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Costa Rica: 2002 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

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 Article IV consultation with Costa Rica, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **January 9, 2003,** 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 February 7, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **March 3, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its March 3, 2003 discussion** of the staff report that concluded the Article IV consultation.

The document(s) listed below have been or will be separately released.

Financial System Stability Assessment

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INTERNATIONAL MONETARY FUND

COSTA RICA

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation with Costa Rica

Approved by Lorenzo Pérez and G. Russell Kincaid

February 7, 2003

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- **Macroeconomic vulnerabilities have increased in recent years** in line with a widening of the public sector deficit (to nearly 6 percent of GDP), an increase in the public debt (to about 50 percent of GDP), growing dollarization, problems in the banking system, limited international reserve coverage, and a crawling peg regime. GDP growth has slowed to around 2 percent, inflation has remained at around 10 percent, and the external current account deficit has widened to around 5.5 percent of GDP.

- **The authorities have begun to take steps to address these vulnerabilities, but progress so far has been gradual and not comprehensive enough**. During the Article IV consultation discussions, the authorities indicated their intention to speed up the process of reform in the months ahead, supplementing a package of temporary fiscal measures approved in December 2002. However, there is opposition in the Assembly to some aspects of the reforms that are needed and their approval will not be easy. The authorities are not requesting Fund financial support at this time.

- **The authorities agreed that a major fiscal effort is essential to address current vulnerabilities and intend to seek early approval of a comprehensive tax reform and a major rationalization of expenditure**. They expect these measures to shift the primary balance from a deficit of 0.3 percent of GDP in 2002 to a surplus of 2.5 percent of GDP by 2004. A strengthening of the fiscal effort should ease pressures on interest rates and boost investment and GDP growth. Against this background, the authorities project a narrowing of the fiscal deficit to about 1 percent of GDP over the medium term and a sharp reduction in the public debt to GDP ratio. The staff supported the authorities' objectives and the measures under consideration. However, it stressed that additional efforts would be needed to achieve these goals; mainly pension reform and privatization to open to private initiative key areas dominated by the public enterprises.

- **An effort is also needed to deal with deep rooted problems in the banking system,** including the undercapitalization of the largest public bank, regulatory voids resulting in an uneven playing field for public and private banks, weaknesses in liquidity and crisis management, an inadequate safety net for the financial system, and weak bank supervision, especially of the large offshore banks. A 2001 FSAP mission made several recommendations to address these problems, but implementation has been slow (see attached FSSA). The staff urged the authorities to speed up these efforts.

- **Differing views emerged in the Article IV discussions on the exchange rate regime**. The authorities noted that the crawling peg had contributed to price stability and raised concerns about the confidence effects of any abrupt change. The staff argued that the regime had been undermined by the growing fiscal and financial weaknesses, had fueled dollarization, and could not prevent some loss of competitiveness. It urged for an early shift to a more flexible exchange regime and the introduction of an inflation targeting framework.

I. Introduction

1. **The Article IV consultation discussions were conducted in San Jose on November 7-20, 2002 and concluded in Washington D.C. on January 8-9, 2003.**[1] Costa Rica has accepted the obligations of Article VIII, Section 2, 3, and 4 of the Articles of Agreement, and maintains an exchange rate system that is free of restrictions on current international transactions. Costa Rica has no outstanding obligations with the Fund.

2. **In concluding the last consultation on July 30, 2001, Directors noted the authorities efforts to maintain reasonable growth and bring down inflation, but stressed that substantial imbalances remained.** They emphasized the increasing vulnerability of the Costa Rican economy due to growing public debt, inadequate bank supervision, a rapid increase in bank lending in U.S. dollars, and stalled structural reforms. Directors urged the authorities to embark on a strong program of reforms, including preparations for the adoption of a more flexible exchange regime.

3. **Costa Rica's statistical database is weak in several areas**, hampering macroeconomic surveillance. The recently published data ROSC identifies several areas for improvement, especially in the data on trade and services, the financing of fiscal deficits, and on public debt. Also, statistics on money and credit and on prudential indicators are not comprehensive. The authorities are undertaking some actions to address these weaknesses. Costa Rica subscribes to the Fund's Special Data Dissemination System (SDDS).

4. **With the victory of President Abel Pacheco, the incumbent center party (*Unidad Social Cristiana*) was returned to office in the spring of 2002, but its position in the Assembly has been weakened:** the party, while still the largest in the Assembly, now holds only one-third of the seats and needs the support of other parties for legislation, especially for the approval of reforms.

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[1] The staff team comprised Messrs. Figuerola (Mission Chief), Martin, and Offerdal, and Mmes. Macario and Mercer-Blackman (all WHD). Mr. Ize (MAE) joined the team for a few days in San José to discuss the FSSA report. Messrs. Kincaid (PDR) and Mr. Pérez (WHD) also participated in the discussions in Washington. The staff met with the Minister of Finance, the Minister of Labor, the President of the Central Bank, other senior government officials, legislators, labor union officials, and other representatives of the private sector.

II. Background

A. Brief Perspective

5. **Economic growth in Costa Rica was quite buoyant throughout most of the 1990s, averaging about 5 percent per year** (see Annex I). This reflected high investment and considerable progress on some structural reforms, leading to a significant improvement in total factor productivity. Progress was made in trade liberalization, pension reform, and in the area of privatization, including opening the banking system to private ownership.

6. **However, economic conditions have weakened considerably in recent years and vulnerabilities have risen.**

- **Economic growth slowed and the external position weakened**. Real GDP growth declined to an annual average of less than 2 percent in 2000-2001, while inflation exceeded 10 percent, the highest in the region (Table 1). Unemployment remained at about 6 percent, but underemployment rose and total factor productivity declined. Export growth slowed reflecting a weakening in demand for non-traditional exports, and the external current account deficit rose steadily, reaching about 4.5 percent of GDP in 2001. Net official reserves remained low at about two months of imports, covering only the public sector component of short term external debt on a residual maturity basis.[2]

- **The overall fiscal deficit (including central bank losses)[3] widened considerably**, reaching an average of 4.1 percent of GDP in 2000-2001. While interest payments increased, the primary surplus weakened to an average of about 0.7 percent of GDP despite an increase in revenue. This reflected mainly wage increases associated with an overly generous indexation mechanism (see Box 1) and an erosion of the surplus of the pension system. The public debt rose from around 40 percent in the late 1990s to nearly 50 percent of GDP at end 2001 (40 percent of the debt is external, but a substantial part of the domestic debt is also denominated in foreign currency).

- **Little progress was made in addressing vulnerabilities in the banking system**. As described in the accompanying FSSA report: (i) the system remained dominated by

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[2] Official reserve liabilities exclude foreign currency liabilities to residents of the Central Bank. The inclusion of these liabilities would reduce net official reserves from US$1,261 million to US$225 million at end-2002. Data on external debt of the private sector are unavailable.

[3] Quasi-fiscal losses reflect the significant interest rate differential between earning assets (mainly international reserves) and liabilities (mainly external debt and central bank bills used in open market operations). The losses declined in 2001 following a partial recapitalization of the Central Bank, but rose again thereafter.

an undercapitalized public bank,[4] (ii) there was weak bank supervision of the offshore banking system, and (iii) there were distortions in prudential norms leading to an uneven playing field between public and private banks and weaknesses in liquidity and crisis management, with adverse consequences for the efficiency and health of the banking system (Box 2).

- **Dollarization grew rapidly, fueled by the widening macroeconomic imbalances and the exchange rate guarantee provided by the crawling peg regime.** By the end of 2001, around 50 percent of deposits and credit of the banking system were denominated in U.S. dollars, increasing the balance sheet risks of a real depreciation of the *colon*. This problem was compounded by the growing share of dollar loans extended to clients whose earnings are in *colones*. With rising dollarization, the ratio of net official reserves to dollar bank liabilities declined to less than 40 percent by end-2001 and the Central Bank's ability to act as a lender-of-last- resort in dollars weakened. At the same time, the share of the public sector debt denominated in foreign currency rose to about 60 percent by end-2001, making the public finances also highly vulnerable to a real depreciation of the *colon*.

- **External competitiveness has eroded and the vulnerability of the crawling peg regime increased.** This regime targets a broadly stable bilateral real exchange rate vis-à-vis the U.S. dollar and could not avert a real appreciation (in effective terms) of the *colon* in recent years as the dollar appreciated vis-à-vis other currencies (Chart 2). By end 2001 the overvaluation of the real effective exchange rate was estimated to be about 10 percent; a problem compounded by the decline in total factor productivity. The crawling peg has also failed to provide a strong nominal anchor to the economy, and its vulnerability has increased in line with the growing fiscal and financial weaknesses and the limited availability of international reserves.

B. Developments in 2002 and Projections for 2003

7. **Economic growth picked up somewhat in 2002, but vulnerabilities increased further.** Real GDP grew by 2.8 percent boosted by further fiscal stimulus and some recovery in the U.S. economy and in the rest of Central America.[5] However, inflation and unemployment remained unchanged and there was little progress in the structural reform area. The external current account deficit rose to 5.5 percent of GDP, reflecting a sharp

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[4] Banco Nacional, the largest bank in the country, is undercapitalized if its capital is adjusted to exclude its participation in its offshore affiliate, BICSA.

[5] The U.S.A. absorbs about one third of Costa Rica's exports (mainly maquila exports), while Central America accounts for one fourth.

increase of imports of capital goods by public enterprises, which was only partially offset by a rebound in tourism and a decline in profit remittances abroad.[6]

8. **The public sector deficit widened significantly to 5.9 percent of GDP in 2002.** The bulk of this deterioration was due to central government operations, where there was a sharp increase of current expenditure relative to GDP, in particular wages, purchases of goods and services, and transfers. Also there was a deterioration in the central government's control of the operations of public enterprises, leading to a sharp increase in wages and investment by these enterprises (in particular by the state telecom and electricity company, ICE), reducing their net surpluses.[7] The losses of the Central Bank also increased. The public sector continued to finance about a third of its deficit in international financial markets, with the rest financed locally. The public debt rose further to 52 percent of GDP in 2002.

9. **The rising public sector borrowing requirements (16 percent of GDP in 2002) increased pressure on local interest rates.** The Central Bank raised its reference interest rate to 18 percent and the widening spread between local and foreign interest rates led to an inflow of short-term capital. Bank deposits rose by nearly 20 percent during 2002 leading to strong growth in credit (25 percent). Most of the credit expansion was in U.S. dollars, despite efforts to promote a more balanced composition of credit, including a reduction in reserve requirements for *colon*-denominated deposits.[8] Net official reserves rose to 2.4 months of imports or 41 percent of banks' dollar liabilities.

10. **Anticipating further economic deterioration in 2003, the authorities began to take corrective measures at the end of 2002.** These measures included:

- The approval by the Assembly of a temporary revenue emergency package in December 2002, entailing increases in personal and corporate income tax rates, certain excises (alcohol, tobacco, luxury vehicles, and casinos), some stamp duties (real estate transactions); and the airport exit tax. All increases will be in effect only for 2003 and are projected to yield about 1 percent of GDP in temporary revenues.

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[6] During the discussions, the authorities expressed concern that statistical problems, mainly on services, could be contributing to an overstatement of the current account deficits.

[7] The influence of unions in public enterprise management has grown markedly since a failed attempt to open the telecom and electricity sectors to private investment. The Assembly approved legislation to this effect in March 2000, but public sector unions were successful in garnering public support to oppose this initiative. Subsequently, the Constitutional Court struck down this legislation.

[8] Reserve requirements for *colon*-denominated deposits were reduced gradually from 11 percent to 5 percent in 2001-early 2002 to be on par with those for foreign currency deposits.

- Enhanced enforcement efforts in the tax administration.
- The introduction of a ceiling of 5.9 percent on the growth of nominal discretionary expenditure of the public sector in 2003.
- The announcement of limits on wage increases and ICE's investment.[9]
- An increase in banks' reserve requirements from 5 to 10 percent for both *colon* and dollar deposits in late December, reversing previous trends.
- An increase of the announced rate of crawl to an annual rate of 10.5 percent from 7.5 percent in December. This reinforced the positive effects on competitiveness of the recent real depreciation of the U.S. dollar vis à vis the Euro. The *colon* is estimated to have depreciated by about 3 percent in real effective terms during 2002

11. **If implemented in full, the above measures will result in some improvement of economic conditions in 2003.** The authorities project these measures to shift the primary balance from -0.3 percent of GDP in 2002 to 1.4 percent in 2003, reducing the combined fiscal deficit from 5.9 percent of GDP in 2002 to about 4 percent in 2003, and keeping the public debt at about 52 percent of GDP. Under these circumstances, the staff projects real GDP growth to remain at around 2 percent in 2003, as relatively buoyant exports (e.g., tourism) and diminished crowding out will stimulate private investment, partially offsetting the withdrawal of fiscal stimulus. Inflation should remain at 10 percent, in spite of the slight acceleration of the rate of crawl, mainly because of a planed tightening of public sector wage policies. The external current account deficit should decline from 5.5 percent of GDP in 2002 to around 4.9 percent in 2003.[10] The authorities expect that increasing confidence will allow sufficient capital market access to finance this deficit and an increase in public sector amortization payments.[11] In January, the authorities placed bonds for a total of US$450 million in international markets at a spread of around 410 basis points, covering a significant portion of the public sector's external financing needs for 2003. Net official reserves are projected to remain unchanged with respect to imports, short term debt, and dollar bank liabilities.

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[9] The authorities limited the six-month public sector wage adjustment to 3.5 percent in January 2003.

[10] Estimates based on the assumption of an average oil price of US$25 per barrel for 2003. An increase of US$1 dollar in the price of oil would raise oil imports by US$17 million or 0.1 percent of GDP. This will have almost a one to one impact on the external current account deficit as the direct effect of such increase on growth, inflation, and the fiscal account is estimated to be rather limited (assuming access to international capital markets is not affected).

[11] More than offsetting a projected deceleration in foreign direct investment (FDI) with respect to the very fast pace of recent years. FDI is still projected to be equivalent to more than 40 percent of the external current account deficit in 2003.

III. Medium term Outlook

12. **The projected improvement of economic conditions will, however, be short-lived in the absence of additional measures for 2004 and beyond.** In a staff baseline scenario, with no comprehensive reforms, real GDP growth would not exceed 2.5 percent and inflation would remain at double digits over the medium term. Against this background, public investment will need to be curtailed and taxes increased for the primary fiscal surplus to remain at 1.4 percent of GDP. Interest rates would remain high and the public sector deficit will increase to about 7.1 percent of GDP by 2010 with the public debt rising steadily and nearing 60 percent of GDP, raising concerns about debt sustainability (see Box 5). Exports would pick up because of the favorable effects of an expected free trade agreement with the U.S.A.(see paragraph 35), but the external current account deficit would widen to about 7 percent of GDP by the end of the decade. The capital account surplus would need to rise to about US$1.6 billion by 2010, well above historical averages, to prevent a decline in the already low reserve coverage to imports and banks' dollar liabilities. The external debt service would reach 24 percent of exports by 2010.

13. **This baseline scenario points to a situation of heightened vulnerability.** It depends on the availability of large amounts of financing and is highly sensitive to changes in macroeconomic conditions. For instance, a combination of slower growth, weaker primary balances, and higher interest rates could raise the public debt ratio to 67 percent of GDP by 2010,[12] while the external debt would rise to about 60 percent of GDP (see Tables 9 and 10). Also, a 30 percent real depreciation of the colon would increase the public sector debt to about 70 percent of GDP by 2010 and the external debt to more than 64 percent in 2010, thus raising more serious concerns about debt sustainability.

