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TECHNICAL ASSISTANCE REPORT: SOVEREIGN ASSET AND LIABILITY MANAGEMENT—SCOPING MISSION

This technical assistance report on Costa Rica was prepared by a staff team of the International Monetary at the request of Ministry of Finance (MoF) of Costa Rica, a Monetary and Capital Markets (MCM) Department mission consisting of David A. Grigorian (IMF, Mission Chief), Phillip Anderson, and Antonio Juambeltz (External Experts) visited San Jose from November 15 to 22, 2022 to assist the authorities in preparing a framework for consolidated Sovereign Asset and Liability Management.

The mission met with officials from the MoF, Banco Central de Costa Rica (BCCR, Central Bank), state-owned banks (Banco Nacional de Costa Rica, Banco de Costa Rica, and Banco Popular y de Desarrollo Comunal), state-owned enterprises (RECOPE, ICE, AYA, and INCOFER), and public pension fund (Caja Costarricense del Seguro Social). The mission wishes to thank the authorities for their cooperation, productive discussions, and their hospitality.

It is based on the information available at the time it was completed on April 2023.

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TECHNICAL ASSISTANCE REPORT

COSTA RICA

Sovereign Asset and Liability Management—Scoping Mission

APRIL 2023

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ABP	Annual Borrowing Plan
ALM	Assets and Liabilities Management
AYA	Instituto Costarricense de Acueductos y Alcantarillados
BCCR	Banco Central de Costa Rica
CCSS	Caja Costarricense del Seguro Social
CD	Certificates of Deposit
CG	Central government
CPI	Consumer Price Index
CRC	Costa Rican Colones
CSAL	Committee for Sovereign Assets and Liabilities
DGGDP	General Directorate of Public Debt Management
EFF	Extended Fund Facility
FX	Foreign exchange
GDP	Gross Domestic Product
ICE	Instituto Costarricense de Electricidad
IMF	International Monetary Fund
INCOFER	Instituto Costarricense de Ferrocarriles
IPSASB	International Public Sector Accounting Standards Board
MCM	Monetary and Capital Markets
MoF	Ministry of Finance
MTDS	Medium-Term Debt Management Strategy
OPC	Operadora de Pensiones Complementarias
OTC	Over-the-counter
RECOPE	Refinadora Costarricense de Petróleo
RIVM	Régimen de Invalidez Vejez y Muerte
ROA/ROE	Return on assets/Return on equity
QIC	Quarterly Issuance Calendar
SALM	Sovereign Asset and Liability Management
SOB	State-owned bank
SOE	State-owned enterprise
SUGEF	Superintendency for banks
SUPEN	Superintendency for pension funds
TSA	Treasury Single Account
USD/US$	United States Dollar

PREFACE

At the request of Ministry of Finance (MoF) of Costa Rica, a Monetary and Capital Markets (MCM) Department mission consisting of David A. Grigorian (IMF, Mission Chief), Phillip Andersen, and Antonio Juambeltz (External Experts) visited San Jose from November 15 to 22, 2022 to assist the authorities in preparing a framework for consolidated Sovereign Asset and Liability Management.

The mission met with officials from the MoF, Banco Central de Costa Rica (BCCR, Central Bank), state-owned banks (Banco Nacional de Costa Rica, Banco de Costa Rica, and Banco Popular y de Desarrollo Comunal), state-owned enterprises (RECOPE, ICE, AYA, and INCOFER), and public pension fund (Caja Costarricense del Seguro Social). The mission wishes to thank the authorities for their cooperation, productive discussions, and their hospitality.

EXECUTIVE SUMMARY

Aided by a 36–month Extended Fund Facility (EFF) in place since March 2021, Costa Rica's reform efforts toward strong, inclusive, and sustainable growth are showing tangible results. On the public debt management side, the authorities' commitment includes reforms of the institutional setup, strategy, and domestic market development. In parallel, efforts are underway to create a framework for a consolidated management of the state's assets and liabilities and to reform the functioning of various building blocks of the consolidated public sector balance sheet, such as state-owned enterprises and banks.

A comprehensive sovereign asset and liability management (SALM) framework can have significant advantages over separate management of sovereign assets and liabilities. It allows analysis of the financial characteristics of the whole balance sheet of the sovereign, identification of sources of costs and risks, and quantification of the correlations among those sources. Thus, when an SALM approach is applied to the consolidated public sector portfolio, overall sovereign risk exposures can be more effectively analyzed and managed with varying degree of policy coordination (depending on formal objectives).

Implementing a full SALM framework can be challenging, but countries have applied it with a range in scope and policy objectives. The challenges are twofold: first, obtaining data on all sovereign assets and liabilities; and second institutional coordination, given that assets and liabilities are managed by a range of entities, some of which enjoy statutory independence or operate under independent boards. Nevertheless, the framework has been applied by numerous countries to more effectively manage currency risk, liquidity risk, asset allocation, and debt composition of the government.

An effective SALM framework is important for a country like Costa Rica with an elaborate balance sheet. In addition to having sizable liabilities and a highly dollarized economy that is reflected in the balance sheet of BCCR, its sovereign balance sheet includes ownership stakes in the financial and real sectors with extensive interlinkages between various components. In this scoping review, five types of entities are considered: (i) the budgetary central government; (ii) the social security system; (iii) the BCCR; (iv) the four largest state-owned enterprises (SOEs); and (v) the state-owned banks (SOBs).

An analysis of the balance sheet of each entity in Costa Rica's broader public sector is the first step in developing a consolidated sovereign balance sheet. The balance sheet composition of each entity, or type of entity, is shaped by the nature of its business, historic policy decisions, and the regulatory regime under which it operates. The BCCR balance sheet has negative equity for historic reasons and significant USD assets and liabilities, related to dollarization. The SOEs, for the most part, are in reasonable financial health and can fund some investment from their retained earnings, while the SOBs are profitable and liquid, and reflect dollarization.

Combining these balance sheets into a consolidated sovereign balance sheet brings out several observations and suggestions that could underpin a follow-up to this scoping exercise. First, the balance sheet remains incomplete, largely due to gaps in information regarding the financial position of the central government (e.g., property, plant, and equipment). This contrasts with the SOEs, SOBs, and BCCR, which provide financial statements in line with international reporting standards.

Second, the combined balance sheet highlights the risks facing the sovereign's net worth, given the wide range of entities it owns and the interlinkages among them. Not only is the sovereign exposed to the risks of owning these businesses, but also to the transmission of risk between them in time of stress or crisis.

Third, the combined balance sheet highlights the presence of two sovereign debt issuers in the local market: the central government and the BCCR. This fragments local currency debt issuance and impedes the emergence of a government yield curve, which plays an important role in overall financial sector development. Addressing this would also allow a single public debt management strategy and aid monetary policy implementation.

The establishment of the Committee on Sovereign Assets and Liabilities (CSAL) is an important step toward consolidated management of sovereign assets and liabilities in Costa Rica. However, the scope of CSAL should be broadened to include the BCCR as a permanent member, given the need for policy and operational coordination with monetary policy. The BCCR can also contribute its detailed understanding of financial sector risks and stability.

