



# COSTA RICA

April 2019

## 2019 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR COSTA RICA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2019 Article IV consultation with Costa Rica, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its March 27 consideration of the staff report that concluded the Article IV consultation with Costa Rica.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 27, following discussions that ended on February 26, with the officials of Costa Rica on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 12, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Costa Rica.

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### **IMF Executive Board Concludes 2019 Article IV Consultation with Costa Rica**

On March 27, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation<sup>1</sup> with Costa Rica.

Costa Rica has made great strides converging towards OECD living standards, and its accession process to the OECD was opened in 2015. Moreover, over the last four decades the export sector has transformed itself from being agricultural-based to high-value-added manufacturing and service-oriented, helped by trade openness and strong FDI inflows. Nevertheless, unemployment and income inequality remain elevated, and the persistently high fiscal deficit and rapidly rising public debt continue to pose vulnerabilities. The new government recognizes the challenges and passed a fiscal reform bill—after nearly two decades of gridlock—into law last December. It is also planning a broad array of reforms, including those required for OECD accession.

Reflecting the impact of a public-sector strike against the fiscal reform, developments in Nicaragua, tighter global and domestic financial conditions, and the uncertainty surrounding the fiscal reform that eroded consumer confidence, growth slowed markedly in 2018 to 2¾ percent, falling below potential and closing the output gap. Inflation remains low, and inflation expectations are converging toward the mid-point of the target range. External sector performance continues to be solid. The banking system is sufficiently well-capitalized to absorb sizable shocks.

Fiscal consolidation and tight financial conditions are expected to keep growth moderate in 2019-20 (around 2¾-3 percent), notwithstanding a pickup in public investment, base effects associated with the 2018 public-sector strike, and improving terms of trade. In the medium term, positive confidence effects and progress with structural reforms, including those related to OECD accession, should lower risk premia and boost investment, pushing growth up towards its potential of 3½ percent. Inflation is expected to remain within the target range. Despite the fiscal reform, the government faces sizable financing needs in the near term and central government debt is expected to reach above 60 percent of GDP in 2023, after which it will gradually decline.

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

The outlook is subject to downside risks, including partial implementation of the fiscal reform, an escalation of global trade tensions, and a sharp tightening of global financial conditions.

### **Executive Board Assessment<sup>2</sup>**

Directors 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.

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<sup>2</sup> At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summing up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

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.

## Costa Rica: Selected Social and Economic Indicators

I. Social Indicators						
Population (2018, millions)	5.0	Human Development Index Rank (2018)	63 (out of 188)			
Per capita GDP (2018, U.S. dollars)	12,570	Life expectancy (2017, years)	79.6			
Unemployment (2018, percent of labor force)	12.0	Literacy rate (2018, percent of people ages >15)	96.7			
Poverty (2018, percent of population)	21.1	Ratio of girls to boys in primary and secondary education (2018, percent)	101.4			
Income share held by highest 10 percent of households	37.3	Gini coefficient (2017)	51.4			
Income share held by lowest 10 percent of households	1.5					
II. Economic Indicators						
	2015	2016	2017	2018 <sup>e</sup>	2019	2020
	Proj.					
	(Annual percentage change, unless otherwise indicated)					
<b>Output and Prices</b>						
Real GDP growth	3.6	4.2	3.4	2.7	2.9	2.8
Output gap (percent of potential GDP)	-0.2	0.6	0.6	0.2	-0.1	-0.5
GDP deflator	3.8	2.0	2.5	2.4	3.7	3.0
Consumer prices (end of period)	-0.8	0.8	2.6	2.0	3.2	3.0
<b>Money and Credit</b>						
Monetary base	9.2	6.4	10.8	2.3	5.5	5.8
Broad money	10.7	7.5	8.6	5.0	6.9	6.9
Credit to private sector	11.8	12.8	8.5	6.2	7.0	7.3
Monetary policy rate (percent; end of period)	2.3	1.8	4.8	5.3	...	...
Exchange rate (national currency per U.S. dollar, average)	528	538	563	588	...	...
REER	119	117	112	107	...	...
	(In percent of GDP, unless otherwise indicated)					
<b>Savings and Investment</b>						
Gross domestic investment	18.4	18.4	18.8	17.5	17.6	17.9
Gross domestic savings	15.0	16.2	15.8	14.3	14.3	14.6
<b>External Sector</b>						
Current account balance	-3.5	-2.2	-3.0	-3.2	-3.2	-3.3
<i>Of which:</i> Trade balance	-8.3	-7.7	-7.4	-7.7	-7.5	-7.4
Financial and capital account balance	-4.7	-2.5	-3.6	-3.0	-3.1	-3.2
<i>Of which:</i> Foreign direct investment	-4.6	-3.7	-4.4	-4.1	-4.2	-4.3
Change in net international reserves (increase +)	622	-260	-424	345	1,005	-305
Net international reserves (millions of U.S. dollars)	7,834	7,574	7,150	7,495	8,500	8,195
Net international reserves (months of next year's imports)	5.2	4.8	4.4	4.5	4.9	4.5
<b>Public Finances</b>						
Central government primary balance	-3.0	-2.4	-3.0	-2.4	-1.8	-0.9
Central government overall balance	-5.6	-5.3	-6.2	-6.0	-5.8	-5.1
Central government debt	40.9	44.9	48.6	53.5	56.2	58.3
Consolidated public sector overall balance 1/	-5.8	-4.7	-5.4	-5.2	-4.8	-4.5
Consolidated public sector debt 2/	45.4	49.8	50.8	56.0	57.4	58.6
<i>Of which:</i> External public debt	11.3	11.3	10.9	12.9	16.5	18.4
<b>Memorandum Item:</b>						
GDP (US\$ billions)	55.4	57.8	58.7	59.0	60.5	63.5
Sources: Central Bank of Costa Rica, Ministry of Finance, and Fund staff estimates.						
e - Estimated figures.						
1/ The consolidated public sector balance comprises the central government, decentralized government entities, public enterprises, and the central bank, but excludes the Instituto Costarricense de Electricidad (ICE).						
2/ The consolidated public debt nets out central government and central bank debt held by the Caja Costarricense del Seguro Social (social security agency) and other entities of the nonfinancial public sector.						



# COSTA RICA

## STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

March 12, 2019

### KEY ISSUES

**Context.** Costa Rica has made great strides converging towards OECD living standards, but significant vulnerabilities persist, mainly from the weak fiscal position and sizable FX lending to unhedged borrowers. Growth slowed markedly in 2018, reflecting multiple shocks buffeting the country. The new government recognizes the challenges and passed a fiscal reform bill—something in the works for nearly two decades—into law last December.

**Focus of Consultation.** The Consultation focused on policies that would help restore fiscal sustainability, strengthen the inflation targeting framework, enhance resilience of the financial system, and boost potential and inclusive growth.

#### Key Policy Messages:

- The fiscal reform constitutes a critical step towards restoring fiscal sustainability, but full and timely implementation is key. Further frontloaded fiscal consolidation, based largely on revenue measures, should be implemented to further reduce debt and financing pressures, while taking measures to protect the poor. Additional efforts to reduce revenue earmarking, improve spending efficiency and quality, and strengthen institutions (e.g. introducing a medium-term expenditure framework and a fiscal council) are also needed.
- 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. The passage of the bill safeguarding the independence of the Central Bank and greater FX flexibility since September 2018 are welcome. Transparency of monetary policy could be further improved by publishing the calendar of monetary policy meetings and their corresponding meeting minutes, helping further anchor inflation expectations.
- Plans to act upon high/medium priority FSSR recommendations—e.g., enacting deposit insurance and consolidated banking supervision laws—should be realized.
- Structural reforms, including those planned under the OECD accession process, should be implemented to improve competitiveness and foster inclusive growth.

Approved by:  
**K. Srinivasan (WHD)**  
**and Y. Sun (SPR)**

Discussions took place in San Jose during February 12-26, 2019. The staff team comprised Ravi Balakrishnan (head), Nan Geng, Fabio Di Vittorio, Ana Lariau, and Jasmin Sin (all WHD); and Eduardo Olaberria (World Bank). Gerardo Peraza, Regional Resident Representative, and Ms. Suazo (OED) also participated in the meetings. Carolina Friend and Cristhian Vera Avellan (WHD) provided assistance from headquarters. Staff met with Head of the Economic Cabinet Edna Camacho, Central Bank Governor Rodrigo Cubero, Finance Minister Rocío Aguilar, members of Congress, other senior government officials, representatives of the financial and private sectors, and labor unions.

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## CONTEXT

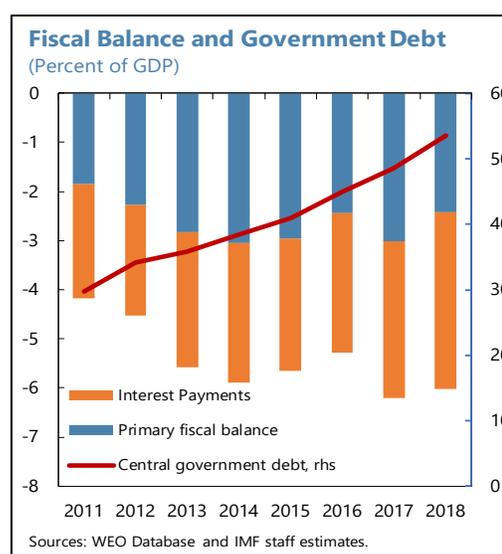
**1. Costa Rica has made great strides converging towards OECD living standards, but significant fiscal vulnerabilities persist.** GDP per capita (PPP terms) increased from 1/3 of the OECD average in 2006 to 40 percent in 2016, while the poverty rate declined from 23 to 20 percent. At the same time, the economy has transformed itself from being agricultural-based to service-oriented, and Costa Rica's accession process to the OECD was opened in 2015. However, unemployment remains elevated, especially amongst youths (30 percent), and in contrast to the general declining trend in Latin America income inequality is stubbornly high. Fiscal deficits have also been persistently large since the Great Recession, undermining fiscal sustainability. Sizable FX lending to unhedged borrowers remains the key financial sector vulnerability.

**2. The new government recognizes the challenges and is planning a broad array of measures, although the political and social environment remains difficult.** After facing off a three-month public sector strike, the new government passed a fiscal reform bill—something in the works for nearly two decades—into law in December 2018. It is also seeking congressional approval to issue Eurobonds and planning reforms of public employment, tax expenditures, and public administration, with draft bills scheduled to be sent to Congress in 2019H1. To boost competitiveness and employment, the government is working on a series of reforms, some of which come under the OECD accession process and facilitated by a special OECD committee created in Congress. The fiscal reform contains sizable spending cuts, however, the government faces significant tests given municipal elections in January 2020 and potential for further social unrest. The authorities' policy actions have been broadly consistent with past Fund advice (Annex I).

## RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

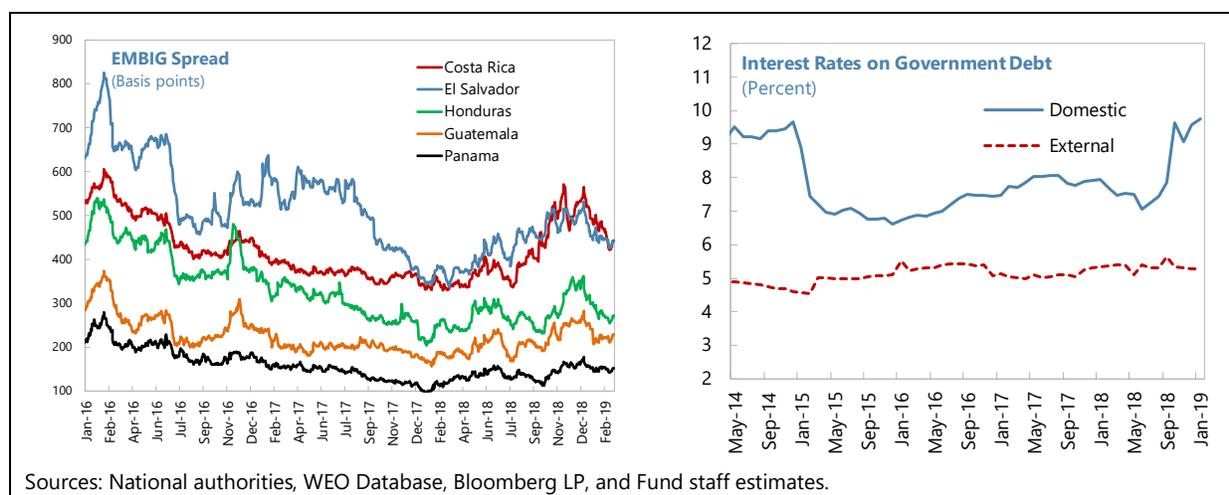
### A. Recent Developments

**3. In the context of a more challenging external financing environment, persistently large fiscal deficits and rapidly rising public debt led to severe financing stress in 2018H2** (Chart). The overall fiscal deficit narrowed slightly in 2018 to 6.0 percent of GDP, helped by expenditure restraint and income from a tax amnesty. This was partly offset by lower tax revenues and a rising interest bill. Public debt continued to rise rapidly, reaching 53½ percent of GDP at end-2018. Reflecting financing strains, the central bank purchased US\$860 million of treasury bills directly from the government in September 2018, something not done since the 1994 crisis. This was followed by a failed debt auction with a low participation in domestic

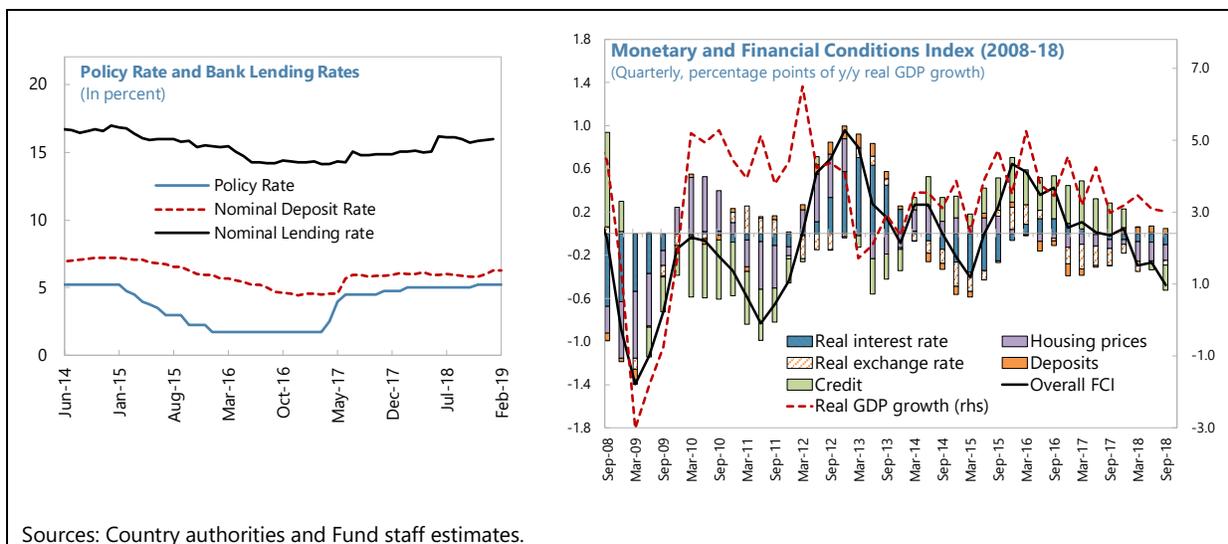


debt swaps in October. As a result, spreads on external bonds spiked to the highest in Central America in mid-November (571 basis points; Chart).

**4. The fiscal reform bill finally got passed into law on December 3, but market reaction has been cautious and financing costs remain high.** The reform—which includes the conversion of the sales tax into a value added tax (VAT), higher income taxes, wage restraint, and a fiscal rule that ties down the growth of spending—is expected to yield savings of about 4 percent of GDP over 2018-23. Shortly following passage of the bill, however, three rating agencies downgraded Costa Rica’s sovereign credit rating and placed the country on a negative outlook, citing continued worsening of debt dynamics and significant funding challenges. Local markets have started to normalize, allowing the government to repay the Central Bank loan and secure financing at longer maturities and swap some short-term debt for longer maturity paper, though at interest rates above 9 percent in U.S. dollars (Chart). The EMBI spread also remains above 400 bps.

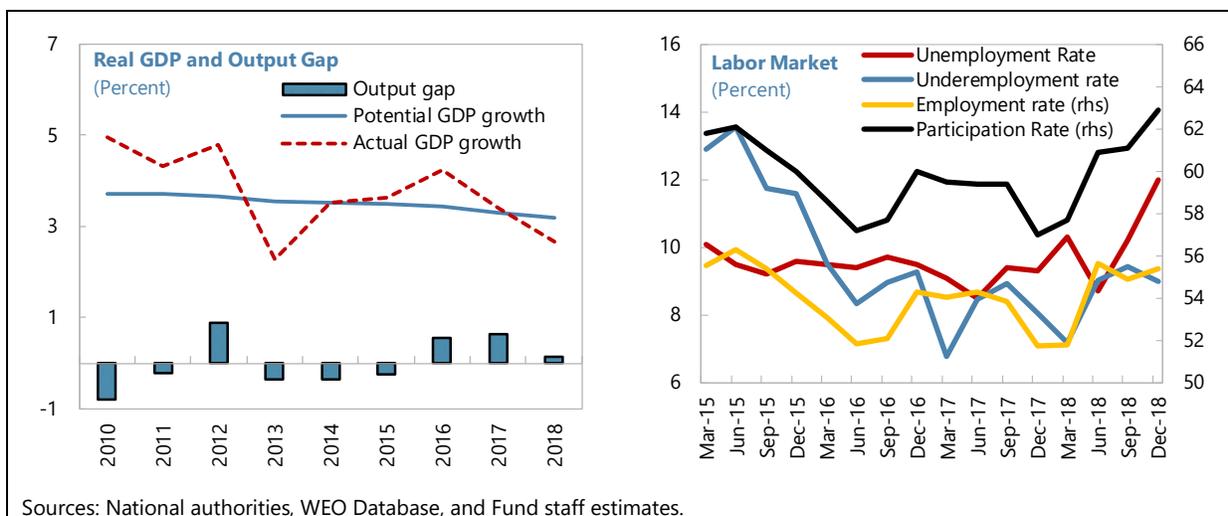


**5. Financial conditions have tightened considerably over the last two years, crimping growth** (Charts). During March 2017 to November 2018, as global financial conditions tightened the BCCR increased the policy rate from 1¾ to 5¼ percent. Combined with economic uncertainty, this helped reduce private sector credit growth, which decelerated to 6¼ percent yoy in December 2018 from an average of 12½ percent over the past five years. Hence, the aggregate monetary and financial conditions index declined considerably in 2018, implying a drag on growth of ½ p.p. in 2018Q3.



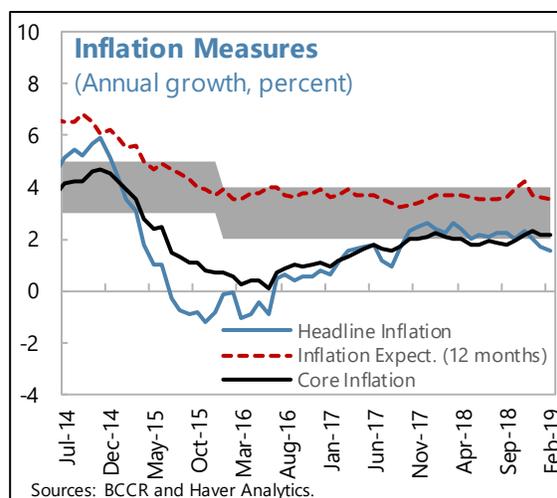
**6. Economic activity has slowed markedly, reflecting multiple shocks buffeting Costa Rica**

(Figure 1). Following the moderation in 2017, growth decelerated further to 2.7 percent in 2018, falling below potential (3.2 percent) and resulting in the output gap shrinking (Chart).<sup>1</sup> The growth slowdown in 2018H2 reflected the impact of the public-sector strike, developments in Nicaragua, rising global interest rates and tighter domestic financial conditions, and the uncertainty surrounding the fiscal reform that eroded consumer confidence. Because of this and a sharp rise in the participation rate, the unemployment rate increased to nearly 12 percent in 2018Q4 (Chart).



<sup>1</sup> Staff uses a suite of models to estimate potential growth, including: (i) a production function approach, (ii) univariate filters, and (iii) multivariate Kalman filters (see IMF WP/15/79 for methodological details).

**7. Inflation remains low, although inflation expectations are in the upper half of the band.** Oil price increases and a sharp depreciation of the colón during 2017 contributed to lifting inflation back into the central bank's 2-4 percent target band (Chart). Throughout 2018, headline inflation stayed within the lower part of the band, though falling below the band in early 2019. Inflation expectations, however, are in the upper half of the band at 3.5 percent, in part reflecting expected pass-through of colón depreciation of almost 7 percent in 2018.<sup>2</sup>



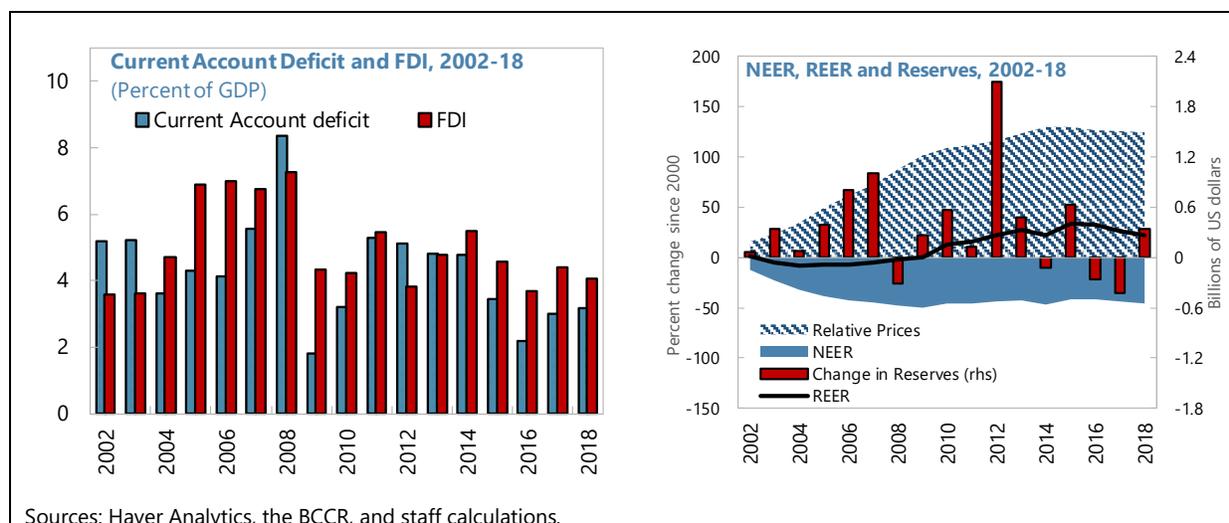
**8. External sector performance has been solid and the external position in 2018 is broadly in line with medium-term fundamentals and desirable policies** (Annex II; Charts). Despite a moderate real effective exchange rate (REER) depreciation of 3 percent, the current account (CA) deficit widened modestly from 3 percent of GDP in 2017 to 3.2 percent of GDP in 2018. The slight deterioration was driven by a higher trade deficit for goods—amid political unrest in Nicaragua that adversely affected intra-regional trade—and lower primary income, which were partially offset by an improvement in the balance of trade for services. Net FDI inflows in 2018 continued to account for about 4 percent of GDP, comfortably covering the current account deficit. International reserves stood at US\$7.5 billion at end-2018, equivalent to 4.7 months of imports and comfortably exceeding the Fund's reserve adequacy benchmark. The external balance assessment (EBA) CA model<sup>3</sup> suggests a modest CA gap of 0.8 percent of GDP for 2018, implying that the REER is broadly consistent with fundamentals (Table). In line with staff's advice and the [IMF's institutional view on capital flows](#), in December 2018, the two capital flow management measures (CFMs) on inflows were removed.<sup>4</sup>

Costa Rica: Results of EBA CA Model for 2018		
(1)	Actual CA	-3.2
(2)	Cyclical contributions	0.2
(3)=(1)-(2)	Actual CA, cyclically adjusted	-3.4
(4)	CA norm, cyclically adjusted 1/	-4.2
(5)=(3)-(4)	CA gap	0.8
	of which: Policy gap	-0.8
	of which: Residual	1.6
(6)	Elasticity of CA to REER	-0.26
(7)=(5)/(6)	REER misalignment for 2018	-3.0
Percentage, "+" = overvaluation.		
Source: IMF staff estimates.		
1/ the CA norm is 0.4 pts lower than estimated in the model after taking into account Costa Rica's substantially lower overall government deficit in 2018 than that used in the model as lower government spending leads to lower domestic demand and hence lower CA deficit.		

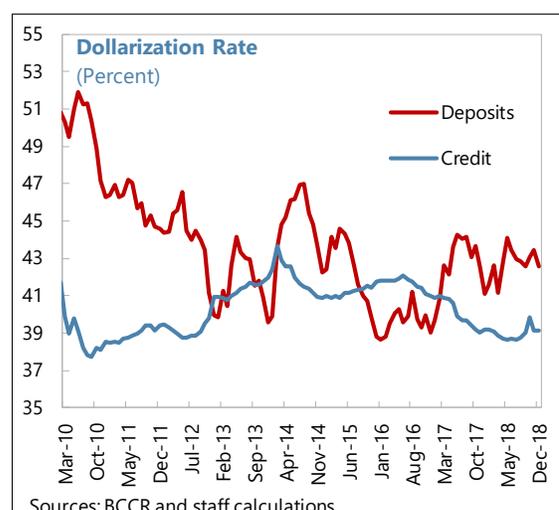
<sup>2</sup> While on the decline and currently at historic lows, inflation expectations have always been high in Costa Rica, reflecting the impact of high inflation on expectation formations (see BCCR N.005/2017).

<sup>3</sup> Costa Rica is included in the EBA CA model, but not in the EBA REER Index and external sustainability models.

<sup>4</sup> The two CFMs (introduced in 2014) granted the central bank the authority, through a qualified majority of its Board of Directors, to activate for a period of up to six months a tax on nonresidents' interest earned on fixed income assets and an unremunerated reserve requirement on external borrowing, with the goal of discouraging capital inflows. These measures were never activated and the central bank's authority to impose them has been removed.



**9. While the financial system appears generally sound, vulnerabilities have increased given exchange rate depreciation, higher interest rates, and policy changes** (Annex III; FSI Heatmap; Figures 3 and 4). Weak activity translated into higher NPLs, which reached 2.1 percent in December 2018. Despite this, banks remain liquid and well capitalized. In response to the credit slowdown, in June 2018 the National Council of Supervision of the Financial System (CONASSIF) reduced provisions for granting FX loans to non-dollar earners and lowered the risk weights for FX loans to high-risk non-dollar earners. Likely reflecting these policy changes and broader economic stress, the gradual de-dollarization trend



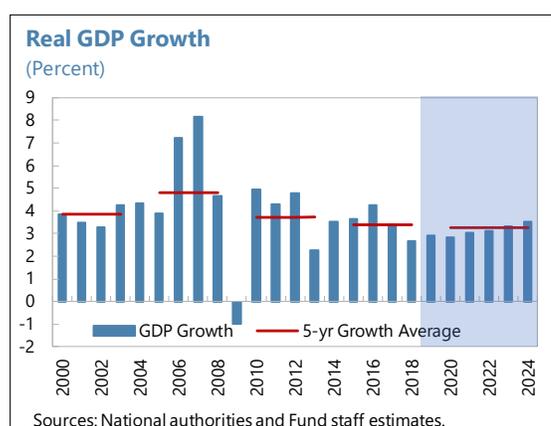
started to reverse, with credit dollarization of about 40 percent in December 2018 (Chart). In line with international standards, in September 2018 (effective 2020) CONASSIF approved regulation changes to allow financial entities not to daily mark assets to market and use an amortized cost basis under strict conditions. In October 2018, the upper limit for central government and central bank debt as a share of pension fund assets was increased from 55 to 80 percent.<sup>5</sup> The dissolution of Banco Crédito Agrícola de Cartago (Bancredito) was completed smoothly in December 2018, with its assets and liabilities absorbed by Banco de Costa Rica (BCR).

<sup>5</sup> At the same time, the limit on total public-sector debt was reduced from 90 to 80 percent.

Costa Rica: Financial Soundness Indicators Heatmap										
Costa Rica	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2	2018Q3
<b>Overall Financial Sector Rating</b>	M	M	M	M	M	M	M	M	M	M
<b>Credit cycle</b>	M	M	M	M	M	L	L	L	L	L
Change in credit / GDP ratio (pp, annual)	3.5	3.7	3.4	3.7	3.4	2.4	1.7	0.6	-0.6	0.4
Growth of credit / GDP (% , annual)	6.4	6.7	6.1	6.5	6.0	4.0	2.9	2.9	0.9	-1.0
Credit-to-GDP gap (st. dev)	-1.1	-0.8	-0.7	-0.9	-0.4	-1.1	-1.3	-2.3	-2.1	-1.1
<b>Balance Sheet Soundness</b>	M	M	M	M	M	M	M	M	M	M
<b>Balance Sheet Structural Risk</b>	M	M	M	M	M	M	M	M	M	M
Deposit-to-loan ratio	105.1	105.3	102.7	105.2	104.2	104.7	104.6	105.6	105.8	104.8
FX liabilities % (of total liabilities)	34.7	35.3	35.5	36.9	37.4	36.2	35.8	35.6	36.0	36.1
FX loans % (of total loans)	42.1	41.5	41.0	40.9	39.9	39.4	39.2	38.8	38.7	39.0
<b>Balance Sheet Buffers</b>	L	L	L	L	L	L	M	M	M	M
<b>Leverage</b>	L	L	L	L	L	L	L	L	L	L
Leverage ratio (%)	9.7	9.5	9.4	9.5	9.5	9.6	9.6	10.0	10.0	10.0
<b>Profitability</b>	L	L	L	L	L	L	L	L	L	L
ROA	1.2	1.2	1.2	1.1	1.1	0.9	0.9	0.9	0.9	0.9
ROE	8.7	8.4	8.8	7.8	7.7	6.6	6.4	6.6	6.2	6.4
<b>Asset quality</b>	L	L	L	L	L	M	H	H	H	H
NPL ratio	1.6	1.6	1.6	1.6	1.7	1.9	2.1	2.0	2.4	2.6
NPL ratio change (% , annual)	1.4	-4.7	-6.7	-7.1	2.3	18.2	32.2	30.3	42.8	34.6
<b>Memo items:</b>	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2	2018Q3
Credit-to-GDP (%)	57.5	58.6	59.5	59.9	60.9	60.9	61.3	60.4	60.3	61.4
Credit-to-GDP gap (%; HP filter)	0.4	0.8	1.0	0.7	1.1	0.4	0.1	-1.5	-1.9	-1.0
Credit growth (%; annual)	13.3	13.2	12.8	13.4	12.5	10.3	8.5	6.1	3.9	5.3
CAR (in %)	16.6	16.6	16.4	16.3	16.1	16.4	16.5	16.8	17.1	17.2
Tier 1 CAR (in %)	12.7	12.5	12.2	12.6	12.5	12.8	12.7	13.2	13.5	13.5

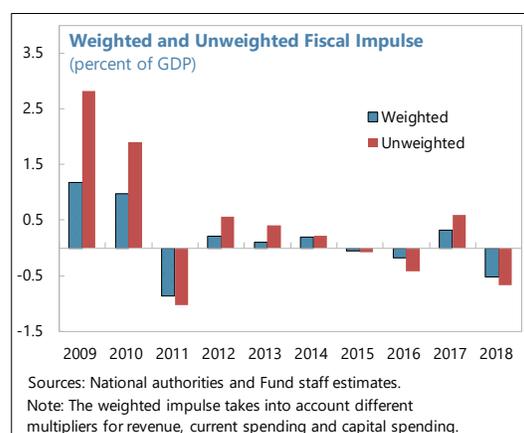
## B. Macroeconomic Outlook and Risks

**10. Growth is expected to remain subdued in the near-term and gradually rise toward potential in the medium term** (Table; Chart). Fiscal consolidation, while improving debt dynamics, will weigh on near-term growth (Box 1), as will tight financial conditions. In the medium term, positive confidence effects and progress with structural reforms, including those related to OECD accession, should lower risk premia and boost investment, pushing growth up towards its projected potential of 3.5 percent by 2024. Inflation is expected to remain within the target range, and the CA deficit should remain low (below 3½ percent of GDP), supported by healthy export growth and given the sizable output gap (related to the fiscal consolidation).