14. **The medium-term outlook would improve measurably under an alternative strategy aimed at addressing these vulnerabilities.** Such a strategy would include:

- a stronger fiscal effort (i.e., a primary surplus of at least 2½ percent of GDP over the medium term, well above the average of around 1 percent in the 1990s) with a more growth-oriented fiscal adjustment, including revenue measures aimed at eliminating distortions, rationalization of expenditure, pension reform, and a downsizing of the public enterprise sector through privatization;
- comprehensive reforms in the banking system; and
- a more flexible exchange rate regime.

This strategy would allow Costa Rica to take full advantage of new foreign trade opportunities, boosting investment and exports, and easing interest rate pressures (the real interest rate is likely to decline to near the historical average of 6 percent). Against this

[12] If real interest rates were to remain unchanged, the public debt will tend to stabilize at current levels, rising only slightly to 54 percent of GDP in 2010.

background, the economy would shift to a path of more dynamic growth (closer to the average of 4-5 percent per year observed in the 1990s), with more sustainable fiscal and external positions: a public debt ratio of less than 40 percent of GDP and an external current account deficit of less than 3 percent of GDP by 2010.

IV. Policy Discussions

15. **Costa Rica's vulnerabilities now risk its past record of relatively rapid growth and reasonable macroeconomic stability.** The authorities agreed that a comprehensive effort was needed to deal on a lasting basis with the increasing economic vulnerabilities. They shared the view that the recent policy package should be seen only as the first stage of a strategy aimed at setting the economy on a more solid path of rapid economic growth over the medium term. Against this background, the authorities intend to obtain congressional approval and put in place an extensive agenda of fiscal and financial reforms in 2003. The staff urged them to proceed expeditiously with this effort, stressing the risks associated with a gradual approach to reform.

16. **However, obtaining legislative approval for these reforms will not be easy.** There is opposition in the Assembly to some aspects of these initiatives and the authorities will need to make a major effort to ensure their approval. There is also strong opposition from public sector labor unions. The authorities have full ownership of the reform agenda and intend to work to broaden that ownership within Costa Rica. They do not intend to seek financial support from the Fund at this time, but they have requested technical assistance in the implementation of some reforms.

A. Fiscal Policy and Reforms

17. **The authorities agreed that a significant improvement in the public finances is needed to ensure fiscal and debt sustainability and intend to take measures to raise the public sector primary surplus to 2.5 percent of GDP over the medium term.** This improvement is equivalent to an increase of nearly 3 percentage points of GDP relative to the 2002 outturn. The authorities expect that achievement of this target would help reduce real interest rates and contribute to a decline in the overall deficit to nearly 1 percent of GDP over the medium term. To achieve this goal, the authorities will seek a comprehensive tax reform, improvements in tax administration, and a rationalization of public expenditure. Staff supported these objectives and the fiscal reform effort, stressing that the targeted improvement in the primary surplus would be essential to place the public finances and the public debt on a sustainable path.

18. **The staff supported the authorities' intention to seek early legislative approval of the recommendations of a high-level bipartisan commission on tax reform, which aim at making the tax structure more efficient and buoyant.** The authorities expect these initiatives not only to replace the yield of the recent revenue measures as they expire, but also

to account for about two thirds of the targeted increase in the primary surplus over the medium term.[13] These reforms envisage:

- a widening of the income tax base to include worldwide income, the unification of the various schedules for individual income with the top rate identical to the flat rate on enterprise profits, and the elimination of several tax exemptions, including four free trade zones and cooperatives;
- the replacement of the sales tax by a VAT, extending its base to include petroleum products and services, reducing the number of goods taxed at zero rates, and granting credits for purchases when the inputs are received; and
- the elimination of deductions for excises, while unifying all excises into one law.

19. **Tax administration has weakened in recent years and the staff supported the steps being taken by the authorities to redress this trend**. Supplementing recent efforts to tighten tax enforcement, they intend to implement a comprehensive package of measures aimed at improving legal and enforcement frameworks and strengthening human capital and the information systems of the collection agency. At the same time, an effort will be made to update methods and control procedures at customs.

20. **Public sector expenditure is in need of a major rationalization**. To this end, the authorities intend to implement most recommendations of a separate bipartisan commission. This commission recommended specific steps to eliminate nonessential expenditures and to create room for a reallocation of expenditure towards social programs and infrastructure. The authorities expect these initiatives to account for the remaining one third of the targeted increase in the primary surplus over the medium term. The staff urged the authorities to proceed expeditiously with these reforms, especially with:

- a comprehensive roll-back of tax revenue earmarking that is not constitutionally mandated, which will facilitate expenditure restraint;
- a modification of indexation mechanisms to limit the growth of wage bonuses;
- a strengthening of the legal role of the budget, with improvements in budgetary techniques and controls, including the introduction of zero-base budgeting, and
- the introduction of new methodologies to assess the effectiveness of social programs.

21. **The authorities agreed with the staff on the need for a recapitalization of the Central Bank to eliminate quasi-fiscal losses.** To this end, they are considering replacing outstanding Central Bank liabilities with central government bonds. This step, while not affecting the combined public sector deficit or debt level, will improve transparency, and provide the Central Bank with additional room for its policies and for a build up of reserves.

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[13] An FAD technical assistance mission discussed these proposals and their yield with the authorities in mid-2002.

The authorities intend to start building support for this initiative in the coming months and to submit a proposal to the Assembly in 2004. In the meantime, they are confident that the recent increase in reserve requirements will help reduce these losses by lessening the need for open market operations, but they recognized the resulting costs imposed on banks.

22. **The staff supported the package of fiscal reforms under consideration, but urged the authorities to consider additional efforts in other fiscal areas, most notably pension reform and a downsizing of the public sector.** The staff noted that in the absence of these reforms, it will be difficult to achieve the fiscal targets sought by the authorities and to ensure a pro-growth restructuring of the public sector, as described in paragraph 14.

23. **The staff urged the authorities to take steps to avert a projected deterioration in the finances of the pension system** (see Box 4). Studies conducted by the Social Security Administration (CCSS) indicate that ensuring the financial viability of the system over the medium term will require at a minimum:

- an increase in the minimum retirement age from the current 62 year for men and 60 year for women;
- a lowering to less than 50 percent of the replacement ratio from the current 60 percent; and
- the introduction of an actuarial fair penalty for early retirement.

Little political support exists for another pension reform at this time. However, the authorities share the staff's concerns and noted that they had begun to consider the measures that will be needed to reform the system. To strengthen the finances of the system while support builds for such reforms, the authorities intend to take steps to improve efficiency in the administration of pension and health programs.

24. **A resumption of rapid economic growth will require significant investments in infrastructure, mainly in areas dominated by the public enterprises, which the public sector is in no position to undertake.**[14] The staff urged the authorities to take steps to allow for greater participation of the private sector in these key areas, including through the privatization of public enterprises. The authorities stressed the strong public support for public enterprises, which were perceived as generally efficient and able to satisfy the needs of the growing economy. In their view, it would be unrealistic to expect the Assembly to approve legislation allowing the privatization of public enterprises in the period ahead. However, they stressed that private sector investment in infrastructure would be encouraged through the granting of concessions, especially in road work, ports, and airports.

25. **With public enterprises expected to continue to play an important role in the economy, the staff expressed concern about the loss of central government control over**

[14] The EIU has given Costa Rica the highest infrastructure risk index.

these enterprises, which contributed to a decline in their operating surpluses and a surge in investment not necessarily justified by commercial reasons. To address these problems, the government will: (i) issue a directive that will align wage adjustments in public enterprises and autonomous entities to the guidelines issued by the Public Sector Wage Commission, and (ii) establish a Public Investment Council in the coming months with the aim of setting limits and priorities for public investment, in line with the needs of the economy and the financing constraints faced by the public sector as a whole.

26. **The financing requirements of the public sector will remain high** (at about 16 percent of GDP) **in the period ahead and the staff stressed that debt management will present a major challenge** (Table 10). So far, Costa Rica has been able to maintain ample access to foreign financial markets despite the emerging vulnerabilities. However, maintaining this market access over the medium term will be difficult in the absence of progress in the reform effort. The staff urged the authorities to keep financial markets well informed of economic developments in the country. It also noted the need for improvements in data and risk management and supported the authorities' intention to request technical assistance from the World Bank in these areas. The staff expressed reservations about the authorities' intention to increase their reliance on foreign borrowing in 2003 and encouraged the development of more attractive instruments for the domestic market, including inflation indexed securities.

B. Financial Reform

27. **The authorities have begun to put in place a number of reforms recommended by the 2001 FSAP mission, but progress so far has been less comprehensive and more gradual than what was envisaged in the FSAP.** These recommendations, which are described in detail in the accompanying FSSA report (also see Box 6 in this report) seek to strengthen prudential regulations, bank supervision, especially of offshore banks, and to reform the financial system safety net.

28. **The staff urged the authorities to ensure that public banks are adequately capitalized.** The Superintendence of Financial Entities (SUGEF) has set a tight deadline for all financial institutions to be in full compliance with capital adequacy requirements, including Banco Nacional (June 2003). In the case of this bank, its Board is working on a plan to comply with SUGEF requirements, which may include the sale of its majority stake in BICSA to Banco de Costa Rica. This bank (also state-owned) already has a 20 percent stake in BICSA and is capitalized in excess of regulations. After this transaction, both banks would satisfy capital adequacy standards.

29. **The staff stressed that a rapid and comprehensive modification of prudential regulations was essential to ensure a level playing field between public and private banks**. The authorities noted that progress will be made with the expected approval of a draft financial reform bill recently submitted to the Assembly. The staff supported these efforts, especially steps: (i) to enhance the administrative autonomy of public banks; (ii) to more clearly separate the functions of public banks between commercial operations and development banking (up to 10 percent of short-term deposits); (iii) to grant additional

powers to the SUGEF to intervene trouble banks expeditiously to improve crisis management, and (iv) to eliminate sundry administrative regulations by the Central Bank. However, the staff noted that other elements of the proposed reform fell short of the recommendations of the FSAP mission and urged a strengthening of these proposals. In particular, the staff questioned:

- the limited reduction of the deposit requirements of private banks in state commercial banks from the current 17 percent to 10 percent, and urged the gradual elimination of this requirements, and
- the decision to limit the reform of deposit insurance to the introduction of an insurance scheme for private banks, covering deposits up to 2½ times GNP per capita,[15] which was not in line with the recommendations of the FSAP mission and failed to provide a comprehensive solution to the issue of safety net for the financial system.

In this context, the staff urged the authorities to implement in full the agenda for reforms recommended by the FSAP mission in the areas of prudential regulatory framework (including offshore banks), safety net for the financial system, and liquidity and crisis management (see Box 6). The authorities agreed to consider these issues in the context of additional reforms to be proposed in the months ahead.

30. **The staff also encouraged the authorities to press ahead with steps to strengthen the supervision of offshore banks,** building on recent progress, which included:

- making financial holding companies, rather than individual banks, the subject of supervision by the SUGEF, greatly improving SUGEF's ability to supervise offshore banks, most of which are owned by Costa Rican holdings,
- prohibiting Costa Rican holding companies from owning offshore banks in jurisdictions in which: (i) banks do not have a permanent physical presence, (ii) have not signed a cooperation agreement with the SUGEF, which allows it, inter alia, access to full information of banks and joint onsite inspections with the jurisdictions' supervisory agency; and (iii) do not have an adequate legal frameworks and prudential standards, and
- the negotiation in recent months of a full information-sharing agreement with Panama (the location of about one third of the offshore banks) adding that on-site inspections have already been conducted under this agreement. Negotiations are underway with The Bahamas, and Cayman Island, although these agreements may be more difficult to secure due to secrecy laws (Bahamas) and lack of physical presence of offshore units (Cayman Islands).

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[15] This coverage ratio compares to about 1½ , 6, and over 8 times per-capita GNP in El Salvador, Guatemala and Honduras, respectively, and is less than the average amount insured in Latin American countries (3.5 times per-capita GDP).

C. Exchange Rate and Monetary Policies

31. **The authorities indicated their intention to maintain the crawling peg regime.** In their view, this regime has provided the economy with needed predictability and enjoys ample public confidence, allowed for enough flexibility against external shocks and helped protect international competitiveness. They felt that no policy change was needed in this area, other than the slight acceleration in the rate of crawl implemented at end 2002.

32. **The staff expressed concern about this decision, noting that while competitiveness problems may have eased recently, the credibility of the crawling peg regime had been undermined by the fiscal and financial weaknesses.** The staff encouraged the adoption of a more flexible exchange regime. Such regime would provide the economy with much needed flexibility as it begin to address current imbalances, will protect competitiveness, will help discourage dollarization, and will provide scope for monetary policy and the adoption of a stronger nominal anchor. The transition to such a regime will require, among other things, improvements in the management of *colon*-denominated liquidity and in the functioning of interbank market, and steps to foster the development of a futures market for foreign currency to allow market participant to hedge foreign exchange risk. Increasing the autonomy of the Central Bank also will be critical, especially regarding the appointment of its Board and in monetary decisions. The elimination of the quasi-fiscal losses of the Central Bank will be essential. These steps would facilitate the adoption of an inflation-targeting framework as a flexible regime is put in place.

33. **The staff supported the authorities' efforts to maintain a tight credit policy to keep inflation under control and to protect net international reserves, including the recent increases in reserve requirements**. At the same time, the staff noted that a policy mix of tight credit policy and loose fiscal policy was not sustainable and welcomed the authorities' decision to seek a more balanced macroeconomic adjustment in the period ahead.

34. **The staff stressed the risk associated with dollarization and urged the authorities to take steps to redress this trend**, through better balancing the risks of dollars and *colones* transactions. To this end, a strengthening of the macroeconomic framework is essential, as well as changes in prudential regulations (e.g., increasing capital requirements on dollar loans to *colones*-earners, and stricter exposure guidelines), and the fostering of inflation-indexed securities, including central bank and treasury securities. The staff also urged the authorities to take steps to build up dollar liquidity in the banking system, including through stricter liquidity ratios.

D. External Sector

35. **The staff welcomed the opening of negotiations for a free trade agreement between the Central American countries and the U.S. (CAFTA), which began in January 2003.** The authorities expect these negotiations to be concluded by the end of the year, with the goal of obtaining congressional approval by mid-2004. However, the authorities acknowledged that negotiations will be difficult in a number of areas, including telecommunications, the financial sector, and agriculture.

36. **The CAFTA will have several positive consequences for Costa Rica.** The country already has access to the U.S. market under the Caribbean Basin Initiative (CBI), but the authorities expect the CAFTA to:

- help promote export growth further and attract additional foreign investment;
- turn the preferences presently granted temporarily under the CBI into permanent preferences and expand them to a larger number of products; and
- lead to more stable rules on norms of origin, product standards, and inspections.

The authorities also expect the fiscal cost of CAFTA to be negligible since tariffs are already low, and around half of imports from the U.S. already pay no import duties (including those for *zonas francas*, tourist firms or state companies which are exempted from paying tariffs).

37. **The authorities stressed efforts underway to upgrade the Central American Common Market (CACM) by improving dispute resolution.** This is a needed step, since, in the absence of an effective dispute resolution mechanism, regional trade differences tend to end up in a WTO panel, lengthening and making more costly the resolution process.

38. **Costa Rica's trade system** is rated by the Fund's Trade Restrictiveness Index as relatively open, but there are still export/taxes quotas affecting the banana sector.