The consolidated foreign-currency (FX) position shows that as of December 31, 2021 liabilities exceed assets by CRC10,285 billion (or 25 percent of 2021 GDP). This confirms the importance of the government's strategy to reduce the FX risk of its debt portfolio in the medium term. It also highlights the need for a deep and liquid FX market to provide hedging opportunities to market participants. The work to develop the FX market, with IMF capacity development support, is important in this regard.

The SALM framework provides insights into the management of liquidity risk. CSAL should establish a framework for cash and liquidity management, including a target for a liquidity buffer broken down between individual entities. This would build on the initiative to establish a Treasury Single Account (TSA, Caja Unica) for the budgetary public sector. Among other system-wide risks that CSAL could begin to analyze are rollover risk, contingent liabilities, and other factors impacting the budget.

Lastly, the consolidated balance sheet shows that public debt is by far the largest government liability and highlights the importance of strengthening debt management. The ongoing efforts of the Ministry of Finance to in this area should continue.

Table 1 below summarizes the mission's recommendations.

Table 1. Key Recommendations

Recommendations	Priority	Timeframe[1]	Responsible Agency
Include the BCCR as a permanent member of the CSAL	High	ST	MoF
Consider broadening the Central Government's financial reporting to include a statement of financial position, consistent with international accrual accounting standards	High	ST	MoF
Establish a framework for analyzing system-wide liquidity risk, rollover risk, contingent liabilities, and other shocks to the budget.	High	ST	National Treasury and CSAL
Consider a realignment of balance sheets of the CG and the BCCR so as to make the former to be the sole issuer of sovereign debt	Medium	MT	MoF/ BCCR
Consistent with MTDS, continue reducing the FX exposure of the consolidated balance sheet	Medium	MT	MoF
Implement a planned liberalization of SOE access to FX via transactions with the private sector and improve market transparency by informing the market of daily FX transactions, including OTC	Medium	MT	BCCR
Advance capacity development on operational issues, such as international debt issuance and investor relations program aimed at attracting nonresident investors to the local market	Medium	MT	DGGDP, MoF

[1] Short term (ST): < 12 months; Medium term (MT): 12 to 24 months.

I. INTRODUCTION

1. **Aided by a 36–month Extended Fund Facility (EFF) in place since March 2021, Costa Rica's reform efforts toward strong, inclusive, and sustainable growth are showing tangible results.** On the public debt management side, the authorities' commitment includes reforms of the institutional setup, strategy, and domestic market development. In parallel, efforts are underway to create a framework for a consolidated management of the state's assets and liabilities and to reform the functioning of various building blocks of the consolidated public sector balance sheet, such as state-owned enterprises and banks.

2. **Despite the setbacks associated with the COVID-19 pandemic, Costa Rica's public debt is considered to be sustainable and is expected to decline in the medium term due to fiscal consolidation.** The recent publication of the Medium-Term Debt Management Strategy (MTDS) document—with an effort to shed light on the state-owned enterprise debt—was an important step forward. The work intended to provide more predictability to the functioning of the domestic debt market and liberalize nonresident investor entry into the domestic market is also welcome. However, the effective management of public debt has been hampered by delays in the parliamentary approval of the government's external borrowing plan. This has derailed the possibility of rolling over the maturing January 2023 Eurobond, thus putting undue pressure on both the fiscal buffers and foreign reserves to repay the bond in time.

3. **An effective sovereign asset and liability management (SALM) framework is important for a country like Costa Rica with an elaborate balance sheet.** In addition to sizable liabilities, its sovereign balance sheet includes ownership stakes in financial and real sector entities with extensive interlinkages among them. While these interlinkages can at times help dampen the impact of shocks, more often they contribute to the propagation of shocks with sizable implications for the sovereign's net worth. An SALM framework could help to identify developmental and risk management bottlenecks and thus help create room for formal policies, such as enhancing net worth and reducing volatility.

4. **A comprehensive assessment and understanding of the sovereign's assets and liabilities and associated risks require detailed financial statements of public entities.** While much of these data are already publicly available in Costa Rica, further granularity is necessary to help detect vulnerabilities and mitigate shocks. A useful next step could be the production of financial reporting for the entire sovereign using the approach outlined in this report.

5. **The report is structured as follows:** Section II outlines the rationale for developing an SALM framework, prerequisites for its effective functioning, and an overview of international experience with SALM. Section III provides a preliminary structure for an SALM framework for Costa Rica, along with the relevant public entities to be included.

Finally, Section IV discusses key policy linkages for an effective SALM strategy and next steps.

II. Rationale, Prerequisites, and International Experiences

A. Rationale for Developing an SALM Framework

6. **A comprehensive SALM framework can bring significant advantages over separate management of sovereign assets and liabilities.** It allows for an analysis of the financial characteristics of the whole balance sheet of the sovereign, identification of sources of costs and risks, and quantification of the correlations among those sources. A financial risk management strategy can then be developed to manage exposures in a cost-efficient manner. Thus, when an SALM approach is applied to the consolidated public sector balance sheet, overall sovereign risk exposures can be more effectively analyzed and managed.

7. **An SALM framework can serve as a central element of an overall macroeconomic management strategy and be adapted to facilitate the attainment of long-term macroeconomic and developmental objectives.** These could include economic diversification, broadening the export base, reducing dependence on key imports, and identifying fiscal challenges (e.g., unfunded social security liabilities that may imply a future claim on resources). For small open economies with a significant role for the state, such as Costa Rica, an SALM approach can shed light on potential macroeconomic and financial challenges and help mitigate them.

B. Prerequisites for an Effective SALM Framework

Data Requirements

8. **Preparing an SALM framework is data-intensive, with requirements similar to those of financial intermediaries applying Asset and Liability Management (ALM).** Most financial intermediaries periodically review their assets and liability positions, analyze currency and interest rate mismatches, and adjust balance sheet structure based on risk exposures and level of risk tolerance. However, conceptual differences and practical difficulties in implementation require a customized treatment when applied to the sovereign.

9. **Many governments' assets are physical in nature (e.g., land, buildings, and plant) and do not readily lend themselves to an analysis of financial risk.** Similarly, governments' main asset in some cases is the country's natural resource wealth and its capacity to tax, and the financial features of this asset may not be easy to define. Even if consistent financial reporting is available across sectors, they may not be of sufficient granularity to be used in an SALM framework. Also, monitoring the performance of SALM may be difficult if the accounting standards vary across the entities included in the consolidated framework.

Institutional Coordination

10. **Adequate coordination and institutional arrangements are important for the implementation of an SALM framework.** These will have to consider the main objectives of the SALM framework and the fact that some institutions that will be included in the consolidated balance sheet enjoy statutory independence or operate under independent boards (e.g., state-owned enterprises and banks, public pension funds, with specific investment mandates, etc.). Navigating this will make the process of coordination particularly challenging.

11. **Coordination may require establishing an oversight committee,** with a broad mandate to seek a more systematic analysis of the public-sector balance sheet and a consolidated approach to risk management. Decisions about transferring risk to the private sector, via insurance or through capital markets, can be taken on the basis of this systematic analysis to ensure that resources were allocated in the most efficient manner.