### Box 1. Fiscal Multipliers in Costa Rica and the Composition of Spending

- Fiscal multiplier estimates for Costa Rica vary widely, although many studies use SVARs.** Estimated cumulative tax multipliers range between -0.01 and -0.3, and those of capital spending between 0.2 and 1.0. There is less consensus regarding current spending, with estimates for the cumulative multiplier ranging from -0.79 to 0.3. A recent BCCR study using an SVAR methodology estimates that after two years the expenditure multiplier is 0.3 and the tax multiplier is -0.14.
- SVARs suffer from endogeneity problems.** SVAR models impose strong assumptions to identify fiscal shocks, and some of these shocks may have already been anticipated by economic agents, introducing endogeneity bias in the empirical estimates.
- The fiscal multipliers used in this report are obtained using the narrative approach.** This approach assesses the motivations behind each fiscal policy decision by looking at contemporaneous documents such as budgets. It discards decisions driven by a desire to respond to current or prospective economic conditions, hence reducing endogeneity bias, but it delivers multipliers that are systematically higher than those of SVARs. Using this approach to identify the fiscal shocks, the Spring 2018 Regional Economic Outlook for the Western Hemisphere (REO 2018) estimates that the multiplier for “high sovereign default risk” countries (e.g. Costa Rica) is 0.6 after two years, while the multiplier for “low default risk” countries is 1.1.
- The composition of the consolidation matters for the growth impact.** The REO 2018 did not find compelling evidence for a difference between spending cut and tax hike multipliers in LAC. The estimated public spending multiplier is 0.6 in countries with high perceived risk in LAC. However, while the current spending multiplier is about 0.3, the public investment multiplier is almost 0.8 after two years, pointing to an important difference between the unweighted and *weighted* fiscal impulse (Chart). Within current spending, adjustments in public wages may have a lower multiplier effect than cuts in transfers (World Bank Semi Annual Report, April 2018).



Costa Rica: Macroeconomic Outlook								
	2017	2018 <sup>e</sup>	Projections					
			2019	2020	2021	2022	2023	2024
Real GDP growth (percent)	3.4	2.7	2.9	2.8	3.0	3.1	3.3	3.5
Potential GDP growth (percent)	3.3	3.2	3.2	3.3	3.3	3.3	3.5	3.5
Output gap (as percent of potential GDP)	0.6	0.2	-0.1	-0.5	-0.8	-1.0	-1.1	-1.1
Consumer prices (percent change; end of period)	2.6	2.0	3.2	3.0	3.0	3.0	3.0	3.0
Central government primary balance (as percent of GDP)	-3.0	-2.4	-1.8	-0.9	-0.5	0.2	0.8	0.8
Central government overall balance (as percent of GDP)	-6.2	-6.0	-5.8	-5.1	-4.8	-4.2	-3.8	-3.3
Central government debt (as percent of GDP)	48.6	53.5	56.2	58.3	60.1	61.1	61.4	61.0
Current account balance (as percent of GDP)	-3.0	-3.2	-3.2	-3.3	-3.3	-3.3	-3.4	-3.4

Sources: National authorities and Fund staff projections.

**11. Growth risks are tilted to the downside** (see Risk Assessment Matrix). Key downside risks originate from: (i) global growth and policy uncertainties, especially related to trade tensions; and (ii) delays in implementing the approved fiscal reforms given a poor track record with previous fiscal rules, powerful public-sector unions, and with municipal and general elections scheduled in 2020 and 2022, respectively. Given weak fiscal fundamentals and sizable fiscal financing needs, Costa Rica is particularly vulnerable to a sharp tightening of global financing conditions. An abrupt deterioration in investor sentiment could result in capital outflows, pressure on the currency, a sharp rise in interest rates, and financing strains (including for banks given their exposure to sovereign debt). Upside risks include rapid implementation of fiscal reforms and structural reforms under the OECD accession process—with the former potentially leading to larger-than-expected confidence effects and thus lower fiscal multipliers.

### Costa Rica: Risk Assessment Matrix 1/

Source of Risks	Relative likelihood	Expected Impact	Policy Response
<b>External risks</b>			
<b>Rising protectionism and retreat from multilateralism</b>	<b>High</b>	<b>Medium</b>	Costa Rica's open economy would be particularly vulnerable to significant changes in trade policies of key trading partners. Notwithstanding the importance of other pull factors, such as the educated labor force, rule of law and geographic location, FDI flows would also be significantly affected by changes in advanced country policies aimed at discouraging investment abroad.
			Allow exchange rate flexibility to help absorb external shocks; advance structural reforms to boost competitiveness; ease monetary policy if weak demand drives inflation below target.
<b>Sharp tightening of global financial conditions</b>	<b>Low/Medium</b>	<b>High</b>	As emerging markets with weak fundamentals seem to be most vulnerable, authorities need to promptly implement the fiscal reform to address fiscal vulnerabilities. Allow exchange rate flexibility to help absorb external shocks; further strengthen supervision and regulation of the financial sector; consider taking additional measures to discourage dollarization; provide emergency liquidity assistance as needed; adopt accommodative monetary policy if financial distress weakens demand and drives inflation below target.
			A sudden rise in international interest rates and a stronger U.S. dollar could impair external bank funding and increase credit risk of unhedged FX borrowers. Moreover, a decline in capital flows to emerging markets would reduce capital flows to Costa Rica, putting depreciation pressures on the exchange rate and increasing the cost of external government and private sector financing with negative consequences on public debt dynamics and economic growth.
<b>Weaker-than-expected global growth</b>	<b>Medium/High</b>	<b>Medium/High</b>	Ease monetary policy if weak demand drives inflation below target and advance on structural reforms to boost competitiveness.
<b>Intensification of security risks</b>	<b>High</b>	<b>Medium</b>	Coordinate with regional trading partners alternative trade routes (transportation logistics). Be ready to provide aid to border region. Seek international support in case of large-scale migration inflows.
			Intensification of security risks in Latin America, particularly Nicaragua, could cause regional socio-economic and political disruptions. Nicaragua is a relatively small trading partner for Costa Rica but an important thoroughfare for regional trade. In addition, a sharp economic contraction could lead to more migration from Nicaragua.
<b>Large swings in energy prices</b>	<b>Medium</b>	<b>Medium</b>	Take advantage of low energy prices to accelerate the adoption of fiscal reforms. Allow exchange rate flexibility to help absorb oil price shocks; advance structural reforms to boost competitiveness.
			Risks to prices are broadly balanced, reflecting offsetting—but large and uncertain—supply and demand shocks. In the near term, uncertainty surrounding the shocks translates to elevated price volatility, complicating economic management and adversely affecting investment in the energy sector. As shocks materialize, they may cause large and persistent price swings. While, on aggregate, higher oil prices would harm global growth.
<b>Domestic risks</b>			
<b>Delays in the implementation of fiscal consolidation</b>	<b>Medium</b>	<b>High</b>	Timely implementation of the fiscal reform and identification of further measures to close the fiscal sustainability gap.
			Worse-than-anticipated growth impact from persistently high fiscal deficits, or higher deficits than projected in the baseline scenario. Higher financing requirements and/or lower investment confidence could increase domestic interest rates. Higher deficits and lower growth would also increase the debt-to-GDP ratio, threatening fiscal sustainability.
<b>High dollarization</b>	<b>Medium</b>	<b>High</b>	Prompt implementation of the de-dollarization measures recommended by the FSSR mission, including: (i) reducing the reserve requirement in domestic currency to levels closer to banks' operative requirements, (ii) increasing the weights for banks' liabilities in foreign currency in the calculation of the liquidity coverage indicator (LCI), and (iii) address weak fiscal fundamentals to boost credibility of macroeconomic policy management.
			Dollarization has persistently remained close to 40 percent, generating liquidity and solvency risks for the financial system, that can be triggered by large external shocks. Currency depreciation could boost expected returns on f/x denominated assets, but could also have negative impact on unhedged households and corporates with FX liabilities, and hence increase the credit risk of the banks' loan portfolio and materialize in higher NPLs.
<b>Adverse climatic conditions</b>	<b>High</b>	<b>Medium</b>	Build a consistent framework with investment in resilience and appropriate ex-ante financing, including fiscal buffers; advance structural reforms to boost competitiveness
			Domestic supply shocks associated with adverse climatic conditions would affect the performance of agricultural activity and road infrastructure, increase production costs and reduce the growth capacity of the Costa Rican economy. A moderate <i>El Niño</i> effect is projected for 2019.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

## POLICY DISCUSSION

**12. Macroeconomic and financial policies should work together to reduce vulnerabilities and be complemented by structural reforms to enhance productivity and inclusiveness.** The policy mix includes: (i) full and timely implementation of the fiscal reform and further front-loaded fiscal measures, while taking steps to protect the poor; (ii) keeping monetary policy data dependent, increasing transparency, and maintaining exchange rate flexibility; (iii) enhancing financial resilience; and (iv) leveraging the OECD accession process to boost competitiveness and inclusive growth through structural reforms.

### A. Restoring Fiscal Sustainability

**13. The fiscal reform constitutes a critical step towards restoring fiscal sustainability and improving tax progressivity, although full and timely implementation is key.** Staff's estimates suggest that the reform will yield savings of about 4.0 percent of GDP over 2018-23 (Table), leading to a primary balance of 0.8 percent of GDP in 2023. The approved reform would improve the progressivity of the tax system and likely reduce inequality, although poverty may increase slightly as planned additional targeted transfers to lower income households are not yet in place (Box 2).

<b>Costa Rica: Fiscal Consolidation Measures</b> (Percent of GDP, cumulative)						
	2018	2019	2020	2021	2022	2023
VAT		0.3	0.6	0.7	0.7	0.7
Income tax		0.3	0.7	0.7	0.7	0.7
Electronic Invoicing		0.0	0.1	0.1	0.2	0.2
Amnesty	0.2	0.3				
Fiscal Rule			0.8	1.1	1.8	2.4
<i>Wage bill</i>	0.0	0.3	0.6	0.8	1.0	1.0
<i>Transfers</i>	0.1	-0.1	0.2	0.3	0.8	1.4
<b>Total Fiscal Reform measures</b>	<b>0.4</b>	<b>1.2</b>	<b>2.1</b>	<b>2.6</b>	<b>3.4</b>	<b>4.0</b>
Other spending (capital expenditure)	0.6	0.2	0.2	0.0	-0.1	-0.1
<b>Total Authorities' measures (A)</b>	<b>1.0</b>	<b>1.5</b>	<b>2.3</b>	<b>2.6</b>	<b>3.3</b>	<b>3.9</b>
<i>Additional measures to reduce central government debt to 50 percent of GDP by 2030</i>		0.4	0.8	0.8	0.8	0.8
<b>Total measures (A+B)</b>	<b>1.0</b>	<b>1.8</b>	<b>3.1</b>	<b>3.4</b>	<b>4.1</b>	<b>4.7</b>

Source: Fund staff calculations.

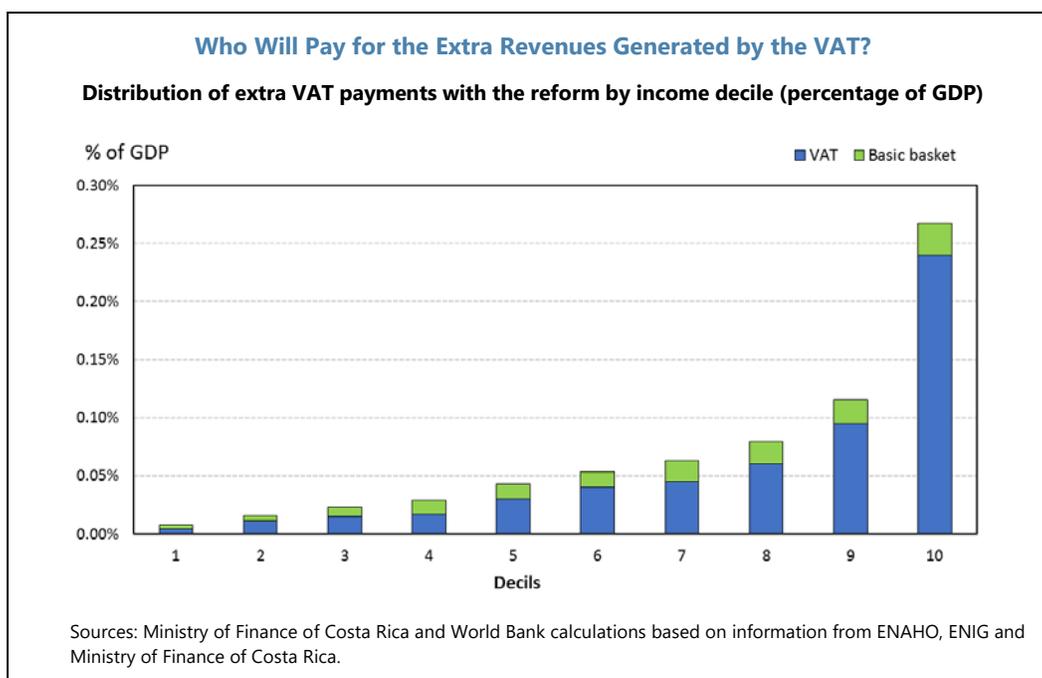
## Box 2. The Distributional Impact of the Fiscal Reform

### Amendments to the income tax law should not have an impact on the poorest segments of the population.

The amendments seek to prevent the erosion of the taxable base and introduce a new taxation regime for capital income and capital gains, which will only affect high income households. The changes to the salary tax rate only affect households earning more than 2,103,000 Costa Rican colones—more than seven times the minimum wage.

**The introduction of the VAT could have a negative impact on the poor.** The impact is, however, expected to be limited by several exemptions and three additional reduced rates: 4 percent for private health services provided by authorized health centers or health science professionals; 2 percent for pharmaceuticals, supplies, machinery, equipment and reactive agents used for industrial production; and 1 percent for the basket of basic goods.

**Overall, the tax reform should improve tax progressivity.** Simulations show that the VAT reform would yield an additional 0.7 percent of GDP in revenue. Out of this, 0.02 percent of GDP (or about 3 percent of the extra revenues collected) will be collected from the two bottom deciles of the income distribution. The two top income deciles, however, will contribute 0.38 percent of GDP (about 55 percent of the extra revenues). The simulations also show that the reform will have a limited impact on poverty, since the post-reform poverty rate increases only marginally, from 20 to 20.3 percent.

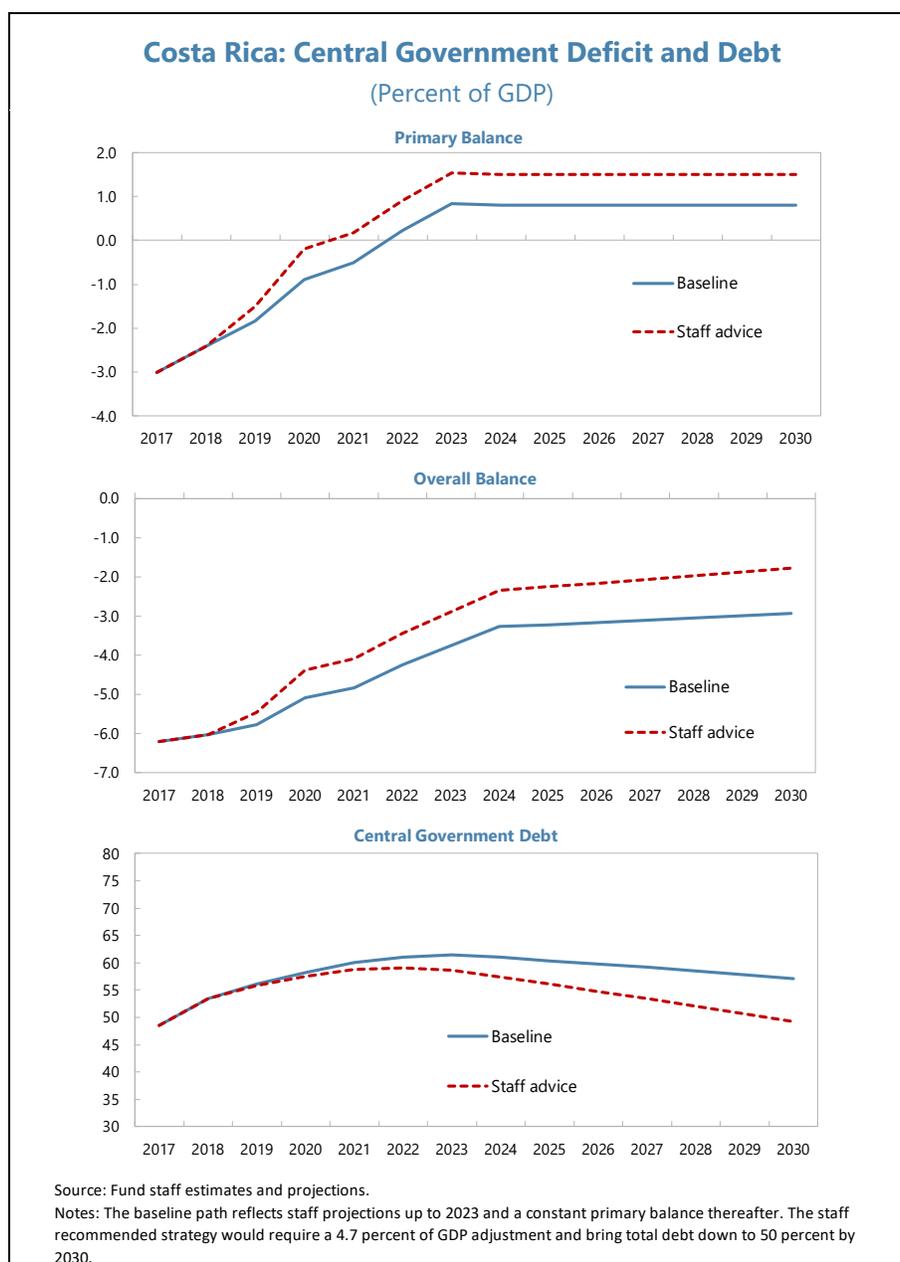


### On the expenditure side, the fiscal rule should not have a significant impact on poverty but would reduce inequality.

The impact depends on the composition of the spending cuts triggered by the fiscal rule. Simulations suggest that across-the-board spending cuts of 5 percent would only marginally increase poverty (less than 0.1 p.p.) and reduce income inequality by 0.2 gini units. This result reflects that 75 percent of public employees belong to the highest quintile of the income distribution. However, poverty would rise less and income inequality would decline more if spending cuts target the top three quintiles of the income distribution<sup>1</sup> and do not affect health or public education transfers.

<sup>1</sup> Under this scenario the adjustment includes: i) a reduction of 10 percent of public wages and pensions for the top quintile, and b) cutting other transfers to the top three quintiles of the income distribution.

**14. The government still has sizable financing needs in the near term.** The government has relied heavily on local capital markets to meet its financing needs in recent years, with domestic debt accounting for 80 percent of central government debt as of end-2018. And rising budget deficits combined with small domestic capital markets have put upward pressure on domestic interest rates. Looking ahead, despite the fiscal reform, gross borrowing requirements are estimated at about 12 percent of GDP in 2019—with almost 70 percent of amortization payments coming due in 2019H1—and will only decline gradually during 2020-24 as fiscal consolidation progresses and

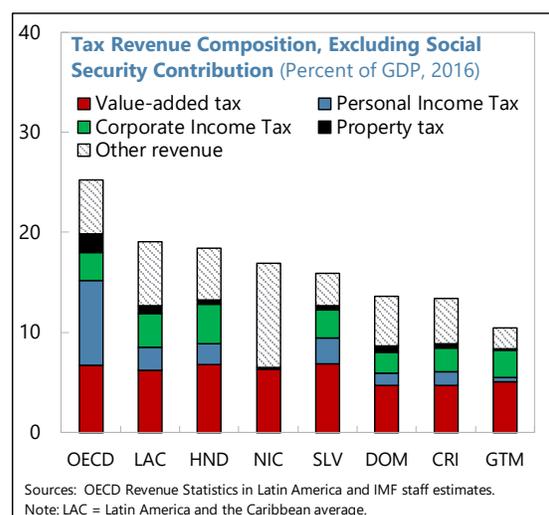


the government is able to lengthen its amortization profile. To ease pressure on local interest rates—which on average remain close to ten percent—the government has asked Congress for approval to issue US\$6 billion of Eurobonds over 2019-24, and is seeking lower cost financing from multilateral agencies. Even if such financing is approved, these funds and the additional revenue from VAT reform will only start flowing in 2019H2, leaving sizable financing challenges and high local financing costs in 2019H1.

**15. An additional front-loaded adjustment of around ¾ percent of GDP is recommended to further reduce debt and near-term financing pressures** (Table; Annex VI). While the fiscal reform is a critical step, the government faces serious short-term liquidity problems and the central government debt ratio is projected to reach 61½ percent of GDP in 2023, putting Costa Rica’s fiscal space “at risk”. This is consistent with the cautious market reaction to the reform, with potential for market confidence to significantly worsen if global financial conditions sharply tighten or authorization to issue Eurobonds is delayed. This, combined with the need to rebuild fiscal space to manage potential shocks and major contingent liabilities (e.g. pensions), presages the need for further front-loaded fiscal measures to reduce financing needs and improve market confidence. Staff estimate that an additional adjustment of ¾ percent of GDP over 2019-20 is required to reduce debt faster and reach 50 percent of GDP by 2030, consistent with studies on sustainable levels of debt in emerging markets.<sup>6</sup>

**16. The additional adjustment should be underpinned by well-designed measures on the revenue side** (Chart). About ⅔ of the fiscal adjustment under the fiscal reform is based on expenditure cuts. Meanwhile, tax revenue (excluding social security contributions (SSCs)) as a percentage of GDP is one of the lowest in the region, suggesting room to raise tax revenue. Possible measures include: (i) increasing the VAT rate from 13 to 15 percent—closer to regional standards and the OECD average of 19 percent—while better targeting transfers to protect the poor; (ii) increasing excise taxes on selected goods and services; and (iii) taxing the profits of the

cooperatives. Moreover, the current tax structure is overly reliant on SSCs—which account for more than ⅓ of total revenues, compared with the OECD average of 25 percent—discouraging labor participation and formality. In contrast, property tax revenue—currently at 0.4 percent of GDP—is low compared with the LAC average of 0.8 percent of GDP, and the tax-free threshold of personal income tax (PIT) is high at about twice the average wage, reducing the redistributive power of tax



<sup>6</sup> While the MAC-DSA implies a threshold of 70 percent of GDP as the upper-bound (rather than a recommended level) for emerging markets (EMs), Mendoza and Oviedo (2004) find that the sustainable level of debt for EMs is 45 percent of GDP. More recent research at the IMF by Ostry et al. (2010) recommends a median long-run debt level of about 50 percent of GDP.

policy. In this context, the composition of tax revenue should be improved by shifting the tax burden from SSCs to property tax and PIT, which would help reduce informality and inequality.

**17. Further efforts to reduce revenue earmarking and excessive fragmentation of the public sector would improve government’s control of the budget.** The fiscal reform has removed significant revenue-earmarking provisions introduced over the years. Other spending rigidities introduced by Constitutional provision persist, such as transfers to public education and the judiciary. To mitigate their effect on the budget, the fiscal reform expanded the definition of the public education sector by including early education centers and technical institutes. However, all current transfers that are not earmarks cannot be reduced below the nominal level of the previous fiscal year. Staff recommend that the Ministry of Finance is entitled to adjust all rigid spending to preserve fiscal sustainability when fiscal deficits or debt reach predefined thresholds.

**18. Improving the efficiency and quality of public spending will help rebalance expenditure towards capital spending and better support growth and equity.** The low efficiency of public spending—particularly regarding social protection, and education—suggests the need for performance-based reforms (Figure 5).<sup>7</sup> Improvements can also be made in public procurement by centralizing procurement contracts. The fragmentation of demand among numerous government agencies generates small-value contracts often executed through uncompetitive methods. A more centralized procurement system could help reduce costs and minimize information asymmetries. Staff welcome the planned rolling out of debit cards as a vehicle to channel cash transfers to low-income households and recommend more effective targeting and coordination of social assistance programs to better protect the poor and reduce inequality, especially in the context of ongoing tax reforms.

**19. Debt management should be streamlined to help contain rollover risks and debt servicing costs.** The primary market suffers from a lack of transparency, fragmentation, and weak price formation. Other operational practices, such as too frequent issuances, use of direct placements instead of competitive methods, and lack of standardized instruments, have hampered development of a secondary market. In response, the authorities have created an interinstitutional team to improve the coordination and the division of responsibility between different agents involved in debt management. Staff also advise timely implementation of recommendations of recent Fund TA on debt management, including: (i) using different instruments to manage debt (medium and long-term bonds) and cash needs (short-term instruments), (ii) moving towards market-based mechanisms and strengthening price discovery by establishing a technical pricing committee in charge of developing guidelines for pricing methodologies; and (iii) improving communication with markets through a successful benchmark policy, predictable auction behavior, and the adoption of a policy for treating unsold bonds.

**20. The recently approved fiscal rule is a step in the right direction but should be strengthened by introducing a medium-term expenditure framework (MTEF) and a fiscal**

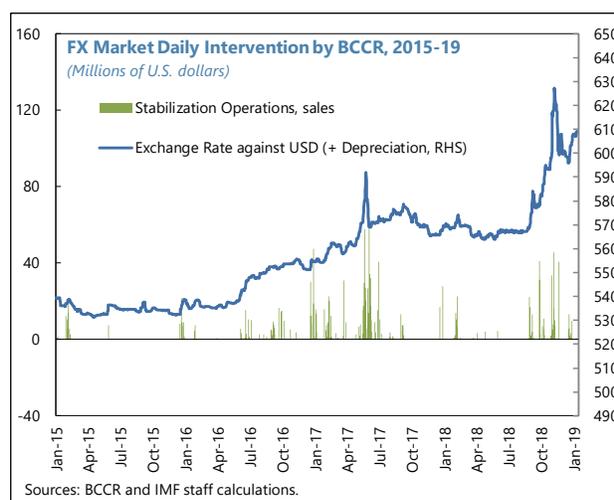
<sup>7</sup> Costa Rica spends around 7-8 percent of GDP on education, but outcomes are similar to those of Chile, which spends only about half as much.

**council.** The fiscal rule mainly affects current spending—shielding public investment from consolidation efforts—unless debt is over 60 percent of GDP. Moreover, it provides some flexibility with well-specified escape clauses which are important given Costa Rica’s vulnerability to natural disasters. However, the new law could further clarify the division of responsibilities between the Ministry of Finance and the Comptroller General of the Republic regarding monitoring of compliance with the rule. An independent fiscal council could act as a watchdog. The authorities are taking steps to create a fiscal council, and Congress is in the process of passing a constitutional reform for an MTEF. Staff encourage the implementation of an MTEF consistent with international best practice, something which has proven to be an effective tool in OECD countries to control public expenditure over the medium term while ensuring support to government strategic priorities.

## B. Keeping Monetary Policy Data Dependent and Enhancing Transparency

**21. The current monetary stance is appropriate and should remain data dependent.** The current policy rate of 5¼ percent is marginally below the estimated neutral rate of 5½ percent.<sup>8</sup> This slightly accommodative stance is appropriate given the projected negative output gap, inflation persistently at the floor of the target range, and that VAT implementation is only expected to have a modest and temporary effect on inflation. Going forward, monetary policy will need to remain data dependent and balance downside risks to inflation stemming from slower activity and upside risks arising from a sharp tightening of global financial conditions (which could prompt further colón depreciation). If growth disappoints, space remains for increased monetary stimulus, but room would be limited if this coincides with fiscal or financing concerns leading to an abrupt deterioration in investor sentiment, capital outflows, and pressure on the currency.

**22. Significant progress has been made to enhance the inflation targeting framework, but scope for increasing transparency remains.** Staff welcome: (i) the passage of the bill on delinking the designation of the President of the central bank from the political cycle and improving the clarity of dismissal rules; and (ii) the increase in FX flexibility since September 2018 and limited use of FX intervention to addressing episodes of large exchange rate volatility, which should be maintained (Chart). Transparency could be



<sup>8</sup> The estimated neutral interest rate is the simple average of results from three models: (i) uncovered interest parity, (ii) an augmented Taylor rule, and (iii) a general equilibrium model (see IMF Working Paper 12/243 for further details). An important caveat is that like for other less financially open economies, the estimates resulting from the different models have a wide range, possibly reflecting data limitations due to thin financial markets and less developed yield curves.

further improved by publishing the calendar of monetary policy meetings and their corresponding meeting minutes.

## C. Enhancing Financial Resilience

**23. Stress tests suggest that the banking system is sufficiently well-capitalized to absorb sizable shocks, although some small banks would require capital injections** (Annex III). The overall banking sector maintains a post-shock capital adequacy ratio (CAR) of 12 percent (Table)—even under the adverse scenario of a combined shock that consists of (i) a large increase in NPLs, (ii) a sizable nominal interest rate increase and (iii) a significant FX depreciation. Four banks would fall short of the minimum regulatory CAR (10 percent). Nevertheless, the affected banks are relatively small and together only account for 13¼ percent of banking sector assets.<sup>9</sup>

Summary of Stress Test Results				
	All Banks	Public	Domestic Private	Foreign Private
<b>Summary of Results</b>				
<i>Solvency</i>				
Pre-shock CAR	13.5	13.7	15.2	13.1
Impact of (percentage points of the original RWA)				
Increase in NPLs 1/	-0.9	-0.9	-0.8	-0.9
Increase in interest rates 2/	0.9	1.1	0.0	0.7
Exchange rate depreciation 3/	-1.4	-1.1	-1.1	-1.9
Post-shock CAR (percent of post-shock RWA)	12.1	12.8	13.3	11.1
Change in CAR (all fundamental shocks)	-1.4	-0.9	-1.9	-2.1
Source: SUGEF; and IMF staff estimates.				
1/ Assumes an increase in NPLs of 2.9 percent of performing loans; and a 40 percent provisioning rate.				
2/ Assumes a 3.5 percentage points nominal interest rate increase.				
3/ Assumes a 18 percent depreciation of the FX rate, leading to 12 percent of FX loans becoming non-performing, and a 40 percent provisioning rate.				

**24. It remains important to monitor and tackle a broader set of financial vulnerabilities** (Figure 4):

- *High dollarization.* Costa Rica has one of the highest levels of credit dollarization in Latin America (about 40 percent). Moreover, around ⅔ of foreign currency credit to the nonfinancial private sector goes to unhedged borrowers. In this context, the set of measures passed by CONASSIF in June 2018 to relax FX lending requirements was a step backward. To further incentivize de-dollarization, staff recommend reversing all the June 2018 measures and prompt and effective implementation of FSSR recommendations, including: (i) introducing different reserve requirements in domestic and foreign currency; (ii) imposing additional capital requirements contingent on the expansion of credit to unhedged borrowers; and

<sup>9</sup> Spillovers from the Nicaragua crisis to Costa Rica's financial system appear limited. As of December 2018, the two banks owned by groups with banks in Nicaragua account for less than 6 percent of banking sector assets.

(iii) allowing private banks more competitive access to the domestic-currency deposit market, hence reducing their reliance on FX funding.

- *Sizable net foreign liabilities of banks.* Costa Rica has one of highest shares of foreign bank funding in Central America (about 10 percent of banks' liabilities), although it is lower than the average for Latin America and Caribbean countries.<sup>10</sup> To mitigate liquidity risks, the weights for banks' foreign currency liabilities in the calculation of the liquidity coverage indicator (LCI) should be raised.
- *Sharply growing household borrowing.* Household borrowing has increased by over 10 percent of GDP since the end of the 2008/09 crisis, accounting for  $\frac{2}{3}$  of the increase in total private sector credit.<sup>11</sup>
- *High sovereign exposure.* The banking sector is highly exposed to sovereign lending compared to the rest of the region. With high and rising public debt, the high exposure to public credit increases borrowing costs, crowding out private credit.

**25. Implementing other outstanding FSAP/FSSR recommendations would enhance the resilience and inclusiveness of the financial system** (Annex IV). Planned legal reforms should provide SUGEF and CONASSIF with essential supervisory tools, strengthen fit-and-proper rules, and include legal protection for supervisors to carry out their duties. Staff encourage their rapid approval. Staff welcome the BCCR's implementation of an emergency liquidity support facility and encourage further progress in establishing crisis management protocols. Rapid approval of the planned law establishing a deposit guarantee fund is important. In addition, staff recommend rolling back the blanket guarantee for deposits in state-owned banks to promote a more level-playing field for all banks. Staff encourage a fast implementation of the risk-based supervisory approach and Basel III standards. The coverage of the credit bureau should be expanded to include loans to households granted by non-bank entities, helping better assess the overall debt burden and household leverage. Building on recent efforts, firmly reinforcing the AML/CFT framework is also key.