V. Other Issues

39. **Costa Rica's social indicators remain among the strongest in Latin America.** (Table 11). Income distribution is fairly equitable and poverty is low. The government's social agenda is comprehensive and the safety net is considered among the more efficient in the region. The country has the top ranking for the region in the UNDP's Human Development Report (43 in 2002 and 41 in 2001).

40. **Costa Rica has a political system that is open, stable, with long standing democratic traditions, and fairly solid institutions**, including a well respected judiciary system. International comparisons show that Costa Rica ranks favorably in Latin America with respect to law and order, degree of corruption, and democratic accountability (e.g., see annual reports by Transparency International and World Bank, "Governance Matters").

41. **In 2000, the Costa Rican government agreed to provide debt relief to Nicaragua and Honduras under the enhanced HIPC Initiative.** However, legislation to implement this relief has not yet been submitted to the Assembly and the staff urged the authorities to seek prompt approval of this initiative.

42. **As regards the anti-money laundering regime**, enforcement procedures on suspicious transactions have been improved. With the approval of Law 82-04 in late 2001, SUGEF supervisory powers in this area were strengthened significantly, including an

increase in penalties. At the same time, the SUGEF issued new "Know your Customer" rules establishing the minimum standards that are to be complied with by institutions.

43. **On disclosure issues**, a recent pronouncement by the Costa Rica Constitutional Court established the obligation for the authorities to make public any International Monetary Fund report on Costa Rica received officially from the Fund. The authorities intend to publish the Article IV staff report and the accompanying FSSA report.

VI. Staff Appraisal

44. **The vulnerabilities of the Costa Rican economy in the recent period have increased significantly.** When seen in the context of high public sector financing requirements, limited reserve coverage, and a sharp increase in the general perception of risk in emerging markets, this presents an urgent and difficult policy challenge. There are few instruments available to counter the impact of a sudden reduction in the availability in external financing or a loss of confidence in the banking system. A rapid reorientation of economic policies is therefore essential to reduce vulnerabilities and the risk of an extremely costly financial/currency crisis.

45. **The measures introduced at the end of 2002 are a welcome development as they will contribute to improving economic conditions in the immediate future**. Implementation of these measures should be rigorous as there is little room for slippages. The rapid approval of the tax package by the Assembly is a sign that the society as a whole is responding responsibly to the deteriorating situation.

46. **However, these measures are of a temporary nature and not comprehensive enough to provide a lasting and adequate solution to current vulnerabilities**. A more ambitious effort will be needed to strengthen the macroeconomic framework and to resume rapid economic growth, while ensuring fiscal sustainability and external viability over the medium term. In this context, the staff supports the authorities' intention to put in place a comprehensive agenda of reforms in the coming months, but a major effort will be needed to ensure rapid legislative passage of this agenda as there is important opposition to some aspects of these reforms. The staff welcomes the authorities' intention to maintain full ownership of this effort and work to broaden ownership within Costa Rica.

47. **The most urgent policy requirement is to strengthen the public finances**. This would support faster economic growth by helping reduce inflation and lowering interest rates. The large and highly dollarized public debt and large fiscal imbalances have contributed to raise concerns about debt sustainability, leaving little time to delay action. A significant up-front adjustment effort based on fiscal reforms aimed at achieving an immediate increase in the primary surplus to at least 2.5 percent of GDP, is essential to ensure fiscal and public debt sustainability.

48. **The staff fully support the authorities' intention to seek prompt legislative approval and implementation of the reforms recommended by high level commissions in the areas of taxes and expenditure.** These reforms will improve the efficiency and buoyancy of the tax system, broadening its base, while contributing to a rationalization of public expenditure. However, they would need to be supplemented by improvements in pension reform to ensure the medium-term viability of the public pension system. Efforts will also be needed in the area of tax administration.

49. **A resumption of rapid economic growth will require significant investment in infrastructure,** mainly in areas dominated by public enterprises, which the public sector will find difficult to undertake. Political circumstances may not favor rapid privatization of public enterprises, but an effort must be made to build support for this step. In the meantime, it is imperative to make a more aggressive use of concessions to facilitate greater participation of the private sector and to encourage private investment in key areas of the economy, including roads, airports, ports, electricity, and telecommunications. It is also essential to take decisive actions to restore government control of the public enterprises, whose increasing autonomy has resulted in surges in their wage bill and investment not based on commercial considerations. In this context, the staff welcomes the authorities decision to establish new wage guidelines for autonomous entities and to set up a Public Investment Council to set limits and priorities for public investment. Public enterprise accountability could be enhanced by requiring them to publish annual reports that are audited externally.

50. **Financial reforms are critical to reduce vulnerabilities in the banking system.** The staff supports the steps being taken to recapitalize public banks and to strengthen supervision and the bill recently presented to the Assembly to begin leveling the playing field between public and private banks through improvements in prudential regulations. However, there are risks associated with the gradual approach adopted by the authorities and efforts have not been as comprehensive as recommended by the FSAP mission. In particular, there is a need for more ambitious reforms to (i) eliminate distortions in prudential regulations, including deposit requirements for private banks in public banks, (ii) strengthen the safety net for the financial system, (iii) improve liquidity and crisis management, and (iv) ensure a more adequate supervision of offshore banks.

51. **The tightening of domestic credit policy to compensate for the relaxation of fiscal policy has protected international reserves.** However, it has also contributed to high interest rates, a crowding out of the private sector, and increases in the quasi fiscal losses of the Central Bank. In this context, a more balanced policy mix is needed and the staff supports the efforts to tighten fiscal policy to unburden domestic credit policy.

52. **The high degree of dollarization is a major vulnerability and steps need to be taken to reverse this trend and to build dollar liquidity.** The strengthening of the macroeconomic framework will help by better balancing the risks of *colones* and dollars transactions, but other changes are also needed. In particular, there is a need to remove distortions that favor lending in U.S. dollars, such as a differential tax treatment of deposits in different currencies and insufficient provisioning or capital requirements on dollar loans,

especially to *colones*-earners. There is also a need to encourage banks to build their dollar liquidity and to reinforce the central bank's ability to act as a dollar lender of last resort.

53. **Competitiveness problems have eased recently, but the crawling peg regime is threatened by fiscal and financial weaknesses while fueling dollarization**. The authorities need to give serious consideration to the adoption of a more flexible exchange rate regime in the immediate future. Progress in addressing fiscal and financial vulnerabilities will facilitate the shift to a flexible regime, but there is also a need to revise the monetary policy framework undertaking steps for the transition to an inflation targeting framework. In this regard, it is essential to strengthen the central bank's autonomy in the conduct of monetary policy and to recapitalize the Bank to eliminate its quasi-fiscal losses.

54. **The Fund's technical assistance to Costa Rica** in the period ahead will focus on assisting the authorities' efforts to implement a solid reform agenda, especially in the fiscal and financial areas. There would also be a need for assistance to improve transparency, with an emphasis on continuing efforts to strengthen economic statistics.

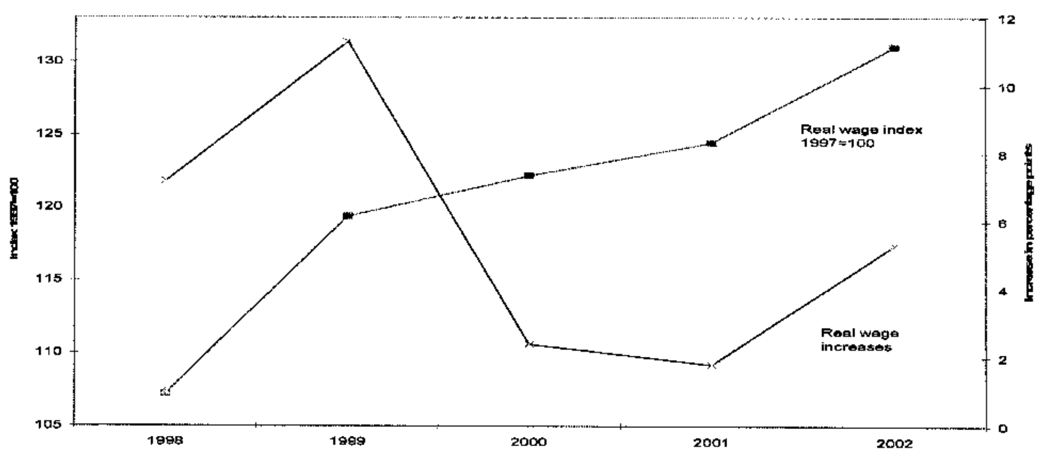
55. It is recommended that the next Article IV consultation with Costa Rica be held on the standard 12-month cycle.

Box 1. Control of Public Sector Expenditure

A report issued in October 2002, by a high-level government commission, emphasized that expenditure control has been undermined by: (i) the large proportion of expenditures spent on wages, pensions, and interests (64 percent of total expenditures or 12 percent of GDP); and (ii) the earmarking of about half of total revenues.

The wage bill has grown steadily from 7.5 percent of GDP in 1998 to 9.1 percent in 2002, reflecting an annual increase of 2.6 percent in the number of public sector workers and of 5.6 percent in real wages. The latter is the result of a scheme that combines a basic wage with the application of a complex system of bonuses based on factors such as seniority, residence, hourly schedule, productivity, living costs, academic qualifications, etc. While basic wages are negotiated semiannually and tend to rise in line with inflation, these bonuses typically increase by a factor of 1.5-2 relative to inflation.

Real Wage Increases and Index



Tax earmarking: About 40 percent of the central government tax revenue is earmarked, but only 6 percentage points are constitutionally mandated. The main sources of earmarking are the income tax (approximately 45 percent is earmarked), the sales tax (22 percent), and the special tax on fuels (100 percent). In a recent ruling, the Constitutional Court reaffirmed that the government could limit any earmarking not mandated by the Constitution.

The recommendations of the aforementioned commission focused on:

- Reviewing the wage bonus practice, limiting collective wage negotiations, and introducing a government employment freeze for a period of at least two years
- Dismantling the system of revenue earmarking.
- Further pension system reform (see Box 4).

These changes will not be easy as some of them will require modifications to the Constitution (such as changes in constitutionally mandated earmakings), while others are opposed by powerful public sector unions and face strong opposition in the Assembly.

Box 2. Structure of Financial System and Offshore Banking

The Costa Rican onshore financial sector is well-diversified and offers an array of modern retail services. While private banks have been steadily increasing their participation over the last decade, public banks (5 out of 21, with about 70 percent of commercial bank assets) still dominate the banking system.

Public and private banks are subject to different legal frameworks:

- Public banks enjoy a full state guarantee of all their liabilities as well as a tax exemption for holders of dollar deposits. However, their operations are subject to administrative controls by the state, which limits their ability to compete with private banks.
- Private banks are not covered by deposit insurance and are required to deposit at least 17 percent of their short-term deposits in state banks at sub-market interest rates.
- Despite the uneven playing field, competition has rapidly intensified with the entry of private banks. While this has generally increased the efficiency and quality of retail services, it has also led to:

(i) Market segmentation: public banks generally concentrate on colon-lending to small borrowers in more traditional sectors and are heavily invested in public securities, while private banks have expanded their operations offshore, and have higher-income customers and strong external ties.

(ii) Perverse financial incentives: reflecting the rising dollarization of their funding, both private and public banks have steadily increase the number of dollar-denominated loans—including mortgages—to colon-earners, exposing the banking system as a whole to exchange rate risk.

Costa Rica: Financial System Structure and offshore banks, 2001
(in percent of GDP)

	June 2001
Total financial system assets	71
Local banks	55
Public banks	32
local (5 banks)	29
offshore (1 bank)	3
Private banks	23
local (16 banks)	13
offshore (9 banks)	10
Brokerage firms	1
Pension and investment funds	1
Other	14
Memorandum Items	
Profitability (return on assets)	
public banks	1.2
private banks	1.7
Ratio of nonperforming loans to total loans	
public banks	3.68
private banks	1.47
Ratio of private offshore banks to private onshore banks (in percent)	
capital	83
credit	111
liquidity	117

Source: BCCR and SUGEF

Offshore banks[1] which are not included in the financial sector statistics, account for a substantial part of total financial intermediation in this country. There are 10 offshore banks (1 public and the rest private, all of them owned by local financial groups). Almost 65 percent of assets of the offshore banks are invested back in Costa Rica, equivalent to 111 percent of credit by private onshore banks. Offshore banks are only partially regulated by the Costa Rican authorities, thus room exists for regulatory arbitrage.

Although private financial groups must report their consolidated quarterly financial statements since 2001, the lack of detail available on offshore transactions and the current inability to perform across the board onsite verifications of transactions still limits SUGEF's capacity to comprehensively assess the overall state of the offshore banks. Recent measures to facilitate fully consolidated supervision should largely resolve this issue as they become fully implemented (see the FSSA report).

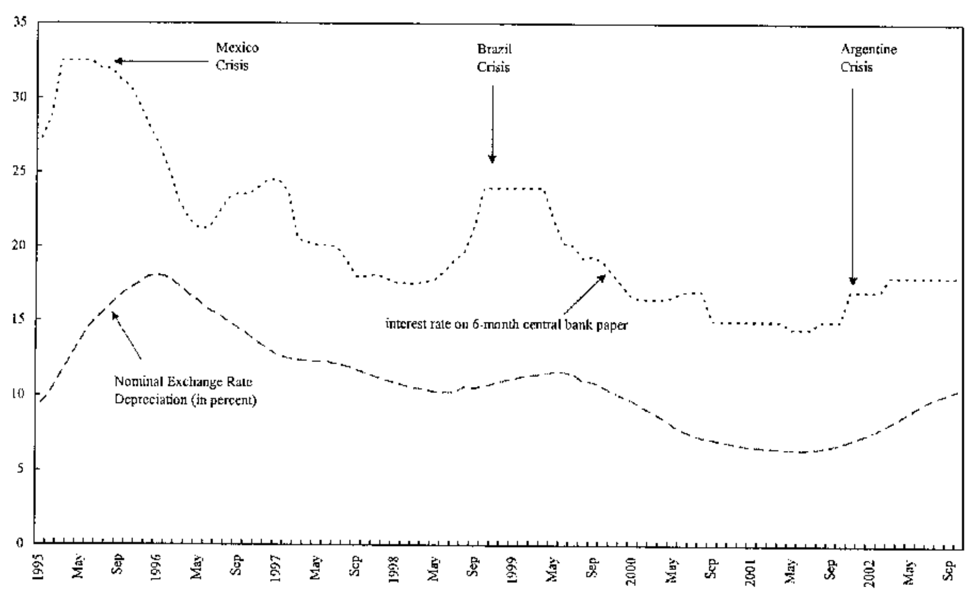
[1] These banks are incorporated outside Costa Rica and are subject to the external jurisdiction's regulations, but are allow to conduct banking functions in Costa Rica.

Box 3. Monetary Policy and The Exchange Regime

The stated objective of credit policy is to maintain a level of international reserves adequate to support the credibility of the crawling peg exchange regime. During the recent market crises (1994/95, 1998 and 2001) reserve outflows were stemmed through interest rate hikes, and small increases in the rate of the crawl. This policy mix, with a tight credit policy and a loose fiscal policy has resulted in high domestic interest rates and thus complicated macroeconomic management by:

- Making the economy more vulnerable to interest rate shocks. The widening spread between domestic and U.S. interest rates has attracted substantial capital inflows in recent years. Hence, a reversal of interest rates spreads will force the central bank (BCCR) to accommodate an outflow of capital, or raise interest further, stifling economic growth.
- Preventing the use of monetary policy to help moderate output and credit cycles—the monetary tightening in 1995 and 2001 occurred as growth was contracting sharply.
- Contributing to a BCCR quasifiscal deficit of about 1½ percent of GDP per year, owing to the large gap between the interest rates on BCCR liabilities (mainly short-term paper for open market operations) and assets (international reserves and nonperforming loans) These nonperforming loans are linked to directed lending operations before 1995, about half of which have been assumed by the government since 1999. The remaining quasi-fiscal debt continues to affect the ability of the central bank to conduct monetary policy.
- Generating substantial inertia in inflation expectations: BCCR has been unable to bring inflation down to single digits because it needs the seigniorage revenue generated by current inflation.
- Leading to some real appreciation in the exchange rate that has reduced external competitiveness, and dampened the contribution of the trade balance to real growth.