12. **The challenge of coordinating independent entities can be eased either by limiting interventions by the central government strictly to support the SALM framework (without compromising independent governance arrangements) or by an overlay strategy.**[2] One possible option is that at the sovereign level, mechanisms are developed to lessen the risk of undue political interference in investment mandates (for example, for particular asset classes). These could include legislative and institutional structures that set limits on such actions and require transparency.

13. **All in all, the more comprehensive the SALM framework aspires to be, the more challenging it will be to secure data and have the appropriate institutional and/or policy coordination setup for its proper functioning.**

C. International Experience with SALM

14. **Countries differ in terms of the scope and policy objectives of their SALM frameworks.**[3] Several governments apply some form of SALM, in which they identify risks and vulnerabilities of sovereign assets and liabilities, without necessarily establishing formal SALM objectives. For example, governments may determine specific debt management or reserve management strategies that reduce certain exposures and balance sheet vulnerabilities, without quantifying the risks. Also, the coverage of entities on both sides of the balance sheet varies across SALM frameworks, where only a minority includes central banks (in some cases only international reserves) and state-owned pension funds and banks.

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[2] In particular, an overlay strategy could entail a legal or institutional framework that requires investment objectives, strategic asset allocations etc., of different entities to take account of aggregate SALM objectives.

[3] Udaibir S. Das, Yinqiu Lu, Michael G. Papaioannou, and Iva Petrova (2012), “Sovereign Risk and Asset and Liability Management—Conceptual Issues” (IMF Working Paper 12/241) provides a good reference for the variety of objectives that can be pursued within an SALM framework.

15. **Because of challenges involved in producing an SALM framework, some countries have developed simple SALM frameworks,** which typically involve integrated management of the net position on central government. While the number of countries that do so is growing, compiling full statements of financial position (i.e., aggregate balance sheets) is a relatively recent practice, a fact that likely reflects these challenges.

16. **Management of sovereign liquidity risk (defined as the minimum level of cash balances that ensures meeting day to day cash requirements of the government) is one of the most common objectives pursued by an SALM.** This objective aims to ensure that the government has sufficient funds available to cover current expenditure and debt amortization during periods when market access is impaired or prohibitively expensive, as well as volatility effects, forecast errors. It is managed by maintaining liquid assets at levels that are sufficiently robust to meet shock scenarios. Countries that have explicit policies in this regard include Denmark, New Zealand, South Africa, Turkey, and Uruguay.

17. **Even when governments produce full statements of their financial positions, moving from consolidated *reporting* of the entities that make up the sovereign to *integrated risk management* across all entities is a major step.** In fact, some countries regularly produce an accounting balance sheet with the objective of monitoring sovereign assets and liabilities, rather than determining mismatches between them.[4]

18. **A few countries have developed their SALM frameworks further through coordination across the sovereign balance sheet.** The list includes Canada, Denmark, Hungary, New Zealand, Norway, Turkey, Sweden, and the United Kingdom. Within the domestic debt portfolio, some countries offset domestic on-lending against domestic debt, in order to manage the net position (e.g., Denmark and New Zealand). Several other countries apply SALM concepts, at least partially, by adopting strategies to reduce vulnerabilities of the sovereign assets and liabilities without necessarily having explicit SALM identified objectives (Table 2).

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[4] For example, New Zealand has been producing a consolidated statement of its financial position since the early 1990s, but the government has not gone beyond coordination between the government and the central bank on managing financial risk across their individual balance sheets, leaving the remainder of the consolidated position to be managed by individual entities.

Table 2. Selected SALM Country Cases

Country	Management of Sovereign Assets and Liabilities
Australia	Allocation of assets between alternative portfolios and funds may take account of the government's broader priorities and objectives, but not specifically of balance sheet risks, coordination is by the responsible ministry.
Canada	The Ministry of Finance has the decision-making authority for both assets and liabilities with day-to-day management delegated to the Central Bank. The coordination is undertaken via regular meetings.
Denmark	Manages the consolidated position of the government debt by considering assets of government funds (e.g., pension funds, holding primarily government bonds and on-lending), guidelines for government guaranteed entities on exchange rate risks and loan types.
Finland, Turkey	Management of central government debt and cash reserves is undertaken on a net basis.
Hungary, Uruguay	The coordination mechanism consists of conducting periodical meetings among the entities involved in SALM.
Mexico	Reduced its external debt in 2006 through issuing domestic securities and using the proceeds to acquire FX from the central bank, which in turn redeemed its securities to reduce negative carry-costs improving the composition of the sovereign balance sheet.
New Zealand	Manages local currency and foreign currency assets and provides derivative transactions for government entities.
Norway	The coordination is through net transfers from oil revenues plus return on assets to the fiscal budget; issuance of public debt as a market benchmark.

Source: Thordur Jonasson and Michael Papaioannou, 2018, "A Primer on Managing Sovereign Debt Portfolio Risks", International Monetary Fund WP 18/74; and country websites.

III. Toward a Consolidated Balance Sheet

A. Budgetary Central Government

19. **The perimeter of institutions covered by the Central Government (CG) of Costa Rica includes both external and internal debt denominated in Colones (CRC) and the U.S. dollar (USD) as well as those indexed to consumer price index (CPI) (Table 3).** Total public debt stood at 68.2 percent of GDP at end-2021. As of December 2021, 55.5 percent of total debt was denominated in CRC; 39.5 percent in USD, and 5 percent in CPI-indexed instruments. Regarding the maturity profile, debt maturing in one year represented 8.9 percent of total debt; 39.4 percent consists of debt maturing in one to 5 years and 51.7 percent matures in more than five years. Fixed rate bonds represented 72.9 percent, variable coupon bonds 22.1 percent, and CPI-indexed bonds 5 percent of total debt.

Table 3. Central Government Balance Sheet
(December 31, 2021, in CRC billions)

Assets		Liabilities	
Financial Assets		**Financial Liabilities**	
CPI-Indexed Local Currency	0	CPI Indexed Local Currency	1,344
Colones	73	Nominal Colones bonds	15,130
Foreign Currency (FX)	195	Foreign Currency (FX)	10,785
Property, plant, equipment	….	Other liabilities	…
Other assets	…		…
		Net Financial Worth	(26,992)
Total assets	…	**Total liabilities and net worth**	**…**

Source: Department of Public Credit (DCP); and Fund staff calculations.

20. **For the medium term, the authorities foresee a significant reduction in government financing needs driven by a fiscal consolidation plan.** According to this plan, after peaking at 12.1 percent of GDP in 2021, government financing needs are expected to decline to 6.8 percent by end-2027. In recent years, financing needs have been covered mostly by borrowing in the local market, amounting on average to about 10 percent of GDP annually during 2018–21.

21. **The government has been taking measures aimed at reducing the riskiness of its debt portfolio.** The weight of debt denominated in CRC has increased to 62.8 percent in 2022 from 60.6 percent in 2017. The government has a benchmark range of the share of debt denominated in CRC between 60 percent and 80 percent. In terms of interest risk, the target share of fixed-rate bonds is 65 to 75 percent of the debt portfolio in the medium-term. Regarding rollover risk, the share of debt maturing in one year has been declining in recent years and stands at 8.9 percent in 2021 compared to 14.6 percent in 2017, presenting a moderately low refinancing risk.