## D. Boosting Competitiveness and Inclusive Growth through a Broad Structural Reform Agenda

**26. Structural reforms are still needed to boost competitiveness and inclusiveness, and the authorities are developing an agenda in this regard** (Figure 6). Costa Rica ranks favorably in many business indicators and remains a regional leader in attracting foreign direct investment. Additional steps are still needed to improve competitiveness and reduce inequality (Annex I). Staff

<sup>10</sup> Staff analysis based on a network model suggests that reduced foreign bank funding could lead to a significant credit reduction in Costa Rica (2016 SIP).

<sup>11</sup> About  $\frac{3}{4}$  of the increase has been in colones, and household credit dollarization currently stands at 28 percent.

welcome the government's plans to boost potential growth and the political consensus regarding the OECD accession process, and underscore the importance of leveraging the latter to implement impactful structural reforms consistent with the OECD five-pillar roadmap (Annex V). Many of these plans still need to be turned into concrete policies, and an assessment of their fiscal impact is still pending. Staff view promoting female labor force participation—including through expanding child-care provision—and addressing weaknesses in transport infrastructure as key priorities. Similarly, staff support 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 sector competition and hence reduce high interest rate spreads. Regarding the latter, staff encourage continuing the recent push to integrate fintech start-ups into the financial ecosystem.

### ***Authorities' Views***

**27. The authorities broadly shared staff's view regarding the outlook, with slightly higher projections (about 0.2 pp) for GDP growth in 2019-20.** The authorities expect that the economy will 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. In the medium and long term, the authorities project growth to return to potential, estimated at 3½ percent.

**28. The authorities stressed that, if fully implemented, the fiscal reform would restore long-term fiscal sustainability.** Government debt would peak at about 62 percent of GDP in 2023 and decline gradually thereafter. The authorities reiterated their commitment to a full and timely implementation of the reform, and would consider further tax measures depending on the evolution of the fiscal deficit and of other fiscal reforms already being evaluated by Congress. They noted that steps are being taken to ensure a smooth introduction of the VAT, thus limiting implementation risks. They also underscored that legislative authorization for multilateral loans and Eurobond placement would ease pressure on local markets and improve debt dynamics.

**29. The Central Bank has taken a more explicit forward-looking approach to monetary policy.** It now bases its policy rate decisions on the 12-18 month-ahead inflation forecast. The Central Bank noted that VAT implementation should only lead to a temporary and modest increase in inflation (1.1 pp in total), with the central estimate for forecast inflation remaining well within the target band. However, it will continue to monitor risks to inflation, adjusting the policy rate as needed. The Bank reaffirmed its commitment to a managed float regime, with intervention limited to preventing excessive colón volatility in a context of partial dollarization.

**30. To enhance financial sector resilience, the authorities are putting in place a comprehensive package of reforms in line with FSAP/FSSR and OECD recommendations.** The authorities' stress tests results are consistent with staff's analysis. The authorities have introduced a lender of last resort mechanism, drafted a crisis management protocol, and are working on bills on

deposit insurance and bank resolution, consolidated banking supervision, operation of foreign bank branches, and securities market law.

**31. 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 reduce excessive regulation, 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. The authorities thus saw their (and staff's) long-term growth projections as conservative.

## STAFF APPRAISAL

**32. Growth is expected to remain subdued in the near-term, before gradually rising toward potential.** Growth risks are tilted to the downside. Inflation is expected to remain within the target range. External sector performance continues to be solid and the external position is broadly in line with medium-term fundamentals and desirable policies.

**33. Enacting the fiscal reform was a critical step, but timely implementation and further front-loaded measures are needed to further reduce debt and financing pressures.** Despite the fiscal reform, the government faces sizable financing needs in the near term and central government debt is expected to reach above 60 percent of GDP in 2023, after which it will gradually decline. This, combined with the need to rebuild fiscal space to deal with future shocks and major contingent liabilities (e.g., pensions), presages the need for further front-loaded measures. Given the relatively low tax-to-GDP ratio, further adjustment should be underpinned by well-designed revenue measures while protecting the poor.

**34. Improving public spending efficiency, debt management, and the institutional framework would allow fiscal policy to better contribute to growth and equity.** Further efforts to reduce budget rigidity and excessive fragmentation of the public sector would improve government control of the budget. The low efficiency of public spending calls for performance-based reforms, while more effective targeting and coordination of social assistance programs would better protect the poor. Debt management should be modernized to help contain rollover risks and debt servicing costs. The recently approved fiscal rule could be strengthened by introducing an MTEF and a fiscal council.

**35. Significant progress has been made to enhance the inflation targeting framework, but scope for increasing transparency remains.** The current slightly accommodative stance is appropriate given the projected negative output gap and inflation persistently at the floor of the target range. Going forward, monetary policy will need to remain data dependent. The passage of the bill to ensure central bank independence, the increase in FX flexibility since September 2018, and limited use of FX intervention to addressing episodes of large exchange rate volatility, are welcome.

Transparency could be further improved by publishing the calendar of monetary policy meetings and their corresponding meeting minutes.

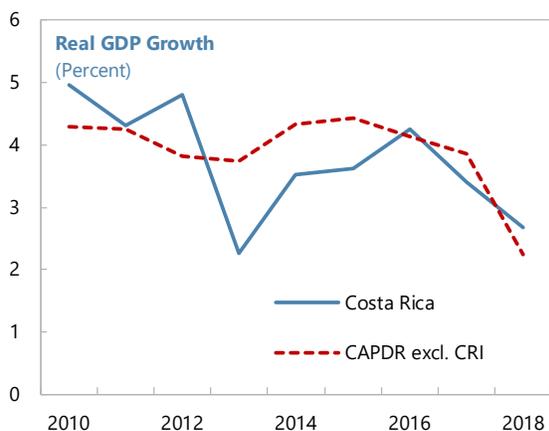
**36. Continued vigilance and further actions are needed to tackle financial vulnerabilities and enhance the resilience and inclusiveness of the financial system.** Stress tests suggest that the banking system is sufficiently well-capitalized to absorb sizable shocks. Nonetheless, it remains important to monitor and tackle financial vulnerabilities related to sizable FX lending to unhedged borrowers, significant net foreign liabilities of banks, sharply growing household credit, and high sovereign exposure. Implementation of pending FSAP/FSSR recommendations, adoption of Basel III standards, and building on recent efforts to further promote financial inclusion are also important.

**37. A broad array of structural reforms, including those required for OECD accession, are needed to boost competitiveness and inclusiveness.** Promoting female labor force participation and addressing weaknesses in transport infrastructure are key priorities. Staff support the OECD's recommendation to undertake an in-depth review of key sectors exempted from the competition law, and measures to increase banking sector competition.

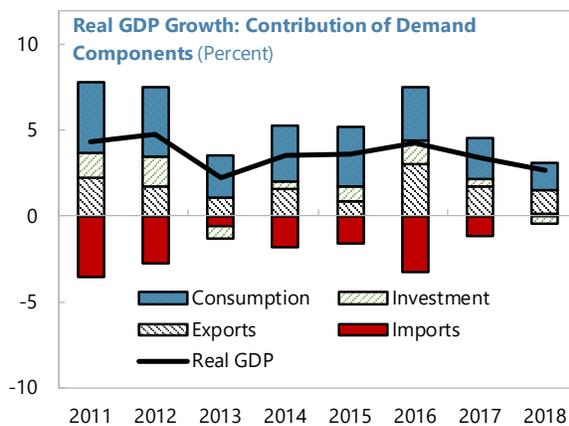
**38. It is proposed that the next Article IV consultation with Costa Rica be held on the standard 12-month cycle.**

**Figure 1. Costa Rica: Recent Developments, Real Sector**

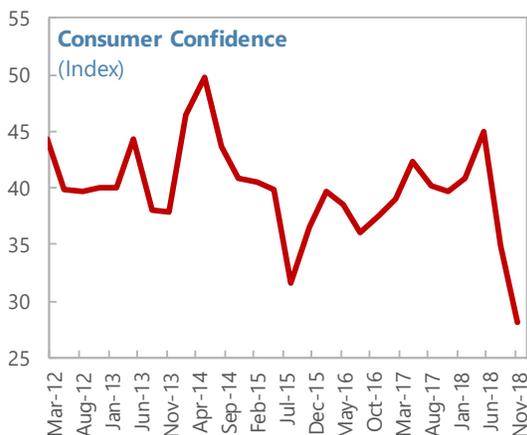
After picking up in 2014-16, real GDP growth has slowed down in line with other CAPRD countries...



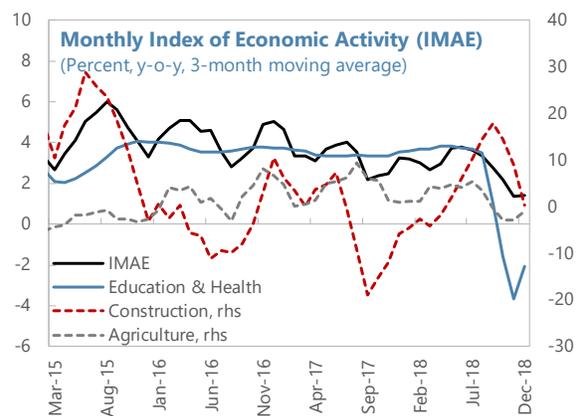
...due to an eroded internal demand...



...partly explained by a sharp decline in consumer confidence due to the uncertainty surrounding the fiscal reform.



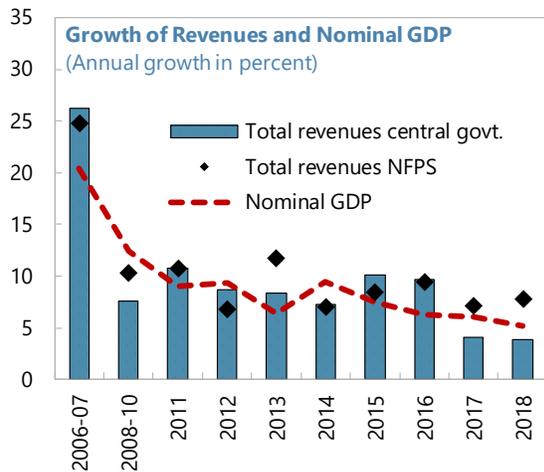
The slowdown of activity in agriculture and manufacturing in 2018, as well as in large services sectors such as health and education, was partially offset by a strong performance of private construction.



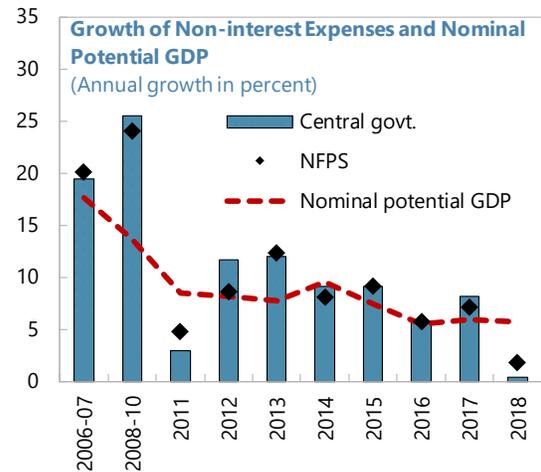
Sources: National authorities, WEO Database, University of Costa Rica, and Fund staff estimates.

**Figure 2. Costa Rica: Recent Developments, Fiscal Sector**

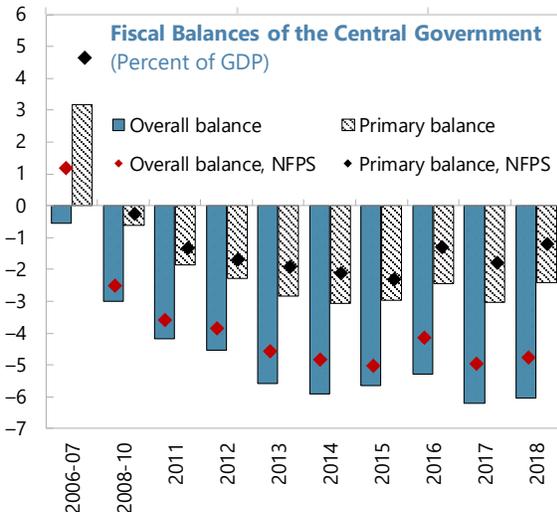
Revenue slowed down as a consequence of lower economic growth...



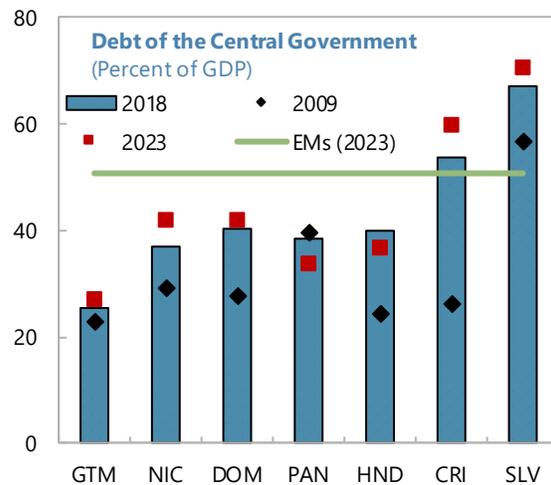
...while growth of non-interest current expenditure declined owed to restrained transfers.



Despite the slight improvements in both the primary and overall deficit, which were helped by expenditure restraint, ...



... the debt to GDP ratio reaches historic highs and is above the regional average.

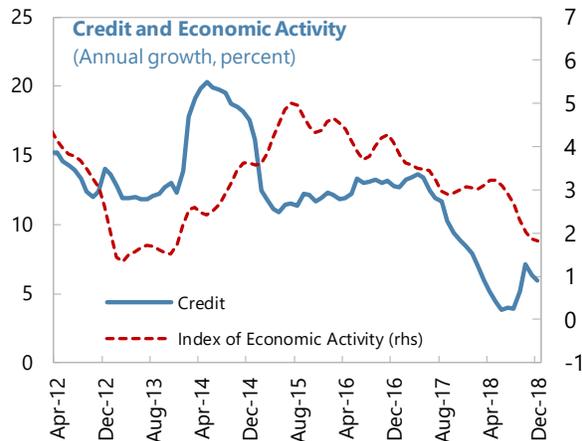
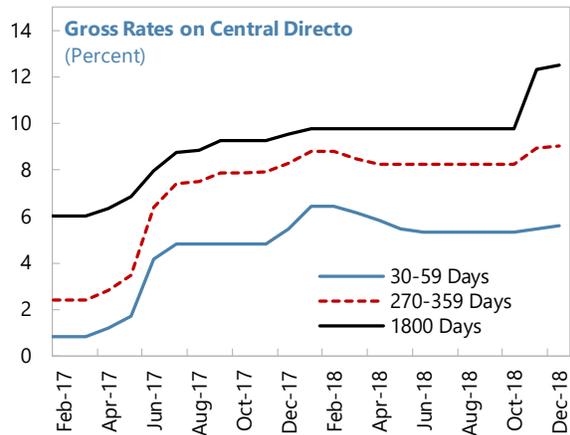


Sources: National authorities, WEO Database, and Fund staff estimates.

**Figure 3. Costa Rica: Recent Developments, Financial Sector**

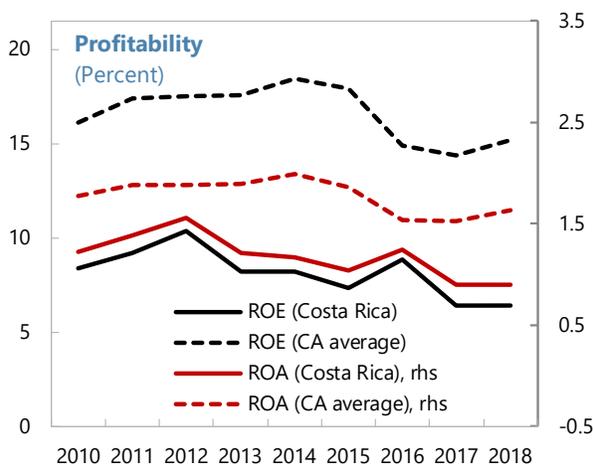
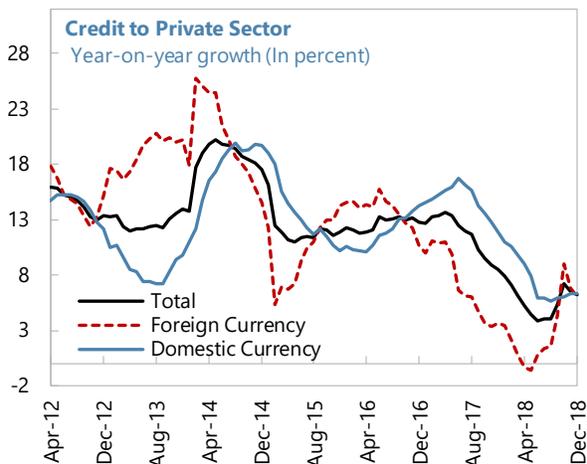
The BCCR started revising its easing cycle in March 2017. On top of raising the policy rate, BCCR also increased the interest rate on term deposits, most notably those with longer maturity.

Higher interest rates, together with slowing economic activity, caused credit growth to fall to half of the pace as in previous years.



Until recent months, credit growth had been on a downward trajectory since mid-2017, driven by falls in both domestic-currency and FX lending.

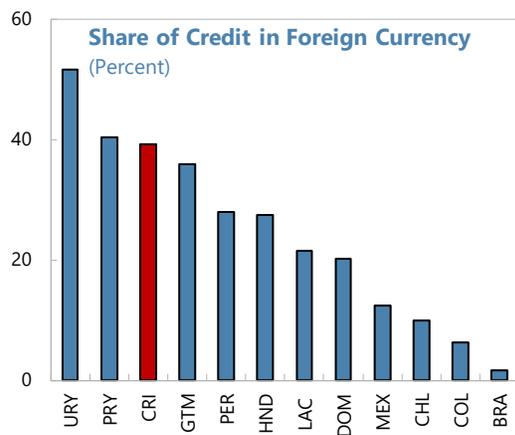
Slowdown in credit depressed bank profitability, which is already low compared to the rest of the region.



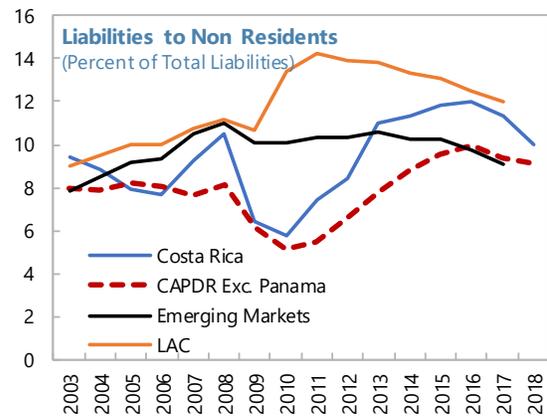
Sources: National authorities, WEO Database, and Fund staff estimates.

**Figure 4. Costa Rica: Financial Sector Risks and Vulnerabilities**

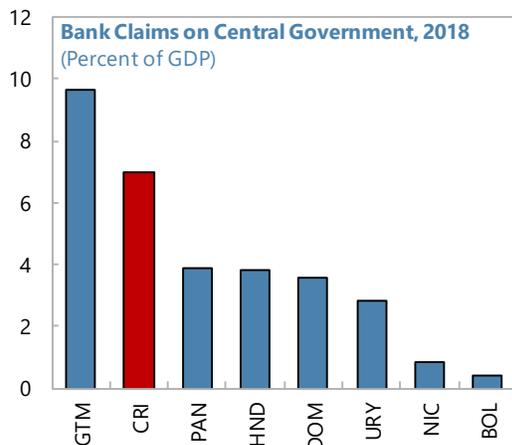
Costa Rica is one of the countries with the highest credit dollarization in the region...



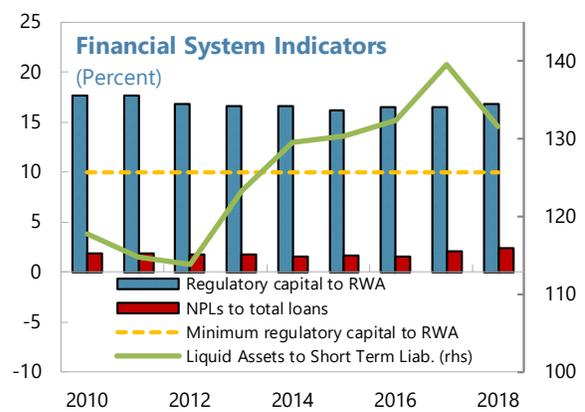
...and among the most reliant on foreign funding.



Exposure to a sovereign with high and rising public debt is another area of concern.



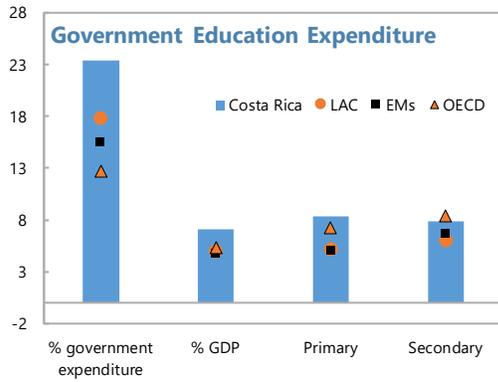
However, banks are adequately capitalized and liquid, and NPLs remain low despite recent increase.



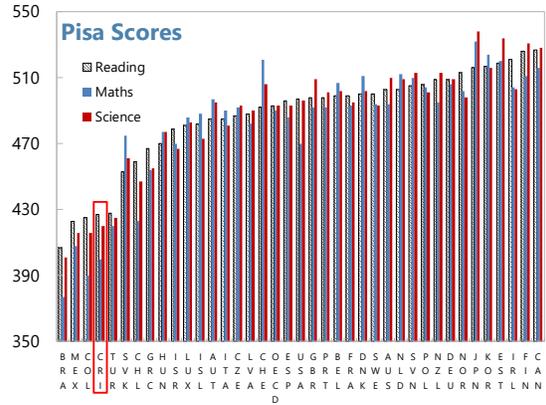
Sources: IFS, WEO Database, and Fund staff estimates.

**Figure 5. Costa Rica: Education Spending and Outcomes**

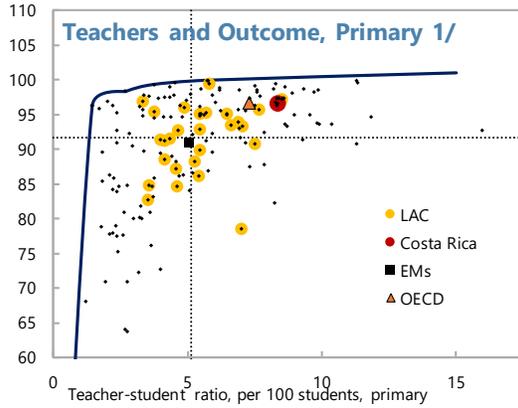
Costa Rica's government spending on education is high compared with that of peers and the OECD average, ...



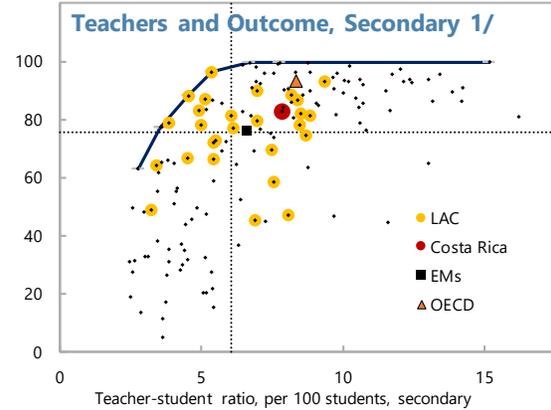
...but education outcome is subpar in terms of PISA scores.



Net school enrollment rates are relatively far from the efficiency frontiers for both primary and...



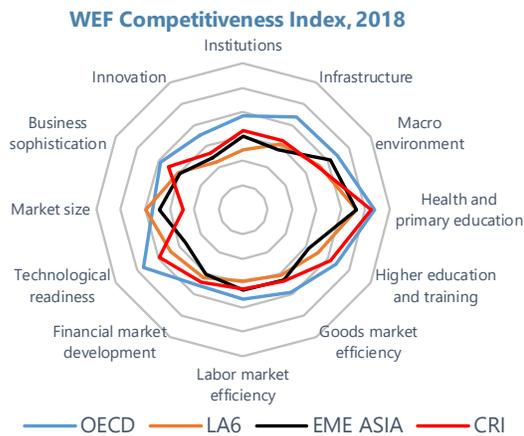
...secondary education.



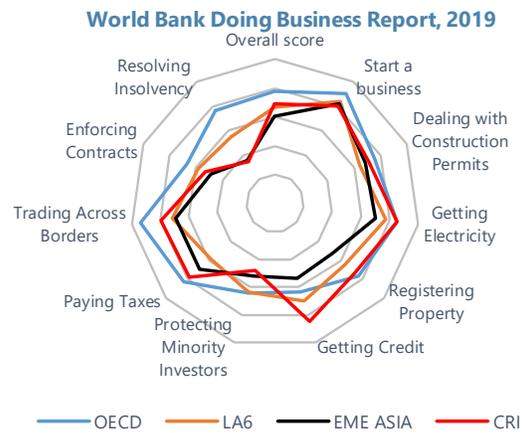
Sources: WEO Database, World Database, OECD, and IMF staff estimates.

**Figure 6. Costa Rica: Competitiveness, Inclusive Growth, and Structural Reforms**

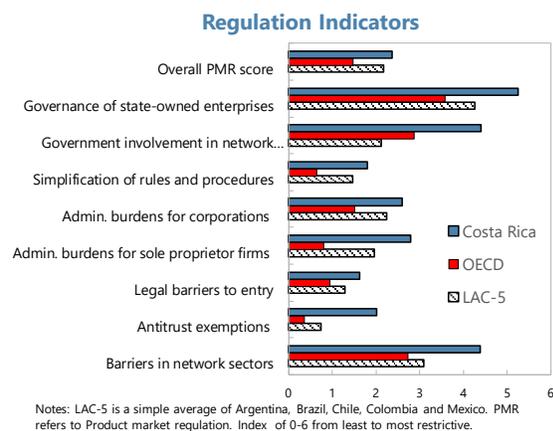
Costa Rica's competitiveness indicators compare favorably with peers but lag the OECD, particularly regarding infrastructure and innovation.



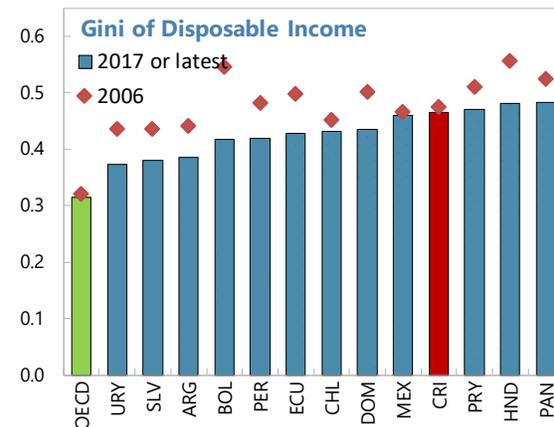
Doing business indicators deteriorated significantly last year, reflecting inefficient government bureaucracy and problematic insolvency and contract-enforcing framework.



Overly complex regulations and weakness in SOE governance deter new firms from entering the market.



Meanwhile, inequality is persistently high compared with both the OECD and regional peers, hindering inclusive growth.



Sources: World Economic Forum; World Bank Doing Business Indicators; OECD, and IMF staff estimates.

**Table 1. Costa Rica: Selected Social and Economic Indicators**

<b>I. Social Indicators</b>						
Population (2018, millions)	5.0	Human Development Index Rank (2018)	63	(out of 188)		
Per capita GDP (2018, U.S. dollars)	12,570	Life expectancy (2017, years)	79.6			
Unemployment (2018, percent of labor force)	12.0	Literacy rate (2018, percent of people ages > 15)	96.7			
Poverty (2018, percent of population)	21.1	Ratio of girls to boys in primary and secondary				
Income share held by highest 10 percent of households	37.3	education (2018, percent)	101.4			
Income share held by lowest 10 percent of households	1.5	Gini coefficient (2017)	51.4			
<b>II. Economic Indicators</b>						
	2015	2016	2017	2018 <sup>e</sup>	Proj.	
					2019	2020
(Annual percentage change, unless otherwise indicated)						
<b>Output and Prices</b>						
Real GDP growth	3.6	4.2	3.4	2.7	2.9	2.8
Output gap (percent of potential GDP)	-0.2	0.6	0.6	0.2	-0.1	-0.5
GDP deflator	3.8	2.0	2.5	2.4	3.7	3.0
Consumer prices (end of period)	-0.8	0.8	2.6	2.0	3.2	3.0
<b>Money and Credit</b>						
Monetary base	9.2	6.4	10.8	2.3	5.5	5.8
Broad money	10.7	7.5	8.6	5.0	6.9	6.9
Credit to private sector	11.8	12.8	8.5	6.2	7.0	7.3
Monetary policy rate (percent; end of period)	2.3	1.8	4.8	5.3	...	...
Exchange rate (national currency per US dollar, average)	528	538	563	588	...	...
REER	119	117	112	107	...	...
(In percent of GDP, unless otherwise indicated)						
<b>Savings and Investment</b>						
Gross domestic investment	18.4	18.4	18.8	17.5	17.6	17.9
Gross domestic savings	15.0	16.2	15.8	14.3	14.3	14.6
<b>External Sector</b>						
Current account balance	-3.5	-2.2	-3.0	-3.2	-3.2	-3.3
<i>Of which:</i> Trade balance	-8.3	-7.7	-7.4	-7.7	-7.5	-7.4
Financial and capital account balance	-4.7	-2.5	-3.6	-3.0	-3.1	-3.2
<i>Of which:</i> Foreign direct investment	-4.6	-3.7	-4.4	-4.1	-4.2	-4.3
Change in net international reserves (increase +)	622	-260	-424	345	1,005	-305
Net international reserves (millions of U.S. dollars)	7,834	7,574	7,150	7,495	8,500	8,195
Net international reserves (months of next year's imports)	5.2	4.8	4.4	4.5	4.9	4.5
<b>Public Finances</b>						
Central government primary balance	-3.0	-2.4	-3.0	-2.4	-1.8	-0.9
Central government overall balance	-5.6	-5.3	-6.2	-6.0	-5.8	-5.1
Central government debt	40.9	44.9	48.6	53.5	56.2	58.3
Consolidated public sector overall balance 1/	-5.8	-4.7	-5.4	-5.2	-4.8	-4.5
Consolidated public sector debt 2/	45.4	49.8	50.8	56.0	57.4	58.6
<i>Of which:</i> External public debt	11.3	11.3	10.9	12.9	16.5	18.4
<b>Memorandum Item:</b>						
GDP (US\$ billions)	55.4	57.8	58.7	59.0	60.5	63.5

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

e - Estimated figures.