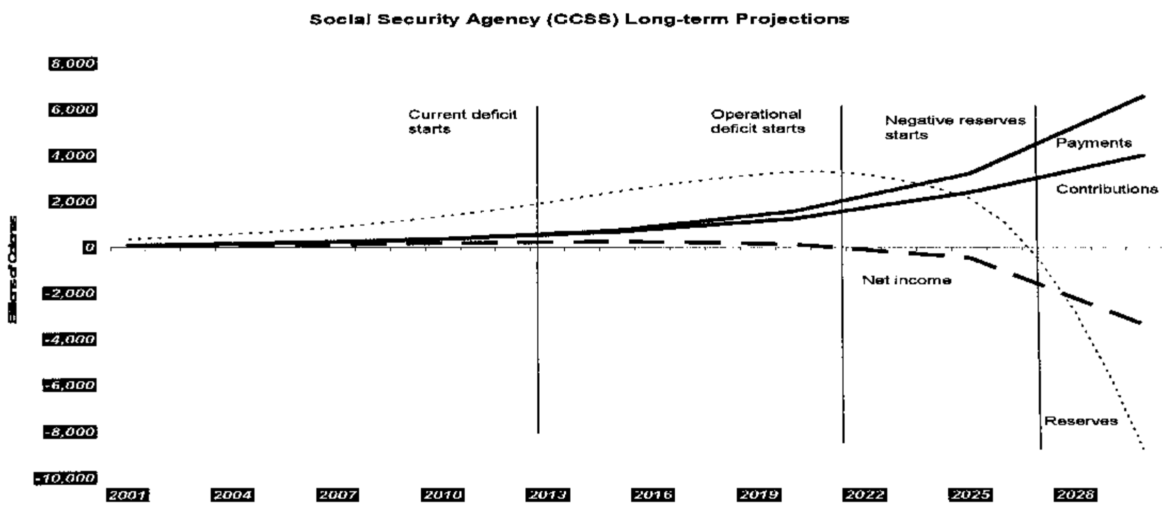
Figure 4. Costa Rica: Policy Response to Financial Crises



Box 4. The Pension System

The pension system, as last reformed in 2000, comprises three pillars: (i) a public, defined benefit system, managed by the Social Security Agency (CCSS); (ii) a private, but compulsory, defined contribution system, with individual pension accounts managed by the financial system; (iii) a voluntary system of individual pension accounts.

The CCSS system has an operating surplus and accumulated reserves for around 7 percent of GDP, but projections prepared by the CCSS indicate that the current pension system is unsustainable in the long-term. Pension payments are rising faster than contributions and in about 20 years the systems operating balance will shift into deficit, leading to rapid depletion of its reserves.



This sustainability problem in the CCSS system arises from three different factors:

- Demographic trends; in 2000 there were 7 active workers for each pensioner, in 2030 it is estimated that there will be 4 active workers for each pensioner;
- Recent rulings by the Constitutional Court and the Attorney General that will largely reverse earlier reforms that sought to limit pension benefits and increase the minimum retirement age;
- The introduction of the three-pillar system in 2000 diverted a portion of pension contributions from the CCSS benefit-defined system to individual accounts without a clearly defined long-term unwinding of pension liabilities from the CCSS system.

Reform of the pension system will need to include: (i) increasing retirement age for men and women; (ii) lowering the reference wage to establish the pension payments; and (iii) increasing contributions.

Box 5. Fiscal Sustainability

Costa Rica's public debt dynamics have substantially worsened in recent years, with the ratio of public debt to GDP estimated to have reached 50 percent of GDP by end-2002 and to increase further over the medium term in the absence of a large and early fiscal adjustment effort. Three possible scenarios illustrate this:

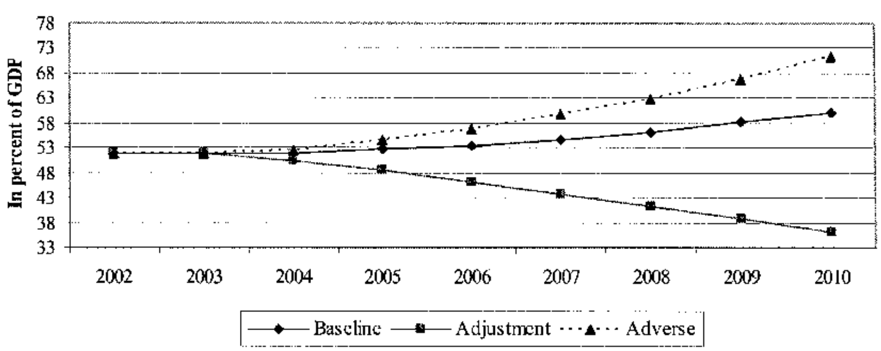
A baseline scenario: The primary fiscal balance increases to 1.4 percent GDP in 2003 and remains at that level thereafter. Real interest rates are assumed to increase from 7-8 percent to 12 percent (compared with a historical average of around 6 percent), and growth stabilizes at 2.5 percent, as crowding out continues to affect the economy.

A fiscal adjustment scenario: the primary surplus increases to 2.5 percent of GDP in 2003 and is maintained at this level. A reduction in public sector financing requirements would contribute to a decline in real interest rates to around the historical level of 6 percent by 2010, inducing more investment and boosting growth up to an annual rate of 4 percent.

An adverse scenario: would be the result of a combination of several negative factors, including: (i) a deterioration of the external environment with lower U.S. growth and higher international interest rates; (ii) a decline in the primary fiscal surplus to 0.7 percent of GDP for the remainder of the period; (iii) a deceleration of GDP growth to about 1.4 percent per year, as the growing public sector financing requirements would crowd out private investment; and (iv) an increase of the interest risk premium over LIBOR.

These three scenarios suggest sharply different paths for the public debt burden. In the baseline, the ratio of public debt to GDP would increase from 52 percent in 2002 to 60 percent in 2010,[1] whereas the stronger fiscal adjustment would lower this ratio to about 36 percent in 2010. By contrast, the adverse scenario would result in a end-period debt ratio of about 71 percent.

Costa Rica: Public Debt Scenarios
(In percent of GDP)



To ensure debt sustainability over the medium term, a strong fiscal adjustment rising the primary surplus to at least 2.5 percent of GDP and continued access to financial markets, are essential.

[1] The debt ratio will increase to 54 percent of GDP if the interest rate were to remain unchanged.

Box 6. Recommendations of the FSAP Mission

As described in the accompanying FSSA report, the FSAP mission found that while the Costa Rican financial system exhibits some strengths derived from an environment with limited volatility, important underlying macro and structural tensions, if not addressed, could undermine that stability in the event of a large shock. A still substantially uneven playing field between public and private financial institutions and the large presence of offshore banks that are only partially supervised and regulated by the Costa Rican supervisory authorities, coexists in an macroeconomic environment of dollarization and a somewhat rigid exchange rate system. The problems are exacerbated by weaknesses in liquidity and crisis management and an inadequate social safety net for the financial sector. The FSAP recommends that the authorities devise a comprehensive and coordinated medium-term strategy that addresses these problems and promotes financial deepening. The main elements of this strategy would include:

- **Reforms of the prudential regulatory framework** aimed at leveling the playing field between public and private banks and on-shore and offshore banks, strengthening the legal mandate of supervisory agencies, allowing the creation of buffers against systemic risks, allowing Costa Rican prudential norms to apply uniformly across all banks, the establishment of a graduated, realistic system of penalties on banks, and the introduction of more graduation in SUGEF's bank rating schemes

- **Reforms of the supervisory framework**, including of on-shore banks and of offshore banks through the introduction of fully consolidated supervision of financial conglomerates, a strengthening of the capabilities of SUGEF and steps to foster improvements in banks' own risk management system and greater market discipline.

- **Reforms of the safety net**, including the introduction of prudential buffers, the introduction of a comprehensive deposit insurance scheme in conjunction with an effective bank failure resolution framework (see below).

- **Improvements in crisis management**, including strengthening operational arrangements of the lender of last resort facility, improvements in procedures for intervening troubled banks, including bank closure and resolution, and changes in legislation to prevent excessive protection of debtors, disincentives for creditor participation, and lack of effective out-of-court workouts.

- **Improvements in liquidity management**, including steps to promote a deepening of the interbank money market, a recapitalization of the Central Bank, the development of a active day-to-day open market intervention capacity, and improvements in the payments system, in particular a strengthening of the management of settlement risk

Steps implemented in recent months

In response the recommendations of the FSAP mission, the authorities implemented a number of steps in recent months, including:

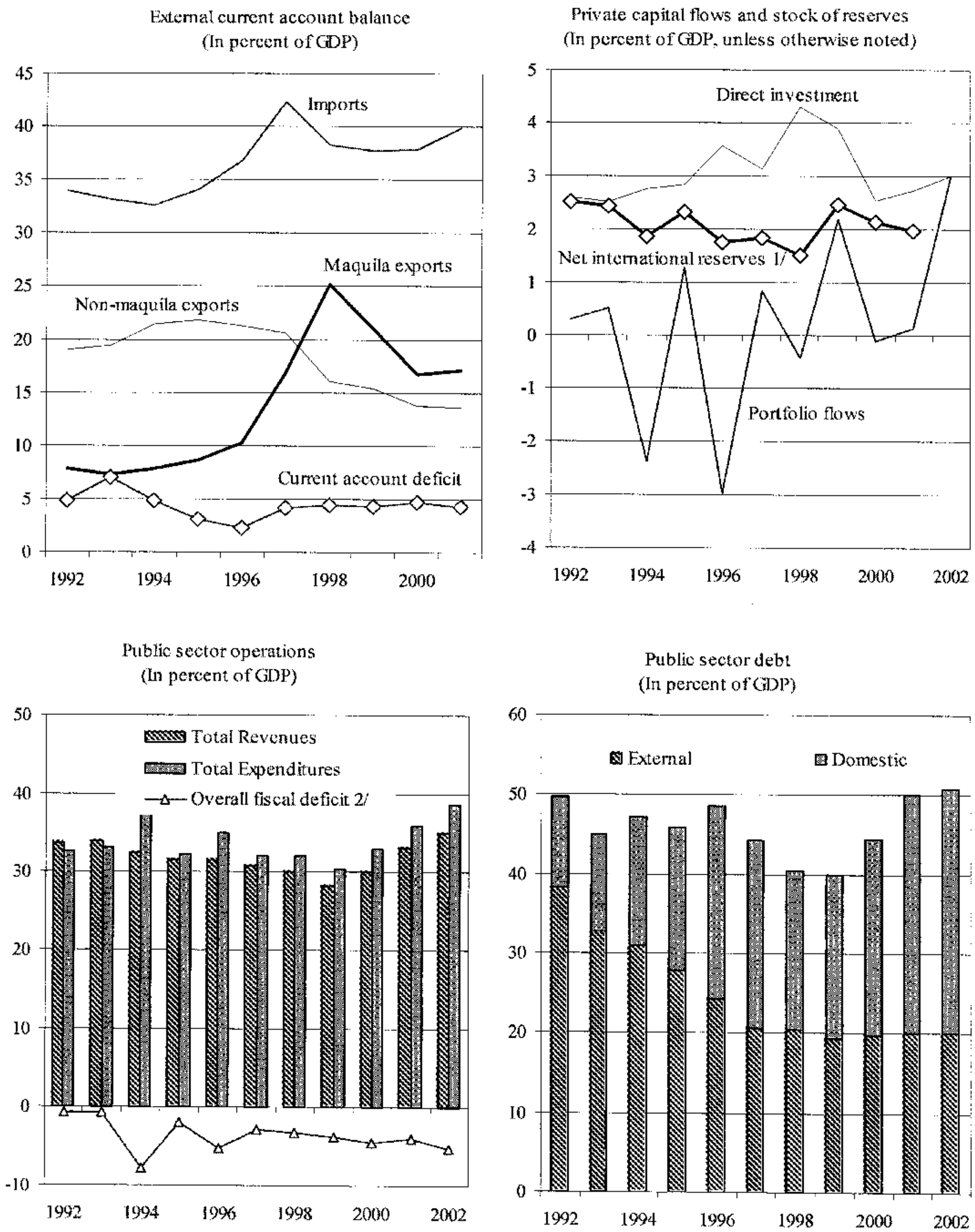
- Measures to facilitate fully consolidated supervision;

- The introduction of a new framework for capital adequacy, with full consolidation of public and private financial groups;

- Strengthening SUGEF capabilities to assess the assess of risk by financial entities with TA from the Federal reserve Bank of Atlanta;

- The introduction of a new chart of accounts, following International Accountant Standards.