22. **On the asset side, the MoF established a TSA at the BCCR in which all institutions of the CG are ordered to maintain deposits.** [5] In addition to reducing transaction costs, this account would allow the government to start building a liquidity buffer to face unforeseen events and it could also settle in various currencies.

B. Social Security System

23. **The pension sector in Costa Rica is multi-pillar, with a large amount of customer assets under management.** Pillar I, created in 1947, is a "defined benefit" scheme consisting of three providers. The main provider is the social security pension fund (CCSS, Caja

[5] Pension funds, SOBs, and SOEs that operate in the competitive sector and local authorities were excluded from TSA.

Costarricense del Seguro Social) that provides the disability, survivor, and death regime (RIVM, Régimen de Invalidez Vejez y Muerte) (Table 4), followed by teachers' pension fund (Junta de Pensiones y Jubilaciones del Magisterio Nacional) and the judicial sector pension fund. Pillar II is a "defined contribution" scheme created in 2000. It is administered by six pension fund operators (OPCs, Operadora de Pensiones Complementarias) and covers over 2.9 million participants. Finally, Pillar III, established in 2000, is a voluntary pension scheme with individual accounts too administered by the OPC.[6]

24. **The CCSS grants a pension to adults over 65 years of age and disabled citizens below the poverty line, who do not qualify to obtain a pension from any other pension scheme.** RIVM has around 1.5 million contributors and 235,000 pensioners. At present, Pilar I is under stress and requires urgent parametric changes. Actuarial reports suggest that RIVM's reserve are projected to be deployed around 2023 and exhausted around 2030.[7] If not addressed soon, these obligations may have to be absorbed by the government.

25. **To achieve long-term sustainability, in January 2022, the Board of the CCSS announced parameter changes in Pillar I, effective January 2024.** Measures included raising the minimum retirement age, a more conservative calculation of the reference salary, and additional monthly contributions required for receiving additional pension. An updated actuarial report of the RIVM (incorporating the recently announced measures) should be carried out to gauge the impact of these changes on contingent liabilities.

Table 4. CCSS Balance Sheet

(December 31, 2021; in CRC billions)

Assets		Liabilities	
Current assets	447		
Investments	2,825	Other liabilities	133
		CCSS reserves for pensions (LX)	3,139
Total assets	**3,272**	**Total liabilities and equity**	**3,272**

Source: CCSS; and Fund staff calculations.

[6] There is also Pillar 0, which is a non-contributory pension for individuals below the extreme poverty line and some other exceptions.
[7] IMF/World Bank FSAP Background Note on "Costa Rica: Insurance and Pension", 2017.

26. **Pilar II includes six OPCs, four of which are managed by SOBs and the CCSS.**[8] Total assets under management of these four OPC was US$11.7 billion as of end-2021.[9]

27. **Although OPCs are strictly speaking located outside of the perimeter of the public sector, they nevertheless may pose some risk to, and should therefore be integrated in, the consolidated SALM framework.** Since mid-2020, OPCs gradually increased their exposure to FX assets. According to current guidelines, an OPC can invest abroad up to 25 percent of its assets.[10] However, they can increase this ratio up to 50 percent if their Corporate Governance ensure compliance with the Investment Governance that establishes acceptable level of risk. The Superintendency of Pensions (SUPEN) is empowered to review all documentation at any time for regulatory compliance. Given the relatively small size of the FX market in Costa Rica, BCCR has been the main supplier of USD to OPCs. Large FX purchases may have an impact on exchange rate, lead to volatility in the market (if done outside of the BCCR), and reduce the stock of foreign currency reserves of the BCCR.

C. Banco Central de Costa Rica (Central Bank)

28. **The main policy objective of the BCCR is to control inflation.** It is also in charge of promoting the efficiency of the internal and external payments system and maintaining its normal operations, among other duties. The balance sheet of the BCCR (Table 5) reflects the past and current challenges to further its mandate in the context of a high level of dollarization of the economy.

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[8] These funds are: (1) BCR Pensiones (Banco de Costa Rica), (2) Popular Pensiones (Banco Popular), (3) BN Vital (Banco Nacional), and (4) Operadora de Pensiones Complementarias y de Capitalización Laboral (CCSS).
[9] Taking into consideration the consolidated sector, total investment abroad represented 31.3 percent of GDP as of December 2021. It was not possible to have a breakdown for the four entities are managed by SOBs and the CCSS.
[10] Per "Reglamento de Gestión de Activos", Acuerdo SUPEN 6-18, November 2018. Other limits include 80 percent limit on investment in public securities and 10 percent limit on investing in securities issued by the same local financial group or conglomerate.

Table 5. BCCR Balance Sheet
(December 31, 2021; in CRC billions)

Assets		Liabilities	
Deposits and O/N (FX)	1,388	Currency (LX)	1,529
Securities (FX)	2,338	Monetary deposits (LX)	1,514
SDRs (FX)	395	Monetary deposits (FX)	2,227
Intl org contributions (FX)	859	CG deposits (LX)	306
Loans to banks and institutions (LX)	853	Debt issuance (LX)	1,893
Other assets	352	Debt issuance (FX)	102
		Liabs to international organizations (FX)	729
		Other liabilities	107
		Equity	-2,223
Total assets	**6,184**	**Total liabilities and equity**	**6,184**

Source: BCCR; and Fund staff calculations.

29. **One notable feature of the BCCR balance sheet is its negative equity position.** This originated many years ago and was primarily driven by quasi-fiscal activities of the BCCR to finance public institutions (as well as sterilized FX interventions). Such activities have not been possible for decades now, given changes to organic laws, but the original burden has lingered through time. The negative equity is on a downward trend, and as of December 31, 2021 was the equivalent of 5.6 percent of nominal GDP, down from an estimated 6.2 percent at end 2020. The reduction has been due to changes in the mix of assets, a reduction in liabilities that have a cost, and the growth of nominal GDP.

30. **The asset side of the balance sheet is dominated by foreign-currency (FX) holdings, accounting for around 80 percent of total assets.** Most of these are official FX reserves (around two thirds of total assets), which—apart from SDR holdings—are denominated in USD. The reserves are conservatively managed, with around 60 percent allocated to the liquidity portfolio with a 1-2-month duration. The investment portfolio is mostly invested in US treasuries and is managed against a 1-3-year benchmark. The other assets in the portfolio are mostly US agencies and supranationals, although a small volume of corporates is permitted. In addition to the in-house team, the BCCR has awarded mandates to four external managers, including the World Bank Treasury. Investment grade multi-currency portfolios are permitted within these mandates, but non-USD exposures are hedged. The Reserves Management Division has effective management systems that allow daily tracking of risk, compliance, and performance against benchmarks.

31. **The liability side of the balance sheet reflects the implementation of monetary policy and the high degree of deposit dollarization.** Just under 20 percent of the liabilities comprise currency issued. A further half is accounted for by deposits, mostly the required reserves of banks, as well as the central government's account. The other major component (at 23 percent of liabilities) is debt issued by the BCCR in the form of certificates of deposits (CDs) with a maximum maturity of two years.

