increase in exchange rate flexibility.

While the banking system is generally sufficiently capitalized, there are small banks that need to strengthen their capital. The financial system also appears to be somewhat vulnerable to rising NPLs, FX lending to unhedged borrowers, and rapidly growing household borrowing. These developments warrant continued vigilance. We welcome the authorities’ plan to discourage dollarization through exchange rate flexibility and a recalibration of prudential measures. We also welcome the authorities plan to clarify the definition of unhedged borrowers. We take note of the authorities’ planned comprehensive package of reforms in line with the FSAP/FSSR and OECD recommendations, including the introduction of a lender of last resort mechanism, a crisis management protocol, and the ongoing work to draft bills on deposit insurance and bank resolution, consolidated banking supervision, and securities market law.

Costa Rica has recently developed a broad structural reform agenda, including reforms for OECD accession, to boost its competitiveness and inclusive growth. We take positive note of the steps to develop a Financial Inclusion Project which includes, inter alia, an assessment of the regulatory framework to identify best practices aimed at addressing the challenges posed by Fintech. We look forward to reforms to upgrade infrastructure, remove red tape, reform the energy sector, expand child care coverage, and strengthen dual education to tackle high youth unemployment.

Mr. Di Tata and Mr. Corvalan Mendoza submitted the following statement:

We thank staff for the informative report and Mr. Villar and Mrs. Suazo for their comprehensive buff statement.

The Costa Rican authorities' recognition of mounting economic vulnerabilities has encouraged them to take decisive policy actions to ensure macroeconomic and financial stability while supporting inclusive growth. Although we broadly share the staff's appraisal, we concur with Mr. Villar and Mrs. Suazo's buff statement that the evaluation of the country's context and vulnerabilities could have been more nuanced. Could staff elaborate on the political situation and its view that there is "potential for further social unrest"?

Costa Rica has made significant progress towards converging to OECD living standards and its economy is now service-oriented. At the same time, however, unemployment and income inequality remain high. Following a slowdown in 2017, growth decelerated further to 2.7 percent in 2018 because of domestic, regional, and global factors. Inflation remains low, with headline inflation staying within the lower part of the central bank 2-4 percent band in 2018. The external current account deficit is comfortably covered by net FDI inflows, international reserves exceed the Fund's reserve adequacy benchmark, and the public debt is estimated at 53 ½ percent of GDP at end-2018. Real GDP growth is projected to rise towards its potential rate of 3 ½ percent a year over the medium term in response to increased confidence and progress with structural reforms. Staff notes that downside risks are related to global growth and policy uncertainties, including trade tensions, and possible delays in implementing fiscal reforms.

We commend the authorities for the passage of the fiscal reform bill last December, which constitutes a major step towards fiscal consolidation, as well as for the approval of the bill safeguarding the independence of the Central Bank of Costa Rica. These reforms are aimed at achieving long-term fiscal sustainability while keeping inflation under control. As noted in the report, the government is also working on several other reforms, some of which come under the OECD accession process.

The fiscal reform bill is expected to yield 4 percentage points of GDP over 2018-23, leading to a primary balance of 0.8 percent of GDP in 2023. We agree with staff that full and timely implementation is key and welcome that the reform is likely to improve the progressivity of the tax system and reduce inequality. The authorities are of the view that the reform is enough to put the public debt on a sustainable footing, but staff recommends additional frontloaded tax measures equivalent to 0.75 percent of GDP over 2019-20 to reduce near-term financing pressures. However, the authorities believe that further tax measures do not seem politically feasible this year, following the recent passage of the fiscal reform bill. They would consider additional tax measures depending on the evolution of the fiscal deficit and believe that near-term pressures might be eased with legislative authorization for multilateral loans and Eurobond placements. We would appreciate staff's comments on the authorities' approach.

We welcome the recently approved fiscal rule, as well as the fact that Congress is considering a constitutional reform to introduce a medium-term expenditure framework (MTEF). Regarding the fiscal rule, it would be important to clarify the division of responsibilities between the Ministry of Finance and the Comptroller General to monitor compliance. A medium-term expenditure framework (MTEF) will enhance control of public expenditure over the coming years and can serve as an important communicational tool to inform investors and the public of the government's strategic plans. We agree with staff that further efforts are also needed to reduce expenditure rigidities, including by entitling the Ministry of Finance to adjust non-earmarked current transfers. There is also a need for timely implementation of the recommendations of recent Fund TA on debt management and for a more centralized procurement system to reduce costs.

Going forward, we agree that monetary policy needs to remain data dependent, paying due attention to inflation risks, and welcome the efforts under way to strengthen the inflation-targeting regime. In particular, we take positive note of the passage of the bill strengthening the central bank's autonomy and the recent increase in exchange rate flexibility by which intervention is limited to addressing episodes of large exchange rate volatility. We agree with staff that a preestablished calendar of monetary meetings and subsequent publication of minutes will add transparency to monetary policy decisions.

The banking system appears liquid and well capitalized, but FX risks should be closely monitored given the high level of dollarization. Stress tests suggest that, in general, the banking system can absorb sizable shocks. However, about 2/3 of foreign currency credit to the nonfinancial private sector goes to unhedged borrowers. In this regard, we encourage the authorities to reverse, as soon as possible, the measures passed by CONASSIF in June 2018 to relax FX lending requirements. We welcome the efforts under way to implement a comprehensive package of reforms consistent with FSSR and OECD recommendations and to adopt a risk-based supervision approach in all four superintendencies. We also take positive note of the draft bills submitted to Congress in March 2018, as well as the bill to strengthen consolidated supervision to be submitted in early April. Could staff comment on the characteristics of the bill being prepared to introduce deposit insurance and strengthen bank resolution? We found Annex III very interesting, with a detailed description of the financial industry's composition. The size of the cooperative sector (10 percent of total assets of the system) caught our attention. We would appreciate staff's clarification on whether cooperatives are subject to similar regulation and supervision requirements to those applied to banks.

Additional reforms are needed to improve competitiveness and reduce inequality. We support the OECD's recommendation to undertake an in-depth review of key sectors exempted from the competition law and increase banking sector competition. We also encourage the authorities to move ahead with their plans to promote female labor participation and address weaknesses in transport infrastructure.

With these comments, we wish the Costa Rican authorities every success in their future endeavors.

Mr. Sigurgeirsson and Mr. Vaikla submitted the following statement:

We thank staff for the report and Mr. Vilar and Mrs. Suazo for their informative buff statement. Costa Rica has enjoyed a long track record of steady but subdued economic growth, with the lowest poverty rates in the region and strong environmental policies, while deterioration of the fiscal situation since the GFC has put debt sustainability at risk. We broadly share staff's appraisal and agree that given the fiscal vulnerabilities and sizeable financing needs, policies should aim at fully implementing the fiscal reforms and achieving front-loaded fiscal adjustment to strengthen fiscal sustainability while protecting the poor.