Chart 1. Costa Rica: Macroeconomic Developments



Sources: Central Bank of Costa Rica, and Fund estimates

Chart 2 Costa Rica Exchange Rate Developments, 1995-2002
(1995=100)

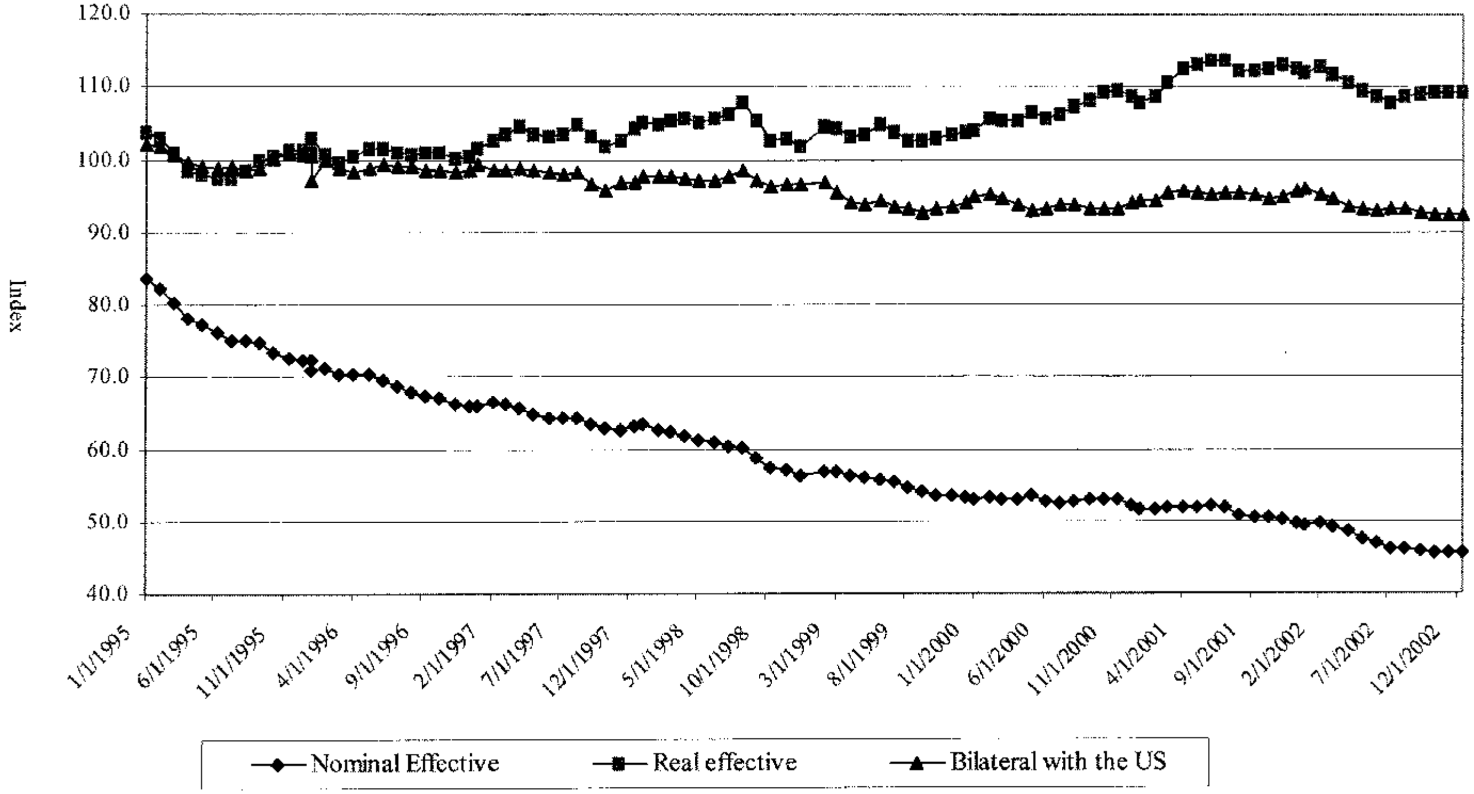


Table 1. Costa Rica: Selected Economic and Financial Indicators

	1999	2000	2001	Prel. 2002	Proj. 2003
	(Annual percentage change)				
National income and prices					
GDP at constant prices	8.2	1.8	1.1	2.8	2.0
Nominal GDP	24.5	9.0	9.6	12.8	12.9
GDP deflator	15.0	7.1	8.4	9.8	10.7
Consumer prices (end of period)	10.1	10.2	11.0	10.0	10.0
Consumer prices (average)	10.0	11.0	11.3	9.1	10.0
External sector					
General merchandise exports, f.o.b.					
Value	-14.9	-6.8	-7.5	-2.3	-0.5
Volume	-10.9	-5.6	-6.2	-5.1	-1.1
General merchandise imports, f.o.b.					
Value	-5.4	2.2	0.6	8.3	2.8
Volume	-6.5	0.8	-1.5	5.8	1.6
Net goods for processing	168.0	-28.1	-54.9	32.8	78.0
Tourism net	22.3	25.5	-1.0	3.3	8.1
Terms of trade (deterioration -) 1/	-5.6	-2.7	-3.4	0.6	-0.6
Real effective exchange rate					
(end of period; depreciation -)	1.7	4.7	3.8	-3.0	...
Central government					
Total revenue and grants	18.1	13.1	18.1	13.0	23.6
Total expenditure	12.5	17.9	17.1	20.8	14.1
Banking system					
Net domestic assets	5.9	21.4	8.6	12.4	10.8
Of which:					
Credit to public sector (net)	-26.5	-12.9	-63.8	70.1	-14.0
Credit to private sector	18.2	31.3	22.9	21.3	18.3
Private financial assets	22.4	17.1	13.7	20.4	10.1
Lending interest rate (end of period)	27.3	27.0	25.8	27.9	29.2
Six-month government bonds interest rate					
(end of period)	17.4	15.0	17.0	19.6	18.8
	(In percent of GDP)				
Gross domestic investment	17.1	17.1	17.8	21.0	17.7
Fixed investment	18.0	17.8	18.1	19.0	19.2
Inventories	-0.8	-0.7	-0.3	2.0	-1.6
Gross national savings	12.0	12.6	13.2	15.5	12.7
Overall public sector balance (-)	-3.7	-4.4	-3.8	-5.9	-4.0
Overall primary public sector balance (-)	0.6	0.5	1.2	-0.3	1.4
Nonfinancial public sector balance (-)	-2.2	-2.7	-2.6	-4.5	-2.7
Central government	-2.9	-3.7	-3.8	-5.0	-4.0
Rest of nonfinancial public sector	0.8	1.1	1.3	0.6	1.2
Central bank losses (-)	-1.6	-1.8	-1.2	-1.4	-1.3
External current account balance					
(including official transfers)	5.2	4.5	4.6	5.5	4.9
Total public sector debt	41.6	43.7	48.7	51.9	51.7
External	19.3	19.7	19.8	19.8	20.4
Domestic	22.3	24.0	28.9	32.1	31.3
	(In percent of exports of goods and nonfactor services)				
External public debt service	7.9	8.7	8.7	8.5	9.9
Of which: Interest	2.4	2.7	3.5	3.4	3.6
	(In millions of U.S. dollars, unless otherwise specified)				
Change in net international					
reserves (increase -)	-480	153	-14	-165	0
Net international reserves 2/	1,240	1,086	1,096	1,261	1,261
Net international reserves (months of					
imports of goods)	2.5	2.3	2.0	2.4	2.2

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

1/ Excludes *maquila.*

2/ Excludes bilateral claims under negotiation with neighboring countries, which in the official statistics are classified as part of international reserves.

Table 2. Costa Rica: Summary of Public Sector Operations, 1999-2003

(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	Prel 2002	Proj. 2003
Revenues	19.8	20.7	22.3	22.7	24.5
Tax revenue	11.9	12.4	13.3	13.3	14.5
Direct taxes	3.5	3.4	3.7	3.7	4.4
Imports	2.6	2.7	2.1	1.7	1.7
Sale tax	5.8	6.3	7.4	8.0	8.4
Nontax revenue	0.1	0.1	0.2	0.1	0.3
Contributions CCSS	5.2	5.4	5.7	5.9	6.0
Other CCSS	0.4	0.5	0.6	0.8	0.9
Net public enterprises	2.3	2.5	2.8	2.8	3.0
Central bank	-0.1	-0.2	-0.2	-0.2	-0.2
Expenditure	19.2	20.2	21.1	23.0	23.2
Wages and salaries	6.6	7.1	7.6	8.3	8.3
Goods and services	1.6	1.7	1.8	2.0	1.9
Pensions	3.5	3.9	4.4	4.4	4.5
Transfers and others	3.2	3.4	3.3	3.7	3.7
Capital expenditure	4.3	4.2	4.0	4.7	4.7
Primary balance	0.6	0.5	1.2	-0.3	1.4
Net interest	4.3	4.9	5.0	5.6	5.4
Overall balance	-3.7	-4.4	-3.8	-5.9	-4.0
NFPS	-2.2	-2.7	-2.6	-4.5	-2.7
Central bank	-1.6	-1.8	-1.2	-1.4	-1.3
Memorandum items					
Overall balance in US$ millions	-591	-708	-617	-1,000	-707
Total public sector debt (In percent of GDP)	41.6	43.7	48.7	51.9	51.7
External	19.3	19.7	19.8	19.8	20.4
Domestic	22.3	24.0	28.9	32.1	31.3
Of which:					
Foreign currency denominated	6.0	6.7	8.4	9.6	9.7
Efective external interest rate (in US dollars)	6.5	6.7	7.5	7.2	7.5
Efective domestic interest rate	14.2	16.0	17.3	18.6	18.8
Nominal GDP (In C mln.)	4,512,763	4,917,764	5,387,526	6,076,083	6,860,753

Sources: Ministry of Finance; and Fund staff estimates

Table 3. Costa Rica: Public Sector Debt, 1999-2003

	1999	2000	2001	Prel. 2002	Proj. 2003
Total Debt of the Public Sector (US$ million)	6,576	6,974	7,978	8,783	9,105
Domestic debt (C bln)	1,005,475	1,178,146	1,557,343	1,948,997	2,146,583
Central Bank	337,490	355,621	463,673	649,264	740,360
External debt (US$ million)	3,057	3,151	3,243	3,355	3,598
NFPS	2,147	2,309	2,463	2,631	2,925
Central bank	887	811	753	653	601
FPS	23	31	26	26	26
	In percent of GDP				
Total	41.6	43.7	48.7	51.9	51.7
Domestic debt	22.3	24.0	28.9	32.1	31.3
NFPS	14.8	16.7	20.3	21.4	20.5
Central bank	7.5	7.2	8.6	10.7	10.8
External debt	19.3	19.7	19.8	19.8	20.4
NFPS	13.6	14.5	15.0	15.5	16.6
Central bank	5.6	5.1	4.6	3.9	3.4
FPS	0.1	0.2	0.2	0.2	0.1

Sources: Ministry of Finance; Central Bank; and Fund staff estimates

Table 4. Costa Rica: Summary of the Balance of Payments, 1999-2003

(In millions of U.S. dollars, unless otherwise indicated)

	1999	2000	2001	Prel 2002	Proj. 2003
Current account	**-681**	**-707**	**-737**	**-931**	**-867**
Trade balance	**580**	**-211**	**-821**	**-1,387**	**-858**
Export of goods (f.o.b.)	6,576	5,813	4,923	5,224	5,521
General merchandise	2,592	2,458	2,209	2,275	2,268
Goods for processing	3,985	3,355	2,714	2,950	3,253
Of which: INTEL	2,562	1,657	912	951	1,046
Import of goods (f.o.b.)	5,996	6,025	5,744	6,612	6,380
General merchandise	4,026	4,118	3,684	4,530	4,616
Goods for processing	1,971	1,907	2,060	2,082	1,764
Of which: INTEL	985	781	1,025	1,045	628
Services	**458**	**665**	**729**	**709**	**793**
Of which: Travel	651	817	809	836	904
Income	**-1,822**	**-1,252**	**-793**	**-407**	**-964**
Of which: Interest on external public debt	198	212	242	242	270
Current transfers	**102**	**92**	**148**	**155**	**163**
Financial and capital account	**940**	**390**	**761**	**1,095**	**867**
Direct investment	**614**	**400**	**445**	**642**	**360**
Portfolio investment	**326**	**-11**	**316**	**454**	**507**
Public sector	85	94	127	116	275
Disbursements	528	559	479	496	770
Amortizations	-443	-465	-352	-380	-495
Private net capital	241	-104	188	338	232
Errors and omissions	**221**	**165**	**-11**	**0**	**0**
Change in net reserves (- = increase)	**-480**	**152**	**-13**	**-165**	**0**
(Annual percentage change)					
Export of goods (f.o.b.)					
Value	22.8	-11.6	-15.3	6.1	5.7
Volume	25.1	-11.8	-15.6	3.1	4.5
General merchandise					
Value	-14.9	-6.8	-7.5	-2.3	-0.5
Volume	-10.9	-5.6	-6.2	-5.1	-1.1
Import of goods (c.i.f.)					
Value	1.0	0.6	-4.4	14.7	-3.3
Volume	-0.4	-1.5	-6.6	13.4	-5.1
General merchandise					
Value	-5.4	2.2	0.6	8.3	2.7
Volume	-6.5	0.8	-1.5	5.8	1.5
(In percent of GDP)					
Current account (% of GDP)	-5.2	-4.5	-4.6	-5.5	-4.9
Export of goods (f.o.b.) (% of GDP)	41.6	36.4	30.1	30.9	31.3
Import of goods (f.o.b.) (% of GDP)	38.0	37.8	35.1	39.1	36.2
Direct investment (% of GDP)	3.9	2.5	2.7	3.8	2.0
Memorandum items:					
NIR (US$ million)	1,240	1,086	1,098	1,261	1,261
NIR (months of imports)	2.5	2.3	2.0	2.4	2.2
External public sector debt (% of GDP)	19.3	19.7	19.8	19.9	20.4
External debt servicing (US$ million)	528	591	708	547	813
Debt serv. to exp. without maquila ratio	20.4	24.0	32.1	24.0	35.9
Of which: Interest	7.3	8.3	10.5	7.7	12.7

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

Table 5. Costa Rica: Summary Accounts of the Banking System, 1999-2003

	1999	2000	2001	Prel. 2002	Proj. 2003
(End-of-period stocks; in millions of colones unless otherwise specified)					
I. Central bank					
Net international reserves (colones) 1/	349,524	334,542	360,535	454,409	491,829
memo item: NIR in US$ millions	*1,239*	*1,086*	*1,096*	*1,261*	*1,261*
NIR, authorities	*1,471*	*1,318*	*1,328*	*1,495*	*1,495*
Net Domestic Assets and MLT foreign liabilities 2/	-75,644	-42,141	-78,791	-148,269	-70,607
Net public sector credit 3/	238,584	212,457	14,963	24,019	58,300
Credit to banks	-196,314	-170,151	-55,073	-59,884	-145,182
Stabilization bonds (BEMs)	-401,313	-417,996	-506,787	-685,884	-622,699
Medium and long-term foreign liabilities	-264,067	-266,968	-235,048	-223,170	-221,684
Other 4/	547,465	600,516	703,155	796,649	860,658
Base money	273,880	292,400	281,745	306,140	421,222
Of which: currency issued	229,813	202,711	223,035	249,870	280,415
II. Commercial Banks					
Net foreign assets (short-term)	-2,438	-12,244	-63,172	-64,181	-64,181
Net Domestic Assets and MLT foreign liabilities	697,930	953,875	1,219,436	1,438,692	1,709,324
Nonfinancial public sector credit, net	41,731	31,756	73,489	126,418	71,076
Private sector credit	764,757	1,004,086	1,233,959	1,496,797	1,771,276
Medium and long-term foreign liabilities	-49,325	-62,855	-73,776	-98,724	-98,724
Other	-59,233	-19,113	-14,236	-85,799	-34,304
Claims on the central bank, net	428,209	445,803	386,632	481,307	439,927
Deposits	1,123,701	1,387,433	1,542,896	1,855,818	2,085,070
III. Banking System					
Net foreign assets (short-term)	347,086	322,297	297,364	390,228	427,648
memorandum: in millions of US$	*1,231*	*1,046*	*904*	*1,084*	*1,098*
Net Domestic Assets and MLT foreign liabilities	1,577,902	1,897,047	2,161,694	2,571,499	2,748,937
Nonfinancial public sector credit, net	280,316	244,213	88,452	150,438	129,376
Private sector credit	764,757	1,004,086	1,233,959	1,496,797	1,771,276
Medium and long-term foreign liabilities	-313,392	-329,822	-308,825	-321,894	-320,408
Other items, net	846,222	978,569	1,148,107	1,246,158	1,168,693
Stabilization bonds (BEMs)	-401,313	-417,996	-506,787	-685,884	-622,699
Of which: in foreign currency (in millions of US$)	*-213*	*-246*	*-928*	*-961*	*-988*
Broad money 5/	1,523,675	1,801,348	1,952,270	2,275,844	2,553,886
Of which: in foreign currency (in millions of US$)	*1,845*	*2,135*	*2,358*	*2,591*	*2,715*
Memorandum Items:					
(Percent changes)					
Private financial assets	22.4	17.1	13.7	20.4	10.1
Of which: Broad money (M2)	16.6	18.2	8.4	16.6	12.2
Banking system credit to the private sector	18.2	31.3	22.9	21.3	18.3
(In percent of GDP)					
Private financial assets	45	48	50	53	52
Of which: Broad money (M2)	34	37	37	37	37
Central bank securities	9	9	9	11	9
Banking system credit to the private sector	17	20	23	25	26
(In percent, unless otherwise indicated)					
NIR/Banking system dollar-denominated liabilities	58	45	36	36	34
NIR/Base Money	128	114	128	148	117
NIR/Central bank monetary liabilities	-274	-266	-160	-120	-244
Money multiplier	5.6	6.2	6.9	7.4	6.1
Accounting exchange rate (average annual)	282.0	308.1	328.9	359.9	389.5

Source: BCCR and staff projections.