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

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

Table 2. Costa Rica: Balance of Payments, Baseline Scenario

	2015	2016	2017	2018 <sup>e</sup>	Projections					
					2019	2020	2021	2022	2023	2024
	(In millions of U.S. dollars)									
<b>Current Account</b>	-1,921	-1,257	-1,774	-1,874	-1,949	-2,110	-2,222	-2,282	-2,532	-2,699
Goods and services balance	2	684	661	819	996	1,172	1,234	1,224	1,224	1,237
Trade balance	-4,607	-4,426	-4,343	-4,529	-4,534	-4,678	-4,899	-5,170	-5,459	-5,792
Export of goods (f.o.b.)	9,452	10,100	10,808	11,078	11,578	12,278	13,000	13,778	14,606	15,481
Import of goods (f.o.b.)	14,059	14,526	15,150	15,607	16,113	16,956	17,899	18,947	20,066	21,272
Services balance	4,609	5,110	5,004	5,348	5,530	5,850	6,133	6,394	6,684	7,029
Of which: Travel balance	2,576	2,845	2,828	2,921	3,015	3,183	3,338	3,488	3,653	3,846
Exports of services	7,694	8,537	8,704	9,058	9,332	9,839	10,322	10,805	11,330	11,944
Imports of services	3,085	3,427	3,701	3,710	3,801	3,990	4,189	4,412	4,646	4,915
Primary Income	-2,380	-2,452	-2,941	-3,188	-3,457	-3,808	-4,000	-4,071	-4,346	-4,551
Secondary Income	457	510	507	494	512	526	543	565	590	615
<b>Capital Account</b>	31	87	41	41	41	41	41	41	41	41
<b>Financial Account</b>	-2,608	-1,547	-2,127	-1,834	-1,909	-2,069	-2,182	-2,241	-2,491	-2,658
Public sector	-1,868	-392	-132	-1,365	-1,997	-985	-1,404	-1,590	-161	-328
Private sector	-1,363	-895	-1,571	-814	-916	-779	-728	-1,051	-2,330	-2,330
Foreign direct investment, net	-2,541	-2,127	-2,583	-2,415	-2,530	-2,729	-2,928	-3,120	-3,309	-3,523
Other private sector flows	1,179	1,232	1,012	1,601	1,614	1,950	2,200	2,069	979	1,193
Change in International Reserves (increase +)	622	-260	-424	345	1,005	-305	-50	400	0	0
<b>Errors and Omissions</b>	-717	-376	-394	0	0	0	0	0	0	0
	(In percent of GDP)									
<b>Current Account</b>	-3.5	-2.2	-3.0	-3.2	-3.2	-3.3	-3.3	-3.3	-3.4	-3.4
Goods and services balance	0.0	1.2	1.1	1.4	1.6	1.8	1.9	1.7	1.7	1.6
Trade balance	-8.3	-7.7	-7.4	-7.7	-7.5	-7.4	-7.4	-7.4	-7.4	-7.4
Export of goods (f.o.b.)	17.1	17.5	18.4	18.8	19.2	19.3	19.5	19.6	19.7	19.8
Import of goods (f.o.b.)	25.4	25.1	25.8	26.4	26.7	26.9	27.0	27.1	27.2	
Services balance	8.3	8.8	8.5	9.1	9.1	9.2	9.2	9.1	9.0	9.0
Of which: Travel balance	4.6	4.9	4.8	5.0	5.0	5.0	5.0	5.0	4.9	4.9
Exports of services	13.9	14.8	14.8	15.4	15.4	15.5	15.5	15.4	15.3	15.3
Imports of services	5.6	5.9	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3
Primary Income	-4.3	-4.2	-5.0	-5.4	-5.7	-6.0	-6.0	-5.8	-5.9	-5.8
Secondary Income	0.8	0.9	0.9	0.8	0.8	0.8	0.8	0.8	0.8	0.8
<b>Capital Account</b>	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
<b>Financial Account</b>	-4.7	-2.7	-3.6	-3.1	-3.2	-3.3	-3.3	-3.2	-3.4	-3.4
Public sector	-3.4	-0.7	-0.2	-2.3	-3.3	-1.6	-2.1	-2.3	-0.2	-0.4
Private sector	-2.5	-1.5	-2.7	-1.4	-1.5	-1.2	-1.1	-1.5	-3.1	-3.0
Foreign direct investment, net	-4.6	-3.7	-4.4	-4.1	-4.2	-4.3	-4.4	-4.4	-4.5	-4.5
Other private sector flows	2.1	2.1	1.7	2.7	2.7	3.1	3.3	2.9	1.3	1.5
Change in International Reserves (increase +)	1.1	-0.4	-0.7	0.6	1.7	-0.5	-0.1	0.6	0.0	0.0
<b>Errors and Omissions</b>	-1.3	-0.7	-0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Memorandum Items:</b>										
Non-oil current account (percent of GDP)	-1.4	-0.4	-0.8	-0.5	-0.8	-0.9	-0.9	-0.9	-1.1	-1.1
Terms of trade (annual percentage change)	8.0	1.5	-6.7	-2.3	1.1	0.5	0.5	0.7	0.7	0.6
Net international reserves (millions of U.S. dollars)	7,834	7,574	7,150	7,495	8,500	8,195	8,145	8,545	8,545	8,545
-in months of next year's non-maquila imports	5.3	4.9	4.6	4.7	5.0	4.6	4.3	4.3	4.0	4.0
-in percent short-term debt 1/	197.7	166.7	167.0	155.3	154.8	162.2	156.0	128.3	126.6	124.6
External financing need (NIR gap to 3 months' of imports)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
External debt (percent of GDP) 2/	42.5	44.2	46.3	49.5	52.8	53.3	54.3	55.2	53.1	51.3

Sources: Central Bank of Costa Rica; and Fund staff estimates.

e - Estimated figures.

1/ Public and private sector external debt on remaining maturity. Includes trade credit.

2/ Includes public and private sector debt.

Table 3. Costa Rica: Central Government Balance, Baseline Scenario

	2015	2016	2017	2018 <sup>e</sup>	Projection					
					2019	2020	2021	2022	2023	2024
	(In billions of colones)									
<b>Revenue</b>	<b>3,994</b>	<b>4,379</b>	<b>4,560</b>	<b>4,737</b>	<b>5,367</b>	<b>5,883</b>	<b>6,297</b>	<b>6,754</b>	<b>7,205</b>	<b>7,717</b>
Tax revenue	3,862	4,168	4,390	4,567	5,224	5,732	6,137	6,584	7,024	7,523
Nontax revenue 1/	132	212	170	169	143	151	160	170	181	194
<b>Expenditure</b>	<b>5,647</b>	<b>6,024</b>	<b>6,610</b>	<b>6,829</b>	<b>7,510</b>	<b>7,882</b>	<b>8,308</b>	<b>8,624</b>	<b>8,970</b>	<b>9,351</b>
Current noninterest	4,330	4,563	4,907	5,096	5,407	5,529	5,703	5,758	5,824	6,245
Wages	2,113	2,178	2,290	2,395	2,448	2,495	2,551	2,610	2,766	2,930
Goods and services	194	198	217	224	239	253	268	284	302	323
Transfers	2,023	2,187	2,400	2,477	2,719	2,781	2,884	2,863	2,756	2,993
Interest 2/	787	886	1,054	1,254	1,459	1,647	1,796	1,964	2,158	2,038
Capital	530	575	649	480	644	706	809	903	988	1,069
<b>Primary balance</b>	<b>-866</b>	<b>-758</b>	<b>-996</b>	<b>-839</b>	<b>-684</b>	<b>-351</b>	<b>-215</b>	<b>94</b>	<b>393</b>	<b>404</b>
<b>Overall Balance</b>	<b>-1,653</b>	<b>-1,644</b>	<b>-2,050</b>	<b>-2,093</b>	<b>-2,142</b>	<b>-1,999</b>	<b>-2,011</b>	<b>-1,870</b>	<b>-1,765</b>	<b>-1,634</b>
Total Financing	1,659	1,734	2,066	2,066	2,142	1,999	2,011	1,870	1,765	1,634
External (net)	598	160	62	141	1,625	1,221	971	930	162	137
Domestic (net)	1,055	1,484	1,988	1,952	517	778	1,041	940	1,603	1,497
Unidentified financing	0	0	0	0	0	0	0	0	0	0
<b>Central government debt</b>	<b>11,969</b>	<b>13,987</b>	<b>16,042</b>	<b>18,576</b>	<b>20,795</b>	<b>22,860</b>	<b>24,950</b>	<b>26,899</b>	<b>28,744</b>	<b>30,462</b>
External	2,929	3,177	3,350	3,744	5,370	6,468	7,448	8,392	8,086	8,246
Domestic	9,040	10,810	12,693	14,832	15,425	16,391	17,502	18,507	20,658	22,216
Other debt (unidentified financing)	0	0	0	0	0	0	0	0	0	0
	(In percent of GDP)									
<b>Revenue</b>	<b>13.6</b>	<b>14.1</b>	<b>13.8</b>	<b>13.7</b>	<b>14.5</b>	<b>15.0</b>	<b>15.2</b>	<b>15.3</b>	<b>15.4</b>	<b>15.5</b>
Tax revenue	13.2	13.4	13.3	13.2	14.1	14.6	14.8	15.0	15.0	15.1
Nontax revenue 1/	0.5	0.7	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4
<b>Expenditure</b>	<b>19.3</b>	<b>19.3</b>	<b>20.0</b>	<b>19.7</b>	<b>20.3</b>	<b>20.1</b>	<b>20.0</b>	<b>19.6</b>	<b>19.2</b>	<b>18.7</b>
Current noninterest	14.8	14.7	14.9	14.7	14.6	14.1	13.7	13.1	12.4	12.5
Wages	7.2	7.0	6.9	6.9	6.6	6.4	6.2	5.9	5.9	5.9
Goods and services	0.7	0.6	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Transfers	6.9	7.0	7.3	7.1	7.3	7.1	7.0	6.5	5.9	6.0
Interest 2/	2.7	2.8	3.2	3.6	3.9	4.2	4.3	4.5	4.6	4.1
Capital	1.8	1.8	2.0	1.4	1.7	1.8	2.0	2.1	2.1	2.1
<b>Primary balance</b>	<b>-3.0</b>	<b>-2.4</b>	<b>-3.0</b>	<b>-2.4</b>	<b>-1.8</b>	<b>-0.9</b>	<b>-0.5</b>	<b>0.2</b>	<b>0.8</b>	<b>0.8</b>
<b>Overall Balance</b>	<b>-5.6</b>	<b>-5.3</b>	<b>-6.2</b>	<b>-6.0</b>	<b>-5.8</b>	<b>-5.1</b>	<b>-4.8</b>	<b>-4.2</b>	<b>-3.8</b>	<b>-3.3</b>
Total Financing	5.7	5.6	6.3	6.0	5.8	5.1	4.8	4.2	3.8	3.3
External (net)	2.0	0.5	0.2	0.4	4.4	3.1	2.3	2.1	0.3	0.3
Domestic (net)	3.6	4.8	6.0	5.6	1.4	2.0	2.5	2.1	3.4	3.0
Unidentified financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Central government debt</b>	<b>40.9</b>	<b>44.9</b>	<b>48.6</b>	<b>53.5</b>	<b>56.2</b>	<b>58.3</b>	<b>60.1</b>	<b>61.1</b>	<b>61.4</b>	<b>61.0</b>
External	10.0	10.2	10.1	10.8	14.5	16.5	18.0	19.1	17.3	16.5
Domestic	30.9	34.7	38.4	42.8	41.6	41.8	42.2	42.0	44.1	44.5
Other debt (unidentified financing)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Memorandum items:</b>										
Non-interest expenditure growth (percent)										
in nominal terms	9.1	5.7	8.1	0.4	8.5	3.0	4.4	2.3	2.3	7.4
in real terms	8.2	5.7	6.4	-1.9	5.8	-0.1	1.4	-0.7	-0.7	4.2
Nominal GDP	29,281	31,136	33,015	34,693	37,035	39,209	41,480	44,035	46,809	49,938
CPI Inflation (period average)	0.8	0.0	1.6	2.3	2.6	3.1	3.0	3.0	3.0	3.0

Sources: Ministry of Finance and Fund staff estimates.

e - Estimated figures.

1/ Transfers to the Social development and Family Transfers Fund (FODESAF) are recorded in net terms.

2/ The inflation adjustment of the principal of TUDES (inflation indexed bonds) was recorded as interest expenditure.

**Table 4. Costa Rica: Summary Operations of the Central Government,  
GFSM 2001 Classification, Baseline Scenario**

	2015	2016	2017	2018 <sup>e</sup>	Projections					
					2019	2020	2021	2022	2023	2024
	(In billions of colones)									
<b>Revenue</b>	<b>3,994</b>	<b>4,379</b>	<b>4,560</b>	<b>4,737</b>	<b>5,367</b>	<b>5,883</b>	<b>6,297</b>	<b>6,754</b>	<b>7,205</b>	<b>7,717</b>
Taxes	3,862	4,168	4,390	4,567	5,224	5,732	6,137	6,584	7,024	7,523
Other revenue 1/	132	212	170	169	143	151	160	170	181	194
<b>Expenditure</b>	<b>5,647</b>	<b>6,024</b>	<b>6,610</b>	<b>6,829</b>	<b>7,510</b>	<b>7,882</b>	<b>8,308</b>	<b>8,624</b>	<b>8,970</b>	<b>9,351</b>
<b>Expense</b>	<b>5,117</b>	<b>5,448</b>	<b>5,961</b>	<b>6,350</b>	<b>6,865</b>	<b>7,176</b>	<b>7,499</b>	<b>7,721</b>	<b>7,982</b>	<b>8,283</b>
Compensation of employees	2,113	2,178	2,290	2,395	2,448	2,495	2,551	2,610	2,766	2,930
Purchases of goods and services	194	198	217	224	239	253	268	284	302	323
Interest 2/	787	886	1,054	1,254	1,459	1,647	1,796	1,964	2,158	2,038
Of which: Adjustment for TUDES	-13	11	32	25	38	37	39	42	44	48
Social benefits	710	681	718	752	803	850	899	955	1,015	1,083
Other expense 3/	1,313	1,507	1,682	1,725	1,916	1,931	1,984	1,908	1,741	1,910
<b>Net acquisition of nonfinancial assets</b>	<b>530</b>	<b>575</b>	<b>649</b>	<b>480</b>	<b>644</b>	<b>706</b>	<b>809</b>	<b>903</b>	<b>988</b>	<b>1,069</b>
<b>Gross operating balance</b>	<b>-1,124</b>	<b>-1,069</b>	<b>-1,401</b>	<b>-1,613</b>	<b>-1,498</b>	<b>-1,293</b>	<b>-1,202</b>	<b>-967</b>	<b>-778</b>	<b>-565</b>
<b>Net lending/borrowing</b>	<b>-1,653</b>	<b>-1,644</b>	<b>-2,050</b>	<b>-2,093</b>	<b>-2,142</b>	<b>-1,999</b>	<b>-2,011</b>	<b>-1,870</b>	<b>-1,765</b>	<b>-1,634</b>
<b>Net financial transactions</b>	<b>1,659</b>	<b>1,734</b>	<b>2,066</b>	<b>2,066</b>	<b>2,142</b>	<b>1,999</b>	<b>2,011</b>	<b>1,870</b>	<b>1,765</b>	<b>1,634</b>
	(In percent of GDP)									
<b>Revenue</b>	<b>13.6</b>	<b>14.1</b>	<b>13.8</b>	<b>13.7</b>	<b>14.5</b>	<b>15.0</b>	<b>15.2</b>	<b>15.3</b>	<b>15.4</b>	<b>15.5</b>
Tax revenue	13.2	13.4	13.3	13.2	14.1	14.6	14.8	15.0	15.0	15.1
Nontax revenue 1/	0.5	0.7	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4
<b>Expenditure</b>	<b>19.3</b>	<b>19.3</b>	<b>20.0</b>	<b>19.7</b>	<b>20.3</b>	<b>20.1</b>	<b>20.0</b>	<b>19.6</b>	<b>19.2</b>	<b>18.7</b>
<b>Expense</b>	<b>17.5</b>	<b>17.5</b>	<b>18.1</b>	<b>18.3</b>	<b>18.5</b>	<b>18.3</b>	<b>18.1</b>	<b>17.5</b>	<b>17.1</b>	<b>16.6</b>
Compensation of employees	7.2	7.0	6.9	6.9	6.6	6.4	6.2	5.9	5.9	5.9
Purchases of goods and services	0.7	0.6	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Interest 2/	2.7	2.8	3.2	3.6	3.9	4.2	4.3	4.5	4.6	4.1
Of which: Adjustment for TUDES	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Social benefits	2.4	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Other expense 3/	4.5	4.8	5.1	5.0	5.2	4.9	4.8	4.3	3.7	3.8
<b>Net acquisition of nonfinancial assets</b>	<b>1.8</b>	<b>1.8</b>	<b>2.0</b>	<b>1.4</b>	<b>1.7</b>	<b>1.8</b>	<b>2.0</b>	<b>2.1</b>	<b>2.1</b>	<b>2.1</b>
<b>Gross operating balance</b>	<b>-3.8</b>	<b>-3.4</b>	<b>-4.2</b>	<b>-4.6</b>	<b>-4.0</b>	<b>-3.3</b>	<b>-2.9</b>	<b>-2.2</b>	<b>-1.7</b>	<b>-1.1</b>
<b>Net lending/borrowing</b>	<b>-5.6</b>	<b>-5.3</b>	<b>-6.2</b>	<b>-6.0</b>	<b>-5.8</b>	<b>-5.1</b>	<b>-4.8</b>	<b>-4.2</b>	<b>-3.8</b>	<b>-3.3</b>
<b>Net financial transactions</b>	<b>5.7</b>	<b>5.6</b>	<b>6.3</b>	<b>6.0</b>	<b>5.8</b>	<b>5.1</b>	<b>4.8</b>	<b>4.2</b>	<b>3.8</b>	<b>3.3</b>
<b>Memorandum items:</b>										
Non-interest expenditure growth (percent)										
in nominal terms	9.1	5.7	8.1	0.4	8.5	3.0	4.4	2.3	2.3	7.4
in real terms	8.2	5.7	6.4	-1.9	5.8	-0.1	1.4	-0.7	-0.7	4.2
Primary balance										
in billions of colones	-866	-758	-996	-839	-684	-351	-215	94	393	404
in percent of GDP	-3.0	-2.4	-3.0	-2.4	-1.8	-0.9	-0.5	0.2	0.8	0.8
Cyclically-adjusted primary balance (percent of GDP)	-2.9	-2.5	-3.1	-2.4	-1.8	-0.8	-0.4	0.4	1.0	1.0
Fiscal impulse (percent of GDP)	-0.1	-0.4	0.6	-0.7	-0.6	-1.0	-0.4	-0.8	-0.6	0.0
Nominal GDP	29,281	31,136	33,015	34,693	37,035	39,209	41,480	44,035	46,809	49,938
CPI Inflation (period average)	0.8	0.0	1.6	2.3	2.6	3.1	3.0	3.0	3.0	3.0

Sources: Ministry of Finance and Fund staff estimates.

e - Estimated figures.

1/ Transfers to the Social development and Family Transfers Fund (FODESAF) are recorded in net terms.

2/ The inflation adjustment of the principal of TUDES (inflation indexed bonds) was recorded as interest expenditure.

3/ Includes subsidies, transfers and other expense.

**Table 5. Costa Rica: Consolidated Public Sector Operations, Baseline Scenario /1**

	2015	2016	2017	2018 <sup>e</sup>	Projections					
					2019	2020	2021	2022	2023	2024
(In billions of colones)										
<b>Nonfinancial public sector:</b>										
<b>Revenue</b>	<b>6,533</b>	<b>7,215</b>	<b>7,576</b>	<b>7,897</b>	<b>8,761</b>	<b>9,313</b>	<b>9,774</b>	<b>10,292</b>	<b>10,811</b>	<b>11,407</b>
Tax revenue	3,917	4,230	4,456	4,636	5,298	5,810	6,219	6,671	7,117	7,622
Nontax revenue	312	415	410	413	423	436	461	489	520	555
Social security contributions	2,225	2,456	2,544	2,673	2,853	2,870	2,884	2,909	2,937	2,977
Operating balance of public enterprises	79	115	167	175	187	198	210	223	237	252
<b>Expenditure 2/</b>	<b>8,004</b>	<b>8,514</b>	<b>9,214</b>	<b>9,553</b>	<b>10,394</b>	<b>10,934</b>	<b>11,534</b>	<b>12,043</b>	<b>12,602</b>	<b>13,209</b>
Current noninterest	6,427	6,772	7,206	7,530	8,023	8,310	8,646	8,882	9,145	9,788
Wages	2,791	2,888	3,016	3,158	3,263	3,357	3,463	3,578	3,795	4,028
Goods and services	643	685	709	741	791	837	886	940	999	1,066
Transfers	2,993	3,200	3,481	3,631	3,970	4,117	4,297	4,363	4,350	4,694
Interest	795	891	1,044	1,230	1,410	1,594	1,737	1,896	2,084	1,941
<i>Of which: Adjustment for TUDES 3/</i>	-7	6	17	13	21	20	22	23	24	26
Capital	783	851	964	793	961	1,029	1,151	1,266	1,374	1,480
<b>Primary balance</b>	<b>-677</b>	<b>-408</b>	<b>-595</b>	<b>-426</b>	<b>-223</b>	<b>-26</b>	<b>-23</b>	<b>144</b>	<b>292</b>	<b>139</b>
<b>Overall Balance</b>	<b>-1,472</b>	<b>-1,298</b>	<b>-1,639</b>	<b>-1,656</b>	<b>-1,633</b>	<b>-1,620</b>	<b>-1,760</b>	<b>-1,752</b>	<b>-1,791</b>	<b>-1,802</b>
Central government	-1,653	-1,644	-2,050	-2,093	-2,142	-1,999	-2,011	-1,870	-1,765	-1,634
Decentralized government entities	224	333	359	384	457	325	199	66	-79	-221
Public enterprises	-42	13	53	53	53	53	53	53	53	53
Total Financing	<b>1,472</b>	<b>1,298</b>	<b>1,639</b>	<b>1,656</b>	<b>1,633</b>	<b>1,620</b>	<b>1,760</b>	<b>1,752</b>	<b>1,791</b>	<b>1,802</b>
External	614	176	76	201	1,642	1,237	987	968	200	175
Domestic	858	1,123	1,563	1,454	-9	383	773	784	1,591	1,627
Unidentified financing	0	0	0	0	0	0	0	0	0	0
<b>Consolidated public sector:</b>										
Central Bank balance	-219	-179	-136	-143	-153	-162	-171	-182	-193	-206
<b>Consolidated public sector balance</b>	<b>-1,691</b>	<b>-1,477</b>	<b>-1,774</b>	<b>-1,799</b>	<b>-1,785</b>	<b>-1,782</b>	<b>-1,931</b>	<b>-1,933</b>	<b>-1,984</b>	<b>-2,008</b>
<b>Consolidated public sector debt</b>										
<b>13,294</b>	<b>15,501</b>	<b>16,779</b>	<b>19,442</b>	<b>21,257</b>	<b>22,963</b>	<b>24,672</b>	<b>26,207</b>	<b>27,606</b>	<b>28,839</b>	
(In percent of GDP)										
<b>Nonfinancial public sector:</b>										
<b>Revenue</b>	<b>22.3</b>	<b>23.2</b>	<b>22.9</b>	<b>22.8</b>	<b>23.7</b>	<b>23.8</b>	<b>23.6</b>	<b>23.4</b>	<b>23.1</b>	<b>22.8</b>
Tax revenue	13.4	13.6	13.5	13.4	14.3	14.8	15.0	15.1	15.2	15.3
Nontax revenue	1.1	1.3	1.2	1.2	1.1	1.1	1.1	1.1	1.1	1.1
Social security contributions	7.6	7.9	7.7	7.7	7.7	7.3	7.0	6.6	6.3	6.0
Operating balance of public enterprises	0.3	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
<b>Expenditure 2/</b>	<b>27.3</b>	<b>27.3</b>	<b>27.9</b>	<b>27.5</b>	<b>28.1</b>	<b>27.9</b>	<b>27.8</b>	<b>27.4</b>	<b>26.9</b>	<b>26.5</b>
Current noninterest	21.9	21.8	21.8	21.7	21.7	21.2	20.8	20.2	19.5	19.6
Wages	9.5	9.3	9.1	9.1	8.8	8.6	8.3	8.1	8.1	8.1
Goods and services	2.2	2.2	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Transfers	10.2	10.3	10.5	10.5	10.7	10.5	10.4	9.9	9.3	9.4
Interest	2.7	2.9	3.2	3.5	3.8	4.1	4.2	4.3	4.5	3.9
<i>Of which: Adjustment for TUDES 3/</i>	0.0	0.0	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Capital	2.7	2.7	2.9	2.3	2.6	2.6	2.8	2.9	2.9	3.0
<b>Primary balance</b>	<b>-2.3</b>	<b>-1.3</b>	<b>-1.8</b>	<b>-1.2</b>	<b>-0.6</b>	<b>-0.1</b>	<b>-0.1</b>	<b>0.3</b>	<b>0.6</b>	<b>0.3</b>
<b>Overall Balance</b>	<b>-5.0</b>	<b>-4.2</b>	<b>-5.0</b>	<b>-4.8</b>	<b>-4.4</b>	<b>-4.1</b>	<b>-4.2</b>	<b>-4.0</b>	<b>-3.8</b>	<b>-3.6</b>
Central government	-5.6	-5.3	-6.2	-6.0	-5.8	-5.1	-4.8	-4.2	-3.8	-3.3
Decentralized government entities	0.8	1.1	1.1	1.1	1.2	0.8	0.5	0.1	-0.2	-0.4
Public enterprises	-0.1	0.0	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Total Financing	<b>5.0</b>	<b>4.2</b>	<b>5.0</b>	<b>4.8</b>	<b>4.4</b>	<b>4.1</b>	<b>4.2</b>	<b>4.0</b>	<b>3.8</b>	<b>3.6</b>
External	2.1	0.6	0.2	0.6	4.4	3.2	2.4	2.2	0.4	0.4
Domestic	2.9	3.6	4.7	4.2	0.0	1.0	1.9	1.8	3.4	3.3
Unidentified financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Consolidated public sector:</b>										
Central Bank balance	-0.7	-0.6	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
<b>Consolidated public sector balance</b>	<b>-5.8</b>	<b>-4.7</b>	<b>-5.4</b>	<b>-5.2</b>	<b>-4.8</b>	<b>-4.5</b>	<b>-4.7</b>	<b>-4.4</b>	<b>-4.2</b>	<b>-4.0</b>
<b>Consolidated public sector debt</b>										
<b>45.4</b>	<b>49.8</b>	<b>50.8</b>	<b>56.0</b>	<b>57.4</b>	<b>58.6</b>	<b>59.5</b>	<b>59.5</b>	<b>59.0</b>	<b>57.7</b>	
Consolidated public sector debt, including ICE	48.9	53.5	54.7	60.3	61.6	62.5	63.4	63.4	61.8	60.6
Nominal GDP	29,281	31,136	33,015	34,693	37,035	39,209	41,480	44,035	46,809	49,938
CPI Inflation (period average)	0.8	0.0	1.6	2.3	2.6	3.1	3.0	3.0	3.0	3.0

Sources: Ministry of Finance and Fund staff estimates.

e - Estimated figures.

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

2/ Expenditure was adjusted downward in 2010 and upward in 2011 by ½ percent of GDP to reflect a capital project recorded in 2010 but undertaken in 2011.

3/ The inflation adjustment of the principal of TUDES (inflation indexed bonds) was recorded as interest expenditure.

**Table 6. Costa Rica: Summary Operations of the Consolidated Public Sector, GFSM 2001 Classifications. Baseline Scenario 1/**

	2015	2016	2017	2018 <sup>e</sup>	Projections					
					2019	2020	2021	2022	2023	2024
(In billions of colones)										
<b>Nonfinancial public sector:</b>										
<b>Revenue</b>	<b>6,533</b>	<b>7,215</b>	<b>7,576</b>	<b>7,897</b>	<b>8,761</b>	<b>9,313</b>	<b>9,774</b>	<b>10,292</b>	<b>10,811</b>	<b>11,407</b>
Taxes	3,917	4,230	4,456	4,636	5,298	5,810	6,219	6,671	7,117	7,622
Social contributions	2,225	2,456	2,544	2,673	2,853	2,870	2,884	2,909	2,937	2,977
Operating balance of public enterprises	79	115	167	175	187	198	210	223	237	252
Other revenue	312	415	410	413	423	436	461	489	520	555
<b>Expenditure</b>	<b>8,004</b>	<b>8,514</b>	<b>9,214</b>	<b>9,553</b>	<b>10,394</b>	<b>10,934</b>	<b>11,534</b>	<b>12,043</b>	<b>12,602</b>	<b>13,209</b>
<b>Expense</b>	<b>7,222</b>	<b>7,663</b>	<b>8,250</b>	<b>8,760</b>	<b>9,433</b>	<b>9,905</b>	<b>10,383</b>	<b>10,778</b>	<b>11,228</b>	<b>11,729</b>
Compensation of employees	2,791	2,888	3,016	3,158	3,263	3,357	3,463	3,578	3,795	4,028
Purchases of goods and services	643	685	709	741	791	837	886	940	999	1,066
Interest 2/	795	891	1,044	1,230	1,410	1,594	1,737	1,896	2,084	1,941
Of which: Adjustment for TUDES	-7	6	17	13	21	20	22	23	24	26
Other expense 3/	2,993	3,200	3,481	3,631	3,970	4,117	4,297	4,363	4,350	4,694
<b>Net acquisition of nonfinancial assets</b>	<b>783</b>	<b>851</b>	<b>964</b>	<b>793</b>	<b>961</b>	<b>1,029</b>	<b>1,151</b>	<b>1,266</b>	<b>1,374</b>	<b>1,480</b>
<b>Gross operating balance</b>	<b>-689</b>	<b>-448</b>	<b>-674</b>	<b>-862</b>	<b>-672</b>	<b>-591</b>	<b>-609</b>	<b>-486</b>	<b>-418</b>	<b>-322</b>
<b>Net lending/borrowing (NFPS)</b>	<b>-1,472</b>	<b>-1,298</b>	<b>-1,639</b>	<b>-1,656</b>	<b>-1,633</b>	<b>-1,620</b>	<b>-1,760</b>	<b>-1,752</b>	<b>-1,791</b>	<b>-1,802</b>
<b>Net financial transactions (NFPS)</b>	<b>1,472</b>	<b>1,298</b>	<b>1,639</b>	<b>1,656</b>	<b>1,633</b>	<b>1,620</b>	<b>1,760</b>	<b>1,752</b>	<b>1,791</b>	<b>1,802</b>
<b>Consolidated public sector:</b>										
Central Bank balance	-219	-179	-136	-143	-153	-162	-171	-182	-193	-206
<b>Net lending/borrowing (consolidated public sector)</b>	<b>-1,691</b>	<b>-1,477</b>	<b>-1,774</b>	<b>-1,799</b>	<b>-1,785</b>	<b>-1,782</b>	<b>-1,931</b>	<b>-1,933</b>	<b>-1,984</b>	<b>-2,008</b>
(In percent of GDP)										
<b>Nonfinancial public sector:</b>										
<b>Revenue</b>	<b>22.3</b>	<b>23.2</b>	<b>22.9</b>	<b>22.8</b>	<b>23.7</b>	<b>23.8</b>	<b>23.6</b>	<b>23.4</b>	<b>23.1</b>	<b>22.8</b>
Taxes	13.4	13.6	13.5	13.4	14.3	14.8	15.0	15.1	15.2	15.3
Social contributions	7.6	7.9	7.7	7.7	7.7	7.3	7.0	6.6	6.3	6.0
Operating balance of public enterprises	0.3	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Other revenue	1.1	1.3	1.2	1.2	1.1	1.1	1.1	1.1	1.1	1.1
<b>Expenditure</b>	<b>27.3</b>	<b>27.3</b>	<b>27.9</b>	<b>27.5</b>	<b>28.1</b>	<b>27.9</b>	<b>27.8</b>	<b>27.4</b>	<b>26.9</b>	<b>26.5</b>
<b>Expense</b>	<b>24.7</b>	<b>24.6</b>	<b>25.0</b>	<b>25.2</b>	<b>25.5</b>	<b>25.3</b>	<b>25.0</b>	<b>24.5</b>	<b>24.0</b>	<b>23.5</b>
Compensation of employees	9.5	9.3	9.1	9.1	8.8	8.6	8.3	8.1	8.1	8.1
Purchases of goods and services	2.2	2.2	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Interest 2/	2.7	2.9	3.2	3.5	3.8	4.1	4.2	4.3	4.5	3.9
Other expense 3/	10.2	10.3	10.5	10.5	10.7	10.5	10.4	9.9	9.3	9.4
<b>Net acquisition of nonfinancial assets</b>	<b>2.7</b>	<b>2.7</b>	<b>2.9</b>	<b>2.3</b>	<b>2.6</b>	<b>2.6</b>	<b>2.8</b>	<b>2.9</b>	<b>2.9</b>	<b>3.0</b>
<b>Gross operating balance</b>	<b>-2.4</b>	<b>-1.4</b>	<b>-2.0</b>	<b>-2.5</b>	<b>-1.8</b>	<b>-1.5</b>	<b>-1.5</b>	<b>-1.1</b>	<b>-0.9</b>	<b>-0.6</b>
<b>Net lending/borrowing (NFPS)</b>	<b>-5.0</b>	<b>-4.2</b>	<b>-5.0</b>	<b>-4.8</b>	<b>-4.4</b>	<b>-4.1</b>	<b>-4.2</b>	<b>-4.0</b>	<b>-3.8</b>	<b>-3.6</b>
<b>Net financial transactions (NFPS)</b>	<b>5.0</b>	<b>4.2</b>	<b>5.0</b>	<b>4.8</b>	<b>4.4</b>	<b>4.1</b>	<b>4.2</b>	<b>4.0</b>	<b>3.8</b>	<b>3.6</b>
<b>Consolidated public sector:</b>										
Central Bank balance	-0.7	-0.6	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
<b>Net lending/borrowing (consolidated public sector)</b>	<b>-5.8</b>	<b>-4.7</b>	<b>-5.4</b>	<b>-5.2</b>	<b>-4.8</b>	<b>-4.5</b>	<b>-4.7</b>	<b>-4.4</b>	<b>-4.2</b>	<b>-4.0</b>
<b>Memorandum items:</b>										
NFPS non-interest expenditure growth (percent)										
in nominal terms	9.2	5.7	7.2	1.9	7.9	4.0	4.9	3.6	3.7	7.1
in real terms	8.3	5.8	5.5	-0.4	5.2	0.8	1.8	0.6	0.6	4.0
NFPS primary balance										
in billions of colones	-677	-408	-595	-426	-223	-26	-23	144	292	139
in percent of GDP	-2.3	-1.3	-1.8	-1.2	-0.6	-0.1	-0.1	0.3	0.6	0.3

Sources: Ministry of Finance and Fund staff estimates.

e - Estimated figures.