The implementation of the fiscal reforms and additional fiscal adjustment will be essential to address the large fiscal deficit and to stabilize debt levels. We commend the authorities for adopting the fiscal reform bill despite the challenging social and political context. Fiscal reform is a much needed and welcome step to reduce financing pressures, contain the large public deficit, and safeguard financial stability. We share staff´s view that, going forward, the full and timely implementation of fiscal reform is essential, which coupled with structural reforms related to OECD accession would have a positive confidence effect. While being fully aware of its political challenge, we urge the authorities to also implement additional front-loaded budget adjustment to take on the sizeable financing needs in 2019, as recommended by staff. Given the low tax revenues-to-GDP, we encourage the authorities to seek opportunities to raise tax revenues by more efficient revenue collection and by broadening the tax base. Moreover, we agree with staff that the authorities should make efforts to improve the efficiency and quality of public spending and to consider introducing a medium-term expenditure framework.

We agree with staff that the current monetary stance is appropriate given low inflation pressure and a negative output gap. We welcome the authorities´ significant efforts in enhancing the inflation targeting framework, increasing FX flexibility, and the implementation of measures aimed at strengthening central bank independence. We encourage the authorities to take measures to deepen the FX market and increase monetary policy transparency.

The financial sector appears sound, while pockets of vulnerabilities exist. According to staff´s stress test, Costa Rica's banking sector would remain sufficiently capitalized even under an adverse scenario. However, we share staff´s concerns regarding increased NPLs, low profitability, and the increase in household borrowing. We also note, risks to the financial system stemming from high dollarization of corporate credit and the uneven regulatory environment as one-third of household loans are provided by less-regulated non-bank financial institutions. We therefore encourage the authorities to address these issues and implement the recommendations given by the FSSR.

Implementation of structural reforms are important to foster economic growth and enhance competitiveness. We commend the authorities for developing a comprehensive structural reform agenda, which after successful implementation would significantly boost the economy´s growth potential and reduce fiscal vulnerabilities. We view enhancing the quality and efficiency of the education system as essential for productivity growth in the long run. We commend the authorities for their efforts to reduce income inequality and increase female labor participation, which is low compared to peer economies.

Mr. Gokarn and Mr. Siriwardana submitted the following statement:

We thank staff for the well-written paper and Mr. Villar and Mrs. Suazo for their insightful buff statement. Costa Rica has made significant improvements in converging towards OECD living standards. Over the years, the economy has transformed to a services-oriented one from being an agricultural economy. The per capita income has increased steadily while poverty has declined. Inflation remains well within the target band and foreign reserves have accumulated to a more comfortable level. The financial sector is resilient to shocks, and banks are liquid and well capitalized. However, growth remains below potential and expects to remain subdued in the near term. Unemployment has increased, especially among the youth. Persistent fiscal deficits are leading to an increasing debt to GDP ratio. Going forward, the priority should be on fiscal consolidation, further improvements in monetary and financial sectors, and urgent structural reforms to stimulate inclusive economic growth. We broadly concur with the thrust of the staff appraisal and would like to make following remarks for emphasis.

Timely implementation of fiscal reforms is imperative to restore fiscal sustainability. We note the passing of the Fiscal Reform Bill (FRB) as an important step forward in this regard. The planned adjustments to yield savings of around 4 percent of GDP over 2018-23 will be particularly important in gradually reducing public debt. The approved tax reforms, which will increase the progressivity of the tax system, as well as the expenditure adjustments through curtailing transfers and public sector wage growth also are welcome initiatives. The rising interest bill could be an added challenge, particularly given the sizable financing needs in the near term. We commend the authorities' assurance, expressed in the buff statement, to remain committed to implement planned reforms. Going forward, we encourage the greater consensus building, utilizing the unprecedented cross-party consensus in Congress, on a broad reform agenda. We stress the need for better targeting social spending to protect the poor, given the significant income inequality and rebalancing expenditures towards capital spending to support growth. Also, we concur with staff on the need for a medium-term expenditure framework, consistent with international best practices. Meanwhile, we note the downgrading of the country's sovereign rating by three rating agencies just after the approval of the FRB, citing continued worsening of debt dynamics, and the cautious market reaction to the FRB. Could staff comment on these developments and authorities' subsequent responses to address this situation?

The current monetary policy stance is appropriate to stimulate economic activity, helping to reduce the output gap, given the planned fiscal policy tightening. We agree with staff's recommendation that monetary policy should be data dependent while effectively anchoring inflation expectations. The progress achieved in moving towards inflation targeting regime is commendable. However, remaining measures, such as increasing transparency, should be implemented to improve its effectiveness. At the same time, a balance should be maintained between increasing monetary stimulus and fiscal or monetary concerns that would lead to undue pressures on the macroeconomic stability. We commend the authorities for allowing more flexibility in the exchange rate, which will help the country absorb shocks while fulfilling a pre-requisite for moving to more effective inflation targeting regime. Also, we welcome the bill passed by Congress to enhance CB independence.

We encourage the implementation of remaining FSAP/FSSR recommendations to safeguard the financial system. The gradual adoption of Basel III standards and risk-based supervision will help to strengthen financial sector stability. At the same time, given the high level of credit dollarization and lending to unhedged borrowers, we encourage the implementation of the recommendations made by the MCM TA to identify targeted measures to reduce credit dollarization. We also encourage the authorities to continue their efforts to enhance financial deepening and inclusion.

We commend Costa Rica's progress by becoming a regional leader in attracting FDI. Building on this, we encourage the authorities to continue structural reforms, including those required for OECD accession. In particular, further improvement of business environment and competitiveness remain key priorities to enhance private sector economic activities. We welcome the ongoing reforms, highlighted in the buff statement, to remove red tape, reform the energy sector, expand child care coverage to improve female labor force participation, and strengthen dual education to tackle high youth unemployment which will also help boost potential growth. We note (in footnote 7, p.17) that Costa Rica spends around 7-8 percent of GDP on education, but outcomes are similar to those of Chile, which spends only about half as much. Could staff comment on the reasons to this situation and possible measures to improve efficiency of education spending to ensure that education system provides labor market needs in an effective manner?

With these remarks, we wish Costa Rican authorities all success in their future endeavors.

Mr. Palei and Mr. Tolstikov submitted the following statement:

We thank staff for their informative report and Mr. Villar and Mrs. Suazo for their insightful buff statement. While Costa Rica for many years has been among the best performers in the region, more recently the country has accumulated substantial vulnerabilities in the fiscal area, which led to a severe financing stress in the second half of 2018. Therefore, staff and the authorities appropriately focused the Article IV consultations on strengthening fiscal policies. At the same time, we note the strength of the monetary policy framework, the resilience of the banking sector, as well as well-developed institutions, low corruption and well-educated population. The implementation of the structural reforms program in the context of the OECD accession should boost inclusive growth and competitiveness.