1/ Adjusted for claims on Nicaragua equivalent to US$232 million.
2/ Decline is the result of central bank recapitalization since 1998 and change in debt instruments from credit to public securities.
3/ Excludes NFPS holdings of stabilization bonds (BEM and ICP).
4/ Includes exchange rate valuations.
5/ Comprises money, quasimoney and other monetary liabilities. Excludes public securities.
6/ Excludes securities purchased by the RNFPS.

Table 6. Costa Rica: Structure and Performance of the Financial Sector 1/

(In millions of colones unless otherwise indicated)

	1998	1999	2000	2001	Oct-02
Number of banks	28	26	23	21	21
Private banks	23	21	18	16	16
Total assets of private banks (percentage of GDP)	10.1%	9.6%	12.7%	14.5%	15.1%
Public banks	5	5	5	5	5
Total assets of public banks (percentage of GDP)	30.8%	29.1%	31.9%	31.2%	31.6%
Capital					
Ratio of capital to risk-weighted assets	14.9	17.8	16.9	15.3	16.3
Asset quality					
Ratio of nonperforming loans to total loans	3.8%	2.9%	3.7%	2.5%	3.0%
Provision coverage					
Ratio of provisions to total loans	4.6%	3.5%	3.6%	2.8%	3.0%
Ratio of provisions to nonperforming loans	125.6%	122.4%	99.8%	114.0%	104.2%
Ratio of foreign currency credit to total private credit	30.2%	37.6%	46.9%	51.4%	53.8%
Ratio of real estate loans to total loans	...	18.1%	17.4%	20.8%	27.7%
Management					
Ratio of administrative expenses to total assets	6.0	5.9	5.7	5.9	5.9
Profitability					
Pre-tax return to average equity	7.6	14.1	12.7	15.0	14.8
Pre-tax return to average total assets	0.9	1.6	1.5	1.7	1.7
Liquidity					
Ratio of loans to deposits	62.3%	62.3%	67.0%	75.9%	77.3%
Ratio of liquid assets to deposits	63.1%	60.7%	56.6%	56.1%	52.9%

Source: Superintendency of Financial Institutions

1/ Does not include approved offshore banks and other nonbank financial institutions.

Table 7. Costa Rica: Indicators of External Vulnerabilty, 1998-2002

	1998	1999	2000	2001	Prel. 2002
Merchandise exports (12-month percent change) 1/	7.1	-10.9	-5.6	-6.2	-5.1
Merchandise imports (12-month percent change) 1/	14.6	-6.5	0.8	-1.5	5.8
Terms of trade (percentage change)	-0.2	-5.6	-2.7	-3.4	0.6
Current account balance (in percent of GDP)	-4.5	-5.2	-4.5	-4.6	-5.5
Central bank net international reserves (in US$ millions) 2/	760	1,240	1,086	1,096	1,261
In months of next year's imports of goods	1.5	2.5	2.3	2.0	2.2
In percent of base money	75	128	114	128	144
In percent of base money and US$ deposits of	0	0	0	0	0
commercial banks at the central bank	39	73	72	106	123
In percent of M2	14	23	19	18	19
NIR excluding commercial bank liabilities (in US$ millions) 3/	-230	302	275	-7	78
Commercial banks foreign assets (in US$ millions)	245	199	275	225	219
Commercial banks foreign liabilities (in US$ millions)	125	175	204	224	257
Public sector external debt (in percent of GDP)	20.4	19.3	19.7	19.8	19.8
NFPS external interest payments to merchandise exports 4/	4.3	7.3	8.3	10.5	7.7
NFPS external amortization payments to merchandise exports 4/	9.3	13.0	15.7	21.5	16.4
REER appreciation (+) (12-month percentage change) 5/	-2.1	1.7	4.7	3.8	-1.8

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

1/ In value terms, excludes maquila.

2/ Excludes bilateral claims under negotiation with neighboring countries, which in the official statistics are classified as part of international reserves.

3/ Excludes reserves purchased through the issue of central bank bonds to commercial banks and commercial bank dollar deposits at central bank.

4/ Excludes merchandise exports associated to the free trade zone.

5/ Average.

Table 8. Costa Rica: Fiscal Sustainability

In percent of GDP unlesss otherwise stated

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Baseline scenario									
USA, real GDP growth, percent	2.4	2.3	4.1	4.4	3.5	3.1	3.1	3.1	3.1
Six-month Libor, US dollars	1.9	1.6	3.9	5.5	5.5	5.5	5.5	5.5	5.5
Real GDP growth	2.8	2.0	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Inflation CPI average	9.1	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Primary balance	-0.3	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Interest expenditure	5.6	5.4	6.0	6.6	6.8	7.6	7.9	8.2	8.5
Combined balance (including central bank losses)	-5.9	-4.0	-4.7	-5.3	-5.4	-6.2	-6.5	-6.8	-7.1
Nonfinancial public sector balance	-4.5	-2.7	-3.3	-3.9	-3.9	-4.7	-4.9	-5.2	-5.4
Central bank quasi-fiscal losses	-1.4	-1.3	-1.4	-1.4	-1.5	-1.5	-1.6	-1.6	-1.7
Public sector debt (including central bank)	51.9	51.8	52.0	52.7	53.3	54.7	56.3	57.9	59.6
Domestic	32.1	31.4	33.4	34.7	35.9	37.6	39.4	41.3	43.3
External	19.8	20.4	18.5	18.0	17.4	17.1	16.9	16.6	16.3
Memorandum items:									
Combined fiscal balance, million US dollar	-998	-704	-858	-1,022	-1,092	-1,318	-1,448	-1,582	-1,733
Effective nominal interest rate, domestic debt, central government	17.5	18.8	19.0	20.0	20.0	22.0	22.0	22.1	22.1
Spread over LIBOR	5.3	5.6	6.6	6.6	6.6	7.1	7.6	7.6	7.9
Adjusted fiscal deficit scenario									
USA, real GDP growth, percent	2.4	2.3	4.1	4.4	3.5	3.1	3.1	3.1	3.1
Six-month Libor, US dollars	1.9	1.6	3.9	5.5	5.5	5.5	5.5	5.5	5.5
Real GDP growth (in percent)	2.8	2.0	3.0	3.5	4.0	4.0	4.0	4.0	4.0
Inflation CPI average in percent	9.1	10.0	9.0	9.0	9.0	9.0	9.0	8.5	8.5
Primary balance	-0.3	1.4	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Interest expenditure	5.6	5.4	5.5	5.4	5.0	4.7	4.4	4.0	3.6
Combined balance (including central bank losses)	-5.9	-4.0	-3.0	-2.9	-2.5	-2.2	-1.9	-1.5	-1.1
Public sector debt (including central bank)	51.9	51.8	50.4	48.7	46.4	44.0	41.5	39.0	36.2
Domestic	32.1	31.4	32.4	32.0	31.2	30.2	29.1	27.8	26.3
External	19.8	20.4	18.0	16.6	15.2	13.8	12.4	11.2	9.9
Memorandum items:									
Combined fiscal balance, million US dollar	-998	-703	-564	-575	-520	-493	-452	-380	-288
Effective nominal interest rate, domestic debt, central government	17.5	18.8	18.0	17.8	17.5	17.3	17.0	16.3	15.5
Spread over LIBOR	5.3	5.6	5.6	4.5	3.5	3.5	3.5	3.5	3.5
Adverse scenario									
USA, real GDP growth, percent	2.4	2.3	3.6	3.9	3.0	2.6	2.6	2.6	2.6
Six-month Libor, US dollars	1.9	1.6	3.9	6.0	6.0	6.0	6.0	6.0	6.0
Real GDP growth (in percent)	2.8	2.0	2.0	1.8	1.8	1.6	1.6	1.4	1.4
Inflation CPI average in percent	9.1	10.0	10.0	10.0	11.0	11.0	12.0	12.0	12.0
Primary balance	-0.3	1.4	1.0	0.7	0.7	0.7	0.7	0.7	0.7
Interest expenditure	5.6	5.4	6.0	7.2	7.5	8.2	9.3	10.6	12.1
Combined balance (including central bank losses)	-5.9	-4.0	-5.0	-6.5	-6.8	-7.5	-8.6	-9.9	-11.4
Public sector debt (including central bank)	51.9	51.8	52.5	54.6	56.6	59.1	62.1	66.1	71.3
Domestic	32.1	31.4	33.8	36.0	38.1	40.6	43.5	47.2	51.8
External	19.8	20.4	18.7	18.7	18.5	18.5	18.6	18.9	19.5
Memorandum items:									
Combined fiscal balance, million US dollar	-998	-703	-914	-1,232	-1,352	-1,549	-1,836	-2,187	-2,614
Effective nominal interest rate, domestic debt, central government	17.5	18.8	18.8	21.0	21.0	22.0	23.8	25.8	27.7
Spread over LIBOR	5.3	7.2	10.5	12.6	13.1	13.5	14.0	14.0	14.0

Sources: Ministry of Finance; Central Bank; and Fund staff estimates

Table 9. Costa Rica: External Debt Sustainability Assesment, 2002-2010

(In percent of GDP unless otherwise noted)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Baseline scenario									
External debt service (in percent of exports of G&S)	12.8	14.5	14.9	17.7	18.1	19.1	20.4	25.8	24.3
External public and private debt	31.3	33.5	36.1	38.8	41.9	44.9	48.0	51.0	54.0
Actual change in external private and public debt	2.9	3.4	4.1	4.4	4.8	4.9	5.1	5.2	5.3
Calculated change in external debt	2.5	3.4	4.1	4.4	4.8	4.9	5.1	5.2	5.3
Current account excluding interest payments	-3.5	-2.7	-2.8	-2.2	-2.3	-1.9	-1.5	-1.2	-0.8
Balance on trade, G&S	-4.1	-3.7	-3.8	-3.2	-3.3	-2.9	-2.5	-2.2	-1.8
Exports of G&S	42.3	43.0	43.8	43.1	45.1	47.2	48.6	48.6	50.0
Imports of G&S	46.5	46.7	47.6	46.3	48.4	50.1	51.1	50.8	51.8
Other net factorial services	0.6	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Non-debt creating inflows	3.0	1.5	2.0	2.0	2.0	2.0	2.0	2.0	2.0
FDI	3.8	2.0	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Other (errors and ommissions and change in NIR)	-0.8	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
Interest payments	-2.0	-2.2	-3.4	-4.2	-4.5	-5.0	-5.6	-6.0	-6.5
Residual	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Sensitivity analysis for external debt-to-GDP ratio									
1. Real growth, GDP deflator, interest rate, noninterest current account and non-debt inflow equal to 1992-2001 average.	31.3	28.5	25.9	23.7	21.7	20.0	18.6	17.3	16.2
2. External interest rates in 2003 and 2004 equal baseline plus two standard deviations	31.3	34.0	36.7	39.5	42.6	45.6	48.7	51.8	54.9
3. Real GDP growth in 2003 and 2004 equals baseline minus two standard deviations	31.3	35.8	41.0	44.1	47.6	51.0	54.5	58.1	61.6
4. Non-interest current account in 2003 and 2004 equals baseline minus two standard deviations	31.3	35.8	40.9	43.9	47.4	50.8	54.3	57.8	61.4
5. Combination of 2-4 using two standard deviation for each shock	31.3	33.1	35.7	39.3	43.5	47.7	52.3	57.1	62.1
6. One time nominal depreciation (30 percent) in 2003	31.3	39.9	42.8	46.0	49.6	53.2	56.9	60.6	64.4

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

Table 10. Costa Rica: Public Sector Debt Sustainability Assesment, 2002-2010

(In percent of GDP unless otherwise noted)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Baseline scenario									
Gross financing requirements	16.0	14.3	14.5	14.8	14.6	14.5	14.9	16.6	16.1
Gross financing requirements (in millions of U.S. dollars)	2,712	2,515	2,676	2,856	2,962	3,067	3,303	3,864	3,916
Public sector debt	51.9	51.8	51.9	52.6	53.3	54.7	56.2	57.8	59.6
Actual change in public sector debt	5.9	4.0	4.7	5.3	5.4	6.2	6.5	6.8	7.1
Calculated change in public sector debt	5.9	4.0	4.7	5.3	5.4	6.2	6.5	6.8	7.1
Primary balance	-0.3	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Revenues	34.6	36.2	37.5	38.3	38.9	39.5	40.2	40.9	41.6
Noninterest expenditure	35.0	34.9	36.1	36.9	37.5	38.1	38.8	39.5	40.2
Interest expenditures	5.6	5.4	6.0	6.7	6.8	7.6	7.9	8.2	8.5
Nondebt financing	1.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1. Real growth, GDP deflator, interest rates, nondebt financing are at 10 year average	51.9	48.4	47.1	45.7	44.1	42.3	40.4	38.3	35.9
2. Interest rates in 2003 and 2004 equal baseline plus two standard deviations	51.9	53.9	56.2	57.1	58.1	60.1	62.3	64.7	67.2
3. Real growth in 2003 and 2004 equal basline minus two standard deviations	51.9	54.8	57.8	51.6	52.7	54.7	56.9	59.3	61.8
4. Primary balance 2003 and 2004 equal baseline minus two standard deviations	51.9	54.3	56.9	58.2	59.6	62.1	64.8	67.7	70.8
5. Combination of 2-4, using two standard deviation	51.9	61.1	71.3	62.3	62.2	63.4	64.6	65.9	67.3
6. A one-time nominal depreciation (30 percent) in 2003	51.9	56.5	55.9	57.1	58.4	60.9	63.4	66.3	69.3
7. A one-time increase of debt/GDP ratio of ten points in 2003 (contingent liabilities)	51.9	61.9	61.3	62.5	63.8	66.3	68.9	71.7	74.7

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

Table 11. Costa Rica: Comparative Social Indicators

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Average for Latin America and the Caribbean
Rank in UNDP Human Development Index (out of 162 countries) (2001)	41	95	108	106	107	...
GDP per capita in PPP, U.S. dollars (1999)	8,860	4,344	3,674	2,340	2,279	7,352
People not expected to survive to age 40 (in percent of population) (1999)	4.0	10.9	15.6	16.0	11.5	9.7
Life expectancy at birth (years) (2000)	76.2	69.5	64.5	65.7	68.1	69.8
Infant mortality (per 1,000 live births) (2000)	13.0	35.0	38.8	33.0	38.0	32.0
Population without access to safe water (1999)	2.0	26.0	8.0	10.0	21.0	22.0
Per capita health exp. in PPP, U.S dollars (1998)	509.0	298.0	155.0	210.0	266.0	n.a.
Physicians per 100,000 people (1990-99)	141.0	107.0	93.0	83.0	86.0	n.a.
Adult illiteracy (1999)	4.5	21.7	31.9	26.0	31.8	12.0
Primary school net enrollment (1997) (percent of relevant age of the population)	91.8	89.1	73.8	87.5	78.6	93.3
Secondary school net enrollment (1997) (percent of relevant age of the population)	55.8	36.4	34.9	36.0	50.5	65.3
Ratio of the per capita income of the richest 10 percent to the per capita income of the poorest 10 percent of the population (1987-98)	20.7	28.5	29.1	119.8	70.7	n.a.
Gini index (World Development Report, 2001) 1/	47.0	52.3	59.6	53.7	50.3	n.a
Percentage of population below the poverty line (1984-99)	11.0	48.3	57.9	53.0	50.3	n.a.
	n.a.	48.3	n.a.	50.0	50.3	n.a.