1/ The consolidated public sector balance comprises the central government, decentralized government entities, public enterprises and the Central Bank.

2/ The inflation adjustment of the principal of TUDES (inflation indexed bonds) was recorded as interest expenditure.

3/ Includes subsidies, transfers and other expense.

Table 7. Costa Rica: Public Sector Debt, Baseline Scenario

	2015	2016	2017	2018 <sup>e</sup>	Projections					
					2019	2020	2021	2022	2023	2024
(In billions of colones)										
Debt issued by:										
<b>NFPS &amp; Central Bank (I) 1/</b>	<b>15,870</b>	<b>18,380</b>	<b>19,964</b>	<b>22,995</b>	<b>25,224</b>	<b>27,357</b>	<b>29,515</b>	<b>31,533</b>	<b>33,449</b>	<b>35,237</b>
Nonfinancial public sector (NFPS) 1/	13,341	15,918	17,933	20,386	22,674	24,806	26,964	28,982	30,897	32,684
Central government	11,969	13,987	16,042	18,576	20,795	22,860	24,950	26,899	28,744	30,462
Rest of nonfinancial public sector 1/	1,373	1,931	1,891	1,810	1,878	1,946	2,015	2,084	2,153	2,222
Central Bank	2,528	2,463	2,031	2,610	2,551	2,551	2,551	2,551	2,552	2,553
<b>Intra-public sector debt holdings (II)</b>	<b>2,576</b>	<b>2,879</b>	<b>3,185</b>	<b>3,554</b>	<b>3,967</b>	<b>4,393</b>	<b>4,843</b>	<b>5,326</b>	<b>5,842</b>	<b>6,398</b>
CCSS 2/	1,501	1,736	1,973	2,280	2,607	2,954	3,320	3,710	4,123	4,565
Other entities of the nonfinancial public sector	1,062	1,129	1,198	1,258	1,343	1,422	1,505	1,597	1,698	1,811
Central Bank	13	14	15	15	16	17	18	20	21	22
<b>Consolidated public sector debt (I-II)</b>	<b>13,294</b>	<b>15,501</b>	<b>16,779</b>	<b>19,442</b>	<b>21,257</b>	<b>22,963</b>	<b>24,672</b>	<b>26,207</b>	<b>27,606</b>	<b>28,839</b>
External	3,300	3,522	3,607	4,470	6,115	7,231	8,228	9,191	8,906	9,086
Domestic	9,993	11,979	13,171	14,972	15,143	15,733	16,443	17,015	18,701	19,753
Other debt (unidentified financing)	0	0	0	0	0	0	0	0	0	0
(In percent of GDP)										
Debt issued by:										
NFPS & Central Bank (I) 1/	54.2	59.0	60.5	66.3	68.1	69.8	71.2	71.6	71.5	70.6
Nonfinancial public sector (NFPS) 1/	45.6	51.1	54.3	58.8	61.2	63.3	65.0	65.8	66.0	65.4
Central government	40.9	44.9	48.6	53.5	56.2	58.3	60.1	61.1	61.4	61.0
Rest of nonfinancial public sector 1/	4.7	6.2	5.7	5.2	5.1	5.0	4.9	4.7	4.6	4.5
Central Bank	8.6	7.9	6.2	7.5	6.9	6.5	6.1	5.8	5.5	5.1
<b>Intra-public sector debt holdings (II)</b>	<b>8.8</b>	<b>9.2</b>	<b>9.6</b>	<b>10.2</b>	<b>10.7</b>	<b>11.2</b>	<b>11.7</b>	<b>12.1</b>	<b>12.5</b>	<b>12.8</b>
CCSS 2/	5.1	5.6	6.0	6.6	7.0	7.5	8.0	8.4	8.8	9.1
Other entities of the nonfinancial public sector	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6
Central Bank	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Consolidated public sector debt (I-II)</b>	<b>45.4</b>	<b>49.8</b>	<b>50.8</b>	<b>56.0</b>	<b>57.4</b>	<b>58.6</b>	<b>59.5</b>	<b>59.5</b>	<b>59.0</b>	<b>57.7</b>
External	11.3	11.3	10.9	12.9	16.5	18.4	19.8	20.9	19.0	18.2
Domestic	34.1	38.5	39.9	43.2	40.9	40.1	39.6	38.6	40.0	39.6
Other debt (unidentified financing)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Nominal GDP	29,281	31,136	33,015	34,693	37,035	39,209	41,480	44,035	46,809	49,938

Sources: Ministry of Finance and Fund staff estimates.

e - Estimated figures.

1/ Excludes the debt issued by the Instituto Costarricense de Electricidad (ICE).

2/ Caja Costarricense del Seguro Social (social security agency).

Table 8. Costa Rica: Monetary Survey, Baseline Scenario

	2015	2016	2017	2018 <sup>e</sup>	Proj.	
					2019	2020
(In billions of colones, unless otherwise indicated)						
<b>Central Bank</b>						
Net foreign assets	4,413	4,445	4,406	4,319	5,374	5,007
Net international reserves	4,167	4,152	4,050	4,533	5,240	5,089
(In millions of U.S. dollars)	7,834	7,574	7,150	7,507	8,512	8,207
Net medium-term foreign assets	0	0	0	0	0	0
Net domestic assets	-2,081	-1,963	-1,657	-1,506	-2,405	-1,866
Net domestic credit	-1,193	-1,442	-1,552	-1,448	-1,605	-1,767
Credit to nonfinancial public sector	-123	-238	-115	-16	-16	-16
Credit to other depository corporations (net)	-1,044	-1,181	-1,408	-1,395	-1,552	-1,714
Credit to other financial corporations (net)	-25	-22	-29	-36	-36	-36
Credit to the private sector (net)	-1	-1	0	-1	-1	-1
Monetary stabilization instruments (-)	-2,491	-2,445	-2,034	-1,934	-1,934	-1,934
Other items (net)	-478	-246	-315	-330	-1,035	-296
Capital account (-)	2,081	2,171	2,244	2,206	2,168	2,131
Monetary base 1/	2,332	2,482	2,749	2,813	2,968	3,141
Currency	1,051	1,109	1,197	1,238	1,281	1,325
Required reserves	1,281	1,373	1,553	1,575	1,688	1,816
<b>Other Depository Institutions</b>						
Net foreign assets	-2,475	-2,719	-2,607	-2,434	-2,598	-2,751
Net domestic assets	19,859	21,914	23,829	24,873	26,440	28,183
Net domestic credit	22,704	24,990	27,239	28,494	30,305	32,274
Credit to nonfinancial public sector (net)	1,999	2,314	2,385	2,344	2,336	2,273
Credit to nonfinancial private sector	16,440	18,541	20,114	21,361	22,853	24,521
Credit to financial corporations (net)	4,265	4,135	4,740	4,789	5,116	5,480
Other items (net)	803	946	899	963	1,028	1,088
Capital account	3,648	4,023	4,309	4,583	4,892	5,180
Liabilities to nonfinancial private sector	17,384	19,195	21,223	22,439	23,842	25,432
In national currency	11,386	12,374	13,621	14,112	14,994	15,994
In foreign currency	5,998	6,820	7,602	8,327	8,848	9,438
Of which: Deposits (including CDs)	17,253	19,043	21,046	22,242	23,890	25,676
<b>Consolidated Financial System</b>						
Net foreign assets	1,938	1,726	1,800	1,878	2,772	2,253
Net domestic assets	18,103	19,819	21,590	22,684	23,486	25,820
Net domestic credit	18,317	20,617	22,384	23,689	25,173	26,778
Other items (net)	1,353	1,054	1,270	1,373	1,037	2,090
Capital account	1,567	1,852	2,064	2,377	2,724	3,049
Broad money	20,040	21,545	23,390	24,562	26,258	28,073
<b>Memorandum Items:</b>						
	(Annual percentage change)					
Monetary base 1/	9.2	6.4	10.8	2.3	5.5	5.8
Broad money	10.7	7.5	8.6	5.0	6.9	6.9
Credit to the private sector	11.8	12.8	8.5	6.2	7.0	7.3
Adjusted by changes in the exchange rate	11.9	11.5	7.6	3.7	6.5	7.1
	(In percent of GDP)					
Monetary base 1/	8.0	8.0	8.3	8.1	8.0	8.0
Broad money	68.4	69.2	70.8	70.8	70.9	71.6
Of which: Deposits denominated in foreign currency	20.5	21.9	23.0	24.0	24.6	25.3
Credit to the private sector	56.1	59.5	60.9	61.6	61.7	62.5
Of which: In foreign currency	23.5	24.4	23.9	24.1	24.1	24.3
Central bank balance	-0.8	-0.3	-0.2	0.1	0.1	0.1

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

e - Estimated figures.

1/ We use a narrower definition of monetary base that includes only currency issued and required reserves.

Table 9. Costa Rica: Medium-Term Framework, Baseline Scenario

	2015	2016	2017	2018 <sup>e</sup>	Projections					
					2019	2020	2021	2022	2023	2024
	(Annual percentage change)									
<b>Real GDP</b>	3.6	4.2	3.4	2.7	2.9	2.8	3.0	3.1	3.3	3.5
Domestic demand	4.2	4.3	2.7	1.1	2.8	2.6	2.7	2.7	3.1	3.2
Consumption	4.2	3.6	2.8	1.9	2.6	2.0	2.3	2.5	2.8	3.0
Private	4.6	4.0	2.8	2.2	2.3	2.3	2.6	2.9	3.0	3.3
Public	2.4	2.4	3.1	0.5	3.6	1.0	0.9	1.0	1.8	2.0
Gross fixed capital formation	3.0	4.8	-3.1	2.2	4.0	4.8	4.7	3.6	4.3	3.9
Exports of goods and nonfactor services	2.6	9.4	5.0	4.1	4.3	4.2	3.7	4.2	4.2	4.8
Imports of goods and nonfactor services	4.4	8.9	3.0	-0.3	3.9	3.4	2.9	3.1	3.5	3.8
	(Contributions to real GDP growth)									
Domestic demand	4.4	4.4	3.9	1.1	2.9	2.6	2.8	2.8	3.1	3.2
Consumption	3.5	3.1	2.4	1.6	2.1	1.7	1.9	2.1	2.3	2.4
Gross domestic investment	0.9	1.4	0.4	-0.4	0.8	0.9	0.9	0.7	0.8	0.8
Net exports	-0.8	-0.2	0.6	1.5	0.0	0.2	0.3	0.4	0.2	0.3
	(In percent of GDP)									
<b>Savings and Investment</b>										
Savings	18.4	18.4	18.8	17.5	17.6	17.9	18.2	18.4	18.6	18.6
Domestic savings	15.0	16.2	15.8	14.3	14.3	14.6	14.9	15.1	15.1	15.2
Private sector	17.3	17.7	17.9	16.8	16.2	16.1	16.4	16.3	16.1	15.9
Public sector	-2.4	-1.5	-2.1	-2.5	-1.8	-1.5	-1.5	-1.1	-0.9	-0.7
External savings	3.5	2.2	3.0	3.2	3.2	3.3	3.3	3.3	3.4	3.4
Gross domestic investment	18.4	18.4	18.8	17.5	17.6	17.9	18.2	18.4	18.6	18.6
Private sector	15.8	15.6	15.9	15.2	15.0	15.3	15.5	15.5	15.6	15.7
Public sector	2.7	2.7	2.9	2.3	2.6	2.6	2.8	2.9	2.9	3.0
<b>Balance of payments</b>										
Current account balance	-3.5	-2.2	-3.0	-3.2	-3.2	-3.3	-3.3	-3.3	-3.4	-3.4
Trade balance	-8.3	-7.7	-7.4	-7.7	-7.5	-7.4	-7.4	-7.4	-7.4	-7.4
Services	8.3	8.8	8.5	9.1	9.1	9.2	9.2	9.1	9.0	9.0
Income	-4.3	-4.2	-5.0	-5.4	-5.7	-6.0	-6.0	-5.8	-5.9	-5.8
Current transfers	0.8	0.9	0.9	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Capital account balance	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Financial account balance	-4.7	-2.7	-3.6	-3.1	-3.2	-3.3	-3.3	-3.2	-3.4	-3.4
Public sector	-3.4	-0.7	-0.2	-2.3	-3.3	-1.6	-2.1	-2.3	-0.2	-0.4
Private sector	-2.5	-1.5	-2.7	-1.4	-1.5	-1.2	-1.1	-1.5	-3.1	-3.0
Foreign direct investment, net	-4.6	-3.7	-4.4	-4.1	-4.2	-4.3	-4.4	-4.4	-4.5	-4.5
Other net private flows	0.7	2.1	1.7	2.7	2.7	3.1	3.3	2.9	1.3	1.5
Change in net international reserves (increase +)	1.1	-0.4	-0.7	0.6	1.7	-0.5	-0.1	0.6	0.0	0.0
Errors and omissions	-1.3	-0.7	-0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Public Finances</b>										
Central government primary balance	-3.0	-2.4	-3.0	-2.4	-1.8	-0.9	-0.5	0.2	0.8	0.8
Central government overall balance	-5.6	-5.3	-6.2	-6.0	-5.8	-5.1	-4.8	-4.2	-3.8	-3.3
Central government debt	40.9	44.9	48.6	53.5	56.2	58.3	60.1	61.1	61.4	61.0
Consolidated public sector overall balance 1/	-5.8	-4.7	-5.4	-5.2	-4.8	-4.5	-4.7	-4.4	-4.2	-4.0
Consolidated public sector debt 2/	45.4	49.8	50.8	56.0	57.4	58.6	59.5	59.5	59.0	57.7
Of which: External public debt	11.3	11.3	10.9	12.9	16.5	18.4	19.8	20.9	19.0	18.2
<b>Memorandum items:</b>										
Nominal GDP (billions of colones)	29,281	31,136	33,015	34,693	37,035	39,209	41,480	44,035	46,809	49,938
Output gap (as percent of potential GDP)	-0.2	0.6	0.6	0.2	-0.1	-0.5	-0.8	-1.0	-1.1	-1.1
GDP deflator (percent change)	3.8	2.0	2.5	2.4	3.7	3.0	2.7	2.9	2.9	3.0
Consumer prices (percent change; period average)	0.8	0.0	1.6	2.3	2.6	3.1	3.0	3.0	3.0	3.0
Consumer prices (percent change; end of period)	-0.8	0.8	2.6	2.0	3.2	3.0	3.0	3.0	3.0	3.0
Credit to the private sector (percent change)	11.8	12.8	8.5	6.2	7.0	7.3	7.5	8.1	8.8	9.3
Net international reserves (millions of U.S. dollars)	7,834	7,574	7,150	7,495	8,500	8,195	8,145	8,545	8,545	8,545

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

e - Estimated figures.

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

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

Table 10. Costa Rica: Financial Sector Indicators

	2011	2012	2013	2014	2015	2016	2017	2018
	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Dec
	(In percent)							
<b>Capitalization</b>								
Risk-adjusted capital ratio	17.3	16.8	16.6	16.7	16.2	16.4	16.8	16.7
Capital-to-assets ratio	15.0	14.8	14.5	14.1	14.1	14.1	13.9	14.2
<b>Asset quality</b>								
Nonperforming loans to total loans	1.7	1.7	1.7	1.5	1.6	1.5	2.0	2.1
Non-income generating assets to total assets	17.7	16.8	17.1	16.3	15.6	15.7	16.2	16.3
Foreclosed assets to total assets	0.8	1.0	1.0	1.0	0.9	0.8	0.8	1.0
Loan loss provisions to total loans	1.8	1.7	1.6	1.6	1.9	2.2	2.8	3.3
<b>Management</b>								
Administrative expenses to total assets	4.2	4.2	3.9	3.6	3.5	3.3	3.1	3.1
Noninterest expenses to gross income	76.5	67.4	68.1	77.7	67.6	67.6	73.7	77.6
Total expenses to total revenues	93.1	90.7	92.5	94.2	92.7	91.3	94.8	95.6
<b>Profitability</b>								
Return on assets (ROA)	1.3	1.5	1.2	1.2	1.0	1.2	0.9	0.9
Return on equity (ROE)	9.1	10.3	8.2	8.5	7.3	8.8	6.5	6.8
Interest margin to gross income	27.2	32.1	30.5	22.8	33.5	32.4	25.3	21.3
<b>Liquidity</b>								
Liquid assets to total short-term liabilities	85.1	92.6	101.2	98.7	97.8	95.9	102.7	98.6
Liquid assets to total assets	28.8	29.2	30.4	29.1	28.9	28.2	29.1	28.0
Loans to deposits 1/	105.2	106.3	106.6	109.5	115.5	115.8	112.3	113.1
Liquid assets to deposits	42.7	44.0	47.0	45.1	46.6	45.0	45.5	43.7
<b>Sensitivity to market risk</b>								
Net open FX position to capital	18.8	19.1	17.8	17.4	19.9	21.4	22.7	21.1
<b>Other</b>								
Financial margin 2/	8.1	7.7	6.8	7.1	7.0	6.9	6.6	7.1

Source: Superintendency of Banks (SUGEF).

e - Estimated figures.

1/ Loans (including contingent credits) divided by deposits held by the public.

2/ Difference between implicit loan and deposit rates.

## Annex I. Past Fund Staff Recommendations and Implementation

2017 Article IV Staff Recommendations	Implementation
Fiscal Policy	
<ul style="list-style-type: none"> <li>Fiscal adjustment to stabilize the public debt ratio.</li> </ul>	<ul style="list-style-type: none"> <li>Fiscal reform (DL 20,850) approved in December 2018, which entails a fiscal adjustment of 4 percent of GDP, but more is needed to reduce debt faster and reach 50 percent of GDP by 2030.</li> <li>Discussion of the reforms of the public pay-as-you-go system began in January 2018, after a roundtable put forward a series of measures to ensure the sustainability of the Costa Rican Social Security Fund (CCSS) in December 2017. In May 2018, the Chamber of Deputies agreed to strengthen this system with a contribution of up to 15 percent of the profits of State public companies.</li> </ul>
<ul style="list-style-type: none"> <li>In the long run, parametric adjustments were recommended to resolve imbalances of the main pay-as-you-go pension scheme.</li> </ul>	<ul style="list-style-type: none"> <li>No progress has been made in the implementation of the parametric adjustments.</li> </ul>
Monetary and Foreign Exchange Policy	
<ul style="list-style-type: none"> <li>Continue reversing the easing monetary cycle.</li> </ul>	<ul style="list-style-type: none"> <li>To contain inflationary pressures stemming from higher oil prices and exchange rate pass-through effects, the BCCR increased its policy rate in several steps, from 1.75 percent in March 2017 to 5.25 percent in November 2018.</li> </ul>
<ul style="list-style-type: none"> <li>Allow more ER flexibility and enhance transparency about the triggers of the FX-intervention rule.</li> </ul>	<ul style="list-style-type: none"> <li>More ER flexibility was seen in 2018 and the use of FX intervention has been limited to addressing episodes of large exchange rate volatility, but not much progress has been made on improving the transparency of the intervention rule.</li> </ul>
<ul style="list-style-type: none"> <li>Safeguard the independence of the central bank.</li> </ul>	<ul style="list-style-type: none"> <li>A bill on delinking the designation of the President of the central bank from the political cycle and improving the clarity of dismissal rules was passed by Congress in February 2019.</li> </ul>
<ul style="list-style-type: none"> <li>Foster the underdeveloped secondary market of government securities, including using standardized instruments with conventional maturities.</li> </ul>	<ul style="list-style-type: none"> <li>The pace of implementation of the FSSR recommendations has been very slow due to the lack of coordination between the relevant debt management institutions. MCM conducted a TA mission in October 2018 and recommended specific measures to develop the secondary debt market.</li> </ul>

Financial Sector	
<ul style="list-style-type: none"> <li>• Key FSAP recommendations including crisis management and the bank resolution framework.</li> </ul>	<ul style="list-style-type: none"> <li>• Some of the 2008 FSAP recommendations, particularly those that require new legislation, remain unimplemented due to the congress's full legislative agenda. Costa Rica still lacks a legal framework for consolidated supervision and corrective measures. The FSSR mission urged the authorities to finalize and pass the draft law on consolidated banking supervision.</li> <li>• The BCCR passed in July 2018 the regulation for an emergency liquidity assistance (ELA) facility. A draft law on deposit guarantee fund and banking resolution prepared by BCCR, CONASSIF and SUGEF is under discussion.</li> </ul>
<ul style="list-style-type: none"> <li>• Measures to reduce systemic risk, including further tightening of prudential requirements to discourage banks' FX exposure.</li> </ul>	<ul style="list-style-type: none"> <li>• Dollarization remains high, which generates systemic risks. A MCM TA mission conducted in February 2018 assisted the authorities to identify targeted measures to reduce credit dollarization, and to recalibrate macroprudential regulations to encourage de-dollarization.</li> <li>• The set of measures passed by CONASSIF in June 2018 to relax FX lending requirements was a step backward on de-dollarization.</li> </ul>
<ul style="list-style-type: none"> <li>• Reinforcement of the AML/CFT regime and the national framework for cross-border consolidated supervision.</li> </ul>	<ul style="list-style-type: none"> <li>• AML/CFT: Development of a national strategy since 2015 in response to low GAFILAT ratings. Several projects have been initiated in 2018 to increase those ratings within one year.</li> <li>• No major developments on cross-border consolidated supervision. The communication and flow of information is very active. <i>Comité de Enlace</i> of Central American Supervisors meets twice per year, and there are virtual meetings every month.</li> </ul>

Structural Reforms	
<ul style="list-style-type: none"> <li>• Improve transport infrastructure, education expenditure efficiency, and promote financial deepening.</li> </ul>	<ul style="list-style-type: none"> <li>• Transport infrastructure: A committee has been created to develop a strategic plan to improve public transportation in the metropolitan area. However, no concrete progress has been made.</li> <li>• Public expenditure efficiency (particularly in education): DL to introduce results-based budget sent to the Legislative Assembly. To strengthen the Ministry of Finance’s control of the budget of the public sector, DL 20,203 that incorporates decentralized entities into the national budget was approved in February 2018 by Congress (still to be enacted). Also, DL 20,649— which aims to reduce the fragmentation of the public sector and eliminate institutions that are not working— was sent to Congress in December 2017 and is still under discussion.</li> <li>• Financial deepening: The banking sector remains dominated by state-owned banks. Promoting competition in the banking sector would help reduce relatively high interest rate spreads. The authorities also need to continue their financial deepening strategy, with a view to lowering the costs of electronic transactions, thereby encouraging greater use.</li> </ul>

## Annex II. External Sector Assessment

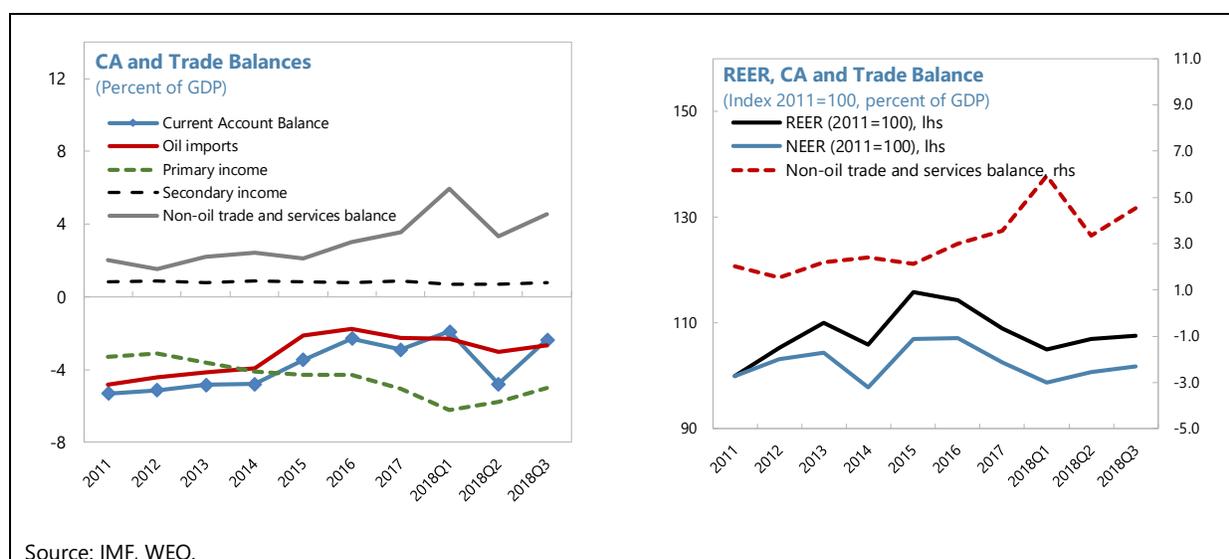
*The external position of Costa Rica in 2018 was broadly in line with the level implied by medium-term fundamentals and desirable policies. The moderate depreciation of the real effective exchange rate (REER), together with the persistent strength in inflows of FDI and exports, suggests some gain in competitiveness.*

**1. The current account (CA) deficit widened modestly in 2018** (Chart). The slight deterioration in 2018, from 3 percent to 3.2 percent of GDP, was driven by higher trade deficit for goods amid political unrest in Nicaragua that adversely affects intra-regional trade. Primary income also fell in 2018 due to higher profit repatriation by foreign-owned companies and higher interest payments on increased public external debt. Nevertheless, lower primary income was fully offset by an improvement in the balance of services trade. Net FDI inflows in 2018 continued to account for about 4 percent of GDP, comfortably covering the current account deficit.

**2. The moderate REER depreciation in 2018, together with the persistent strength in exports and FDI inflows, suggests some gain in competitiveness.** With inflation stayed low and the nominal exchange rate against the U.S. dollar depreciated about 4½ percent, the CPI-based REER depreciated by about 3 percent in 2018 which suggests some gain in competitiveness (Chart). The improvement is confirmed by the persistent strength of exports and FDI as well as by survey results. Costa Rica improved in the World Economic Forum's (WEF's) Global Competitiveness Index 2017-18 ranking from 54 to 47, driven mainly by an improvement in its score on institutions.<sup>1</sup> Costa Rica is well on track in its process of joining the OECD, which will likely boost investors' confidence and attract additional FDI. Nevertheless, bottlenecks to competitiveness remain, including insufficient infrastructure, public spending inefficiencies and excessive regulatory costs. Moreover, the persistent large fiscal deficits continue to pose a risk to external stability, impeding competitiveness.

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<sup>1</sup> Survey rankings entail certain degree of uncertainty around point estimate. Uncertainty bands around point estimates are not provided by the compiler, and reliance on experts' opinions introduces an element of subjectivity.

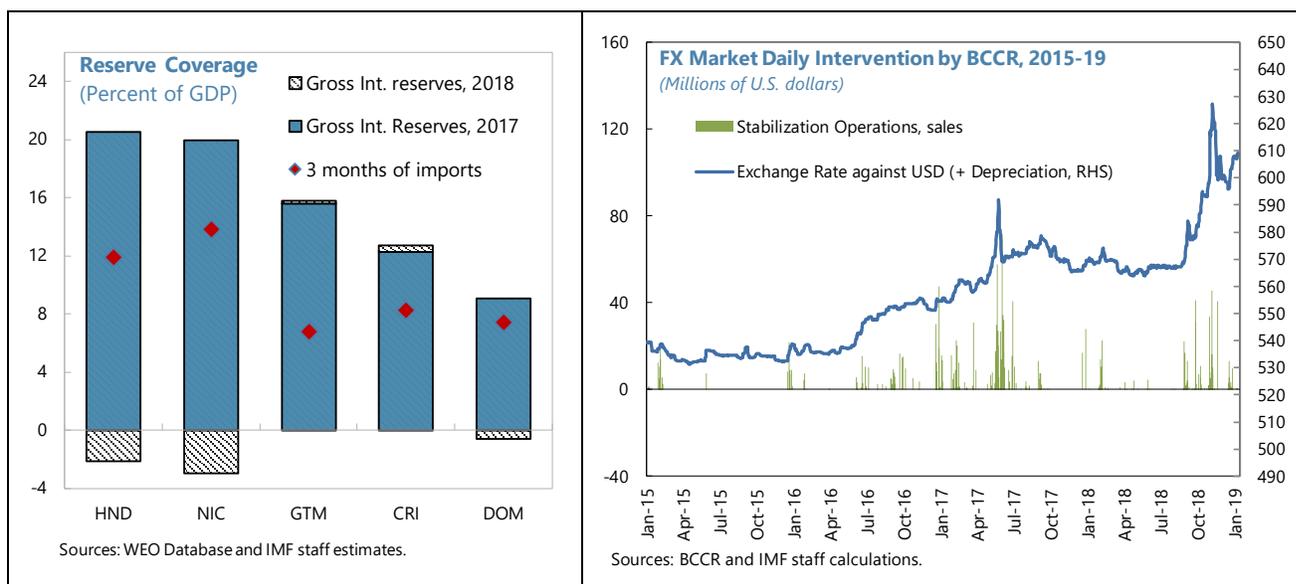


**3. The external position in 2018 is broadly in line with medium-term fundamentals and desirable policies.** The multilaterally consistent external balance assessment (EBA) CA model<sup>2</sup> suggests a modest CA gap of 0.8 percent of GDP for 2018, implying that the REER is broadly consistent with fundamentals (Text Table). The policy gap for Costa Rica suggested by the model is small and negative at -0.8 percent of GDP, which is largely explained by the higher-than-desired fiscal deficit. Over the medium term, as import growth gradually picks up in tandem with the expected recovery of domestic demand the CA balance is projected to reach about -3½ percent of GDP by 2024, which is broadly consistent with the cyclically adjusted CA norm of -4.2 percent of GDP considering the still sizable output gap.

Costa Rica: Results of EBA CA Model for 2018		
(1)	Actual CA	-3.2
(2)	Cyclical contributions	0.2
(3)=(1)-(2)	Actual CA, cyclically adjusted	-3.4
(4)	CA norm, cyclically adjusted 1/	-4.2
(5)=(3)-(4)	CA gap	0.8
	of which: Policy gap	-0.8
	of which: Residual	1.6
(6)	Elasticity of CA to REER	-0.26
(7)=(5)/(6)	REER misalignment for 2018	-3.0
Percentage, "+" = overvaluation.		
Source: IMF staff estimates.		
1/ the CA norm is 0.4 ppts lower than estimated in the model after taking into account Costa Rica's substantially lower overall government deficit in 2018 than that used in the model as lower government spending leads to lower domestic demand and hence lower CA deficit.		

<sup>2</sup> Costa Rica is included in the EBA CA model, but not in the EBA REER Index and the ES models.

**4. Reserves increased in 2018 thanks to the disbursement of the Latin American Reserve Fund (FLAR) loan** (Charts). The disbursement of the FLAR loan in 2018Q1 to BCCR for balance of payments support added US\$1 billion to international reserves. As of end-2018, reserves stood at US\$7.5 billion, equivalent to 4.7 months of imports or 105 percent of the ARA float metric, within the range considered as adequate (100-150 percent). The BCCR has limited its use of FX intervention to episodes of large exchange rate volatility since September 2018.



**5. The external financing structure remains healthy, with FDI comprising about half of total external liabilities.** Although the net international investment position (IIP) worsened in 2018 relative to the previous year—reaching a negative position of more than 50 percent of GDP, the stock of FDI inflows continued to account for about half of the total external liabilities. FDI inflows—which accounted for almost 5 percent of GDP in 2018—are more than enough to fully finance the CA deficit. External debt increased further in 2018—reaching almost 50 percent of GDP—and is expected to remain high over the medium term owing to the planned external public debt issuances. Nevertheless, staff sees no significant vulnerabilities related to external debt sustainability, and projects the external debt-to-GDP ratio to decline gradually towards the medium term after peaking at 55 percent of GDP in 2022 (Annex VII).