With a weak fiscal position and large near-term refinancing needs, Costa Rica is vulnerable to a sharp tightening of global financial conditions. Medium-term fiscal sustainability is also at risk. Therefore, we welcome the recent approval of the fiscal reform, which included measures on the revenue and spending sides, as well as adoption of the fiscal rule. It is an important step in addressing fiscal vulnerabilities. While the implementation of the fiscal reform can stabilize public debt-to-GDP ratio at about 60 percent of GDP by 2023, we agree with staff that it is still a rather high level for a middle-income country, such as Costa Rica.

Additional structural fiscal measures will enhance the chances of success. Improvements could be made in the efficiency and quality of public spending through enhanced procurement procedures and more effective targeting of social assistance programs. Public debt management should be strengthened to increase efficiency of public debt market and coordination between participating agencies, in line with the recommendations of the Fund TA. The introduction of the medium-term expenditure framework and creation of a fiscal council would underpin the recently approved fiscal rule.

Given low inflation and ongoing growth slowdown, we agree that the slightly accommodative monetary policy stance is appropriate at the current juncture. It is encouraging that Costa Rica’s external position remains relatively strong, and international reserves exceed the reserve adequacy benchmarks. We welcome the authorities' efforts to strengthen the inflation targeting regime, including the recent legislation enhancing the central bank's independence. An increase in the exchange rate flexibility is instrumental in adjusting to volatility in international financial markets. The recent removal of two capital flow management measures is also a step in the right direction.

As evidenced by stress tests, Costa Rica's financial system is well-capitalized and can withstand substantial shocks. Banks are liquid and NPLs are relatively low. At the same time, several vulnerabilities require authorities' attention, including high dollarization, high net foreign liabilities of banks and growing household borrowing. There is also a concern about possible sovereign-bank nexus, since high and rising public debt is largely financed by domestic borrowing.

Despite Costa Rica's favorable positions in global business and development rankings, there is still room to improve business environment and competitiveness. In this regard, we welcome the authorities' efforts to implement the structural reform agenda consistent with the OECD accession roadmap.

With these remarks, we wish the authorities further success.

Mr. Castets and Ms. Albert submitted the following statement:

We thank staff for their insightful set of papers, as well as Mr. Villar and Mrs. Suazo for their informative buff statement. Costa Rica experienced poverty reduction and increase of GDP per capita during the last decade, notably thanks to a well-thought model of ecotourism. Despite this progress, tackling fiscal vulnerabilities to put debt on a more sustainable path is the main challenge. We recognize noticeable efforts made by authorities, especially through the adoption of fiscal reform, and encourage them to take a strong ownership to implement the necessary measures. We also see the need to continue to improve financial resilience, including addressing the risk associated to the high degree of dollarization of the economy. We generally concur with staff's analysis and recommendation and would like to add the following comments:

Outlook and risks

Authorities' commitment to implement reforms will be key to prevent the materialization of existing downside risks. GDP growth is projected to remain moderate, due to fiscal consolidation efforts and tight financial conditions, and should increase gradually to reach its assessed potential of 3.5 percent in 2024. In the meantime, the country remains exposed to several risks, especially a potential lack of implementation of the fiscal consolidation and a new tightening of global financing conditions, which could imply a loss of confidence and hampering growth. The significant recent increase of unemployment rate from 8.7 percent in the second quarter of 2018 to 12 percent in the fourth quarter is also a source of concern. The report underlines the intensification of security risks in the RAM, in connection with developments in Nicaragua. Could staff provide more details on the influence of these developments on Costa Rica, their assumptions in the baseline scenario and their view about the risk of a possible large-scale migration inflow? We are surprised that the main report, doesn't mention (i) the importance of authorities' involvement in clean development, as the country committed to ridding the country of fossil fuels by 2050 and (ii) doesn't give details about the evolution of the tourism activity (ecotourism), a main growth driver. Could staff elaborate on its forecasts for tourism in a context of anticipated slowdown in the United States (main source)? We welcome that the external position is broadly in line with medium term fundamentals and desirable policies. However, borrowing requirements are about 12 percent of GDP in 2019, concentrated in the short term, and the government asked Congress approval to issue 6 billion USD of Eurobonds and financing for multilateral agencies. Could staff provide some details about their scenario regarding the coverage of the financing requirement this year?

Fiscal stance

We urge the authorities to continue to deploy efforts to limit public debt expansion and welcome measures to mitigate the negative impact of fiscal consolidation on the poor. Debt sustainability is at risk considering the rapid deterioration of the fiscal situation which led last year to an overall deficit at 6.0 percent of GDP and a level of central government debt at 53.5 percent. The significant weight of interest payments, with the increase of domestic interest rate on government debt, and the direct purchase of the central bank of 860 M USD last September, the first time since the 1994, are sources of concern. In this context, we welcome the major fiscal reform adopted after nearly two decades of gridlock and encourage a strong ownership of its implementation, which is expected to contribute to savings amounting to 4 percent of GDP by 2023. Reforms to reinforce tax progressivity and efforts to mitigate the negative impact of VAT reform on the poor will contribute to the social acceptability of the adjustment and limit its impact on the poorest. Nonetheless, we note that 2/3 of the fiscal adjustment is based on expenditure cuts and therefore strongly encourage to concentrate the spending cuts to the top three quintiles of the income distribution (cf. Box 2). We share authorities' view about the difficulty of an additional effort about 0.7 percent of GDP, as advocated by staff, which will be complicated in a context of ongoing reforms and potential social contest.

We value the fact that the fiscal rule takes into account vulnerability to natural disasters and also support the establishment of a medium-term expenditure framework and a fiscal council to improve public spending efficiency and debt management (especially the implementation of the recent TA recommendations).

Monetary policy and exchange rate

The management of monetary policy appears appropriate. Inflation has been low and came back into the 2-4 percent target band, with inflation expectations in the upper half of the band because of the recent depreciation of the colón. We welcome the more forward-looking approach as well as the recent bill to improve central bank independence and greater exchange regime flexibility (with a change of the regime classification from crawl-like to "floating") which will help to increase resilience against shocks. We also agree with staff that monetary stance should remain data dependent.

Financial sector

We see room for further progress on dollarization. Stress tests suggest that banks are resilient to shocks, including exchange rate shocks. However, the high dollarization degree of the economy (40 percent of the credit) remains a source of concern. We note the reduction of provisions for granting foreign exchange loans to high risk non-dollar earners last years and consider critical to increase further these provisions. Moreover, the banking sector is highly exposed to sovereign lending and the share of foreign bank funding is high (10 percent of liabilities). These issues deserve to be monitored carefully. Consequently, we urge the authorities to work on it to mitigate the related risks by implementing quickly the FSSR recommendations. Could staff indicate the next authorities' steps to reduce dollarization and bank sovereign exposure risks?