Source: UNDP Human Development Report 2001.

1/ For Costa Rica , El Salvador and Honduras, the information refers to the 1996 surveys, for Guatemala to the 1989 survey, and for Nicaragua to the 1993 survey.

COSTA RICA: THE DECLINE IN TREND GROWTH[16]

1. Trend Growth in Costa Rica and in Central America

Economic growth in Costa Rica has been consistently among the highest in the Central American region for the period 1970-2001, both compared to the average for the region and to growth rates in each of the countries (Table 1A). However, the volatility of growth (measured by the standard deviation) was constant or declined since the mid-1980s for the other four countries, whereas it has steadily increased in Costa Rica, and was almost twice the regional average for the 1996-2001 period (Table 1B).

Table 1A. Central America: Average annual GDP growth; 1970-2001

	1971-75	1976-80	1981-85	1986-90	1991-95	1996-01	1970-01
Costa Rica	6.0	5.2	1.0	4.6	5.1	4.5	4.7
El Salvador	5.5	1.0	-1.9	2.2	6.1	2.9	2.7
Guatemala	5.6	5.7	-1.1	2.9	4.3	3.6	3.7
Honduras	2.0	7.2	1.7	3.1	3.5	2.8	3.6
Nicaragua	5.6	-4.2	0.6	-3.3	1.5	5.0	1.0
Average	**4.9**	**3.0**	**0.1**	**1.9**	**4.1**	**3.8**	**3.1**

Table 1B. Central America: Standard deviation of annual GDP growth; 1970-2001

	1971-75	1976-80	1981-85	1986-90	1991-95	1996-01	1970-01
Costa Rica	2.3	2.9	4.8	1.8	3.0	3.5	3.5
El Salvador	1.2	6.0	5.2	1.5	1.5	1.7	4.6
Guatemala	1.9	2.2	2.6	2.0	0.7	1.1	2.7
Honduras	3.7	5.5	2.5	2.4	3.0	2.4	3.4
Nicaragua	5.1	12.9	4.0	4.7	2.0	1.4	7.0
Average	**2.8**	**5.9**	**3.8**	**2.5**	**2.0**	**2.0**	**4.2**

Since 1995, Costa Rica has experienced a period of declining trend in real GDP growth (Chart 1). This follows a period of about 13 years, from the early 1980s, with steadily increasing trend growth. This earlier phase was associated with recovery to macroeconomic stability from the steep crisis in 1980-81, high investment, and structural reforms that generated considerable productivity gains. Progress was particularly noticeable in two areas:

- **trade liberalization**, where Costa Rica started, in the mid-1980s, an aggressive strategy to unilaterally remove tariff and non-tariff barriers to trade (Table 2);[17]

[16] Prepared by Erik Offerdal.

[17] In recent years, Costa Rica has also benefited from the trade preferences under the Caribbean Basin Initiative, as well as emphasizing bilateral and multilateral trade agreements in its trade strategy (bilateral agreements have been negotiated with Chile, the Dominican

(continued)

- **privatization:** by 1991 the sale, merger, or liquidation of 40 state enterprises under the umbrella of the CODESA holding company (out of a total of 43) had been completed.

Table 2. Costa Rica: Trade Liberalization, 1985-2000

	1985	1990	1995	2000
Average tariff	53.0	16.4	11.7	6.1
Tariff dispersion (standard deviation)	27.4	8.8	8.5	8.3

Sources: Central Bank, U.N., and Fund Staff estimates

However, since the mid-1990s, investment has slowed down, the external climate has deteriorated, and productivity growth has been declining because of a large and unfinished structural reform agenda.

2. Growth accounting for Costa Rica

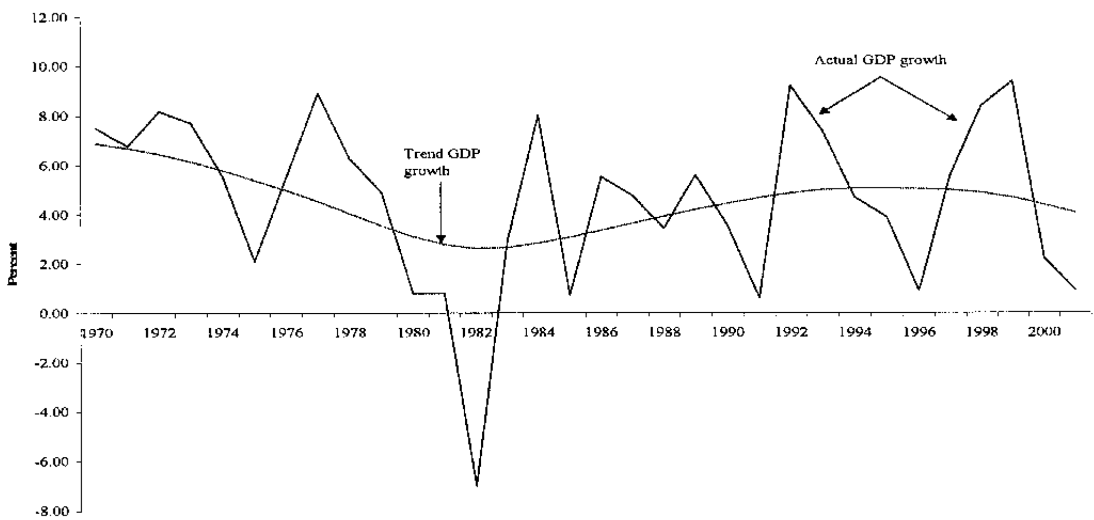
Using a simple growth accounting framework, the trend GDP growth illustrated in Chart 1 can attributed to the sum of contributions coming from fixed capital formation, labor, and a residual that captures changes in Total Factor Productivity (TFP). For this analysis, the following methodology was employed:

- GDP is generated by a Cobb-Douglas production function with constant returns to scale and equal weights for labor and capital;[18]

Republic, Mexico, and Canada, and the country is actively participating in the negotiations with the U.S. for a Central American Free Trade Agreement.

[18] The equal weights for capital and labor follows the estimates from national accounts data derived Cordero (*Empleo Crecimiento y Equidad, Instituto de Investigaciones y Ciencias Económicas, Universidad de Costa Rica, 2000, Chapter IV*). The results described below are not overly sensitive to changes in this assumption.

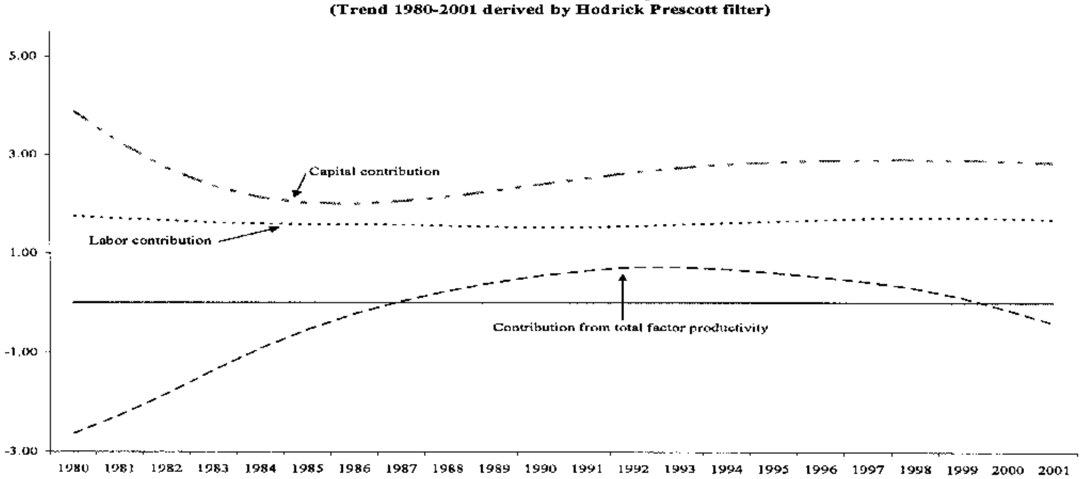
Costa Rica: Actual and trend GDP growth, 1970-2001
(Trend growth derived with Hodrick-Prescott filter)



- labor input is the total number of man-years, with no explicit corrections for improvements in human capital on account of education and/or health;
- capital input is derived by using a perpetual inventory method to calculate the capital stock based on data on total investment in constant prices from 1967 and an assumption of declining-balance depreciation of seven percent annually for the overall capital stock.

Capital accumulation has consistently been the largest factor behind trend growth since 1980; contributing importantly to the steadily increasing trend growth between 1982 and 1995 (Chart 2). Since the mid-90s, however, the contribution from capital has been virtually constant.

Costa Rica: Contributions to growth
(Trend 1980-2001 derived by Hodrick Prescott filter)



The contribution from total factor productivity, although negative in the early 1980s, increased rapidly and contributed importantly to the improvements in trend growth through 1995. Since that time, however, the contribution from TFP has declined rapidly, playing an important part in the declining growth.[19]

The contribution from labor has been practically constant throughout the period.

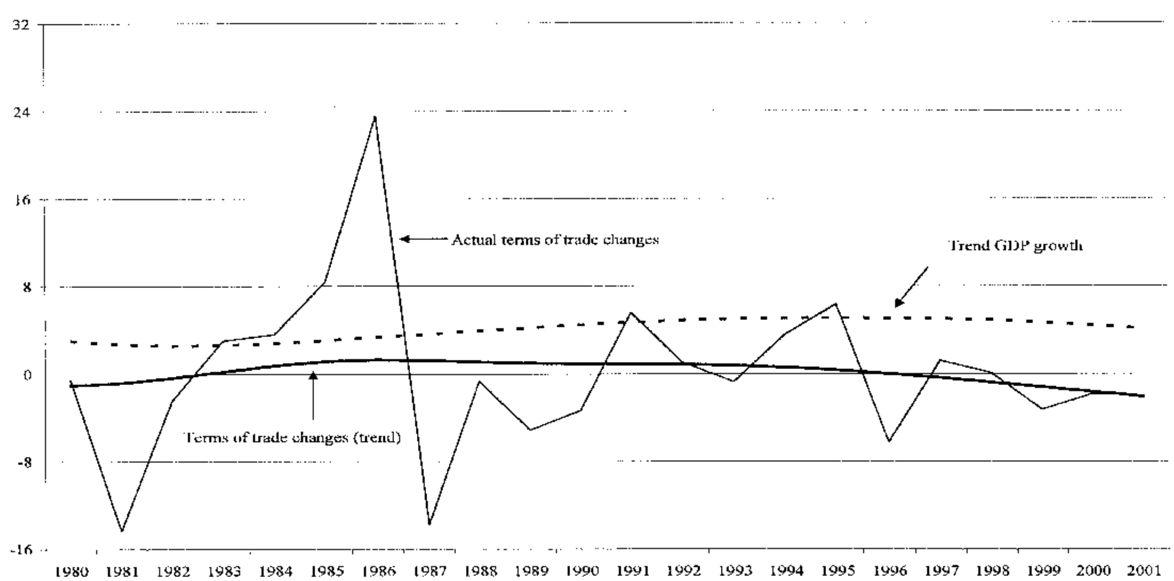
3. Some factors behind declining trend growth

Three trends have been important in explaining these growth developments: the external environment, domestic investment, and structural reforms.

i) The external environment facing Costa Rica has also deteriorated since the mid-1990s, adversely affecting an export-oriented growth strategy:

- Since 1995, the country has been hit by a series of negative terms of trade shocks, largely related to changes in world commodity prices (rising oil prices, declining coffee and banana prices), as well as the collapse of the semi-conductor market in 2000.

Costa Rica: GDP growth and terms of trade changes
(Trends derived by Hodrick-Prescott filter)



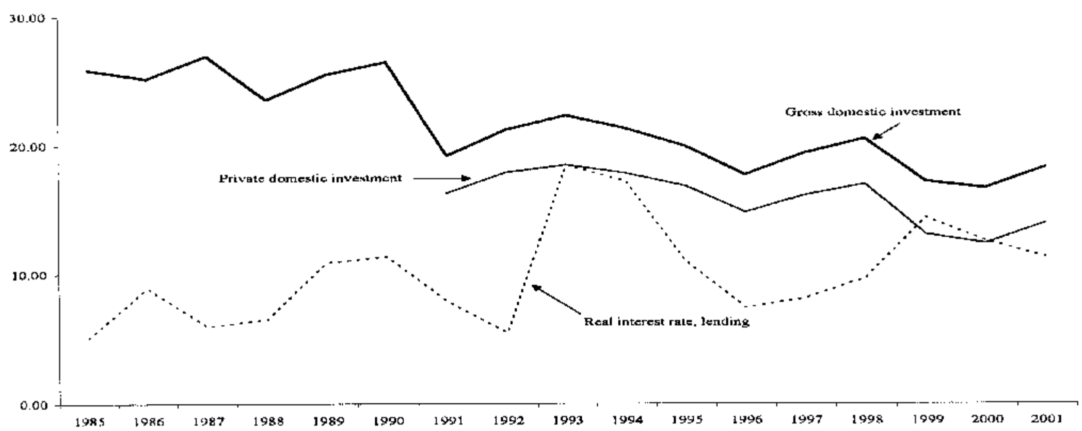
[19] Cordero (op. cit.) found a similar decline in the TFP contribution after 1995.

- The rate of crawl or nominal depreciation has declined from 13.5 annually in 1996 to 6.2 percent in 2001, contributing to a steady appreciation of the real effective exchange rate of 12 percent during that period.

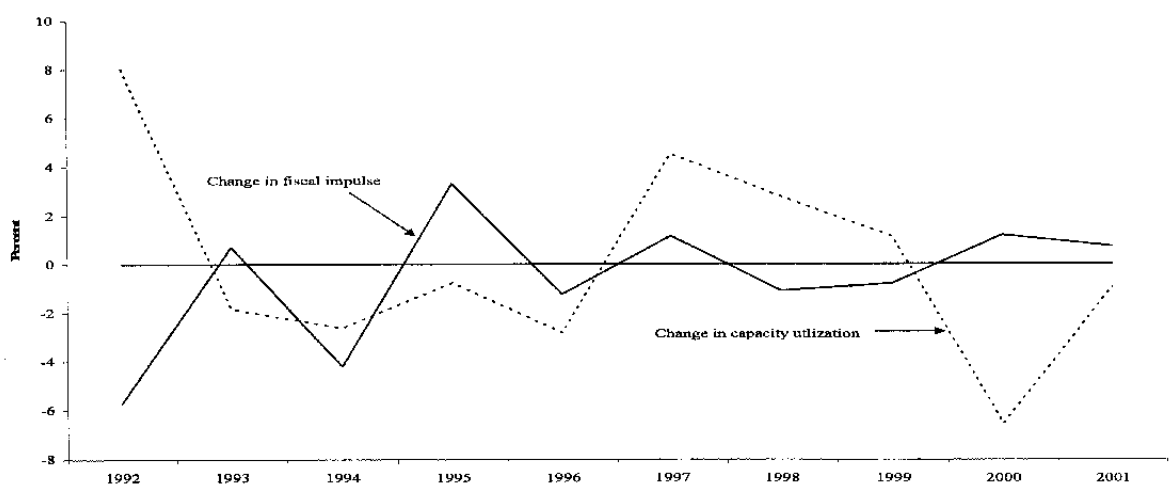
- The downturn in the U.S. economy.

ii) Gross domestic investment remained fairly steady at a level of around 25 percent of GDP from the early 1970s through 1990. However, since the early to mid-1990s, investment has been on a secular decline, with the gross investment ratio coming down to about 17 percent of GDP by 2000/2001, and a corresponding decline in private domestic investment. Two factors are important in explaining this development:

Gross domestic investment and savings, 1985-2001
(Percent of GDP)



Costa Rica: Fiscal Impluse and Change in Capacity Utilization, 1992-2001



- The deteriorating fiscal position has crowded out investment. During the nineties, the high public sector financing requirements have maintained an upward pressure on nominal interest rates, while inflation has declined from an annual average of about 20 percent in the period 1990-95 to an annual average of about 12 percent from 1996 onwards. Thus, real interest rates have steadily increased, reducing incentives for investment.[20]

- Fiscal policy was consistently procyclical until 1999,[21] exacerbating the impact on production and employment of external shocks, contributing to higher output volatility (ref. Table 1B) and an uncertain investment climate.

iii) The pace of structural reforms have stagnated in recent years: Costa Rica still has high marginal income tax rates, competition is stifled through state enterprise monopoly or dominance in many strategic sectors (telecommunications, electricity, insurance, financial services), and the infrastructure is decaying. As a result, aside from the changes associated with the establishment of INTEL plant, there has been little or no change of the structure of the economy in recent years.