## Annex III. Macro-Financial Stability Update

*The Costa Rican financial system is highly concentrated and dominated by public banks. The banking sector is overall well-capitalized, but banks' low profitability may reflect structural problem of inefficiency. Rising NPLs, persistently high dollarization and fast-growing household borrowing pose risks to the financial system. Our stress test results show that the overall banking system remains sufficiently capitalized under the adverse scenario of a combined shock that includes: (i) a sharp increase in NPLs, (ii) a large increase in the interest rate, and (iii) a significant FX depreciation.*

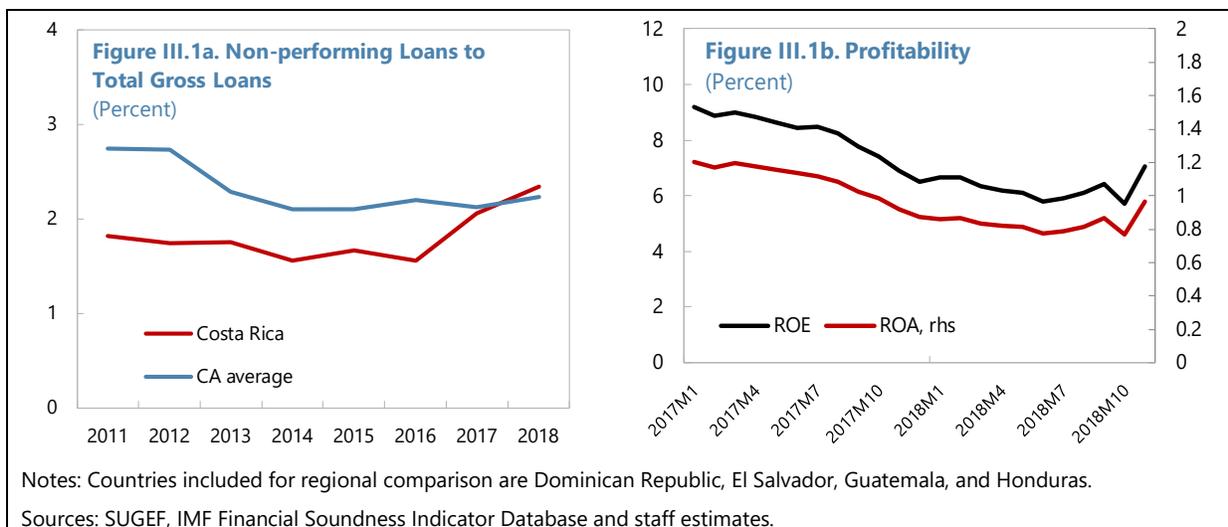
### A. Soundness of the Financial Sector and Risks

**1. The Costa Rican financial sector is highly concentrated.** As of December 2018, total assets of the financial sector amounted to 95 percent of GDP, of which about 80 percent (or 76 percent of GDP) are held by the banking sector, while the remaining 20 percent is held by non-bank financial institutions including cooperatives, financial mutuals and other intermediaries. Out of the 14 banks<sup>1</sup> in the banking sector, the 3 public banks control 58 percent of market share by assets, compared to 39 percent by the 9 foreign private banks, and 3 percent by the two domestic private banks. Cooperatives are the largest market players outside the banking sector. The 24 cooperatives collectively account for 10½ percent of total assets of the financial sector.

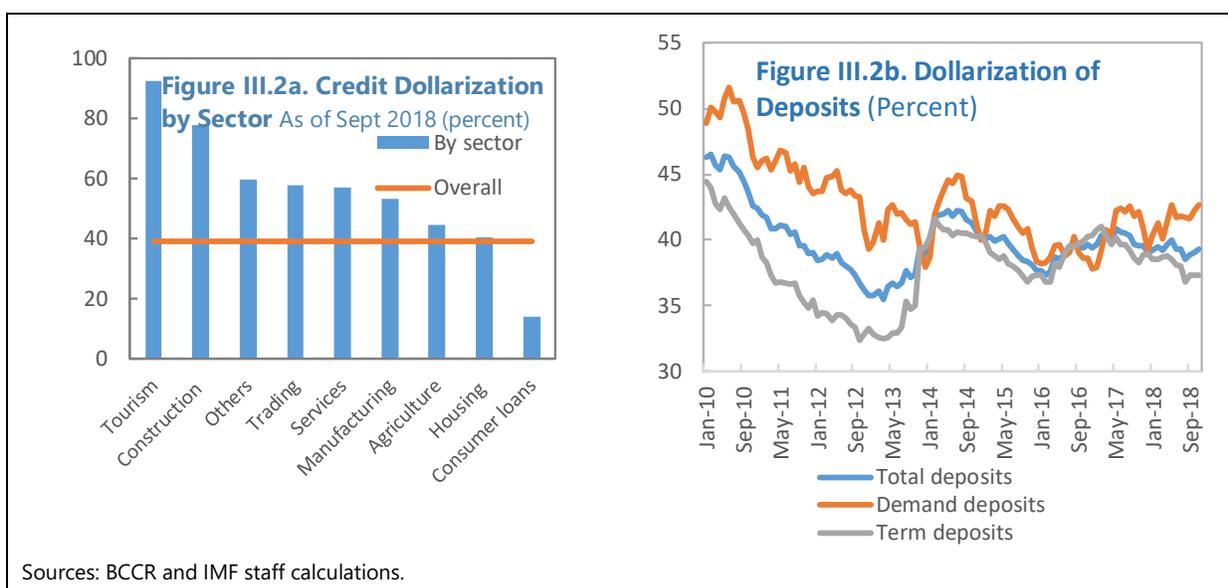
**2. Public banks dominate the domestic-currency lending and deposit markets, while private banks dominate FX lending.** The three public banks account for about ¾ of domestic-currency loans and deposits in the banking sector. FX lending, however, is dominated by private banks, who account for ⅔ of FX loans in the banking sector. As a result, private banks have much higher credit dollarization rates than public banks (73 percent vs. 29 percent as of December 2018). Private banks also lend more by proportion to unhedged borrowers. As of October 2018, 73 percent of the FX loans by private banks are lent to borrowers who are not FX earners (vs. 56 percent for public banks).

**3. Banks are well capitalized, but profitability is low compared to the rest of the region.** The capital adequacy ratio (CAR, or total capital over risk-weighted assets) for the overall banking sector was 13½ percent as of December 2018, well above the 10 percent minimum regulatory requirements. (Table III.1) Reflecting more volatile exchange rate movements, higher borrowing costs and slower economic growth, NPLs (non-performing loans to total loans) for the banking sector increased from below 2 percent in 2016 to 2.7 percent in November 2018, surpassing the regional average (Figure III.1a). Bank profitability is low compared to regional averages (Figure 3, main text) although the downward trend observed since mid-2017 seems to have reversed in November 2018 (Figure III.1b).

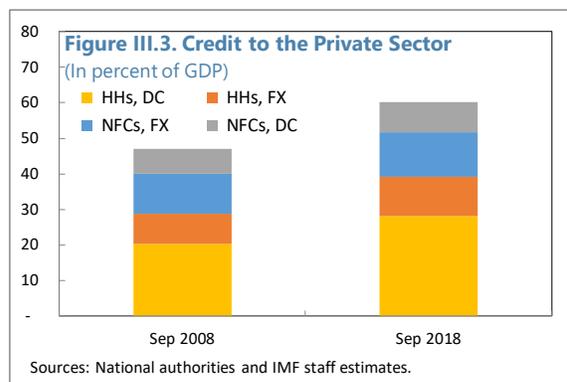
<sup>1</sup> Excluding Banco Crédito Agrícola de Cartago (Bancrédito), which had been under government intervention since December 2017 and completely absorbed by the state-owned Banco de Costa Rica in December 2018.



**4. Dollarization remains persistently high.** Temporary periods of declining dollarization of credit and deposits have occurred since 2010 but they have not been sustainable. As of December 2018, dollarization of credit to the private sector remained close to 40 percent. Credit dollarization varies widely across different sectors. (Figure III.2a) Tourism and construction are the two most heavily dollarized sectors, with the former having over 90 percent of credit denominated in FX. Agriculture, housing and consumer credit, on the other hand, are the least dollarized. Dollarization of deposits is equally high at about 40 percent, with demand deposits being more heavily dollarized at 43 percent (Figure III.2b).



**5. Household borrowing has increased sharply in the past decade.** Until the recent slowdown, credit in Costa Rica had been growing at a double-digit rate (since the end of the GFC). Credit to the private sector increased to 60 percent of GDP in September 2018 from 47 percent of GDP ten years ago, driven by household borrowing. During the last decade, household borrowing in colones increased by 8 percent of GDP, whereas household borrowing in FX increased by 3 percent of GDP. Although credit to households is less dollarized (28 percent) than credit to corporates (59 percent), most Costa Rican households are non-dollar earners and hence highly exposed to exchange rate risk in the event of FX depreciation. About one-third of household loans are provided by less-regulated non-bank financial institutions, making it harder for regulators to keep track of household indebtedness.



**Table III.1. Costa Rica: Selected Banking Sector Soundness Indicators as of December 2018**

	All Banks	Public	Domestic Private	Foreign Private
<b>Selected Banking Sector Ratios (Percent)</b>				
<i>Capital Adequacy</i>				
Total capital / RWA (CAR)	13.5	13.7	15.2	13.1
<i>Asset Quality</i>				
NPLs/ total loans	2.4	3.0	1.2	1.7
FX loans/total loans	48.2	28.5	88.8	72.4
<i>Funding</i>				
Deposits/total liabilities	75.6	79.6	64.0	70.5
Deposits/total loans (net)	114.5	124.8	94.1	101.9
<i>Profitability</i>				
ROA (after-tax)	0.7	0.4	1.5	1.1
ROE (after-tax)	6.1	3.4	12.8	10.1
<i>Liquidity</i>				
Liquid assets/total assets	21.7	20.2	20.0	24.2
Liquid assets/short-term liabilities	66.1	55.7	91.6	84.2
<i>Sensitivity to Market Risk</i>				
Net FX exposure / capital	27.5	6.8	88.3	50.7

Sources: SUGEF and IMF staff calculations.

## B. Stress Testing

**6. The stress tests cover the main risks to solvency and liquidity faced by the banking sector** (Figure III.4, Table III.2). The top-down solvency stress test includes: (i) credit risk, through an

aggregate NPL shock<sup>2</sup> as well as differentiated sectoral shocks; (ii) market risk, though interest and exchange rate risk; (iii) contagion risk through interbank exposure, and (iv) a set of reverse tests. The liquidity stress test models a simple liquidity drain that affects all banks in the system proportionally.

- The *Credit risk scenario* assumes a system-wide proportional increase in NPLs of 2.9 percent of currently performing loans; and, separately, increases in NPLs of 1.7, 2.6, 3.4 and 3.6 percent of performing loans in the services, trade, consumption and housing sectors respectively—which together account for more than  $\frac{3}{4}$  of total loans. All shocks are calibrated to the mean value plus three standard deviations of NPLs over the last decade. A provisioning rate of 40 percent is assumed for new NPLs. Consistent with the composition of banks' balance-sheet data, results suggest that credit risk losses from a credit shock, both system-wide and sectoral, would materially affect banks capital adequacy, but losses would be limited: the CAR for the system would remain above 12½ percent, still well above minimum requirements. The CAR of one small bank would fall below 10 percent.
- The *interest rate risk shock* assumes a nominal interest rate increase of 3½ percentage points, being the size of policy rate rise since March 2017. The analysis includes: (i) the flow impact from the gap between interest sensitive assets and liabilities; and (ii) the stock impact from bond repricing. While the simulated increase in interest rates would result in valuation losses on fixed income instruments, these would be largely offset by an increase in interest income as most banks have long cumulative interest sensitive positions across maturity buckets. Overall, system-wide CAR would improve marginally and the CAR of one small bank would fall below 10 percent.
- The *FX risk shock* assumes an 18 percent nominal depreciation of the bilateral exchange rate with the US dollar, like the overall depreciation that occurred in 2008-09, and looks at: (i) the direct exchange rate risk effect on FX exposures; and (ii) the indirect effect through credit risk causing an additional 12 percent of FX credit to become non-performing (assuming all the FX loans to unhedged borrowers (67 percent of total) would become NPLs following a 100 percent nominal depreciation). Our results indicate that the simulated FX depreciation would result in both direct and indirect losses, with significant indirect losses through credit quality. Overall, the CAR for the whole system would decrease by about 1½ percent to about 12 percent—still above the regulatory minimum. The CAR of three banks would fall below the 10 percent threshold, which collectively account for about 9 percent of market share by asset value.

**7. A combined solvency shock would require recapitalization of some banks, although the system would satisfy minimum CAR requirements.** The combined shock includes: (i) the proportional increase in NPLs, (ii) the interest rate shock, and (iii) the FX risk shock. It should be noted that such combined shock represents a very extreme scenario with low probability of occurrence. Results show that, even subject to such extreme shock, systemwide CAR would only fall

<sup>2</sup> We adopt SUGEF's regulatory definition of NPLs, i.e. loans that are 90 days overdue plus those under judicial collection.

to about 12 percent, thus remaining above the regulatory minimum. However, four individual banks would fall short of the minimum regulatory CAR, thus requiring some recapitalization. However, even after such a severe combined solvency shock, the affected banks would only account for 13¼ percent of market share, and the identified capital shortfalls would only amount to 0.12 percent of GDP.

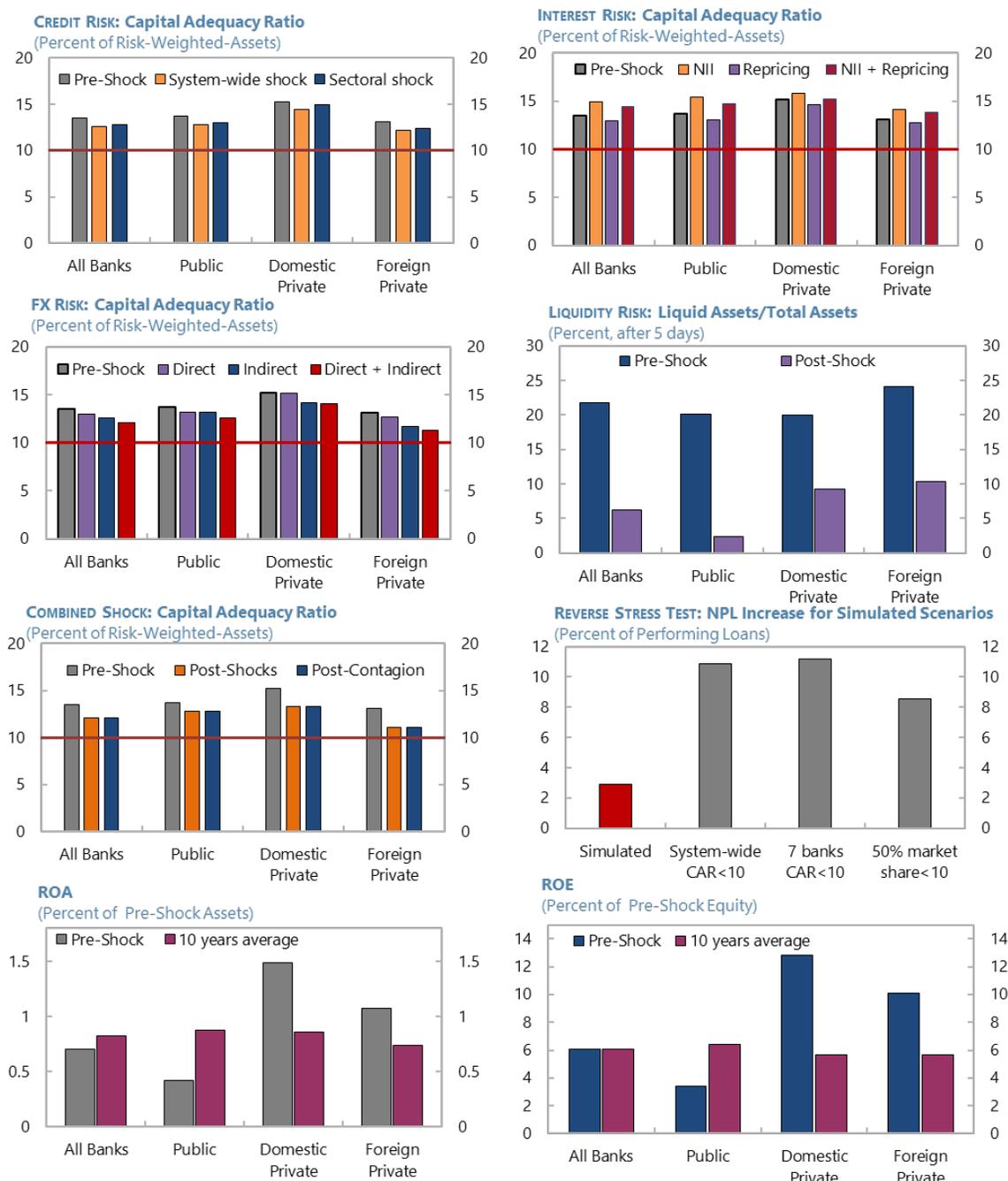
**8. Contagion risks stemming from domestic interbank exposures are limited and there is no second-round effect following the combined macro-shock.** Contagion risks are assessed using a matrix of interbank exposures containing, for each bank, the net credit to every other bank in the system. The exercise illustrates what happens to other banks when one bank fails to repay its obligations in the interbank market as a result of the combined shock. Our results show that there is no contagion stemming from domestic interbank exposures through second-round effects. This is because interbank lending is very thin in Costa Rica, and mainly constituted by deposits of private banks into two of the state-owned banks, equal to 2¼ and 3½ percent of their total deposits respectively, to finance the *Sistema de Banca para el Desarrollo*.

**9. The reverse test indicates that system-wide NPLs would need to increase enormously for the system-wide CAR to fall below minimum requirements.** The reverse stress test answers what the NPL increase would have to be for: (i) the system-wide CAR, (ii) the CAR of at least 7 banks (half of total), and (iii) the CAR for 50 percent of the total market share, to fall below the regulatory minimum of 10 percent. An increase in NPLs of 10.9 percent of currently performing loans would be necessary for the system-wide CAR to fall below 10 percent, and NPLs would need to increase by 11.2 and 8.6 percent of currently performing loans respectively for at least 7 banks or half of the total market share to fall below the 10 percent regulatory minimum.

**10. The liquidity stress test suggests that liquidity shortfalls following a short-lived drain on deposits would be manageable.** The liquidity stress test assumes a widespread liquidity drain on all banks of 10 and 8 percent per day of demand deposits in domestic and foreign currency respectively; and a 5 and 3 percent per day withdrawal of time deposits in domestic and foreign currency respectively, affecting all banks. Assuming roll-off rates of 95 percent and 1 percent for liquid and illiquid assets respectively, our results indicate that, although the share of liquid to total assets would tumble, all banks except one would remain liquid after 5 days, meaning that the cash inflows from maturing assets being rolled off are able to cover the cash outflows from the deposit drain.

**11. The stress tests suggest the banking sector would remain sufficiently capitalized even under the adverse scenario assumed by the BCCR.** Under the worst-case scenario, the BCCR assumes a combined shock of a 40 percent FX depreciation, an increase in the interest rate on colones by 750 bps and an increase in the interest rate on dollars by 500 bps. The BCCR does not assume an exogenous shock on NPLs. If we instead adopt the shock assumptions used in the BCCR's adverse scenario, three more foreign private banks would fall below the 10 percent CAR threshold under the combined shock, mainly because of the adverse impact of the FX depreciation on NPLs. Overall, the banking sector remains well capitalized with a post-shock CAR of about 12 percent, similar to what we have using our own assumptions.

**Figure III.4. Costa Rica: Stress Test Results**



Source: SUGEF, and IMF staff estimates.  
 Notes: The sample includes a total of 14 banks, of which 3 state owned, 2 domestic private and 9 foreign private. *The System-Wide Credit Risk Shock* assumes 2.9 percent (3 s.d. over average NPLs during the last 10 years) of banks' outstanding performing loans to become non-performing; and the *Sectoral Shock* assumes increases in banks' NPLs in the services, trade, consumption and housing sectors (which together account for more than 3/4 of total loans) by 1.7, 2.6, 3.4 and 3.6 percent respectively (average sectoral NPLs over the last 10 years plus 3 s.d.). The *Interest Rate Shock* assumes a 3.5 percentage points nominal interest rate increase. The *FX Shock* assumes a 18 percent depreciation of the FX rate, leading to 12 percent of FX loans becoming NPLs. The *Liquidity Shock* assumes a 10 and 8 percent per day withdrawal of demand deposits in domestic and foreign currency respectively; and a 5 and 3 percent per day withdrawal of time deposits in domestic and foreign currency respectively. Only banks that remain liquid after 5 days are included in the liquidity ratio chart above.

Table III.2. Costa Rica: Stress Test Results

	All Banks	Public	Domestic Private	Foreign Private
<b>Asset Quality</b>				
Non performing loans (NPLs, Percent of Total Loans))	2.3	2.9	1.2	1.7
Capital adequacy ratio (CAR) pre-shock	13.5	13.7	15.2	13.1
<b>Credit Risk Stress Test 1/</b>				
<i>1. "Proportional increase in NPLs"</i>				
Post-shock CAR (Percent)	12.6	12.8	14.4	12.2
CAR change (Pct Points)	-0.9	-0.9	-0.8	-0.9
<i>2. "Sectoral shocks to NPLs"</i>				
Post-shock CAR (Percent)	12.8	13.0	14.9	12.4
CAR change (Pct Points)	-0.7	-0.7	-0.3	-0.7
<b>Interest Rate Risk Stress Test 2/</b>				
<i>1. Net interest income impact</i>				
Post-shock CAR (Percent)	14.9	15.4	15.8	14.2
CAR change (Pct Points)	1.4	1.7	0.6	1.1
<i>2. Repricing impact</i>				
Post-shock CAR (Percent)	14.4	14.8	15.2	13.8
CAR change (Pct Points)	-0.5	-0.6	-0.6	-0.4
Overall change in CAR (NII and Repricing)	0.9	1.1	0.0	0.7
<b>FX Risk Stress Test 3/</b>				
<i>1. Direct Foreign Exchange Risk</i>				
Post-shock CAR (Percent)	13.0	13.2	15.2	12.7
CAR change (Pct Points)	-0.5	-0.5	0.0	-0.4
<i>2. Indirect Foreign Exchange Risk</i>				
Post-shock CAR (Percent)	12.1	12.6	14.1	11.3
CAR change (Pct Points)	-0.9	-0.6	-1.1	-1.4
Overall change in CAR (Direct and Indirect)	-1.4	-1.1	-1.1	-1.9
<b>Interbank Stress Test</b>				
CAR (after the macroshocks)	12.1	12.8	13.3	11.1
CAR after the first iteration	12.1	12.8	13.3	11.1

Sources: SUGEF and IMF staff estimates.

Notes: : The sample includes a total of 14 banks, of which 3 state owned, 2 domestic private and 9 foreign private.

1/ *The proportional increase in NPLs* assumes 2.9 percent (average NPLs over the last 10 years plus 3 s.d.) of banks' outstanding performing loans to become non-performing; and the *Sectoral Shock* assumes increases in banks' NPLs in the services, trade, consumption and housing sectors (which together account for more than 3/4 of total loans) by 1.7, 2.6, 3.4 and 3.6 percent respectively (average sectoral NPLs over the last 10 years plus 3 s.d.).

2/ *The Interest Rate Shock* assumes a 3.5 percentage points nominal interest rate increase, and a provisioning rate of 40 percent.

3/ *The FX shock* assumes an 18 percent depreciation of the colon, leading to 12 percent of FX loans becoming non-performing, and a provisioning rate of 40 percent.

## Annex IV. Implementation Status of FSSR Recommendations

Costa Rica: FSSR Strategic Objectives and Related Key Recommendations	(*)	Implementation Status
<b>Strengthening the regulatory environment</b> (CONASSIF, SUGEF, SUGESE, SUPEN)		
Finalize the law that allows SUGEF to exercise effective consolidated supervision.		<b>In progress.</b> The draft bill on consolidated supervision was sent to financial entities for consultation in December 2018.
Enhance legal and regulatory frameworks that support corrective measures.		<b>In progress.</b> The legal framework is included as part of the bill on consolidated supervision. Regulatory framework may need to be developed after the bill is passed.
Implement fit-and-proper rules.		<b>Partly done.</b> The Corporate Governance Regulation and SUGEF's Suitability Regulation were approved by CONASSIF in 2016 and 2018, respectively. The draft bill on suitability (N°20.542) presented to the Legislative Assembly in 2017 is still pending approval.
<b>Strengthening the supervisory framework</b> (SUGEF, SUGESE, SUPEN)		
Provide legal protection for the supervisors.		<b>In progress.</b> This is part of the planned reform to the Securities Market Regulatory Law.
Consolidate the newly introduced risk-based supervisory (RBS) approach.		<b>Partly done.</b> The RBS model was launched in 2016 and is currently being strengthened by technical assistance on specific risks. Regulations on entities' financial scoring are pending.
Strengthen insurance and pension RBS with stress testing and forward-looking tools.		<b>Under consideration.</b> The authorities are considering the TA need on the capital capacity of insurance companies.
<b>Fostering secondary markets to improve pricing and liquidity</b> (SUGEVAL)		
Align primary markets with secondary markets' liquidity needs (BCCR, MoF).		<b>In progress.</b> The authorities are working with IMF TAs on these issues. Regular meetings are being held between the Ministry of Finance and the Stock Exchange to improve public debt management.
Implement specific market trading mechanisms for fixed-income securities.		<b>In progress.</b> Work is underway on reforms to the regulations on valuation of financial instruments. The authorities are considering the TA need on price formation.
Review current valuation and price formation processes.		<b>In progress.</b> Work is underway on reforms to the regulations on valuation of financial instruments. The authorities are considering the TA need on price formation.
Improve post-trading settlement failures management.		<b>Under consideration.</b> The authorities are considering the TA need on the Clearing and Settlement System and international markets.

<b>Strengthening financial safety nets</b> (BCCR, MoF, CONASSIF)		
Implement an emergency liquidity assistance (ELA) facility at BCCR to provide timely support to illiquid but solvent banks.		<b>Complete.</b> The BCCR board approved in July 2018 a regulation on ELA facility.
Use purchase and acquisition resolution transactions to avoid delaying payment of insured deposits.		<b>In progress.</b> This is included in the draft bill on deposit insurance and banking resolution prepared by BCCR, CONASSIF and SUGEF.
Create a crisis management committee to formalize decision-making.		<b>Partly done.</b> A draft proposal will soon be sent to the Financial Stability Commission. Scenarios and alert thresholds have been established, as well as (informal) inter-institutional working groups.
Implement a deposit insurance scheme for all deposit-taking institutions.		<b>In progress.</b> This will be included in the draft bill on deposit insurance and bank resolution.
<b>Mitigating risks related to high dollarization</b>		
Allow for higher exchange-rate volatility (BCCR).		<b>Complete.</b> Exchange rate flexibility has increased since September 2018. The de facto exchange rate regime has been reclassified from "crawl-like" to "floating".
Recalibrate prudential regulation to accelerate reduction of dollarization (SUGEF).		<b>In progress.</b> The definition of unhedged borrowers is under review and the impact evaluation of any changes is underway.
Increase liquidity and reserve requirements in foreign exchange (BCCR).		<b>In progress.</b> It has been under discussion how this can be best implemented.
<b>Mitigating risks related to the sustainability of pensions</b> (SUPEN)		
Introduce reforms for sustainability of first pillar with solutions that consider the second pillar <b>(1)</b> .		<b>In progress.</b> The Board of Directors of CCSS (Caja Costarricense de Seguro Social) has agreed in principle to reduce the benefits of first pillar by matching the future increases in the second pillar (complementary pensions). A new PRODEFI (system of financial and actuarial projections for CCSS) will be developed in 2019 to improve pension projections. Progress has been made with benefit reduction of the Judicial Branch's pension plan and with actuarial projections for the teachers' pension plan.
Close critical gaps in the regulation and supervision of the first pillar pension plans <b>(2)</b> .		<b>In progress.</b> Draft bills have been prepared to broaden SUPEN's supervisory authority over the Old Age, Death and Disability scheme (IVM). Several courtroom victories were obtained in 2018 concerning supervisory powers over certain occupational regimes of the second pillar, which indirectly strengthens SUPEN's capacity to supervise the first pillar.