32. **A significant share of BCCB liabilities is denominated in USD.** At just over CRC 3,000 billion, this represents 36 percent of total liabilities and is equivalent to one-half of total assets. Reserve requirements are 15 percent of banks' deposits and are payable in the currency of the deposits. More than half of reserve requirements on December 31, 2021, were denominated in USD, reflecting the high degree of deposit dollarization. However, only a small portion of the locally issued securities were in USD. The other FX liability was borrowing from international organizations, at around 8 percent of total liabilities. In January 2022, the BCCR contracted a loan for US$1.1 billion from Fondo Latinoamericano de Reservas to bolster reserves levels.[11]

33. **The BCCR plays an active role in the foreign currency market, including as the intermediary for all public sector institutions.** At present, regulation requires that the central government and the non-bank public sector undertake all FX transactions with the BCCR. The objective has been to smooth the impact of public sector FX requirements on the exchange rate. Nevertheless, this role puts an undue pressure on BCCR's foreign reserves and is expected to diminish along with the development of the FX market.[12]

D. State-Owned Enterprises

34. **The government of Costa Rica has an ownership stake in the enterprise sector, especially utilities.** The mission focused on the four largest SOEs (ICE, RECOPE, AYA, and INCOFER) to develop an understanding of the non-financial public sector and its contribution to the overall balance sheet (Table 6). ICE has by far the largest balance sheet, with assets around five times larger than the next highest, RECOPE. However, in terms of revenues and expenses, RECOPE has larger annual flows than ICE.

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[11] This transaction is not included in Table 5 because it was completed after December 2021.

[12] The BCCR is developing a package of reforms, with the help of IMF capacity development support, to reorganize its FX operations aimed at strengthening its reserve position and deepening the FX market. This includes incentivizing the nonfinancial public sector entities to manage their FX needs more efficiently and rely more on market-based transactions. (IMF Staff Report "Third Review Under the Extended Arrangement Under the Extended Fund Facility", November 2022).

Table 6. Consolidated Balance Sheet of SOEs
(December 31, 2021; in CRC billions)

Assets		Liabilities	
Financial assets	1,006	Accounts payable (RECOPE)	255
Inventories (RECOPE)	266	USD debt	1,889
Property, plant, equipment	7,323	CRC debt	1,309
Other assets	748	Other liabilities	1,190
		Equity	4,700
Total assets	**9,343**	**Total liabilities and equity**	**9,343**

Sources: Company annual financial statements; and Fund staff calculations.

Note: A minor proportion of "USD debt" is denominated in other currencies, but this does not have a material impact on risk exposure.

35. **Not surprisingly, the assets of SOEs are dominated by "property, plant, and equipment", accounting for around 80 percent of total assets.** In aggregate, they have equity equivalent to around half of total assets, but this total masks differences among entities. AYA and INCOFER are funded almost entirely by equity, whereas for ICE, equity amounts to around 40 percent of assets.

36. **ICE accounts for over 90 percent of SOE debt. Around 57 percent of ICE's debt is denominated in FX, mostly in USD.** The company is aware of the risk this poses to its financial position posed by the FX debt and has reduced the share of in in total debt from 72 percent in 2020. There are some modest offsets to the USD liability: around 8 percent of revenues are from tariffs set in USD and the company holds some financial assets in USD. Nevertheless, the company has developed a strategy to target a USD debt share of 48.5 percent by 2026. The strategy considers the relative costs of borrowing, financial risk, and the level of development of the local bond market. The latter is seen as a constraint on their debt management policy.

37. **To obtain a full picture of the financial risks faced by the SOEs, the tariff-setting regulations need to be considered.** As monopolies, their tariffs and fees are set by the relevant regulatory authority and the framework for this process has an impact on how and when the companies can pass on costs arising from increases in the prices of their inputs to their customers. The impact of this is particularly important for RECOPE, which is the monopoly importer and distributor of refined hydrocarbon products. With annual imports of products worth more than US$2 billion (around 3 percent of GDP) that are exposed to changes in the oil price and the exchange rate, this poses a sizable risk management problem. Current tariff setting arrangements result in a timing mismatch between when RECOPE commits to purchasing product in USD and when the sales price is set in CRC. The company

is examining a hedging framework and process to mitigate this risk. RECOPE has also been asked by the government to consider hedging from the point-of-view of the consumers to help smooth price fluctuations. This work is at an early stage.

38. **For most companies, the tariff and fee setting framework is based on a principle of full cost recovery, with no expectation by the government of a dividend.** All profits are retained by the entity and deployed for investment. The exception is INCOFER, which runs at a loss and depends on transfers from government amounting to around a quarter of its revenues. The other companies fully cover their costs and can make investments from retained earnings.

39. **The SOEs are controlled to some extent by the BCCR and CG in their management of liquidity and financial risk.** As noted in section III (C), the BCCR requires SOEs to channel all their FX transactions through the BCCR, with volumes potentially smoothed over time. In addition, the SOEs are required to bank only with the SOBs[13] and make their financial investments only in government securities.[14] Finally, SOEs are constrained by the lack of local derivatives market (e.g., forward FX), even when the BCCR permits them to have direct market access.

40. **When the legislation for the TSA was first drafted, it included the liquidity of SOEs within its perimeter.** However, the final version of the bill excluded SOEs, SOBs and the CCSS, leaving SOEs still concerned that this may change. Including SOEs in the TSA would not be in line with international sound practices for non-budgetary entities and should be avoided.

E. State-Owned Banks

41. **The government of Costa Rica has sizable holdings of assets in the financial sector.** Banks play a dominant role in Costa Rica's financial sector, comprising approximately 80 percent of total financial sector assets. Within the banking sector, the assets and liabilities of SOBs—Banco Nacional de Costa Rica, Banco de Costa Rica, and Banco Popular y de Desarrollo Comunal—accounted for 58 percent of total, as of December 2021.[15] While SOBs function as fully corporatized entities and are liquid and profitable, some differences exist between them and private sector banks. Table 7 below provides a summary of key financial indicators by type of ownership.

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[13] The exception is ICE, which maintains an external account in USD.
[14] RECOPE established a sinking fund for its USD bond but was required to invest the funds at the MoF in tailor-made instruments.
[15] The share was 56 percent in August 2022, based on the latest available data.

Table 7. Selected Financial Indicators of the Banking Sector
(December 31, 2021; in percent, unless otherwise indicated)

	Total system	State-owned banks	Private banks
Total deposits, billions of CRC	22,062	12,745	9,318
Total loans, billions of CRC	19,980	10,695	9,285
Capital adequacy ratio	13.1	13.1	13.2
Loans to deposits	90.6	83.9	99.6
Liquid assets to total assets	36.7	38.5	34.4
Return on assets (ROA)	0.8	0.7	0.9
Return on Equity (ROE)	6.8	5.7	8.4
Nonperforming loans (NPLs) to total gross loans	2.4	2.8	1.9
Loan loss reserves to non-performing loans	173.7	152.6	211.5
FX-denominated loans to total private credit	43.3	23.9	66.8

Source: SUGEF.