Structural reforms

We encourage the authorities to implement their reform agenda to boost their potential growth and increase inclusiveness. We support them in their OECD accession process. We note the estimated potential growth of 3.5

percent is considered as a conservative assumption both by staff and authorities, and the country is one of the region's most vulnerable countries to long-term fiscal pressures from population aging. We thus see the need to pays attention to design appropriate pension reforms and healthcare spending. As the quality of Costa Rica road is worse than most region except LA6 and SSA, we consider the reduction of infrastructures gaps to improve roads and reduce congestion as a priority. We also share staff recommendation to increase female labor force participation through the expansion of the coverage of the National Child care and Development Network.

Mr. Jin and Ms. Zhao submitted the following statement:

The Costa Rican economy has made great strides converging towards OECD living standards, but growth has recently slowed and macro vulnerabilities—mainly from the weak fiscal position and sizable foreign exchange lending to unhedged borrowers—have risen. In light of the downside risks to the economic outlook, macroeconomic and financial policies should work together to reduce vulnerabilities and structural reforms are also needed to enhance productivity and inclusiveness. We broadly agree with the staff appraisal and would limit our comments to the following for emphasis.

The fiscal reform constitutes a critical step towards restoring fiscal sustainability and improving tax progressivity, with full and timely implementation being the key. The pace of fiscal reform needs to strike a balance between narrowing the fiscal sustainability gap and limiting the adverse impact on growth. Given Costa Rica's low tax revenue compared to other countries in the region, it is desirable to focus fiscal adjustment on raising revenues through measures such as broadening the tax base and raising the VAT rate, while protecting the poor at the same time. On the expenditure side, public spending should be balanced towards growth-friendly capital spending to better support growth and equity.

While the overall banking sector is well-capitalized, further improvements in financial regulation and supervision are warranted. We share staff's concern that a large proportion of foreign currency credit to the nonfinancial private sector goes to unhedged borrowers. We welcome staff's elaboration of the reason behind the borrowers to hedge and encourage further studies on how to mitigate such risk. We also see merit in staff's suggestions to impose additional capital requirements contingent on the expansion of credit to unhedged borrowers.

It is encouraging to note that the central bank has made significant progress to enhance the inflation targeting framework. We welcome the authorities' efforts to increase central bank independence and enhance foreign exchange flexibility. Going forward, we agree that monetary policy need to remain data dependent and balance downside risks to inflation stemming from slower activity and upside risks from a sharp tightening of global financial conditions.

Finally, we concur with staff and the authorities that a broad array of structural reforms are needed to boost competitiveness and inclusiveness, including promoting female labor force participation, addressing weaknesses in transport infrastructure, and enhancing banking sector competition.

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

The Acting Chair (Mr. Furusawa) remarked that Costa Rica had made significant progress in elevating living standards and reducing poverty, and was on track to join the OECD countries. However, while the country had many economic strengths, it faced vulnerabilities, especially on the fiscal side. Directors' gray statements noted that policies and structural reforms should focus on reducing vulnerabilities or enhancing productivity and boosting competitiveness and inclusive growth. In particular, full and timely implementation of fiscal reforms would be important to restore fiscal sustainability.

Ms. Suazo made the following statement:

On behalf of the Costa Rican authorities, I thank Directors for their constructive views and policy recommendations, which have been conveyed to the authorities. I also thank the mission chief, Mr. Balakrishnan, and his team for the constructive engagement with the authorities. Overall, the policy actions suggested by the staff in the fiscal, monetary, financial, and structural reform areas are in line with the authorities' economic policy program, and most of them are already being implemented. Because of the commitment to macroeconomic stability and their full awareness of the country's fiscal vulnerabilities, the authorities took decisive policy actions that led to a major fiscal reform finally enacted by congress in December 2018, after nearly two decades of great luck and notwithstanding a three-month strike of public sector employees. The past reform is balanced and comprehensive as it comprises both revenue and expenditure measures, including caps on compensation and a fiscal rule that ties down expenditure growth. Crucially, the recent fiscal reform removes all legally mandated earmarked spending.

The expected total yield of the reform is estimated at 4 percent of GDP by 2023, which if fully implemented is sufficient to put public debt on a sustainable footing. After passage of the fiscal reform, domestic financing conditions for the government have significantly improved with all of the gross financing needs for the first semester of 2019 already covered so far this year. The Emerging Markets Bond Index (EMBI) spread has tightened faster than for other emerging markets and is currently close to its historic low.

The authorities are committed to full and timely implementation of the fiscal reform. It should be stressed that 4 percent of GDP is already a large adjustment, and the reform was met with considerable opposition and social unrest. It is not politically feasible in the near term to consider additional frontloaded revenue measures as suggested by staff, as it would create uncertainty and tensions in an already strained social fabric. It would also hurt growth. Instead, the authorities are focusing on reforms to public employment, organizational changes to the state, and overall government streamlining.

The authorities are in the process of creating an independent fiscal council to evaluate macro-fiscal assumptions in the budget and medium-term fiscal framework and to verify compliance with the fiscal rule. They are also taking steps to improve debt management, including through Fund technical assistance (TA), which should improve fiscal sustainability through better rollover of expiring debt and lower debt servicing costs. The authorities are willing to consider further adjustment measures contingent on the evolution of the fiscal deficit and of the other fiscal reforms already being evaluated by congress. The inflation targeting framework has been strengthened with monetary policy entirely data driven and forward-looking. Exchange rate policy has become more flexible with a regime now classified by the Fund as floating. A bill passed by congress enhanced the independence of the central bank, and authorities are currently considering scheduling a regular calendar of monetary policy meetings as well as publishing the minutes.

As demonstrated by stress tests and highlighted by the staff, the financial sector is resilient under different shock scenarios. To continue enhancing its resilience, the authorities are implementing an ambitious and comprehensive package of reforms consistent with Financial Sector Stability Review (FSSR) and OECD recommendations. Going forward, the authorities are committed to discourage dollarization through continued exchange rate flexibility and a recalibration of prudential measures. They note that the June 2018 reduction in provisions on dollar loans to unhedged borrowers was adopted following a sharp deceleration of foreign exchange credit and was designed to be temporary. They are currently considering a faster pace, further increasing the provision, and are revising the definition of enhanced borrowers to make it stricter.

The authorities have developed a broad structural reform agenda, including under the OECD accession process, that has broad political support and is on track. The authorities are also working on reforms to remove red tape, reform the energy sector, expand childcare coverage to improve female labor force participation, and strengthen dual education to tackle high youth unemployment. In addition, the government is implementing and planning an ambitious array of already financed projects to improve roads and reduce congestion in the country's road network. These reforms should boost potential growth beyond the current estimate.

Costa Rica's attractive business environment related to policy predictability, strong institutions, and a well-educated workforce will continue making the country a competitive destination for FDI. The external sector is strong with reserves comfortably above adequacy and an expert sector that is dynamic and well diversified in both products and markets. Moreover, as noted by several gray statements, Costa Rica is one of the global leaders in green development as reflected in the authorities' recently launched decarbonization plan.

