International Monetary Fund

Costa Rica and the IMF

Press Release:
IMF Executive Board Completes Second Review Under Stand-By Arrangement with Costa Rica
December 18, 2009

Country's Policy Intentions Documents

Costa Rica: Letter of Intent and Memorandum of Economic and Financial Policies

November 18, 2009

Letter of Intent

San José, November 18, 2009

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C.

Dear Mr. Strauss-Kahn:

1. The purpose of this letter is to inform you about the progress in the implementation of our economic program, which is being supported under the Stand-By Arrangement (SBA) approved by the IMF Executive Board on April 10, 2009. The attached supplement to the Memorandum of Economic and Financial Policies (MEFP) summarizes developments since the completion of the first program review on September 23, 2009, and describes modifications to the program.

2. Macroeconomic developments have been broadly in line with projections made at the time of the first program review. The decline in real GDP moderated in the second quarter of 2009, mainly reflecting a recovery in the manufacturing sector. Inflation fell to 4 percent in October, and inflation expectations are gradually approaching the central bank's inflation target range for 2010. The external current account deficit is likely to be smaller than projected, and in the past two months the *colón* has traded continuously below the ceiling of the currency band. Liquidity and solvency indicators of the banking sector remain adequate.

3. Performance against the program targets remains very strong. All quantitative performance criteria for end-September were met, most with significant margins. Work is underway toward the implementation of the two end-December structural benchmarks (submission of draft laws to create a deposit insurance scheme and strengthen the bank resolution framework).

4. In light of this performance and our continued commitment to the program, we request completion of the second review under the SBA. Our intention remains to treat the arrangement as precautionary. We are requesting to change the frequency of program reviews from quarterly to biannual, given reduced uncertainty about the external environment and lower program risks, and bring forward the availability date of the fourth purchase under the arrangement. The third and final program review would be expected to take place in late June 2010. The program's quantitative performance criteria and indicative targets for end-December 2009 and end-March 2010, and remaining structural benchmarks are set out in Tables 1 and 2 of the attached supplement to the MEFP.

5. We believe that the policies described in the attached supplement to the MEFP are adequate to meet the objectives of our program. However, if needed, the government stands ready to take additional measures. In accordance with the Fund's policies, we will be in continuous communication with the Fund with regard to policy actions related to this program.

Sincerely yours,

/s/	/s/
Jenny Phillips Minister of Finance	Francisco de Paula Gutiérrez President, Central Bank of Costa Rica

Attachments

Supplement to the Memorandum of Economic and Financial Policies
November 18, 2009

1. ***Recent developments***. Macroeconomic developments have been broadly in line with projections made at the time of the first program review. The decline in real GDP moderated in the second quarter of 2009 (to -2.4 percent y/y, from -4.5 percent in the first quarter), mainly reflecting a recovery in the manufacturing sector. Moreover, in September the indicator of economic activity rose 0.3 percent from the previous month (seasonally adjusted), marking the seventh consecutive month of positive growth. In October, headline and core inflation fell further, to 4.0 and 5.7 percent (y/y) respectively, while median 12-month inflation expectations declined to 7.3 percent, gradually approaching to the central bank (BCCR)'s inflation target range of 4–6 percent for end-2010. In the first half of 2009, the external current account was broadly in balance, whereas the capital account posted a modest surplus (0.4 percent of GDP), despite a significant slowdown in FDI. In the third quarter, exports showed signs of recovery while import growth remained subdued. As a result, the trade deficit through September was substantially lower than during the same period last year. In addition, the colón has traded continuously below the ceiling of the currency band since mid-August. In the banking sector, the aggregate nonperforming loan ratio and the capital adequacy ratio deteriorated slightly, but liquidity and solvency indicators remained adequate.

2. ***Performance under the program***. All quantitative performance criteria for end-September were met, most of them with significant margins. Base money growth at end-September was somewhat above program projections, reflecting a temporary spike in commercial bank deposits at the BCCR that reversed during October.

3. ***Macroeconomic framework***. The outlook for 2009 and 2010 remains broadly unchanged from the first program review. The macroeconomic framework assumes a gradual recovery with real GDP growth of around 2.5 percent in 2010, following a 1–1.5 percent contraction in 2009. Inflation is on track to fall to 5 percent (12-month basis) by end-2009, and is expected to remain within the central bank's target band of 4–6 percent in 2010. The external current account deficit is now expected to be somewhat smaller than previously projected at 3.0 percent and 4.5 percent of GDP in 2009 and 2010, respectively.

4. ***Fiscal policy***. Central government revenues through September were 7.7 percent lower than during the same period of 2008, mainly owing to a sharp drop in import-related taxes (including sales and excise taxes collected at customs). This performance was somewhat weaker than assumed in the program, and revenues for the whole year 2009 could fall short of program projections by about 0.3 percent of GDP. At the same time, central government spending has been lower than projected, and we expect some underexecution to persist through the end of the year. As a result, we are keeping the program target for the overall central government deficit in 2009 unchanged at 4.1 percent of GDP. The deficit target for 2010 of 4.1 percent of GDP also remains unchanged, although with lower estimates for both revenues and expenditures in light of the anticipated underperformance in 2009. Our quarterly fiscal program for 2010 envisages a gradual withdrawal of fiscal stimulus. The program allows for a small positive fiscal impulse

during the first half of the year, to provide continued support to domestic demand until the recovery of the private sector strengthens.