Introduce held-to-maturity valuation for some pension fund assets.		<b>Complete.</b> The migration to IFRS 9 made it possible for financial entities not to daily mark assets to market and use an amortized cost basis under strict conditions.
<b>Strengthening the monitoring of financial stability</b> (BCCR, CONASSIF)		
Improve coordination mechanisms and information-sharing arrangements.		<b>Partly done.</b> The Financial Stability Commission has helped coordinate these issues.
Empower the newly created Financial Stability Commission.		<b>In progress.</b> An Executive Order has been drafted to broaden the Commission's power. The document is under study by the Commission members.
Establish a matrix of responsibilities for macroprudential policy.		<b>Under consideration.</b> The authorities are considering the TA need on developing a matrix of micro- and macro-prudential responsibilities.
<b>Advancing the national agenda for financial deepening and inclusion</b>		
Create a national coordination mechanism for financial inclusion (BCCR).		<b>In progress.</b> A diagnosis on the state of financial inclusion in Costa Rica will be ready in March 2019. BCCR will then develop a strategy (including the coordination mechanism) for financial inclusion, and is working to connect fintech companies to SINPE (electronic payment system).
Develop and approve a National Strategy for Financial Inclusion (BCCR).		
Review the regulatory perimeter of SUGEF.		<b>Pending.</b> Changes will require legal reforms which are not currently being considered.
Enhance the legal framework for financial consumer protection (CONASSIF).		<b>Under consideration.</b> The authorities are considering the TA need on improving financial consumer protection.
(*) <b>Impact</b> on financial stability if left unaddressed: <b>HIGH</b> <span style="background-color: red; color: black;">■</span> <b>MEDIUM-HIGH</b> <span style="background-color: orange; color: black;">■</span> <b>MEDIUM</b> <span style="background-color: yellow; color: black;">■</span>		
<b>Notes:</b> (1) Government, first pillar providers, and SUPEN; (2) Attorney General of the Re. of Costa Rica		

## Annex V. Structural Reforms Needed to Further Improve Competitiveness and Foster Inclusive Growth

OECD <sup>1</sup>	GOVERNMENT REFORM PLAN <sup>2</sup>
<b>Making Labor Market More Inclusive</b>	
Continue moving to a simplified minimum wage structure with more modest levels differentiated based on age and/or location.	A tripartite commission (workers, employers, and government), is exploring ways to reduce the number of minimum wages from the current 23 to 16 by 2024 (except for domestic service by 2030). In the public sector, the Government will promote the concept of a single salary but considering different factors and social dialogue.
Implement a comprehensive plan to reduce informality, including greater enforcement of obligations to pay contributions.	Establish a program for the formalization of micro-entrepreneurs through the temporary exoneration of their contributions to social programs. The expansion of the capacity of the Ministry of Labor (MTSS) to strengthen the application of labor regulations has been redirected towards increased coordination and the exchange of information between different agencies.
Increase the supply of publicly-funded childcare services.	Expand the coverage of the National Child Care and Development Network in at least 40,000 new places, aimed at gender equality, improving opportunities for women, increasing employment and reducing poverty. Strengthen childcare at the municipal level incorporating their own budget leveraging the state subsidy in child care and development services.
Classify all spending on early childhood education and care under the constitutionally-mandated spending on education.	According to the fiscal reform law No. 9635, Art. 29, budgeted resources for early childhood, and preschool shall be accounted for within the eight percent of GDP designated for state education.
Strengthen the enforcement of labor regulations by granting inspectors the right to impose sanctions directly and ensuring sanctions are large enough to act as a deterrent.	Increase the budget and human resources of the Labor Inspection Directorate at the MTSS. Expand the capacity of the MTSS for inspection using technology and more inspectors to monitor compliance with labor legislation on minimum wages, labor rights and formality.
<b>Enhancing the Quality and Efficiency of the Education System</b>	
Establish better educational outcomes as the main policy target, instead of a focus on spending, and develop performance indicators.	<p>The Ministry of Education is working together along the Ministry of Finance and the Inter-American Development Bank, to train all budget officers in Result-Based Project Programming.</p> <p>Improve labor market responsiveness, ensuring that the educational system provides an adequate mix that reflects labor market needs.<sup>3</sup></p> <p>Strengthen the quality and effectiveness of vocational teaching, addressing skills gaps through close engagement with industry.</p>
<p><sup>1</sup> Meehan, L. (2018), "Structural policies to boost productivity and inclusion in Costa Rica", OECD Economics Department Working Paper, No. 1485, OECD Publishing, Paris.</p> <p><sup>2</sup> Costa Rica Authorities; and PAC Political Platform Crecer y Crear la Costa Rica del siglo XXI: Compromiso País, PAC 2018.</p> <p><sup>3</sup> José-Luis Álvarez-Galván (2015), "A Skills beyond School Review of Costa Rica, OECD Reviews of Vocational Education and Training," OECD Publishing, Paris.</p>	

<p>Rebalance education spending towards early childhood and secondary education. Strengthen targeted support for at-risk students, and teachers' training.</p>	<p>The passage of the fiscal reform law will allow the expansion of early childhood education coverage.</p> <p>Strengthening targeted support through the creation of the Unit for the Promotion, Reincorporation and Educational Success, in March 2018 (which absorbs <i>Yo me Apunto</i> and PROEDUCA programs).</p>
<p>Establish and enforce a comprehensive set of minimum standards for all early childhood care centers.</p>	<p>Migrate from care only to care, integral development and education in early childhood to form a subsystem of education for equitable early childhood in which each infant has access to the same quality of service regardless of which service they attend.</p>
<p>Strengthen the national assessment system to provide information at the system, school and student level.</p>	<p>Strengthen and expand the Permanent System of Evaluation and Support of the educational system so that it integrates support provided to the educational centers, reality of the classroom, teaching performance, students' performance, school environment, infrastructure, educational environment, community participation and administration of the center.</p>
<p>Monitor the results of the dual education pilot program and consider options for developing vocational education further, in close conjunction with employers.</p>	<p>Strengthening of Technical Education through employability, innovation and entrepreneurship of Professional Technical Education students at the secondary level encourage student permanence in the system. The creation of the Unit for the Promotion, Reincorporation and Educational Success is also part of these efforts.</p>
<p>Reform the secondary school assessment system (<i>Bachillerato</i>) to better recognize partial achievement and increase flexibility.</p>	<p>Integrate and promote intermediation favoring inter-institutional dialogue and with employers, including the coincidence of names given to qualifications and jobs.</p> <p>Adapt the National Institute of Learning's (INA) requirement for 9<sup>th</sup> grade or <i>Bachillerato</i> including leveling courses or doing specific competency courses to raise the employability of people, linked especially to dynamic niches of the economy. Also, the INA should turn its efforts to provide scholarships, care, night care, night or weekend hours, adequacy of income requirements.</p> <p>Substitution of the final <i>Bachillerato</i> tests by the new FARO testing methodology in primary and secondary education.</p>
<p><b>Promoting Innovation, Technological Diffusion and Integration into GVC</b></p>	
<p>Ease regulatory barriers to FDI in some key network sectors (electricity supply, maritime and surface transport) and many service sectors (road freight transport, cargo-handling and storage and warehouse).</p>	<p>Ensure that FDI attraction strategies are properly aligned with the policy of productive transformation, so that FDI contributes to the nation's strategic sectors and achieves high levels of productive, labor and fiscal linkages to the local economy including not only existing sectors (life sciences, IT enabled services, advanced and light manufacturing, and tourism) but also new sectors (i.e., activities that contribute to the national decarbonization strategy).</p>
<p>Increase private sector's contribution to R&amp;D while improve knowledge transfer to business from government's contribution</p>	<p>Promote R&amp;D, through the creation of a long-term strategic plan that harmonizes and consolidates the government agencies in charge of the sector along with universities, technology centers, and businesses—avoiding duplication of functions.</p>

<p>Improve knowledge and technological production indicators (publication activity, intellectual production)</p>	<p>Promote business innovation through the creation of Regional Entrepreneurship and Innovation Laboratories to provide business support and capitalization services (business incubators; training; technology transfer; foster spin-offs with universities and companies; and supply financing services (seed capital, risk capital, angel investor networks). Invigorate the commercial relations of domestic and foreign investment firms (linkages).</p> <p>Turn the country into a destination for high-level research, leveraging its strategic geographical position, favorable climate, and other advantageous conditions; attract PhDs and experts to the country, in coordination with the academic and productive sectors.</p>
<p>Enforce legal framework for intellectual property rights, particularly in relation to copyright piracy and trademark counterfeiting.</p>	<p>N/A</p>
<p>Increase the share of competitive funding of FEES to raise the quality of research and to incentivize linkages with the business sector.</p>	<p>N/A</p>
<p>Achieve full operational status and support the consolidation of CONAFAC, to purport the standardization and digitalization of land border crossings in Costa Rica and enhance and facilitate international trade.</p>	<p>Implementation of the Border Integration Program and the Central American Trade Facilitation Strategy with emphasis on Coordinated Border Management.</p>
<b>Strengthening Competition</b>	
<p>Adopt and implement the bill reinforcing the powers, independence and funding of the competition commission.</p>	<p>Work is currently underway on a draft proposal to replace the bill (19.996) to strengthen the competition authority in Costa Rica. The COPROCOM will be a decentralized body attached to the MEIC with administrative, budgetary and functional autonomy.</p>
<p>Continue implementation of the action plan to increase consistency with the OECD Guidelines on Corporate Governance of State-Owned Enterprises.</p>	<p>The government has prepared a SOE Action Plan, which includes actions to establish an ownership coordinating entity, develop an ownership policy, improve corporate governance of SOEs (including the selection criteria, composition and expertise of SOE boards), promote the adoption of international financial reporting standards, and enhance the monitoring and disclosure of SOE performance.</p>
<p>Continue evaluation of exemptions from competition in the 25 sectors and eliminate unjustified exemptions.</p>	<p>Costa Rica is undertaking in-depth reviews of 25 sectors exempt from competition law. So far, the government has proposed that exemptions will be maintained only in certain activities within 5 to 7 sectors.</p>
<p>Open entry to FinTech start-ups, with appropriate regulation.</p>	<p>SUGEVAL is currently studying the regulatory experiences in other countries with particular interest on a regulatory sandbox.</p> <p>SUGEVAL is developing a Financial Inclusion Project, which includes: (i) a diagnostic and assessment of regulatory innovation in new technologies in the financial industry, focusing in promoting financial inclusion; (ii) assessment of the Costa Rican regulatory framework to identify best practices aimed at addressing the challenges posed by Fintech; (iii) a proposal of regulatory innovation in the strategy of financial inclusion.</p>

<p>Establish one-stop-shops for business registration and licensing at the local level with information available via the internet.</p>	<p>Conclude the process of digitizing procedures, integrating databases and creating efficient access to information and user assistance platforms (digital government), including institutions of national government, autonomous institutions and municipalities, reducing face-to-face interactions (p.43). The government is using the successful experience of PROCOMER to develop platforms and regulations for business facilitation.</p>
<p>Continue to improve the insolvency regime.</p>	<p>The government is working on a draft legislation to expedite the exit of bankrupt companies.</p>
<p>Approve and implement the proposal to institutionalize the Presidential Council on Competitiveness, Innovation and Human Talent (PCCI), unifying its three sub-councils and strengthening its technical secretariat.</p>	<p>A bill is being considered to institutionalize the PCCI to ensure its sustainability, unify its three sub-councils, strengthen the technical secretariat and add a strategic advisory branch (Bill 20,331) .</p>
<p><b>Addressing Transport Infrastructure Gaps</b></p>	
<p>Improve coordination among the different public-works bodies by clarifying mandates and granting overall control to a single lead agency. Priorities projects based on cost-benefit analysis.</p>	<p>The First Lady's office together with the Ministry of Planning are taking the lead in inter-institutional coordination. Inter-institutional working groups have been set up for the effective planning, design and execution of key transport and infrastructure projects. The pre-investment stage is being strengthened by the support and follow-up provided by the working groups to accomplish more effective outcomes on infrastructure projects that address existing gaps.</p>
<p>Clarify the mandates of the National Concessions Council (CNC) and the PPP unit and introduce mechanisms to align and coordinate the work of the two entities.</p>	<p>Implement the new legal and administrative framework for public-private partnerships, involving inter-institutional coordination and management control. Use turnkey contracting as a mechanism to develop public works.</p>

## Annex VI. Public Debt Sustainability Analysis

*The fiscal reform has helped to stabilize debt, but financing needs of the public sector remain large. Under the baseline scenario, the debt stock is projected to rise to 61½ percent of GDP by 2023, driven by a large interest bill, which is only partially offset by shrinking fiscal deficits. There are substantial risks to the projected debt path from plausible macro shocks, particularly to GDP growth.*

### A. Key Assumptions

- 1. Debt definition.** The public debt sustainability analysis considers a restricted coverage of the public sector at the central government level due to data availability and reliability. The rest of the consolidated public sector has been broadly in balance in recent years as the cash surplus of the social security system and other decentralized government entities broadly offset the small central bank deficit—resulting from its liquidity management operations—while public enterprises are broadly in balance.
- 2. Growth and fiscal policy assumptions.** The baseline anticipates a recovery in potential growth from an estimated 3.2 percent in 2018 to 3.5 percent by 2023. Positive confidence effects stemming from an efficient implementation of the fiscal reform, coupled with structural reforms in the context of OECD accession, are expected to boost investment and increase productivity in the medium term. Regarding fiscal policy, the baseline assumes a prompt implementation of the recently approved fiscal reform. In this context, the primary fiscal position is projected to improve, while the interest bill will remain large from rising public debt.

### B. Results and Assessment

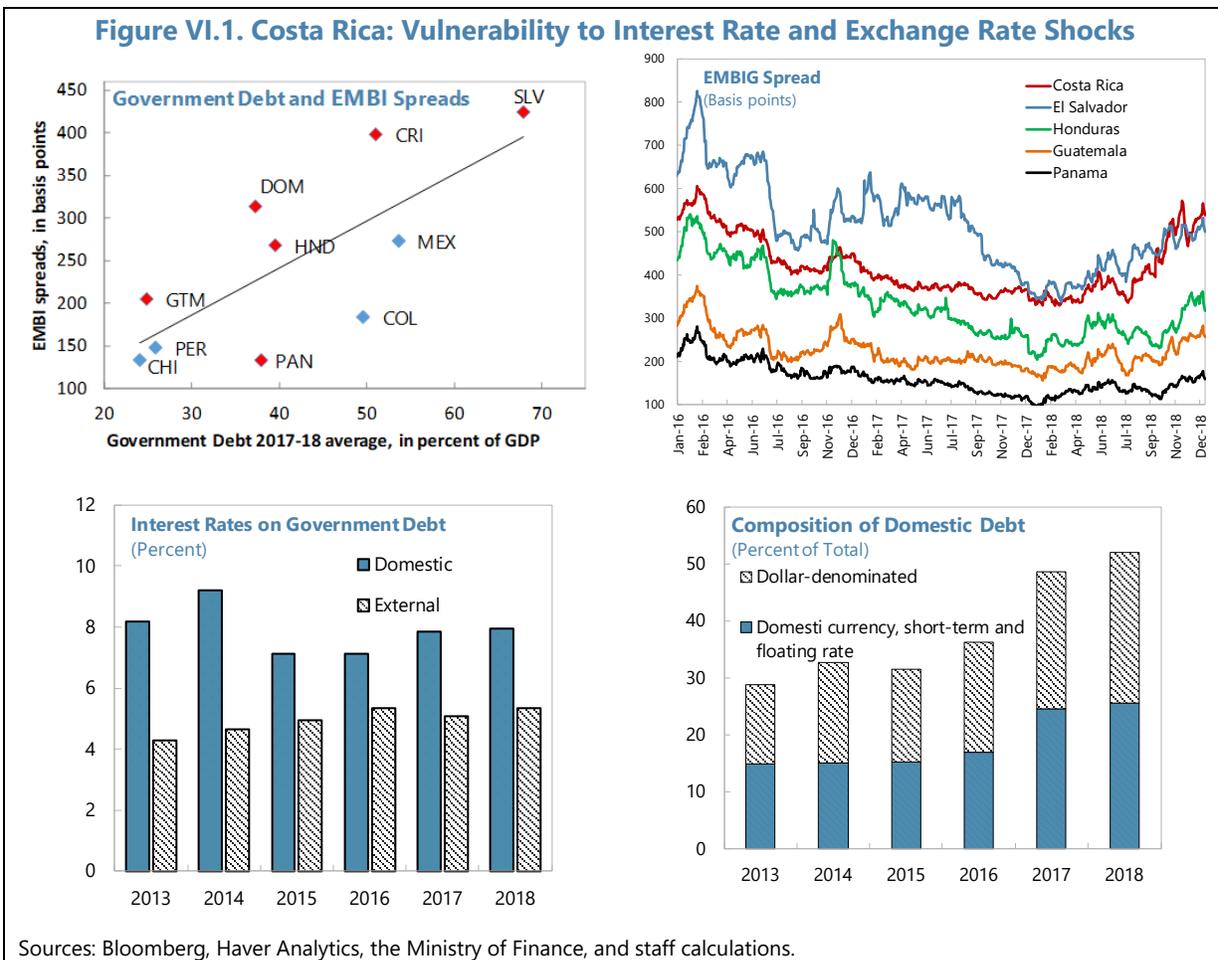
- 3. Results.** In the baseline, the headline deficit remains around 3¼ percent of GDP in 2024 due to the higher interest bill from rising public debt, which peaks at 61½ percent of GDP in 2023, and remains on a downward trajectory thereafter. The average gross financing needs would be 10.6 percent of GDP in 2019-24. In the adjustment scenario, additional front-loaded measures of ¾ percent of GDP would help reduce debt faster, reaching a prudent level of 50 percent of GDP by 2030. Both the baseline and adjustment scenarios assume tightening in credit spreads driven by favorable market reaction to fiscal consolidation, as well as a decline in domestic interest rates following the external bond issuance, which would reduce pressure on the domestic market. Both scenarios also assume access to external financing through a Eurobond issuance and loans from IFIs.
- 4. Assessment.** The deterioration of the fiscal situation has put debt sustainability at risk. While the debt level is below the vulnerability threshold of 70 percent of GDP in 2018, it remains sensitive to shocks under stressed scenarios. In addition, while still below the vulnerability threshold of 15 percent of GDP, gross financing needs increased substantially in 2018 due to a dramatic worsening of the financing situation related to the uncertainty surrounding the fiscal reform, which forced the government to heavily rely on costly short-term domestic debt. Also, market perception indicators deteriorated in 2018. After the approval of the fiscal reform, domestic debt swaps have improved debt dynamics (swapping debt due in 2019-20 for debt due in 2023 and beyond). In

addition, gross financing needs are expected to decline over time as the fiscal balance improves with the implementation of the reform and the government is able to continue lengthening its debt amortization profile.

- Under the combined macro-fiscal shock, the debt level would reach 71 percent of GDP by 2024. Moreover, debt levels have high sensitivity to growth shocks, which may be particularly prominent under heightened external risks of greater protectionism and economic isolationism in advanced economies identified in the risk assessment matrix.
- Gross financing needs in the baseline were at 12½ percent of GDP in 2018 but are expected to decline to 8 percent of GDP by 2024 due to an improved fiscal position resulting from the implementation of the recently approved fiscal reform and the reduction in amortization payments as the government is able to issue debt at longer maturities. Gross financing needs in 2024 reach 10½ percent of GDP under the combined macro-fiscal shock, and 9¾ percent of GDP under the contingent liability shock.<sup>1</sup>
- Market perception indicators deteriorated in 2018, and vulnerabilities to interest rate and exchange rate shocks persist.
  - Due to the uncertainty surrounding the fiscal reform, coupled with deterioration in investor sentiment in other emerging market countries with weak fundamentals, spreads on Costa Rica’s external bonds spiked to the highest in Central America in 2018, above 550 bps. The approval of the fiscal reform had a positive impact on spreads, but it was partially offset by the effect of Moody’s, S&P’s and Fitch’s credit ratings downgrades. The country could see its sovereign credit spreads increasing further under high-risk scenarios identified in the risk assessment matrix, involving tighter global financial conditions or rising concerns about the future economic performance of the U.S.
  - Domestic financing costs increased in 2018 due to the uncertainty surrounding the fiscal reform, the pass-through of policy rate hikes to domestic market rates, and the increase in the supply of domestic bonds to finance the growing financing needs. In addition, a relatively high reliance on floating rate and dollar-denominated bonds increases the vulnerability of public debt to possible future interest rate and exchange rate shocks.

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<sup>1</sup> The standard contingent liability shock in the DSA template is calibrated as a 10 percent loss in the value of banking system assets excluding claims on government. The size of this shock is of similar magnitude to maximum possible direct losses from complete write-down of bank exposures to sovereign debt and associated need for bank recapitalization to restore capital adequacy ratios, though actual losses would likely be larger under such an extreme scenario of full-blown sovereign debt and economic crisis.



- Mitigating factors.** A stable investor base is an important mitigating factor. Notwithstanding the vulnerabilities associated with external and FX debt, highlighted in the debt profile indicators of the heat map, more than half of total domestic debt is held by captive local institutional investors, including the social security system, nonfinancial public-sector institutions, and banks.
- Recommended adjustment path.** Fiscal consolidation should strike an appropriate balance between reducing debt faster and limiting the adverse impact on growth. An additional front-loaded adjustment of ¾ percent of GDP relative to the baseline is recommended to reduce near-term financing pressures and debt faster.

## Figure VI.2. Costa Rica: Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

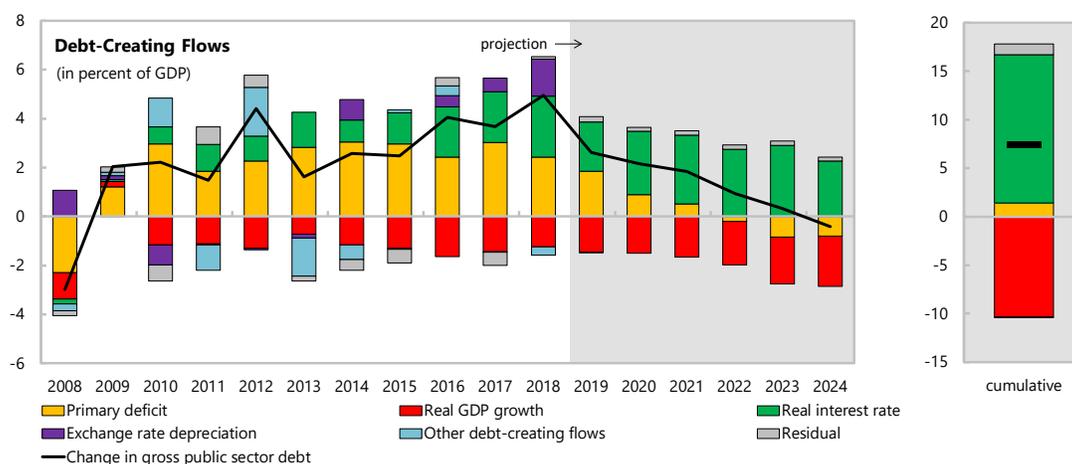
(In percent of GDP unless otherwise indicated)

### Debt, Economic and Market Indicators 1/

	Actual			Projections						As of February 15, 2019		
	2008-2016 2/	2017	2018	2019	2020	2021	2022	2023	2024	Sovereign Spreads		
Nominal gross public debt	33.6	48.6	53.5	56.2	58.3	60.1	61.1	61.4	61.0	EMBIG (bp) 3/ 469		
Public gross financing needs	11.7	10.6	12.4	12.0	10.4	11.4	11.6	10.3	8.1	5Y CDS (bp) 398		
Real GDP growth (in percent)	3.5	3.4	2.7	2.9	2.8	3.0	3.1	3.3	3.5	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	5.8	2.5	2.4	3.7	3.0	2.7	2.9	2.9	3.0	Moody's	B1	B1
Nominal GDP growth (in percent)	9.5	6.0	5.1	6.8	5.9	5.8	6.2	6.3	6.7	S&Ps	B+	B+
Effective interest rate (in percent) 4/	8.9	7.5	7.8	7.9	7.9	7.9	7.9	8.0	7.1	Fitch	BB	BB

### Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance 9/
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024		
Change in gross public sector debt	2.0	3.7	5.0	2.6	2.2	1.8	0.9	0.3	-0.4	7.5	
Identified debt-creating flows	2.0	4.2	4.8	2.4	2.0	1.7	0.8	0.2	-0.6	6.4	
Primary deficit	1.9	3.0	2.4	1.8	0.9	0.5	-0.2	-0.8	-0.8	1.4	0.2
Primary (noninterest) revenue and grants	13.7	13.8	13.7	14.5	15.0	15.2	15.3	15.4	15.5	90.9	
Primary (noninterest) expenditure	15.6	16.8	16.1	16.3	15.9	15.7	15.1	14.6	14.6	92.3	
Automatic debt dynamics 5/	0.1	1.2	2.8	0.6	1.1	1.1	1.0	1.0	0.2	5.0	
Interest rate/growth differential 6/	-0.1	0.6	1.3	0.6	1.1	1.1	1.0	1.0	0.2	5.0	
Of which: real interest rate	0.9	2.1	2.5	2.0	2.6	2.8	2.7	2.9	2.3	15.3	
Of which: real GDP growth	-1.0	-1.4	-1.2	-1.5	-1.5	-1.7	-1.8	-1.9	-2.0	-10.3	
Exchange rate depreciation 7/	0.2	0.6	1.5	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Use of Deposits (negative)	0.0	0.0	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroarea)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes 8/	0.0	-0.5	0.1	0.2	0.2	0.2	0.2	0.2	0.2	1.1	



Source: IMF staff calculations.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as  $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+g\pi)]$  times previous period debt ratio, with  $r$  = interest rate;  $\pi$  = growth rate of GDP deflator;  $g$  = real GDP growth rate;  $a$  = share of foreign-currency denominated debt; and  $e$  = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as  $r - \pi(1+g)$  and the real growth contribution as  $-g$ .

7/ The exchange rate contribution is derived from the numerator in footnote 5 as  $ae(1+r)$ .

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

**Figure VI.3. Costa Rica: Public DSA - Composition of Public Debt and Alternative Scenarios**

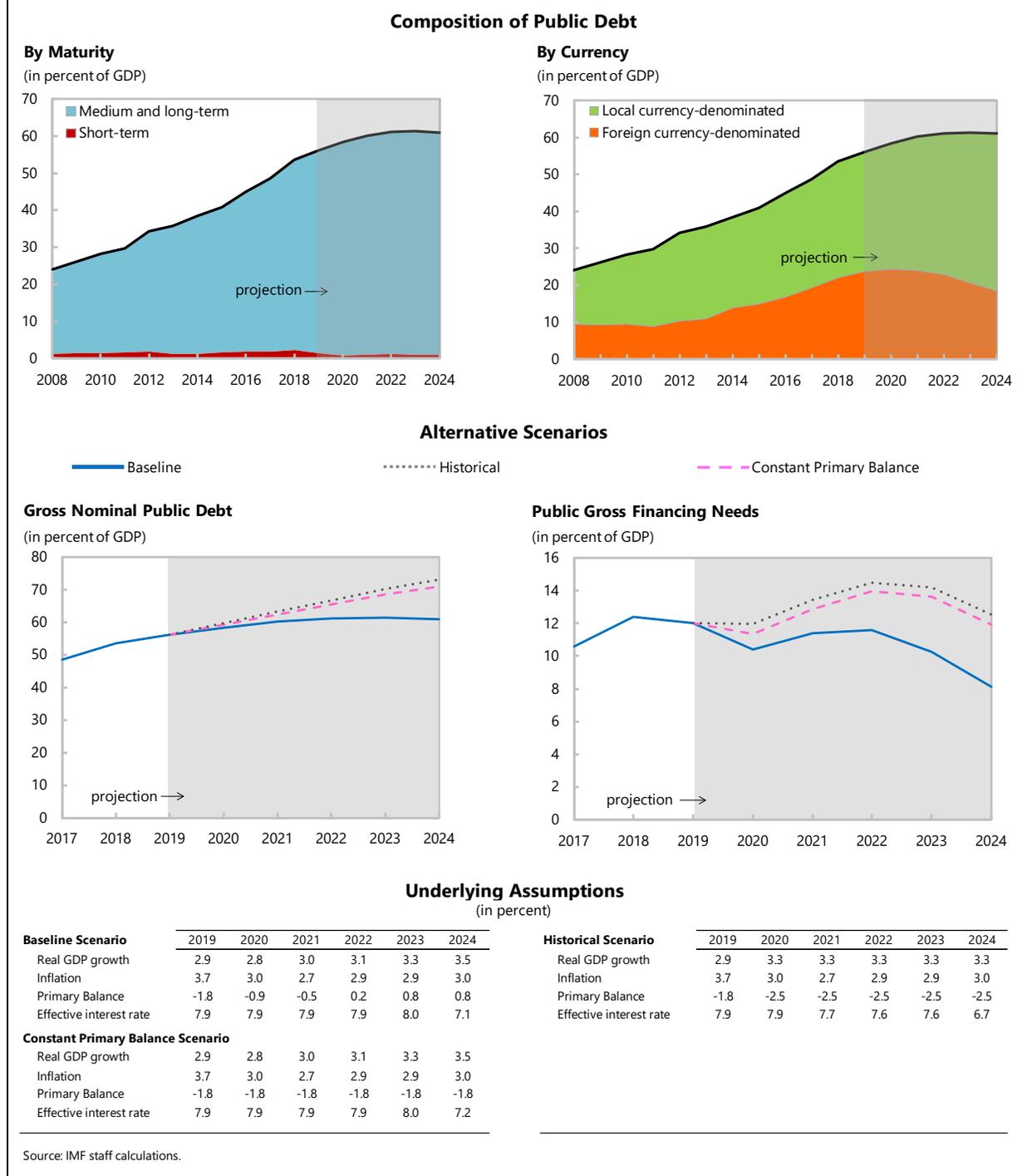


Figure VI.4. Costa Rica: Public DSA - Realism of Baseline Assumptions

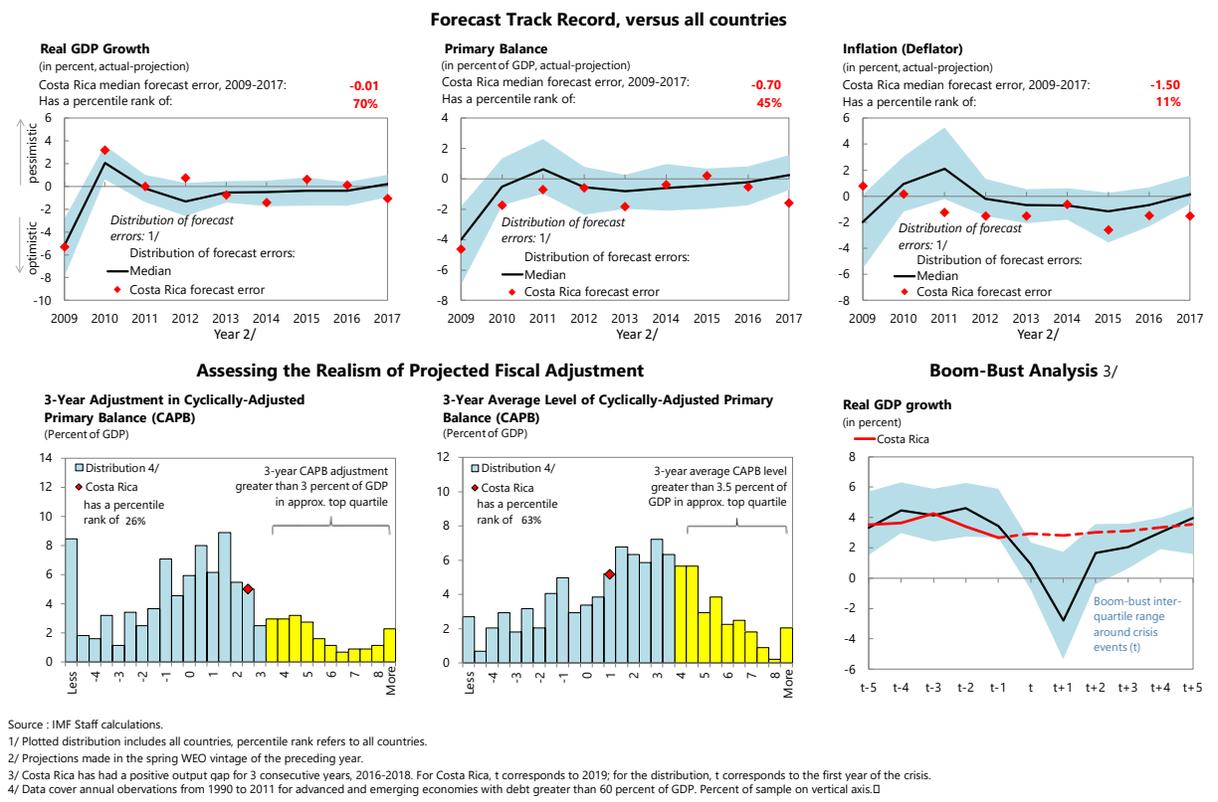
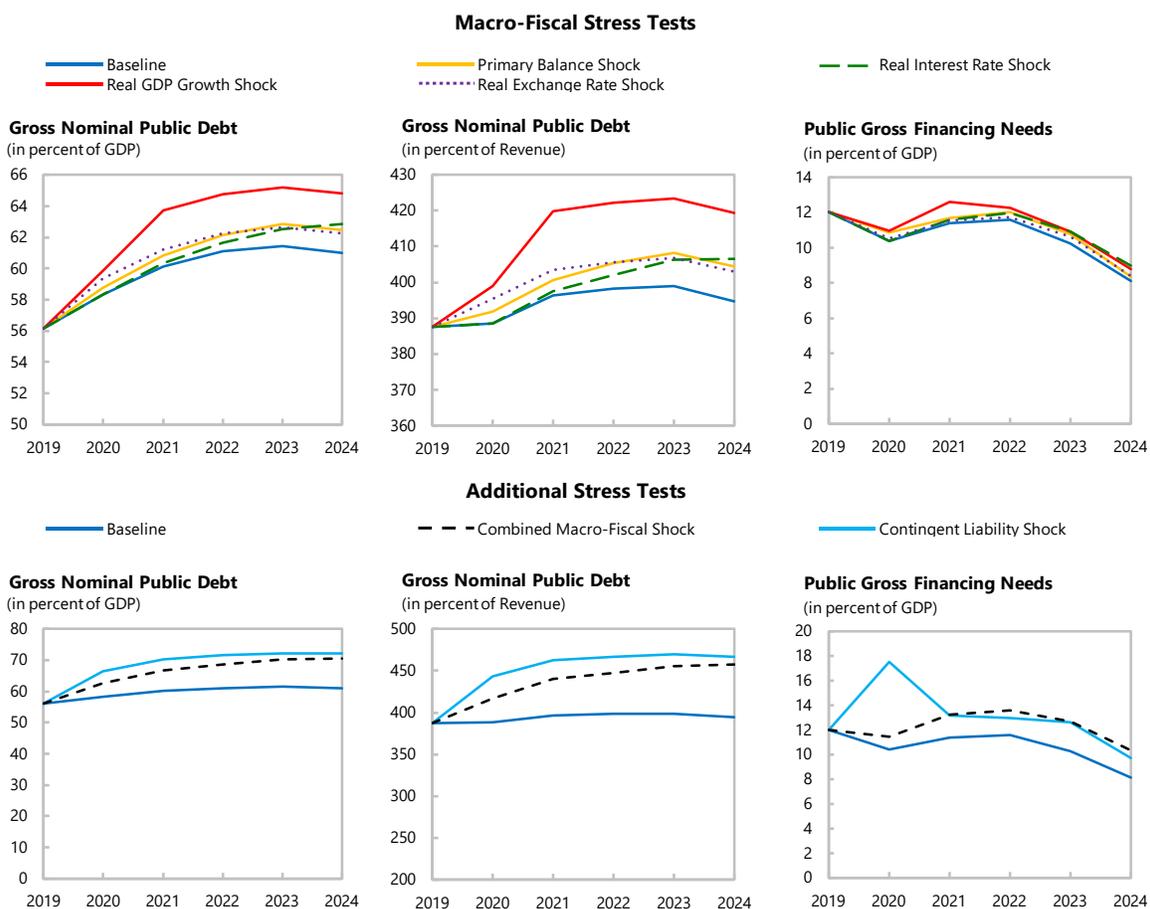


Figure VI.5. Costa Rica: Public DSA - Stress Tests



**Underlying Assumptions**  
(in percent)

	2019	2020	2021	2022	2023	2024
<b>Primary Balance Shock</b>						
Real GDP growth	2.9	2.8	3.0	3.1	3.3	3.5
Inflation	3.7	3.0	2.7	2.9	2.9	3.0
Primary balance	-1.8	-1.4	-0.7	-0.2	0.5	0.8
Effective interest rate	7.9	7.9	7.9	7.9	8.1	7.2
<b>Real Interest Rate Shock</b>						
Real GDP growth	2.9	2.8	3.0	3.1	3.3	3.5
Inflation	3.7	3.0	2.7	2.9	2.9	3.0
Primary balance	-1.8	-0.9	-0.5	0.2	0.8	0.8
Effective interest rate	7.9	7.9	8.2	8.5	9.0	8.3
<b>Combined Shock</b>						
Real GDP growth	2.9	1.1	1.3	3.1	3.3	3.5
Inflation	3.7	2.5	2.3	2.9	2.9	3.0
Primary balance	-1.8	-1.4	-1.2	-0.2	0.5	0.8
Effective interest rate	7.9	8.3	8.2	8.6	9.1	8.4
<b>Real GDP Growth Shock</b>						
Real GDP growth	2.9	1.1	1.3	3.1	3.3	3.5
Inflation	3.7	2.5	2.3	2.9	2.9	3.0
Primary balance	-1.8	-1.2	-1.2	0.2	0.8	0.8
Effective interest rate	7.9	7.9	7.9	7.9	8.1	7.1
<b>Real Exchange Rate Shock</b>						
Real GDP growth	2.9	2.8	3.0	3.1	3.3	3.5
Inflation	3.7	5.5	2.7	2.9	2.9	3.0
Primary balance	-1.8	-0.9	-0.5	0.2	0.8	0.8
Effective interest rate	7.9	8.3	7.9	7.9	8.1	7.1
<b>Contingent Liability Shock</b>						
Real GDP growth	2.9	1.1	1.3	3.1	3.3	3.5
Inflation	3.7	2.5	2.3	2.9	2.9	3.0
Primary balance	-1.8	-7.4	-0.5	0.2	0.8	0.8
Effective interest rate	7.9	8.7	8.2	8.2	8.3	7.4

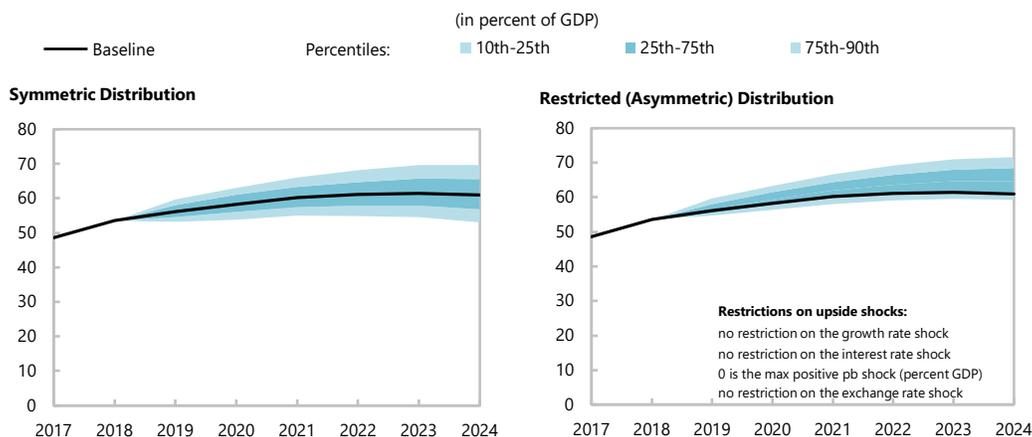
Source: IMF staff calculations.