Mr. Di Tata made the following statement:

The government of Costa Rica recently was able to get approval of an important fiscal reform bill that is expected to yield 4 percentage points of GDP over 2018-2023. However, the staff recommends additional frontloaded tax measures equivalent to 0.75 percent of GDP over 2019-20 to reduce near-term financing pressures. This is politically unfeasible at this stage. If the authorities need to do more, the best way under the current circumstances, if necessary, is to further restrain spending, including by improving efficiency. There is no political space at this stage for submitting another bill to further increase revenue. Submitting another bill could affect the implementation of the fiscal reform bill as well as the passage of other important legislation, including structural reforms.

The authorities agree with the staff that full and timely implementation of the fiscal reform bill is key, and they already indicated that Costa Rica is willing to consider other contingency measures to address the fiscal situation if necessary.

Mr. Alkhareif made the following statement:

We join others in thanking the staff for the excellent work and Ms. Suazo for her informative remarks. We have not issued a gray statement, but we wanted to join others in commending the authorities for their efforts in improving living standards and reducing poverty rates. However, the country faces significant challenges, including on the fiscal side, and therefore we welcome the recent approval of the fiscal reform. Like Ms. Pollard and Mr. Palei, we agree that there is scope to improve the efficiency of public sector spending to rebalance expenditure toward capital spending and more effective targeting of social programs. Also, as highlighted by Mr. Di Tata, we encourage the staff to take into account the political economy when formulating the Fund's advice. On monetary policy, we welcome the more forward-looking approach as well as the recent move to improve the central bank's independence, as highlighted by Mr. Meyer, Mr. Castets, and others.

Finally, we welcome the authorities' efforts to improve the structural reform agenda. Like Mr. Tan, we take positive note of the recent creation of the special legislative committee for OECD accession that aims to foster transparency, efficiency, and growth. With these remarks, we wish the authorities continued success.

Mr. Jin made the following statement:

We thank the staff for the informative report, and we also thank the authorities for their progress made in improving living standards and reducing poverty rates. In light of the downside risks to the economic outlook, we encourage the authorities to make continued efforts to improve fiscal sustainability, reduce risks in the banking sector, and speed up the implementation of structural reforms. We issued a gray statement and want to make additional points.

We note that the persistent large fiscal deficit and the rapidly rising public debt led to severe financing stress in Costa Rica last year, and the central bank had to purchase treasury bills directly from the government. The elevated public debt and the sizeable government financing costs add to the vulnerabilities of the Costa Rican economy. We tried to examine the structure of the external debt, and we found that most of the external public debt comes from the traditional creditors, official creditors, and the staff's confirmation is welcome. In this regard, we believe it is the common responsibility of both traditional creditors and non-traditional creditors to ensure the external sustainability of developing countries. With these remarks, we wish the authorities every success in their future endeavors.

Mr. Coronel made the following statement:

We issued a gray statement, but we have two questions and one comment. The first question concerns the labor participation rate. We notice that it has increased in the last few years, and we would like to hear the staff's comments regarding female labor participation. Has it increased in tandem with male labor force participation?

The second question is regarding the migration dynamics with Nicaragua, and we would like to know how that affects Costa Rica's labor statistics. There is seasonal migration that comes in in waves to harvest the crops. There is also semi-permanent migration, for which the cycle is a little longer, and there is permanent migration. We would like to understand that regional phenomenon better.

Our comment is also in line with those of Mr. Di Tata and Mr. Mouminah. We also would like to ask the staff to exercise caution when it comes to advice on additional adjustments in Costa Rica. Social tensions remain and the political consensus is still fragile. As we mention in our gray statement, we believe that the recommendations at some point could become a practical option, but we should not let the perfect be the enemy of the good.

The staff representative from the Western Hemisphere Department (Mr. Balakrishnan), in response to questions and comments from Executive Directors, made the following statement:[1]

I thank Directors for their insightful gray statements and questions, to which we have provided written answers. I would also like to thank the Costa Rican authorities for the open nature of the discussions we had in San Jose and for the great hospitality. We also met with parties across the political spectrum, various committees in congress, the special committee regarding OECD accession, the budget committee, as well as labor unions. Overall, it was a productive and rich Article IV consultation.

As Ms. Suazo mentioned, the authorities and the staff agree on many of the policy priorities, and their economic policy program for 2019-2022 is ambitious and focuses on many of the right areas. The key, as always, in all

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

countries is turning these plans into concrete and credible actions, and we will be watching that closely.

Let me expand on two themes which have been raised in the gray statements. First, on the coverage of topics in the Article IV consultation this time around, in every Article IV consultation, there are many topics to cover, and we need to prioritize carefully. Given the developments over the last year and in previous years, there was a clear need to focus on core fiscal and financial issues for this consultation. Other structural issues are important, not just climate change adaptation, but also competitiveness, pension reform, and inequality, which is higher than in any other country in the OECD. Many of these issues, however, are slow moving and so we will focus on them in future Article IV discussions.

Let me turn to the issue of the composition and timing of the additional fiscal adjustment. Our recommendation is for additional frontloaded fiscal adjustment underpinned by well-designed revenue measures. This is predicated on the desirability of rebuilding fiscal space to manage potential shocks, such as climate change, and also major contingent liabilities. An example of the latter are pension labilities. These were analyzed in the 2017 consultation and Western Hemisphere Department's 2018 departmental paper, which estimates that Costa Rica has one of the largest fiscal gaps in the region when it comes to pension contingent liabilities. That was part of the reasoning for the recommendation.

It is true that the government has made a significant effort, and passing the fiscal reform was a critical step to restoring fiscal sustainability, and there was a three-month strike. They have used a significant amount of political capital in that. We are very aware of the political environment. It is also true that the external financial environment has somewhat eased in recent months given changes in expectations regarding future Fed hikes. Indeed, Costa Rica's EMBI spread currently stands at around 440 basis points, 443 was yesterday's reading. This is a significant decline relative to the peak last year, 570 basis points, but it is still high, even by historical standards. It is not a low EMBI spread. Global financial conditions could quickly tighten considerably depending on how the U.S. outlook evolves and future Fed decisions. Moreover, gross financing needs will remain high for the foreseeable future, above 10 percent of GDP.

Given all this, additional adjustment in 2019-2020 would be prudent. What is the best way to achieve this? We fully agree that the government has to decide what is politically feasible and when. We are not being specific about timing at all. Our general recommendation is that the additional frontloading, whenever it takes place, would be helpful in reducing debt and financing pressures, and it would be prudent given that the global financial conditions cycle could easily turn. Moreover, at three-quarters of a percent of GDP, the recommended adjustment is not large, and as noted in our written responses, various revenue measures could achieve it and would provide an additional major signal to markets of strong commitment to safeguarding fiscal sustainability.

We totally agree that the government has to take into account the political environment and decide whether it is necessary or not. We believe it will still be prudent given that debt will continue to rise until 2023 to around 62 percent of GDP, and that the fiscal reform is largely spending-based and also backloaded.