42. **Table 8 presents the stylized consolidated balance sheet of the SOBs.** There appear to be significant linkages between SOBs and other components of the consolidated balance sheet of the government (especially the CG). About 20 percent of SOB's assets are invested in (domestic law) government securities.[16] For comparison, the share of assets of private banks invested in government bonds is about 12 percent. While this is in line with bank claims on domestic government debt in emerging market economies,[17] further increases in exposure to sovereign (risk) may not be desirable as it may have significant impact on the regulatory capital during times of sovereign stress (when higher risk-weighting may be applied to banks' sovereign exposures).

Table 8. Consolidated Balance Sheet of SOBs
(December 31, 2021; in CRC billions)

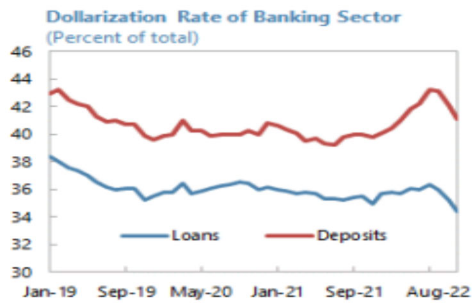
Assets		Liabilities	
Cash and due from banks	2,069	Deposits and S-T funding	13,794
Net loans & advances to banks	11,435	L-T funding	2,538
Securities and derivatives	4,879	Other liabilities	533
of which, Gov. securities	3,820		
Other assets	820	Equity	2,337
Total assets	19,203	**Total liabilities and equity**	19,203

Source: FitchRatings; and Fund staff calculations.

[16] Banks hold no externally-issued Costa Rican government debt.
[17] Basel Committee on Banking Supervision (2017), "The Regulatory Treatment of Sovereign Exposures," Discussion Paper, December; Figure 9.

43. **In addition, SOBs hold the deposits of SOEs and are their only source of domestic loanable funds, as mandated by law.** SOBs also provide a wide-range of fee-based services to government agencies through their extensive branch network. These links are very important for SOBs' business model but also make them vulnerable to public finance shocks. As of end-December 2021, SOBs also maintained a total exposure of CRC1,435 billion to the BCCR. Finally, SOBs appear to draw much of their funding from short-term deposits, both retail and corporate/SOE.

Figure 1. Balance Sheet Dollarization



Source: SUGEF; and Fund staff calculations.

44. The banking sector remains highly dollarized, which complicates monetary management and may have financial stability implications. While the share of FX loans to the non-financial private sector has declined over time (Figure 1), deposit dollarization—measured by FX deposits in total customer deposits—is high and growing.[18] In addition, banks maintain rather large *net* FX exposures (with relatively soft prudential guidance on this provided by BCCR) and are constrained in their ability to change their position above a threshold amount per period (i.e., day or month). This puts a premium on developing the FX market to reduce the pressure on the BCCR to provide foreign exchange (in effect be the sole provider of foreign exchange) at times of stress.

45. **The government also owns (and/or manages on behalf of customers) a number of non-bank financial institutions.** These by and large are part of conglomerates held by their respective umbrella holding companies, which also hold SOBs.[19] A thorough analysis (of potential liability limits for the government from owning and managing these institutions) is necessary before including them into the consolidated balance sheet of the government.

F. Consolidated Public Sector Balance Sheet

46. **This section compiles a consolidated balance sheet for the public sector, drawing on the data and discussion in the previous sections (Table 9).** Several observations are drawn, and suggestions made for follow up to this scoping exercise.

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[18] Notably, the share of FX loans of SOBs is nearly three times less as that of private banks (Table 7).
[19] Costa Rica also has the Deposit Guarantee Fund administered by the BCCR. However, due to its very small size (with total assets of US$1.7 million) and young age (it was created in 2021), the mission considered it unnecessary to include it in the SALM perimeter at this stage.

Table 9. Stylized Consolidated Sovereign Balance Sheet
(December 31, 2021; in CRC billions)

Assets		Liabilities	
FX reserves BCCR	4,121	CG & SOE debt (FX)	12,674
SOB Net loans (FX)	2,744	BCCR Monetary deposits (FX)	2,422
Other assets (FX)	859	BCCR debt issuance (FX)	102
Government cash (FX)	195	State bank deposits / funding (FX)	2,277
LX assets BCCR	853	Other liabilities (FX)	729
Government cash (LX)	73	Currency issued (LX)	1,529
SOB Cash and due from banks (LX)	2,069	CG & SOE debt (LX)	15,131
SOB Net loans (LX)	8,691	BCCR Monetary deposits (LX)	1,625
SOB Securities and derivatives (LX)	4,879	BCCR debt issuance (LX)	1,893
SOE cash and investments (LX)	1,006	State bank deposits (LX)	14,055
CCSS investments (LX)	2,825	CCSS reserves for pensions (LX)	3,139
Property, plant, equipment (SOEs)	7,323	Other liabilities (LX)	1,963
Property, plant, equipment (CG)	[…]		
Other assets (BCCR, SOBs, SOEs, CCSS)	2,633		
Other assets (Government)	[...]	Net worth	[…]
Total assets	**[…]**	**Total liabilities and equity**	**[…]**

Source: Costa Rican authorities; and Fund staff calculations

Note: Cross holdings between entities have not been netted, in order to show the interlinkages between them. For example, the SOB's deposits in the BCCR are shown as an asset for SOBs and a liability for the BCCR.

47. **First, despite the detailed effort described above, the balance sheet remains incomplete.** This is due to the financial position of the central government, where there is no information about property, plant, equipment as well as other assets and liabilities. This contrasts with the SOEs, SOBs, and BCCR, which provide financial statements in line with international reporting standards. As the central government is the largest entity in the public sector this represents a significant gap. Governments around the world are moving to produce full statements of financial position and the International Public Sector Accounting Standards Board (IPSASB) has produced standards tailored for the public sector. Such reporting supports transparency, is a useful input to long-term fiscal policy, and promotes more effective stewardship of the government's sizable asset base.

48. **Second, the balance sheet highlights the risks to the sovereign's net worth.** The government owns more than half of the commercial banking systems and has significant investments in the real economy. This exposes the government balance sheet to the risks of those businesses. In addition, there are interlinkages across the entities. For example, the SOBs lend to the SOEs and the GC; SOEs invest liquidity in the CG and SOBs; CCSS holds government securities. Shocks to any part of the balance sheet are therefore likely to have

implications for other entities. An integrated view of the public sector and an understanding of the linkages provides an opportunity to improve the resiliency of the system as a whole.

49. **Third, the balance sheet shows the presence of two sovereign debt issuers in the local market.** This fragments local currency debt issuance and impedes the emergence of a government yield curve, which plays an important role in overall financial sector development. Intermediaries report that the operations of dual issuers have created confusion in the market in the past, in particular with anomalous pricing. In addition, the interest paid by the BCCR on its securities contributes to its negative capital position.