5. ***Monetary and exchange rate policies***. The downward trend of core inflation and inflation expectations, and the persistence of a negative output gap suggest that the inflation target for 2010 (4–6 percent) is achievable. However, there are some upside risks to the outlook as the dampening effect of the fall in commodity prices of early 2009 will unwind, and depreciation expectations and nontradables inflation remain above the target range. In view of these risks, the BCCR will continue to maintain a cautious approach to monetary policy easing. Our exchange rate policy will remain guided by the objective of gradually achieving greater flexibility of the *colón*.

6. ***Safeguards assessment***. The recommendations of the safeguard assessment of the BCCR that was completed in July 2009 are being implemented. In particular, the BCCR has appointed an external auditor to conduct annual audits of the BCCR financial statements from 2008 onwards. The scope of the audit includes an analysis of the existing gaps between the BCCR's accounting practices and IFRS, in order to establish an action plan for the implementation of IFRS by 2011.

7. ***Program monitoring***. The program will continue to be monitored on a quarterly basis, by quantitative performance criteria, indicative targets, and structural benchmarks. We are requesting to change the frequency of program reviews from quarterly to biannual, given reduced uncertainty about the external environment and lower program risks. The next and final program review is therefore expected to take place in June 2010. The quantitative performance criteria and indicative targets for end-December 2009 and end-March 2010 are set out in Table 1. The structural benchmarks of the program and the phasing of access under the arrangement are set out in Tables 2 and 3, respectively.

Table 1. Costa Rica: Quantitative Performance Measures

(In billion of colones, unless otherwise indicated)

	2009 Program								2010 Program
	End-March 1/		End-June		End-September		End-December		End-March 2/
	Prog. 3/	Actual	Prog. 3/	Actual	Prog. 4/	Actual	Prog. 4/	Proposed	Proposed
Quantitative Performance Criteria									
Floor on cash balance of the Central Government (cumulative)	-210	-106	-312	-206	-471	-377	-639	-639	-322
Ceiling on the debt stock of the Central Government	4,303	4,239	4,356	4,338	4,753	4,551	4,871	4,914	5,286
Ceiling on NDA of the Central Bank 5/	-915	-1,301	-786	-1,244	-970	-1,170	-896	-896	-800
Floor on NIR of the Central Bank (million of US$) 5/	3,500	4,167	3,350	3,936	3,555	4,059	3,705	3,705	3,405
Continuous Performance Criteria									
Accumulation of external debt arrears	0	0	0	0		0		0	0
Indicative targets									
Floor on cash balance of the combined public sector (cumulative)	-146	-43	-325	-179	-524	-411	-774	-774	-352
Memorandum item									
Base money	1,102	1,101	1,144	1,024	1,079	1,170	1,240	1,240	1,163
Program exchange rate (ask price, colones per U.S. dollar)	576	558	576	569	576	576	576	576	576

Sources: Central Bank of Costa Rica; Ministry of Finance; and Fund staff projections.

1/ Projection only. Performance criteria were only set from end-June onward.

2/ The end-March 2010 quantitative PCs will be evaluated at the 2009 program exchange rates as defined in the TMU for the first review (IMF Country Report No. 09/303).

3/ IMF Country Report No. 09/134.

4/ IMF Country Report No. 09/303.

5/ The floor on NIR and ceiling on NDA at end-September and end-December have been adjusted by $205 million compared to the levels set at program approval (IMF Country Report No. 09/134) to reflect the special and general SDRs allocations of 132.81 millions SDRs.

Table 2. Structural Benchmarks

	Test Date	Status
Establishment of a monthly monitoring report for the banking system.	End-June 2009	Met
Unification of the money market under a single platform.	End-June 2009	Met (by August 2009)
Establishment of a system of daily forecasting of systemic liquidity in the money market.	End-June 2009	Met
Submission to parliament of a draft law to strengthen the bank resolution framework.	End-December 2009	
Submission to parliament of a draft law to create a limited deposit guarantee scheme.	End-December 2009	

Table 3. Schedule of Availability of Disbursements

Amount	Date	Conditions for Disbursement
SDR 328,200,000	April 10, 2009	Executive Board approval of the 18-month Stand-By Arrangement.
SDR 41,025,000	September 23, 2009	Observance of performance criteria for end-June 2009 and completion of the first review under the Stand-By Arrangement.
SDR 41,025,000	December 16, 2009	Observance of performance criteria for end-September 2009 and completion of the second review under the Stand-By Arrangement.
SDR 41,025,000	January 29, 2010	Observance of performance criteria for end-December 2009.
SDR 41,025,000	June 17, 2010	Observance of performance criteria for end-March 2010 and completion of the third review under the Stand-By Arrangement.