In response to Mr. Coronel’s question on labor force participation, there was a significant increase in labor force participation in Q4 last year. I do not have the data on female labor force participation, what happened in the last few quarters, but that was a big reason behind the increase in overall unemployment and youth unemployment.

We will have to respond bilaterally on the more detailed question of trends in recent years. What is true is that there is still a significant gender gap in Costa Rica. There has been significant progress over the years, but in comparison to other OECD countries, there is scope to take additional measures. I know they are working on various measures when it comes to childcare.

On migration, and the question about seasonal migration and structural migration, there has been a significant increase in migration to Costa Rica, both economic and refugees in recent times. I would say that we are studying in more detail the spillovers from Nicaragua to the region as a whole, so that is a work in progress, but it is something we are focusing on. As of now, we put it as a risk in the risk assessment matrix, but we will be following closely the impact of migration on Costa Rica’s labor market and also whether additional fiscal resources are needed to deal with the migrants.

There was one other question from Mr. Jin on the composition of the external debt. It is true the data is not comprehensive in the sense that we have data on who bought the initial bonds, not the ultimate holders now, and we also have data from the Coordinated Portfolio Investment Survey on public and private debt, but it is not comprehensive. What it clearly shows is that the vast majority of the holdings are in the United States and in Europe.

Mr. Coronel recommended that, for the next Article IV consultation, the staff focus on the issues he raised on labor force participation and migrants from Nicaragua.

Mr. Di Tata made the following statement:

We agree that the additional measures might be necessary. My question is why the staff insists on another bill for additional revenue measures that the authorities are saying that is politically unfeasible at this stage? Why not consider other measures that do not need congressional approval, including further spending restraint if necessary?

We are not saying that Costa Rica does not need to consider additional revenue measures. In fact, it does. But at this stage, this could generate additional social unrest and could complicate the approval of other reforms. Because the adjustment is not large, why not consider the possibility of other measures? The implementation of the fiscal reform bill could be put in danger if another bill is submitted to congress for additional revenue measures.

Mr. Meyer made the following statement:

Our chair indicated some sympathy for Mr. Villar’s and Mrs. Suazo’s call for a somewhat more balanced overall assessment of the current situation, especially with regard to fiscal policy.

I thought that the answer given by the staff was quite convincing in that there was no disregarding the political situation, but as I understood it, the staff is trying to show possible alternatives, time tables. In terms of substance, as Mr. Di Tata mentioned, going forward, more has to be done to move to a more sustainable situation. Maybe it was not as clear in the document, but I thought the staff did a convincing job in presenting the discussions on the fiscal topic, and I wanted to thank the staff for that.

We were struggling when we drafted our gray statement on how to position ourselves with the spreads, with the market reaction to this important reform being so muted. We thought that the staff’s response in the Board was quite helpful in understanding, and going forward, one has to observe the situation and then find the right timing in terms of the political context. When is the right timing to do more measures?

The staff representative from the Western Hemisphere Department (Mr. Balakrishnan), in response to further questions and comments from Executive Directors, made the following additional statement:

> To follow up on the composition issue, it is a good discussion to have. It is not an easy discussion. The only additional point I would make is that the spending measures are not easy. They were backloaded for a reason. Spending has traditionally been quite inflexible in Costa Rica. The measures they took were substantial, but they are also kicked in in the outer years, so there is already implementation risk around that.
>
> With regard to the additional spending measures, tackling wages and tackling transfers are additional measures one can identify. Can one get significant yields in the short term from those measures? For example, the public employment reform, that will not deliver savings in the short term. Most estimates show that could potentially increase spending in the short term, and if it is credible and comprehensive, could lead to efficiency savings in the long run. That is the only point I will make about the spending side. There already is a significant adjustment on the spending side, and it will not be easy. It has led to social unrest, and additional spending measures could exacerbate that situation as well.

Ms. Suazo, in a brief concluding statement, thanked Directors for their views and policy recommendations.

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

The following summing up was issued:

> Executive Directors agreed with the thrust of the staff appraisal. They commended Costa Rica for the significant progress made in improving living standards and reducing poverty. Directors noted that while the medium-term outlook is generally positive, it faces downside risks. Directors encouraged the authorities to continue their efforts to address fiscal and financial vulnerabilities, strengthen the economy’s resilience, and advance structural reforms to foster inclusive growth.

Directors commended the recent fiscal reform, which is important for restoring fiscal sustainability. They called for full and timely implementation of the fiscal reform to improve market confidence and rebuild fiscal space to manage potential shocks and major contingent liabilities, especially pensions. While being mindful of the current political constraints, Directors generally considered that further front-loaded measures might be needed to reduce financing pressures and improve debt dynamics. Directors underscored that given the relatively low tax-to-GDP ratio, any further adjustment, if needed, should be underpinned by well-designed revenue measures while protecting the poor. To allow fiscal policy to better contribute to growth and equity, they highlighted the importance of improving public spending efficiency and debt management, ensuring better targeting of social assistance, and implementing a medium-term expenditure framework and fiscal council.

Directors welcomed the passage of the bill safeguarding the central bank independence and greater foreign exchange flexibility. They considered that monetary policy should continue to remain data dependent and balance downside risks to inflation stemming from slower activity and upside risks to inflation arising from tighter global financial conditions. Directors noted that transparency could be further improved by publishing the calendar of monetary policy meetings and their corresponding meeting minutes, helping further anchor inflation expectations.

Directors observed that the banking system is sufficiently well-capitalized to absorb shocks. They saw need for continued efforts to monitor and tackle financial vulnerabilities related to high dollarization, sizable net foreign liabilities of banks, sharply growing household borrowing, and significant sovereign exposure. Directors welcomed the authorities' plans to push ahead with the FSAP/ FSSR recommendations and encouraged their rapid implementation and adoption of Basel III standards.

Directors welcomed the authorities' efforts to implement structural reforms in line with the OECD accession process, to boost competitiveness and inclusive growth, and to continue pursuing green development and the objectives of the Paris Agreement. They viewed promoting female labor force participation, tackling youth unemployment, and addressing weaknesses in transport infrastructure as key priorities. Directors supported the OECD's recommendation to undertake an in-depth review of key sectors (e.g. electricity) exempted from the competition law, and measures to increase banking competition and reduce high interest rate spreads.

It is expected that the next Article IV consultation with Costa Rica will be held on the standard 12-month cycle.