Figure VI.6. Costa Rica: Public DSA Risk Assessment

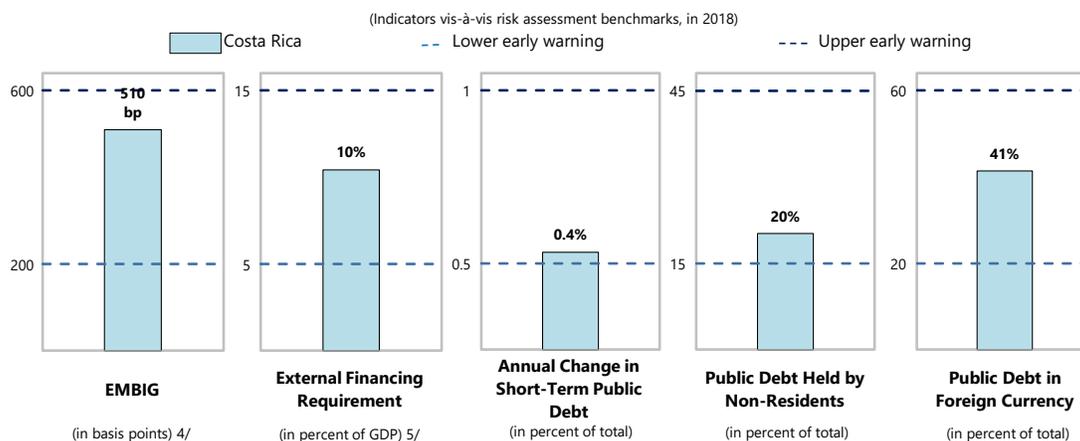
Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Evolution of Predictive Densities of Gross Nominal Public Debt



Debt Profile Vulnerabilities



Source: IMF staff calculations.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 17-Nov-18 through 15-Feb-19.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

## Annex VII. External Debt Sustainability Assessment

### Costa Rica: External Debt Sustainability Framework, 2013-23 (In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest current account 6/ -5.1
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	
<b>Baseline: External debt</b>	38.8	42.3	42.5	44.2	46.3	<b>49.5</b>	<b>52.8</b>	<b>53.3</b>	<b>54.3</b>	<b>55.2</b>	<b>53.1</b>	
Change in external debt	6.3	3.5	0.3	1.7	2.1	3.3	3.3	0.4	1.1	0.8	-2.0	
Identified external debt-creating flows (4+8+9)	-2.1	-1.4	-4.3	-3.4	-2.1	-2.2	-2.4	-2.5	-2.7	-2.9	-2.9	
Current account deficit, excluding interest payments	3.9	3.7	2.3	0.8	1.6	1.5	1.3	1.2	1.2	1.1	1.2	
Deficit in balance of goods and services	2.0	1.5	0.0	-1.2	-1.1	-1.4	-1.6	-1.8	-1.9	-1.7	-1.7	
Exports	31.4	32.4	30.9	32.2	33.3	34.1	34.6	34.9	35.0	35.0	35.1	
Imports	33.4	33.9	30.9	31.0	32.1	32.7	32.9	33.0	33.2	33.3	33.4	
Net non-debt creating capital inflows (negative)	-4.8	-5.5	-4.6	-3.8	-4.5	-4.2	-4.3	-4.4	-4.5	-4.5	-4.5	
Automatic debt dynamics 1/	-1.3	0.5	-2.0	-0.4	0.8	0.4	0.5	0.8	0.6	0.6	0.5	
Contribution from nominal interest rate	0.9	1.1	1.2	1.4	1.4	1.7	1.9	2.2	2.2	2.2	2.2	
Contribution from real GDP growth	-0.7	-1.3	-1.4	-1.7	-1.5	-1.2	-1.4	-1.4	-1.5	-1.6	-1.7	
Contribution from price and exchange rate changes 2/	-1.5	0.7	-1.8	0.0	0.9	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	8.4	4.9	4.6	5.0	4.1	5.5	5.8	2.9	3.7	3.7	0.8	
External debt-to-exports ratio (in percent)	123.3	130.6	137.5	137.2	139.1	145.1	152.8	152.8	155.2	157.5	151.6	
<b>Gross external financing need (in billions of US dollars) 4/</b>	6.2	6.4	5.0	5.2	6.3	6.2	6.8	7.6	7.3	7.5	9.2	
in percent of GDP	12.2	12.4	9.0	9.0	10.8	10.4	11.2	12.0	10.9	10.7	12.4	
<b>Scenario with key variables at their historical averages 5/</b>						<b>49.5</b>	<b>50.8</b>	<b>50.4</b>	<b>50.6</b>	<b>50.8</b>	<b>48.4</b>	<b>-7.1</b>
<b>Key Macroeconomic Assumptions Underlying Baseline</b>												
						Historical Average	Standard Deviation					
Real GDP growth (in percent)	2.3	3.5	3.6	4.2	3.4	3.5	1.8	2.7	2.9	2.8	3.1	3.3
GDP deflator in US dollars (change in percent)	4.7	-1.8	4.5	0.1	-1.9	4.6	5.8	-2.0	-0.4	2.1	1.9	2.1
Nominal external interest rate (in percent)	2.9	3.0	3.0	3.4	3.2	3.2	0.4	3.6	3.9	4.3	4.2	4.3
Growth of exports (US dollar terms, in percent)	4.5	4.7	3.5	8.7	4.7	6.1	7.3	3.2	3.8	5.8	5.5	5.4
Growth of imports (US dollar terms, in percent)	1.9	3.2	-1.2	4.7	5.0	5.3	13.6	2.5	3.1	5.2	5.5	5.8
Current account balance, excluding interest payments	-3.9	-3.7	-2.3	-0.8	-1.6	-3.2	2.0	-1.5	-1.3	-1.2	-1.2	-1.1
Net non-debt creating capital inflows	4.8	5.5	4.6	3.8	4.5	4.8	1.0	4.2	4.3	4.4	4.5	4.5

1/ Derived as  $[r - g - r(1+g) + ea(1+r)] / (1+g+r+gr)$  times previous period debt stock, with  $r$  = nominal effective interest rate on external debt;  $r$  = change in domestic GDP deflator in US dollar terms,  $g$  = real GDP growth rate,  $e$  = nominal appreciation (increase in dollar value of domestic currency), and  $a$  = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as  $[-r(1+g) + ea(1+r)] / (1+g+r+gr)$  times previous period debt stock.  $r$  increases with an appreciating domestic currency ( $e > 0$ ) and rising inflation (based on GDP deflator).

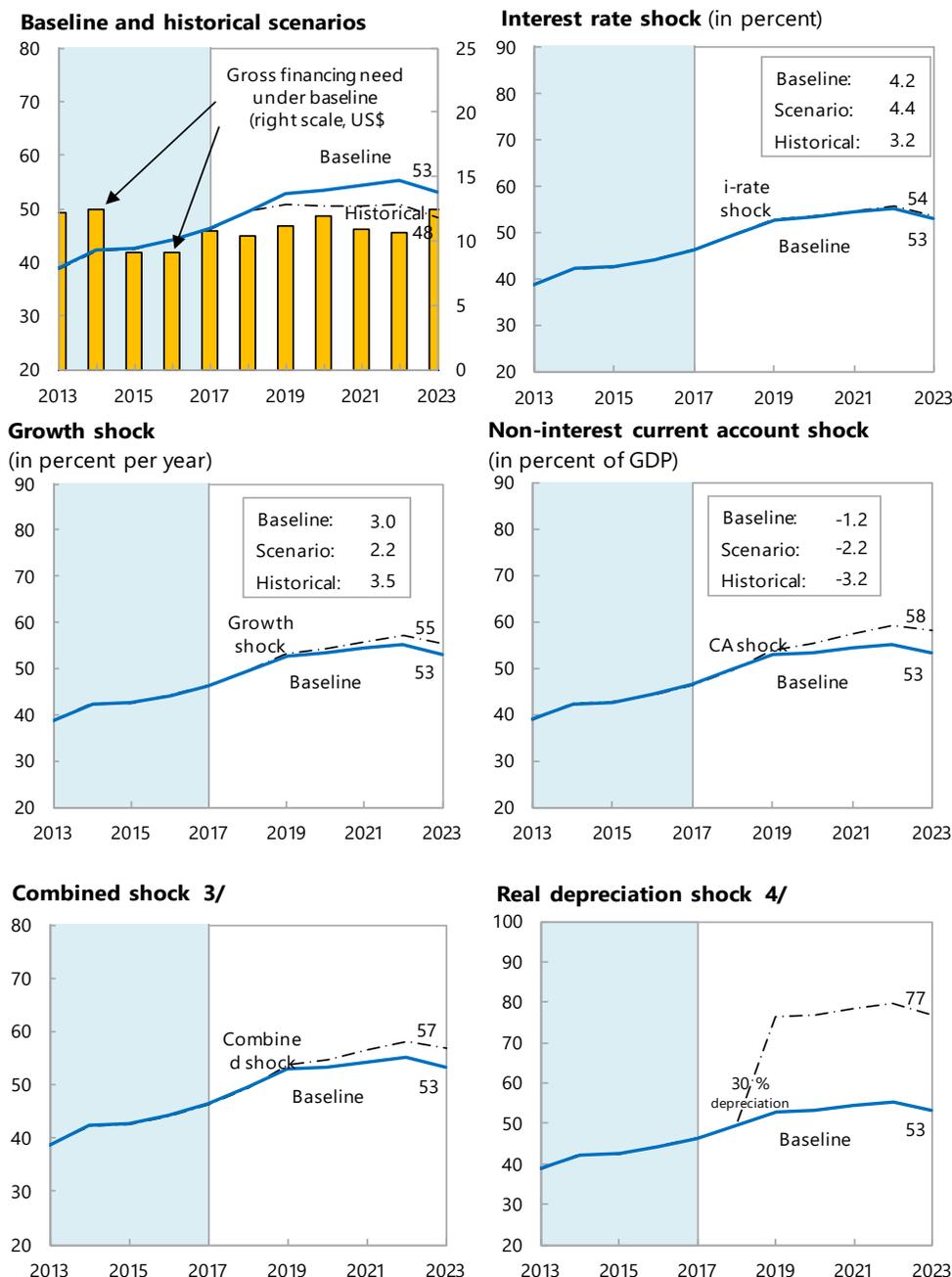
3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

### Costa Rica: External Debt Sustainability: Bound Tests 1/ 2/ (External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.  
 1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.  
 2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.  
 3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.  
 4/ One-time real depreciation of 30 percent occurs in 2018.



# COSTA RICA

## STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

March 12, 2019

Prepared by: The Western Hemisphere Department

### CONTENTS

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## FUND RELATIONS

(As of January 31, 2019)

**Membership Status:** Joined: January 8, 1946; Article VIII

<b>General Resources Account:</b>	<b>SDR Million</b>	<b>% Quota</b>
Quota	369.40	100.00
Fund holdings of currency	298.07	80.69
Reserve Tranche Position	71.34	19.31

<b>SDR Department:</b>	<b>SDR Million</b>	<b>% Allocation</b>
Net cumulative allocation	156.53	100.00
Holdings	84.96	54.27

### Outstanding Purchases and Loans:

None

### Latest Financial Arrangements:

<b>Type</b>	<b>Date of Arrangement</b>	<b>Expiration Date</b>	<b>Amount Approved (SDR Million)</b>	<b>Amount Drawn (SDR Million)</b>
Stand-By	04/11/2009	07/10/2010	492.30	0.00
Stand-By	11/29/1995	02/28/1997	52.00	0.00
Stand-By	04/19/1993	02/18/1994	21.04	0.00

### Projected Payments to Fund

(SDR Million; based on existing use of resources and present holdings of SDRs):

	<b>Forthcoming</b>				
	2019	2020	2021	2022	2023
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.79	0.80	0.80	0.80	0.80
<b>Total</b>	<b>0.79</b>	<b>0.80</b>	<b>0.80</b>	<b>0.80</b>	<b>0.80</b>

**Exchange Rate Arrangement.** Costa Rica's de jure current exchange rate arrangement classification is "managed float." The central bank committed to allow the exchange rate to be freely determined by foreign currency supply and demand but reserved the right to participate in the market to meet its own foreign currency requirements and those of the nonbank public sector and, at its discretion, to prevent sharp fluctuations in the exchange rate. Since August 2018, the central bank has allowed more flexibility in the exchange rate by departing from the 2 percent band against the U.S. dollar and limited use of FX intervention to addressing episodes of large exchange rate volatility. Accordingly, the de facto exchange rate arrangement was reclassified to "floating" from "crawl-like",

effective August 21, 2018. Costa Rica maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.

**Article IV Consultation.** The last Article IV consultation was concluded on June 27, 2017 (Country Report No. 17/156).

**FSAP participation and ROSCs.** The FSAP took place in 2001 and was updated in 2008. A data ROSC took place in 2002 with a reassessment in 2010. A fiscal ROSC took place in 2007, with a reassessment in 2013.

### Technical Assistance.

Department	Time of Delivery	Purpose
STA, CAPTAC-DR Real Sector	February 2018 April 2018 November 2018 November 2018 February 2017 April 2017 August, September 2017 October 2017 January 2018 March 2018 June 2018 August 2018  October 2018	Government Finance Statistics (GFS): Technical Assistance GFS: Focused Training Technical Assistance GFS: Diagnosis GFS: Implementation Strategy National Accounts System (NAS): Service Surveys NAS: Construction survey quarterly measurements NAS: Service Surveys NAS: Annual Accounts by Institutional Sector NAS: Quarterly National Accounts NAS: Monthly Indicator of Economic Activity, Manufacturing and Commerce NAS: Integrated Economic Accounts and Financial Assets Survey NAS: Quarterly National Accounts NAS: Integrated Economic Accounts/ Business Economics Study NAS: Annual Accounts: primary sector.
MCM, CAPTAC-DR	April 2017 January 2018 March 2018 January, February 2017 February, April 2017 July 2017 April 2018 July, September 2018 November 2018	OMX: Strengthening central bank's capacities for financial stability analysis OMX: Support in designing a facility of last resort OMX: Systemic risk monitoring at the central bank SBF: IFRS Training SBF: Credit risk supervision SBF: Liquidity risk supervision SBF: Treasury management workshop SBF: Credit risk supervision SBF: IRRBB regulation
FAD, CAPTAC-DR	February 2017 February, April 2017 April 2017 July, October 2017; February 2018 February 2018 April 2018 April 2018 February 2017 March 2017 September, October 2017; April 2018 October, November 2017 January 2018 March 2017 April 2017 July 2017; February, April 2018 September, November 2017 April 2018	AAA: Container control model AAA: Process management AAA: Value database AAA: Improvement of clearance and registration processes AAA: Risk-based segmentation AAA: Improvement of clearance processes AAA: Improvement of customs processes AAT: Strengthen the audit area AAT: Strengthen the taxpayer registry AAT: Strengthen the Audit Area AAT: Strengthen the Taxpayers Registry AAT: Strengthen the Comprehensive Control of VAT Credit (massive controls) PFM: Accounts - Budget - Costing PFM: Treasury - Treasury Single Account PFM: Fiscal Risk-Specific Risks PFM: Treasury-Contingency plan PFM: Fiscal Risks - SOEs

**Resident Representative:** Gerardo Peraza (based in Guatemala) is the regional resident representative for Central America, Panama and the Dominican Republic.

## RELATIONS WITH THE WORLD BANK AND BANK-FUND COLLABORATION UNDER THE JOINT MANAGEMENT ACTION PLAN (JMAP)

**1. The IMF's Costa Rica team is in coordination with the World Bank's Costa Rica team to identify macroeconomic challenges and macro-critical reforms and define the work plans of the two teams.**

**2. The teams agree that Costa Rica's main macroeconomic challenges are to safeguard fiscal sustainability, strengthen the monetary policy framework, maintain financial sector stability and enhance competitiveness.**

**3. Based on the shared assessment of macroeconomic challenges, the teams identify four reform areas as macro-critical:**

- *Fiscal consolidation.* The fiscal reform, which incorporates both revenue and spending measures, is a critical step to restoring fiscal sustainability. However, its full and timely implementation is key. Additional front-loaded consolidation, based on well-designed revenue measures while taking steps to protect the poor, is needed to further reduce debt and near-term fiscal financing pressures, and to build fiscal space for potential shocks and contingent liabilities (e.g., pensions). More efforts to increase spending efficiency, strengthen fiscal institutions, and streamline debt management are also needed.
- *Monetary policy framework.* Further institutional reforms and enhancing transparency of monetary policy would help to strengthen the inflation targeting framework. The recent increase in exchange rate flexibility and limited use of FX intervention to addressing episodes of large exchange rate volatility should be maintained.
- *Financial sector stability.* Approval of legislation on consolidated supervision, deposit insurance and banking resolution will be critical to bring the regulatory framework up to international best practices. Implementation of outstanding FSAP/FSSR recommendations would enhance the resilience and inclusiveness of the financial system.
- *Competitiveness.* Continued progress with the implementation of structural reforms, including those that are part of the work plan for OECD accession process, will boost competitiveness and foster inclusive growth.

**4. The teams agree on the following division of labor:**

- *Fiscal consolidation.* The IMF (the Fund) will continue to provide policy recommendations on macro-fiscal issues, including the overall strategy of fiscal consolidation and implementation of the fiscal reform. The World Bank (the Bank) will seek opportunities to provide technical assistance to support the use of public-private partnerships as a vehicle to finance key infrastructure projects.

- *Monetary policy framework.* The Fund will continue to provide policy recommendations to strengthen the inflation targeting regime and to maintain a flexible exchange rate regime.
- *Financial sector stability.* The Bank and the Fund will cooperate as necessary in assisting the country in implementing the FSAP/FSSR recommendations.
- *Competitiveness.* The Bank will continue to provide policy recommendations in key areas. In terms of lending, the government is being supported by a project in higher education (approved in September 2012), and a health operation (approved in March 2016). The government has also requested technical assistance from IFC Advisory services to improve the investment climate.

**5. The teams have the following requests for information from their counterparts:**

- The Fund team requests to be kept informed of progress in the above macro-critical structural reform areas. Timing: when milestones are reached (and at least semi-annually).
- The Bank team requests to be kept informed of the Fund's assessments of macroeconomic policies and prospects. Timing: when milestones are reached (and at least semi-annually).

**6. The table below lists the teams' separate and joint work programs for 2019-20.**

<b>Table 1. World Bank and IMF Planned Activities in Macro-Critical Structural Reform Areas</b>			
<b>Title</b>	<b>Products</b>	<b>Provisional Timing of Missions</b>	<b>Expected Delivery Date</b>
World Bank Work Program	Public Expenditure Review Tax and Trade Work OECD Accession Support		May 2019 June 2020 July 2019
IMF Work Program	Staff visit Regional Conference Article IV Consultation Technical assistance: Revenue administration Customs administration PFM Debt management Banking supervision and regulation Money and FX market operations Government finance statistics National Accounts and price statistics	September 2019 December 2019 February 2020 2019	September 2019 December 2019 February 2020

**7. The attached table summarizes the financial relations between Costa Rica and the World Bank (in million U.S. dollars).**

<b>Table 2. Costa Rica and the World Bank: Financial Relations</b>			
<b>Project Name</b>	<b>Total loan</b>	<b>Undisbursed through FY19</b>	<b>Projected disbursements in FY19/20</b>
Higher Education Improvement Project	200	20	5/15
Strengthening Universal Health Insurance	420	195	0/75
Fisheries Project	90	Under preparation	0/5

**8. Other analytical or advisory services:**

<b>Task Name</b>	<b>Delivery</b>
PMR MRP Implementation Costa Rica	28-Mar-2019
PMR Domestic C-Market Infrastructure	28-Mar-2019
PMR Costa Rica: carbon offset demand	29-Mar-2019
PMR: carbon offset supply (P3)	29-Mar-2019

## RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

**Recent activities.** The IBD's loan portfolio in Costa Rica has 11 sovereign guaranteed operations, with an approved amount of US\$1,627.3 million. The available amount for disbursements is US\$889.1 million (55 percent of the approved) and is concentrated in the areas of Transportation (40 percent), Energy (28 percent), Education (10 percent), Citizen Security (8 percent), Integration and Commerce (6 percent), Water and Sanitation (5 percent) and Innovation (2 percent). The average age of the operations is 2.56 years. Disbursements of sovereign guaranteed operations during 2019 are expected to reach US\$55.9 million, concentrated in the areas of Energy (89 percent), Innovation (5 percent) and Others (6 percent). Disbursement projections do not consider US\$350 million of a Policy Based Loan (PBL) that is being discussed with the government.

<b>IDB Disbursements, Amortization and Net Flows</b>											
<b>Sovereign Guaranteed Operations</b>											
(In millions of U.S. dollars)											
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019*
Disbursements	41.3	55.7	121.0	86.9	131.3	209.9	173.4	154.4	164.6	258.8	55.9
Amortization	46.0	45.3	47.0	45.2	36.9	32.5	39.1	53.8	55.8	63.7	72.5
Interest and charges	12.2	11.9	10.9	9.9	10.3	10.7	13.2	22.2	25.3	42.5	52.1
Net cash flow	18.9	1.5	-60.9	-29.9	-82.6	-164.6	-119.5	-76.7	-83.5	-152.6	68.7

\* Projections (February 2019). Do not include US\$350 million of a PBL that is being discussed with the government.

<b>Sovereign Guaranteed Operations (as of February 8, 2019)</b>				
(In millions of U.S. dollars)				
	Approved	Disbursed	Committed	Available
<b>Loans in execution*</b>	<b>1,627.3</b>	<b>733.8</b>	<b>4.4</b>	<b>889.1</b>
Cantonal Road Network Program	55.4	55.4	0.0	0.0
Water and Sanitation Program	73.0	9.2	0.0	63.8
Violence Prevention and Social Inclusion Promotion Program	132.4	132.4	0.0	0.0
Power Sector Development Program 2012-16 (Reventazón Hydroelectric Project)	250.0	168.0	4.4	77.6
Building and Equipping of Education Infrastructure	167.5	167.5	0.0	0.0
Innovation and Human Capital for Competitiveness Program	35.0	13.2	0.0	21.8
Infrastructure Transport Program (PIT)	450.0	170.0	0.0	280.0
Border Integration Program of Costa Rica	100.0	0.0	0.0	100.0
First Renewable Energy, Transmission and Distribution of Electricity Program	200.0	0.0	0.0	200.0
Tropical Storm Nate Emergency Response Program	20.0	18.1	0.0	1.9
Cantonal Road Network II Program	144.0	0.0	0.0	144.0
<b>Non-reimbursable Technical Cooperations**</b>	<b>8.7</b>	<b>4.5</b>	<b>0.6</b>	<b>3.6</b>
<b>Total</b>	<b>1,636.0</b>	<b>738.3</b>	<b>5.0</b>	<b>892.7</b>

\* Excludes Private Sector Loans; \*\* Excludes MIF Technical Co-operations.

## STATISTICAL ISSUES

(As of February 2019)

**General:** Data provision is broadly adequate for surveillance. The quality of macroeconomic data has continued to improve in recent years. This was confirmed by a reassessment of the Data Module Report on the Observance of Standards and Codes (ROSC) that was published in February 2010. Further statistical improvements are being pursued, including in the real, monetary, fiscal and balance of payments sectors. The Central Bank, the Ministry of Finance, and the National Institute of Statistics and Census make data available to the public through regular official publications on their websites ([www.bccr.fi.cr](http://www.bccr.fi.cr), [www.hacienda.go.cr](http://www.hacienda.go.cr), and [www.inec.go.cr](http://www.inec.go.cr)).

**National accounts:** National accounts are compiled generally in accordance with the *System of National Accounts 2008 (2008 SNA)*. The Central Bank disseminated the annual national accounts data for the years 1991-2016 and quarterly estimates up to 2018 Q3. Quarterly estimates are released with around a 90-day lag, but TA is assisting in the compilation of quarterly supply and use tables that may reduce this towards 60 days, as well as providing more frequent granular data. The present base year is 2012 but the Central Bank plans to publish during the second semester of 2019 preliminary estimates rebased to 2017. Estimation of real estate activities including owner-occupied housing has been improved. Accounting depreciation is used instead of estimating consumption of fixed capital. In the new system, double deflation method is applied to obtain annual value added in constant prices; whereas single extrapolation is used for quarterly volume estimates using output volume indicators and appropriate price indices are used to derive current value estimates. Changes in inventories are largely obtained following the *2008 SNA* recommendations for those products for which enough information is available, though TA recently recommended improvements to estimates for cattle and poultry. The informal activity of households as producers of goods and services is included in GDP levels (but not separately estimated) via the compilation of employment and remuneration matrices.

**Price statistics:** Consumer price index (CPI) compilation generally follows the concepts and definitions of the CPI Manual. Its structure, scope, and coverage were updated in March 2017. The index reference period is June 2015. However, the CPI weights are based on the 2012/2013 Income and Expenditure Survey so are now out of date. The index only covers urban households. These comprise approximately 73 percent of the total population and 82 percent of the total consumption expenditures of Costa Rica. Atypical movements in the data are investigated and corrected when necessary. During 2018 a new Income and Expenditure Survey was collected, and a rebasing of the CPI may take place during 2019.

The PPI generally follows the concepts and definitions of the PPI Manual, and is calculated both by product and economic activity (for manufacturing and selected services activities). The base year of the PPI for domestic manufacturing and for services (transportation, accommodation and food services, and professional services) is 2012.

**Government Finance Statistics:** The concepts and definitions used in compiling GFS generally follow the guidelines of the GFSM 1986. However, financing data and government debt, which use national concepts that combine instruments and holders, are not in accordance with international standards. Monthly fiscal statistics are only compiled and disseminated for budgetary central government (although these data are not reported to STA), while annual statistics are compiled and disseminated for the entire public sector and its subsectors. Annual data for the *GFS Yearbook* are reported on a regular basis, most recently for 2017.<sup>1</sup> The place of issuance (Costa Rica or abroad) criterion is followed to classify domestic and foreign debt, instead of the internationally recommended holder residency criterion. Fiscal data discrepancies among national compilers on particular items are not regularly reconciled, although large fluctuations or discrepancies are investigated. Fiscal statistics are not regularly reconciled with monetary statistics, or other macroeconomic statistics.

**Monetary and Financial Statistics:** Central Bank of Costa Rica (CBCR) reports the Standardized Report Forms (SRFs) 1SR for CBCR, 2SR for the other depository corporations (ODCs), and 5SR for monetary aggregates for publication in the IMF's *International Financial Statistics (IFS)* on a monthly basis with a lag of two months. The reported monetary statistics are broadly in line with the methodology of the *Monetary and Financial Statistics Manual (MFSM)*. The classification of financial instruments and economic sectors follows the *MFSM* with some exceptions. Accrued interest is not classified together with underlying instruments, as recommended by the *MFSM*. The CBCR is working on expanding the coverage of the monetary statistics to include money-market investment funds (MMF) as ODCs and non-MMF investment funds and pension funds as other financial corporations.

**Financial sector surveillance:** Costa Rica reports all core financial soundness indicators (FSIs) and one of the 13 encouraged FSIs for deposit takers on a monthly basis for posting on the IMF's FSI website with less than one quarter lag. The authorities are planning to expand the reported FSIs for the encouraged set of deposit takers.

**External sector statistics:** The Central Bank of Costa Rica (BCCR) compiles and disseminates quarterly balance of payments and international investment position (IIP) statistics, which are produced on a sixth edition of the Balance of Payments and International Investment Position Manual (BPM6) basis. Source data are generally adequate and derived from sound collection programs and work is still ongoing to improve the coverage of financial transactions of the nonfinancial private sector (such as those related to trade credit and advances), and remuneration of employees.

The BCCR also compiles and disseminates on a monthly basis the Data Template on International Reserves and Foreign Currency Liquidity, reports semi-annual data to the Coordinated Portfolio Investment Survey (CPIS) and annual inward and outward Coordinated Direct Investment Survey

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<sup>1</sup> Costa Rica regularly reports to STA GFS division annual data in the format of GFSM 2014. The institutional coverage for Revenues and Expenses is General Government, but for Transactions and Stocks of assets and liabilities is Budgetary Central Government plus Social Security Fund.

(CDIS), and submits quarterly external debt statistics to the Quarterly External Debt Statistics (QEDS) database.

**Data Standards and Quality:** Costa Rica is in observance with the Special Data Dissemination Standards (SDDS). Data Module Report on the Observance of Standards and Codes (ROSC) was published in February 2010.

Costa Rica: Table of Common Indicators Required for Surveillance (As of February 24, 2019)					
	Date of latest observation	Date received	Frequency of Data <sup>5</sup>	Frequency of Reporting <sup>5</sup>	Frequency of Publication
Exchange Rates	Feb 19	Feb 19	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	Feb 19	Feb 19	D	D	D
Reserve/Base Money	Feb 19	Feb 19	D	D	D
Broad Money	Jan 19	Feb 19	M	M	M
Central Bank Balance Sheet	Jan 19	Feb 19	M	M	M
Consolidated Balance Sheet of the Banking System	Jan 19	Feb 19	M	M	M
Interest Rates <sup>2</sup>	Feb 19	Feb 19	D	D	D
Consumer Price Index	Jan 19	Feb 19	M	M	M
Revenue, Expenditure, Balance, and Composition of Financing <sup>3</sup> – Central Government	Jan 19	Feb 19	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt <sup>4</sup>	Jan 19	Feb 19	M	M	M
External Current Account Balance	Sep 18	Dec 18	Q	Q	Q
Exports and Imports of Goods and Services	Sep 18	Dec 18	Q	Q	Q
GDP/GNP	Sep 18	Dec 18	Q	Q	Q
Gross External Debt	Sep 18	Dec 18	Q	Q	Q
International Investment Position	Sep 18	Dec 18	Q	Q	Q
<p><sup>1</sup> Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.</p> <p><sup>2</sup> Both market-based and officially-determined, including discounts rates, money market rates, rates on treasury bills, notes, and bonds.</p> <p><sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.</p> <p><sup>4</sup> Including currency and maturity composition.</p> <p><sup>5</sup> Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).</p>					

**Statement by Mr. Leonardo Villar, Executive Director for Costa Rica**  
**March 27, 2019**

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.