50. **A realignment between the balance sheets of the BCCR and CG would provide benefits for both public debt management and monetary policy.** A transfer of debt to the CG balance sheet would provide an opportunity to consolidate borrowing under one entity and conduct a unified public debt management strategy. At present, the BCCR's borrowing is through short-tenor instruments, which have greater refinancing and interest-rate risk than a longer-dated portfolio would have. If the BCCR balance sheet did not have a negative equity position, there would be less pressure for choices made in the implementation of monetary policy to consider the implications for the BCCR's financial position.[20]

51. **The above exercise also allows one to make inferences about the liquidity risk of the consolidated balance sheet**. First, international reserves of the BCRR can comfortably cover Monetary Deposit liabilities denominated in both currencies. Taking into consideration the most liquid assets of the public sector (FX reserves BCCR, LX assets BCCR and LX SOB Cash and due from banks) they exceed the BCCR Monetary Deposits in both currencies and FX State bank deposits by CRC1 billion. This indicates that the liquidity risk in the entire public sector as of end 2021 was moderately low.

52. **For a complete risk analysis, off-balance sheet exposures should also be incorporated, particularly those related to the contingent liabilities of the total public sector.** Generally, an important input for policy making is the probability of materialization of contingent liabilities and their likely fiscal impact. In Costa Rica's case, contingent liabilities related to SOEs and social security Pillars I and II should also be taken into account.

53. **The consolidated balance sheet also shows that FX liabilities exceeds FX assets by CRC10,285 billion.** This is a driver behind the strategy of the government (and some SOEs, especially ICE) to reduce the FX risk of its debt portfolio over the medium term.

54. **Taking into consideration the "liquid" component of the FX assets and compared with FX liabilities, the foreign currency risk remains low.** The international

[20] There is a risk that central banks with weak financial positions have poorer policy outcomes, see for example, Peter Stella, 2008, "Central Bank Financial Strength, Policy Constraints and Inflation", IMF Working Paper 08/49.

reserves (mainly owned by BCRR) cover the FX BCCR Monetary deposits and additional 15 percent of FX CG and SOE debt stock.

55. **Beyond the above balance sheet analysis, other FX risk still are latent.** First, the potential needs of additional USD for the MoF to pay down the Eurobond maturing January 2023 (see para 59 below) together with potential purchases of foreign exchange by pension funds and SOEs in the upcoming months could lead to pressure on BCRR reserves.

IV. POLICY CONSIDERATIONS AND NEXT STEPS

56. **The authorities of Costa Rica have taken some steps toward building an SALM framework.** CSAL was established in April 2021 with the aim of coordinating public debt management, cash management, and financial programming of the Budget. The TSA was established to reduce costs and strengthen transparency in the administration of CG funds, while a Bill has been tabled with the Parliament with the objective of improving public sector liquidity management.

57. **Other efforts are underway that would directly or indirectly contribute to the formation and management of an SALM framework.** Specifically, a Bill has been tabled with the Parliament that proposes consolidation of debt management functions under a General Directorate of Public Debt Management (DGGDP). If adopted, this will contribute to risk management of the overall debt portfolio, debt servicing, evaluation (clear accountability), and reporting. In addition, a Bill to liberalize the entry of nonresident investors into Costa Rican debt market has just been approved by the Parliament. This measure will likely result in deeper markets and compressed spreads both for the sovereign as well as private and public sector borrowers.[21] The remainder of this section discusses policy areas that are critical for the formation of an SALM framework.

A. SALM and MTDS

58. **In April 2022, the MoF issued an updated MTDS document for 2022-27, a key building block for an SALM framework.** The report's main objective is to provide cost and risk assessments of various debt issuance strategies. The MoF's preferred borrowing strategy includes a mix for external (USD-denominated multilateral and bilateral) and domestic debt. In particular, the strategy targets securities denominated in local currency to reach 74 percent of total debt in the medium term. Additionally, the target share of fixed-rate securities is 84 percent of total debt. The issuance of CPI-linked bonds that lengthen the maturity profile is maintained because of the increasing demand from institutional investors,

[21] The draft bill "Promotion and Opening of the Costa Rican Domestic Public Debt Market" (File No. 22.893) will streamline the access of nonresidents investors to securities issued under local jurisdiction and equalize (withholding) taxation of interest. In addition, the bill seeks to enable the integration of local and international market infrastructure.

such as pension and investment funds. Finally, it is proposed to issue securities with over 5 and 7 year maturity, mitigating rollover risk.

59. **However, bottlenecks remain that could complicate the implementation of public debt management.** The main bottleneck is the requirement for the government to seek parliamentary authorization for external borrowing, which if approved is often limited in scale and comes with a time lag. For instance, the Parliament's recent authorization[22] would not give the MOF enough time to launch a new bond to roll over $1 billion Eurobond maturing in January 2023.[23] Consequently, it is expected that the MoF will—potentially against its preferred strategy—use its deposits at the BCCR (converted to FX using foreign reserves), together with new borrowing from multilateral institutions and private sector, to pay down the bond.

60. **Both the MoF and BCCR issue fixed-rated CRC and USD-denominated securities in the domestic market.** The BCCR issues short-term CDs up to one month maturity and bonds up to 2-year maturity, both in CRC. In addition, to mop up occasional excess FX liquidity, the BCCR has until recently issued USD-denominated bonds with 3- and 5-year maturities. In turn, MoF issue securities with maturities of 3, 5, 7, 15, and 30 years in CRC and 3, 5, 7, 10, and 20 years in USD.

B. SALM and Market Development

61. **A deep and liquid domestic government bond market is a key ingredient for the implementation of an integrated SALM framework in Costa Rica.** Given strong interlinkages between the sovereign and banking sector, a developed domestic market will compress yields and lengthen the yield curve and reduce rollover risk, thus containing sovereign risk. In addition, by tapping into the domestic bond market SOEs may be able to reduce their reliance on banks for borrowing and help to obtain more competitive and longer-term funding. Ultimately, the development of the market would require concerted efforts from debt managers, central bankers, and regulators and will help build a cushion for the financial sector (and ultimately the government itself) against cut-offs from the foreign market and sudden stops.

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[22] On November 29, Costa Rica's Parliament approved the issuance by the executive branch of debt in the international markets up to US$5 billion through 2025 conditioned on a set of macroeconomic and other objectives. The debt can be issued in tranches of US$1.5 billion for the first and second issuances (timed for the first and second halves of 2023, respectively) and in tranches of US$1 billion for the third and fourth issuance, with a minimum maturity of 5 years for each tranche. The law established a maximum yield for the first tranche, 750 basis points above the relevant US Treasury bond yield, at the time of the issuance. Conditions also include for the MoF to publish—no later than March 31st of each year—a report informing about CG's fiscal and debt conditions.

[23] Selection of underwriters and external legal advisors, preparation of documentation, implementation of marketing actions (such as investors meetings and discussion with rating agencies), takes significant time, potentially several months.

62. **At present, the National Treasury is responsible for investor relations.** Going forward, regular communication with the investor base is a way for the soon-to-be established DGGDP to obtain inputs for quarterly issuance calendars (QICs) and support efficient functioning of the domestic market. The Annual Borrowing Plan (ABP), used in conjunction with MTDS and annual budgets will go a long way in providing predictability and strengthening investor relations.

63. **Albeit an outcome of a coordinated decision, the joint issuance of debt securities by BCCR and MoF generates inefficiencies and increases operational risk.** As recommended in the MTDS report, the BCCR should limit its issuance to the very short segment of the curve. Doing so would avoid giving conflicting signals to the market. Better coordination would help identify future opportunities to better distribute liquidity and FX risks (e.g., through Liability Management Operations, LMOs). Uruguay offers a useful example in this regard (Box 1).