APPROVAL: April 22, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. ***Could staff elaborate on the political situation and its view that there is "potential for further social unrest"?***

- The President's party, Partido Acción Ciudadana (PAC), has only ten seats in Congress (out of 57). This, combined with the nine seats held by its partner in government, the center-right Partido Unidad Social Cristiana (PUSC), still falls short of a simple majority (29 seats). PAC and PUSC have received ad-hoc support from the center-left Partido Liberación Nacional (PLN, 17 seats), for example for approval of the fiscal reform last December. However, the three parties altogether hold only 36 seats in the Assembly, less than the qualified majority of 38 seats needed to approve major legislation (e.g. the bill authorizing issuance of Eurobonds).
- Costa Rica has a renowned tradition of vibrant democracy and freedom of expression. The three-month public sector strike against the fiscal reform bill last year was the longest strike in Costa Rican history. As the spending cuts under the fiscal reform start to bite and more difficult reforms advance (e.g., the planned reform of public employment), more strikes are certainly possible. Moreover, earlier this month, the Court, public universities, and the Caja (the public pension fund) publicly claimed that they should be excluded from the wage cuts required under the fiscal reform. Indeed, the public universities announced that they will sue the government in courts to defend their salary benefits.

2. ***The report underlines the intensification of security risks in the RAM, in connection with developments in Nicaragua. Could staff provide more details on the influence of these developments on Costa Rica, their assumptions in the baseline scenario and their view about the risk of a possible large-scale migration inflow?***

- While Nicaragua is a relatively small trading partner for Costa Rica (representing less than 5 percent of total exports and about 1 percent of total imports), it is an important thoroughfare for regional trade, particularly with the Northern Triangle. The authorities estimate that the situation in Nicaragua reduced real GDP growth in 2018 by 0.2 percentage points given its negative impact on trade flows.
- A deterioration of the situation in Nicaragua could lead to large migration inflows to Costa Rica. According to United Nations data, there are 42,000 Nicaraguan refugees in Costa Rica, of which 23,000 officially applied for asylum in 2018. Before the

conflict in Nicaragua, Costa Rica only received on average about 50 asylum applications per year from Nicaraguan citizens. Costa Rica is required to provide food, housing, medical assistance and other services to incoming refugees. While the Costa Rican government has a comprehensive plan of assistance for migrants already in place, the available current budget allocation may not be enough to cover the extraordinarily large migrant flows observed since mid-2018. The government is working with NGOs to collect additional resources.

Fiscal Policy

3. ***Considering the high dollarization of the financial system, staff's comments on the pros and cons of the planned Eurobond issuance are welcome.***

- The main con of Eurobond issuance is that it increases the share of dollar-denominated debt, and thus the exposure to FX risks. However, without the Eurobond issuance, the Central Government would still issue debt in US dollars in the domestic market (around 27 percent of domestic sovereign debt is in dollars). And these domestic issuances would likely be at higher interest rates and shorter maturities. For example, recent (March 4, 2019) issuances of dollar-denominated debt in the domestic market at 5 and 7 years had rates of 9.0 and 9.6 percent, respectively. Based on current 10-year Treasury bond rates and a decline in the EMBI spread of about 100 bps since end-2018 (in line with spread compression for other EMs), as well as conversations with investors, Costa Rica could well issue a Eurobond of 10-year maturity at around 7 percent. Moreover, issuance in Eurobonds has historically led to a significant decline in local currency rates. Hence, issuing in Eurobonds would likely significantly improve the debt profile and lower interest rates relative to issuing in local markets.

4. ***Going forward, revenue-based measures and public financial management reform are warranted to sustain the fiscal adjustment. Given the upcoming election, we wonder whether the fiscal consolidation strategy advised by staff is feasible. What would be the second-best solution?***

5. ***Staff recommends additional front-loaded fiscal measures. As the authorities consider that further tax measures do not seem politically feasible this year, we would welcome staff comments on whether the authorities should instead focus on spending measures.***

6. ***However, the authorities believe that further tax measures do not seem politically feasible this year, following the recent passage of the fiscal reform bill. They would consider additional tax measures depending on the evolution of the fiscal deficit and believe that near-term pressures might be eased with legislative authorization***

for multilateral loans and Eurobond placements. We would appreciate staff's comments on the authorities' approach.

- Given that 60 percent of the total adjustment of the fiscal reform is on the spending side, implementation risks associated with the fiscal rule, and the low level of the tax-to-GDP ratio, staff still believe that the additional recommended adjustment of ¾ percent of GDP should be achieved by adopting well-designed revenue measures. Since the adjustment is small, it can be achieved in a variety of different ways depending on what is politically feasible. For example, raising excise taxes alone could yield a significant chunk of the necessary adjustment. And raising the VAT rate from 13 to 15 percent would likely yield more than is needed (around 1 percent of GDP). The government could also consider the sale of public assets to complement a primary balance adjustment.

7. ***Meanwhile, we note the downgrading of the country's sovereign rating by three rating agencies just after the approval of the FRB, citing continued worsening of debt dynamics, and the cautious market reaction to the FRB. Could staff comment on these developments and authorities' subsequent responses to address this situation?***

- The fiscal reform bill was passed on December 4 2018. The credit rating agencies downgraded Costa Rica's credit ratings on December 5 2018 (Moody's, from Ba2 to B1), December 21 2018 (S&P, from BB- to B+) and January 15 2019 (Fitch, from BB to B+).
- The agencies welcomed the passage of the fiscal reform but cited persistently high fiscal deficits, high-near term financing needs, and still rising debt that would be above the level of peer countries. According to many investors, the downgrades were not a surprise and some considered them overdue.
- As noted in the staff report, the authorities are working on a broad array of measures apart from the fiscal reform and have made sustained efforts in recent months to secure domestic financing at longer maturities.

8. ***We welcome that the external position is broadly in line with medium term fundamentals and desirable policies. However, borrowing requirements are about 12 percent of GDP in 2019, concentrated in the short term, and the government asked Congress approval to issue 6 billion USD of Eurobonds and financing for multilateral agencies. Could staff provide some details about their scenario regarding the coverage of the financing requirement this year?***

- The gross financing needs of 2019 are 12 percent of GDP. The planned coverage of these needs, based on discussions with the authorities, is the following:

	Percent of GDP
Public gross financing needs	**12.0**
Fiscal deficit	5.8
Debt amortizations	6.2
Domestic	6.1
External	0.2
Sources of funds	**12.0**
Domestic bond placements	7.5
External	4.5
Bond placements	2.5
Bilateral	0.1
Multilateral	2.0

Monetary policy and the external sector

9. ***We note that according to staff's assessment, Costa Rica's external position is broadly in line with fundamentals and desirable policies. Considering staff's call for a front-loaded fiscal adjustment, we welcome further comments on the desirable policy settings in the EBA CA model and their impact on the model's results.***

- The multilaterally consistent external balance assessment (EBA) CA model suggests a modest CA gap of 0.8 percent of GDP for 2018, implying that the external position is broadly in line with medium-term fundamentals and desirable policies. The policy gap for Costa Rica suggested by the model is small and is largely explained by the 2018 overall fiscal deficit being higher the desired medium-term deficit under the adjustment scenario.

10. ***Could staff elaborate on its forecasts for tourism in a context of anticipated slowdown in the United States (main source)?***

- Travel and tourism exports—estimated at 6½ percent of GDP in 2018—accounted for about 40 percent of total services exports and 20 percent of total exports. The total contribution of travel and tourism to GDP, including activities directly and indirectly supported by the industry, amounted to about 13 percent of GDP.
- Over the past decade, the industry has been diversifying into business trips, health and medical tourism, and studying aboard. While vacationing continues to be the single largest slice of the tourism revenue (64 percent), the rest is now divided among business trips (15 percent), health or medical tourism (13 percent), and studying in

the country (8 percent). In addition, there has been a growing share of tourists and travelers to Costa Rica from Europe (18 percent of total).

- Going forward, travel/tourism exports are expected to stay around the same level, as share of GDP, supported by a weaker colón, still robust—albeit moderating—US demand, and the ongoing diversification into business, medical services, and education trips as well as into other markets.

Financial sector

11. ***The authorities' reliance on domestic markets for public sector financing needs has left the banking sector highly exposed to sovereign lending. Could staff provide more details on what percent of total credit is going to the public sector?***

- As of December 2018, net credit to the central government accounts for 8.2 percent of total domestic credit. As a share of GDP, it's less than 7 percent and not the highest in the region (see Figure 4 of the Staff Report).

12. ***At the same time, vulnerabilities stemming from high dollarization and high sovereign exposure continue to exist. In this vein, we were surprised to read that measures introduced by CONASSIF in June 2018 to relax FX lending requirements were adopted shortly after the MCM mission providing Technical Assistance aimed at reducing credit dollarization, and recalibrating macroprudential regulations that encourage de-dollarization. Staff's comments are welcome.***

- The measures passed by CONASSIF in June 2018 were in response to the recent slowdown in credit growth. While the measures that reduce the provisions for granting FX loans to unhedged borrowers will be reversed by June 2020, the other measures (that implicitly lowered weights attached to unhedged borrowers in the calculation of capital requirements) are permanent. To promote de-dollarization, staff recommend the authorities to reverse all the June 2018 measures (see Paragraph 24, bullet 1). To promote credit growth, the authorities could instead use measures that aim at promoting credit denominated in domestic currency.

13. ***We welcome the efforts under way to implement a comprehensive package of reforms consistent with FSSR and OECD recommendations and to adopt a risk-based supervision approach in all four superintendencies. We also take positive note of the draft bills submitted to Congress in March 2018, as well as the bill to strengthen consolidated supervision to be submitted in early April. Could staff comment on the characteristics of the bill being prepared to introduce deposit insurance and strengthen bank resolution?***

- The bill on deposit insurance and bank resolution is still under preparation and staff has not yet seen the draft. Based on mission discussions, the current draft of the deposit insurance bill has two separate buckets for: (i) public banks, and (ii) private banks and other entities. Of course, details may change significantly before the bill is finalized and sent to Congress.
- While rapid approval of the planned law as it currently stands would be a positive first step, to promote a more level-playing field for all banks, staff also recommend rolling back the blanket guarantee for deposits in state-owned banks.

14. ***We found Annex III very interesting, with a detailed description of the financial industry's composition. The size of the cooperative sector (10 percent of total assets of the system) caught our attention. We would appreciate staff's clarification on whether cooperatives are subject to similar regulation and supervision requirements to those applied to banks.***

- The financial cooperatives mentioned in Annex III are supervised by SUGEF, although they are governed by a different law. Same as banks, cooperatives are subject to the 15 percent reserve requirements and 10 percent capital adequacy ratio.

15. ***Could staff indicate the next authorities' steps to reduce dollarization and bank sovereign exposure risks?***

- To reduce dollarization, staff recommend reversing all the June 2018 measures and encourage prompt and effective implementation of the FSSR recommendations, including the ones mentioned in Paragraph 24 and in Annex IV. To reduce banks' sovereign exposure risks, staff recommend full implementation of the fiscal reform and additional front-loaded measures to contain government borrowing (Paragraphs 13-16), and timely approval of the Eurobond issuances to relieve pressures on domestic capital markets.

16. ***We share staff's concern that a large proportion of foreign currency credit to the nonfinancial private sector goes to unhedged borrowers. We welcome staff's elaboration of the reason behind the borrowers to hedge and encourage further studies on how to mitigate such risk.***

- Many non-dollar earners still prefer borrowing in FX because of the lower interest rates and the general perception of low exchange rate volatility.

Structural issues and climate changes

17. ***We note (in footnote 7, p.17) that Costa Rica spends around 7-8 percent of GDP on education, but outcomes are similar to those of Chile, which spends only about half***

as much. Could staff comment on the reasons to this situation and possible measures to improve efficiency of education spending to ensure that education system provides labor market needs in an effective manner?

- Costa Rica's public spending on education has increased significantly over the past decade from 5 percent of GDP in 2008 to about 8 percent in 2018, surpassing the level in most OECD countries and well above the Latin America average of about 5 percent of GDP. The dramatic increase was largely due to the recent spending increases that were used mainly for increases in teachers' salaries, which are now elevated by international standards. However, this has not translated much into improvements in educational outcomes, suggesting significant scope for improving efficiency.
- To improve efficiency and educational outcomes, Costa Rica should use more results-based financing, strengthen leadership at all levels of the education system, improve evaluation mechanisms, and enhance accountability for teachers and institutions. Reinforcing the vocational technical track would also contribute to reducing drop-outs at the secondary level and tackle high youth unemployment.

18. ***Costa Rica should be commended for their model of sustainable development and climate change adaption. With nearly all of its electricity generated from renewable sources, and the initiative and steps made to decarbonize the transportation sector, the authorities and people of Costa Rica have proven to be among the global leaders in green development and pursuing the objectives of the Paris agreement. For countries that are highly vulnerable to natural disasters and climate change, these issues should be more prominently covered in Article IV reports. Staff's comments why this report is entirely void of climate change actions are welcome.***

19. ***We note on the Risk Assessment Matrix that adverse climate conditions are a high risk for Costa Rica. However, the report did not discuss the need to strengthen ex-ante resilience. Was this an issue that was discussed with the authorities and do they have plans to address it?***

20. ***In this vein, we appreciate the country's ambition and demonstrated global leadership in clean development and pursuing the objectives of the Paris agreement. Given the prominence of this issue in the country, as also reflected in the government's recently released "Decarbonization Plan" and the hosting of the pre-COP25 meeting later this year, we are wondering why any reference to it was curiously absent from the document.***

- Staff did cover climate change issues in detail during the last Article IV Consultation, producing a SIP on Climate Change, Environmental Policies and Output Trade-Offs. [2]

[2] https://www.imf.org/en/Publications/CR/Issues/2017/06/27/Costa-Rica-Selected-Issues-and-Analytical-Notes-44992. For this year's Consultation, given the fiscal and financing stresses Costa Rica faced in 2018 and the passage of the fiscal reform, the focus was on taking a deep dive into core fiscal and financial issues. We also included some detailed distributional analysis of the fiscal reform given the potential impact on poverty and inequality. In future Consultations, we will likely return to covering broader structural issues in more detail, including climate change adaption.