Box 1. Coordinated Issuance and Liability Management Operations in Uruguay

In countries that experience strong capital inflows, central banks (CBs) often intervene to reduce appreciation pressures on the home currency and by doing so accumulate FX reserves in excess of desired targets. That was the case in Uruguay in 2010, when the CB's reserves grew well above prudential metrics.[24] To address this issue the Debt Coordination Committee, consisting of the MoF and Central Bank, launched a joint two-stage LMO.

In the first stage, the MoF auctioned medium-term Peso-denominated securities, where investors could participate with new money (Pesos and/or USD), securities issued by the Central Bank, and/or local Treasury Notes with shorter maturities.

In the second stage, the Central Bank securities received in the first stage were sold to the CB for Pesos and/or USD. Of the total US$960 million equivalents, US$810 million equivalents were sold to CB at prevailing FX rates and yields. The remaining US$150 million were shorter Treasury Notes that investors delivered in exchange for new (i.e., just created) benchmark securities.

As a result of this joint exercise, the CG reduced its currency mismatches (increasing the share of Uruguayan Peso in its liabilities and its USD assets). It also increased the average time to maturity of the consolidated public sector debt and contributed to the development of the local market (by adding a new peso-denominated benchmark and retiring several small illiquid domestic securities).

In turn, the CB improved its balance sheet by replacing its CD by a combination of: (1) lower holdings of USD assets and (2) higher holdings of pesos on its liability side. This allowed CB to improve the currency mismatch that had been generated as a result of sterilizations carried out previously.

A. SALM and Debt Management, and Fiscal and Monetary Policies

64. **The composition of much of the sovereign balance sheet is driven by decisions taken as part of fiscal policy, monetary policy, and public debt management.** Each of these are separate policy areas with their own objectives and accountabilities. However, given the interconnections and interdependencies between their respective policy instruments, high level coordination is important. For example, fiscal policy decisions drive the level of public debt, which will influence choices in debt composition and ultimately sovereign risk. Fiscal policy will also have an impact on economic output, which will need to be factored into decisions on the stance of monetary policy. Decisions about the composition of domestic debt (made by debt managers) and the level of short-term interest rates (made by the central bank) will jointly influence the shape of the yield curve and cost of funding of elements of the SALM framework.

65. **At present, the focus of CSAL is fiscal policy and debt management and consideration should be given to broadening it to explicitly include the asset side of the sovereign balance sheet.** To that end, broadening the membership of CSAL to include the BCCR would be essential. The terms of reference of CSAL set out in Decree 42964-H are broad, ranging from strategic (e.g., fiscal risks and long-term fiscal and debt sustainability) to

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[24] André Amante, Phillip Anderson, Thordur Jonasson, Herman Kamil, and Michael Papaioannou, 2019, "Sovereign Asset and Liability Management in Emerging Market Countries: The Case of Uruguay", IMF Working Paper No. 19/290.

operational (e.g., cash flow projections). Given the links between the BCCR's liquidity and reserves management and the MoF's fiscal and debt management functions, a broader mandate for the CSAL should support coordination in these areas.

66. **In addition to high level policy coordination, the presence of BCCR in CSAL may help satisfy BCCR's need for frequent and up to date information on debt payments and cash flows of the sovereign and large SOEs.** This is needed to implement operations to control the level of liquidity in the financial system, as government transactions are a major driver of these. In addition, given the significant proportion of foreign-currency public debt, debt-related flows have an influence on the level of foreign-currency reserves managed by BCCR and, ultimately, the market exchange rate.

B. SALM and Financial Stability

67. **Financial stability considerations and potential costs of financial sector support measures have been on the horizon since at least the beginning of the Global Financial Crisis.** The crisis has raised the stakes for the link between financial sector soundness on one side and fiscal/debt considerations on the other side. Subsequent interventions in favor of systemically important financial institutions in a number of advanced markets have put a price tag on this link and may have increased the contingent liabilities of the government by creating moral hazard. The relationship between financial sector health and fiscal/debt problems is very strong empirically.

68. **The relationship between fiscal/debt conditions and financial sector soundness can be two-way.** On the one hand, concerns over excessive government borrowing and heightened sovereign risk may have implications for financial sector profitability and funding costs, capitalization, and liquidity. Debt managers should be aware of these channels to not add excessive risk to the financial sector stability. On the other hand, financial sector borrowing may be constrained during a crisis (i.e., due to increasing credit risk and non-performing loans), with implications for its ability to lend to government.

69. **Among the measures to safeguard the financial sector, consistent with Basel III recommendations, some countries have in recent years introduced risk weights on debt issued by distressed sovereigns.** Sovereign debt managers should be aware of the implications of these and other measures on the ability of the financial sector to maintain its exposure to public debt and coordinate with central banks and regulatory agencies to minimize these implications.

C. Considerations for Next Steps

70. The establishment of the CSAL is an important step toward a consolidated management of sovereign assets and liabilities in Costa Rica. **However, the scope of CSAL should be broadened to include the BCCR as a permanent member, with resulting stronger coordination with monetary policy.**

71. **The government should consider broadening its financial reporting to include a statement of financial position, consistent with IPSASB's accrual accounting standards.** This would improve risk management, support transparency, provide a useful input to long-term fiscal policy, and promote more effective stewardship of the government's sizable asset base.

72. **In collaboration with the National Treasury, CSAL should establish and monitor a framework for cash and liquidity management, including a liquidity buffer.** This would build on the initiative to establish a TSA for the budgetary public sector. Among other system-wide risks that CSAL could begin to analyze are rollover risk, contingent liabilities, and other risks to the budget.

73. **The government MoF and the BCCR should consider a realignment of their balance sheets that makes the government the sole issuer of sovereign debt instruments.** This would support securities market development, allow a unified public debt management strategy, and strengthen monetary policy. This issue has been considered before in Costa Rica; a renewed focus could build on these efforts, and formulate potential transition pathways and timeframes. The realignment could be implemented gradually, in order to avoid abrupt changes to individual balance sheets. From the perspective of a consolidated public sector balance sheet and net worth such a move would be neutral.

74. **Consistent with the recent MTDS and progress in domestic debt market development, the MoF should continue reducing the FX exposure of its debt.** Some SOEs, are also aiming to reduce FX risk in the medium term. Maintaining such exposures without opportunities for hedging could become costly.

75. **A deep and liquid FX market is a precondition for the provision of hedging opportunities for market participants.** Planned liberalization of SOE access to foreign exchange (via transactions with the private sector) and expected improvement in transparency (by informing the market of all daily FX transactions, including OTC) are welcome developments. As the market develops, the MoF too could have direct access to the FX market meet its debt-related and other FX requirements. Due to its explicit and implicit mandate in the FX market, the BCRR has a key role to play in promoting the development of FX hedging markets (e.g., forward transactions), although ultimately it is the private sector that would provide the product.

76. **Capacity development on debt management should continue.** The preparation for international debt issuance and an investor relations program aimed at attracting non-residents to the local market should be given priority as they could bolster the development of the SALM framework.