Table 3. Costa Rica: Indicators of structural changes, 1991-2001

	Average 1991-95	1996	1997	1998	1999	2000	2001
	(Exports by commodity as shares of GDP)						
Total exports	27.3	30.5	32.0	38.0	41.6	36.4	30.3
Traditional goods	9.7	9.3	8.2	8.1	6.1	5.5	4.6
Non-traditional goods	10.9	13.8	14.3	14.2	10.8	10.1	9.7
Maquila	7.2	8.6	10.3	16.9	25.2	21.0	16.7
INTEL	0.0	0.0	0.0	7.0	16.2	10.4	5.6
Other	7.2	8.6	10.3	9.9	9.0	10.6	11.1
	(Value added by sector as shares of GDP)						
Agriculture and fisheries	11.6	11.6	11.2	11.2	10.8	10.7	10.7
Manufacturing	21.1	20.9	21.4	21.9	25.3	23.8	21.8
Construction and services	67.3	67.4	67.5	66.9	63.9	65.6	67.5
Memorandum items:							
GDP growth (percent)			5.6	8.4	8.2	1.8	1.1
GDP growth excluding INTEL (percent)			5.6	6.3	2.8	3.8	2.7

[20] In an econometric analysis of the determinants of private investment, Cordero (op. cit.) finds a strong negative influence of interest rates.

[21] The fiscal impulse, calculated using the standard WEO methodology, increases (and fiscal policy becomes more expansionary) when capacity utilization increases and vice versa. A similar procyclical tendency is evident in monetary policy.

COSTA RICA: FUND RELATIONS
(As of December 31, 2002)

I. Membership Status:

Joined: January 8, 1946
Status: Article VIII

II. General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	164.10	100.0
Fund holdings of currency	144.11	87.82
Reserve tranche position	20.00	12.2
Holdings exchange rate		

III. SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	23.73	100.0
Holdings	0.06	0.27

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-By	11/29/95	2/28/97	52.00	0.00
Stand-By	4/19/93	2/18/94	21.04	0.00
Stand-By	4/08/91	9/30/92	33.64	25.64

VI. Projected Obligations to the Fund (SDR million): Based on existing use of resources and present holdings of SDRs):

	Forthcoming			
	2003	**2004**	**2005**	**2006**
Principal				
Charges/interest	0.46	0.45	0.45	0.45
Total	**0.46**	**0.45**	**0.45**	**0.45**

VII. Exchange Rate Arrangements: Costa Rica has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. Costa Rica's current exchange arrangement is a crawling peg. The central bank adjusts the exchange rate daily on the basis of the differential between inflation in Costa Rica and its main trading partners. Buying and selling exchange rates were 368.57 and 369.12, respectively, for September 30, 2002.

VIII. Last Article IV Consultation: The 2001 Article IV consultation was concluded by the Executive Board on July 30, 2001 (SM/01/190). Costa Rica is on the standard 12-month Article IV consultation cycle.

IX. FSAP Participation and ROSCs Assessments: An FSAP mission visited Costa Rica on October 22–30 and December 5–13, 2001. A ROSC mission visited Costa Rica in June 2002.

X. Technical Assistance:

Department	Dates	Purpose
STA	April 2002	Establishment of an integrated data base for Costa Rica
	February 2001	Assist in preparing the SDDS metadata and improving the compilation of the monetary data.
	November 2000	Follow-up on balance of payments statistics.
	July/December 1999	Balance of payments and banking statistics.
MAE	March 2000	Assess the condition of the banking system and the regulatory and prudential framework.
	February 1999	Strengthening the financial management and procurement systems.
	September 1998	Monetary programming and liquidity forecasting, the use of monetary instruments, and the development of a secondary market for government securities.
	March 1998	Reforming the payments system.
FAD	July 2002	Tax Policy and administration
	December 1999	Assess the fiscal database and develop a working plan to improve statistics.
	November 1999	Advice on tax policy.
INS	November 2001	Regional course on financial programming and policies, Costa Rica.

Costa Rica: Relations with the World Bank

I. Financial Relations

(in millions of U.S. dollars as of December 31, 2002)

IBRD/IDA/IFC Operations by Sector	Committed [1]	Disbursed	Debt Outstanding
Agriculture	56.8	56.8	1.2
Education	28.6	28.6	10.7
Electric Power & Other Energy	117.4	117.4	0.0
Environment	32.6	10.5	10.5
Finance	15.0	15.0	0.0
Health, Population & Nutrition	39.0	21.6	15.9
Industry	4.9	4.9	0.0
Oil & Gas	3.0	3.0	0.0
Public Sector Management	3.5	3.5	0.0
Telecommunications	57.9	57.9	0.0
Transportation[2]	166.3	166.3	18.1
Water Supply and Sanitation	42.0	41.0	10.4
Multisector	205.3	205.3	25.8
TOTAL	**772.3**	**731.8**	**92.6**

IBRD Loan Disbursements (US$ millions, as of December 31, 2002)	1997	1998	1999	2000	2001	2002
Total Net Disbursement	**-34.3**	**-20.7**	**-22.7**	**-27.4**	**-18.8**	**-11.3**
Gross Disbursement	19.6	19.8	11.6	5.8	8.4	11.6
Amortizations	53.9	40.5	34.4	33.3	27.2	22.9

1/ Net of cancellations.

2/ Includes one IDA project (US$6.4 million)

II. Recent World Bank Activities

Current Portfolio: thc Bank's portfolio in Costa Rica consists of three active IBRD projects (for a total of $76 million) and two Global Environmental Facility (GEF) grants (for a total of US$15 million). Combined, all five projects have US$48 million undisbursed. The Ecomarkets Project and the Health Sector Strengthening and Modernization Project will be active until 2006, while the Water Supply project is schedule to close by December 31, 2003. In addition, the Biodiversity Grant will be active until 2005 and the Ecomarkets Grant until 2006.

The last Bank study on Costa Rica was the "Costa Rica Social Spending and the Poor" published in October 2002. The report includes a poverty profile and identifies the main vulnerable groups in the country. It also provides a social sector expenditure review, which identifies opportunities to improve the effectiveness of social spending.

Bank's Future Assistance: In recent years, the Bank's lending program in Costa Rica has been small, and thc program of economic and sector work was reduced. However, the Pacheco Administration has requested greater Bank involvement in financial and technical assistance. As a result of this request, the Bank will begin preparation of a 2004-2006 Country Assistance Strategy (CAS) in the first quarter of 2003 that would support the Government's development program. The CAS will evaluate potential assistance on the areas of Infrastructurc, Education, Poverty and Social Protection, Public Sector Reforms and Financial Sector, among others.

COSTA RICA: RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

I. FINANCIAL RELATIONS

(In millions of U.S. dollars)

A. Operations (as of October 1, 2002)

	Approved	Disbursed	Available
Loans in execution	583.9	209.1	374.8
Energy	350.0	120.6	229.4
Education	28.0	6.7	21.3
Health and sanitation	93.0	66.0	27.0
Land title register reform	65.0	0.0	65.0
Reform and public sector modernization	46.3	15.4	30.9
Pre-investment	1.6	0.4	1.2
Nonreimbursable technical cooperation	18.3	9.5	8.8
Total	**602.2**	**218.6**	**383.6**

B. Loan Disbursements

	1997	1998	1999	2000	2001	Proj. 2002
Disbursements	**124.9**	**54.5**	**52.4**	**80.3**	**31.5**	**48.8**
Amortization	60.3	58.2	87.4	77.9	80.4	80.0
Interest and charges	57.2	57.2	58.2	57.8	54.0	50.8
Net cash flow	**7.4**	**-60.9**	**-93.2**	**-55.4**	**-102.9**	**-82.0**

C. Lending Program for 2002–03 (tentative)

Competitiveness support program	100.0
Sustainable agricultural support program	17.5
Science and technology program	50.0
Pacific integration road corridor (PPP)	50.0
Urban poverty reduction program	50.0
Health ministry training program	8.0
Total	**225.5**

II. Recent Activities

A Policy dialogue paper was prepared during the first months of 2002 for the incoming administration, and was discussed with the new economic cabinet during a full-day session on June 7, 2002. The document was centered on policies to improve competitiveness. The conclusions of this first round in the dialogue with the new administration are being incorporated in the Strategy Paper, or EBP (*Estrategia del Banco para el País*), currently under preparation.

III. Future Plans

A profile of the Strategy Paper (EBP) will be presented for discussion to the authorities in a forthcoming mission, due in early November, 2002. The proposed strategy is based on four pillars: macroeconomic stability, competitiveness, human capital generation, and institutional strengthening. A preliminary and tentative operational program will also be discussed, including activities and non-financial outputs aimed at promoting consensus for reforms.

COSTA RICA: STATISTICAL ISSUES

General

The overall quality of macroeconomic statistics has improved in recent years. However, there are some areas of concern that include the consistency of data on the financing of the public sector domestic debt, and consistency between balance of payments and external debt statistics. The authorities are cooperating fully in providing available data to the Fund through electronic means and participation in the Special Data Dissemination Standard (SDDS). A mission visited San José from July 6-19, 2001 to prepare the data module of Report on the Observance of Standards and Codes (ROSC).

Real sector

New series of national accounts compiled in accordance with the *SNA 1993* and based on a 1991 benchmark year have been published in 2000, thus replacing the old series with a 1966 base year. Although the new series represent an important improvement in the quality of the national accounts estimates, a STA mission that visited the country in November 1999 found that weaknesses remains in the source data. That mission also noted weaknesses in private consumption, gross fixed capital formation, and changes in inventories components of GDP estimates by expenditure. The ROSC mission found that weakness of data sources were still adversely affecting the quality of the national accounts, especially the quarterly estimates. Further improvements of the national accounts require improved source data by strengthening the statistical system, establishing and maintaining a statistical register, and regularly conducting economic surveys and censuses.

Government finance statistics

The methodology for compiling government finance statistics follows the guidelines of the *1986 A Manual on Government Finance Statistics* (1986 GFSM). However, the staff has noted some problems in the compilation of data on the operations of the central government, which derived from combining inappropriately information on a cash and an accrual basis. Moreover, there are significant discrepancies between the above-the-line fiscal figures and estimates of the deficit from the financing side. Costa Rica reports data for publication in IFS and the GFS yearbooks.

Monetary statistics

After assistance provided by STA in 1996, 1998, and 2001, provided by STA, improvements were made to the classification, coverage, and timeliness of the money and banking statistics, in particular those pertaining to the Central Bank of Costa Rica. There is a need to collect information on offshore operations of bank conglomerates. A recent STA mission compiled enhanced monetary data, which include balance sheets of cooperatives, savings and loans institutions, and private financing corporations for publication in *IFS*. The mission also noted inconsistencies in the sectorization principles applied in the compilation of data for the central bank, other depository corporations, and other macroeconomic statistics. The mission made several recommendations, including the standardized sectorization of institutional units, and the development of a unified reporting system for monetary data that would meet the needs of STA and WHD.

Balance of payments statistics

Substantial progress in the application of appropriate methodologies and procedures in the compilation of balance of payments statistics has been achieved after the two technical assistance missions on balance of payments statistics (1999 and 2000), including the estimation of quarterly balance of payments statistics and the preparation of a provisional statement on international investment position. Costa Rica has reported to STA quarterly balance of payments (1999-2001) and partial international investment position data (1996-1999) for publication in *BOPSY* and *IFS*. However, shortcomings relating to incomplete coverage of the financial account that excludes equity holdings abroad and long-term liability of private banks. Furthermore, the coverage of service data is limited. Statistical techniques have been developed to eliminate the effects of valuation changes from reserve flows, but no such adjustments are made to the flows of foreign financial assets and liabilities of banks.

COSTA RICA: CORE STATISTICAL INDICATORS
(As of January 21, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	01/14/03	12/31/02	12/31/02	12/31/02	12/31/02	12/31/02	12/31/02	11/30/02	12/31/01	11/30/02	2001	9/30/02
Date Received	01/14/03	01/15/03	01/10/03	01/10/03	01/10/03	01/10/03	01/08/03	01/10/03	10/11/02	01/10/03	11/20/02	01/10/03
Frequency of Data	W	W	M	D	M	M	M	M	Q	M	A	M
Frequency of Reporting	D	D	M	M	M	M	M	M	Q	M	A	M
Source of Update	A	A	A	A	A	A	A	A	A	A	A	A
Mode of Reporting	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C
Confidentiality	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of Publication	D	W	M	M	W	M	M	M	M	M	A	M

Statement by the IMF Staff Representative on Costa Rica
March 3, 2003

The information on recent developments provided below has become available since the staff report was circulated and does not affect the thrust of the staff appraisal.

- **Economic activity has picked up**. The central bank's overall activity index recorded a year-on-year increase of 2.8 percent in December 2002, compared to an increase of 2.5 percent in November. This is in line with estimates in the staff report.

- **Inflation has slowed.** The inflation rate in January 2003 was 9.2 percent (year on year), down from 9.7 percent at end-2002. This decline contributed to a decision by the central bank to reduce its reference interest rate from 18.0 percent at end-2002 to 17.8 percent in January 2003.

- **Public sector wage increases have been limited.** As anticipated in the staff report, the government issued a presidential decree limiting the January semi-annual public sector wage adjustment to 3.5 percent on average. Workers at the bottom of the wage scale received more than the average increase, while those at the top, received no increase. The wage bill in the public sector, which includes second-round effects on wage bonuses, will increase by around 6 percent in the first semester of 2003, or broadly in line with projected nominal GDP trends.

- **Negotiations with public enterprises are proving difficult**. Efforts to limit the increase in investment spending by the state telecommunications and electricity company (ICE) encountered a setback. Facing strong resistance from the executive board of ICE and its powerful labor union, last weekend the authorities agreed to investment ceilings for this enterprise that exceeded by far their original objective. In contacts with the authorities, they reiterated their commitment to reducing sharply the fiscal deficit in 2003 and indicated that they already have begun to consider alternative measures to ensure achievement of this objective.

- **The sovereign Eurobond issues mentioned in the staff report were successfully completed.** Two Eurobonds—totaling US$450 million—were issued in late January 2003 (with 5- and 10-year maturities). The average spread relative to comparable U.S. treasuries was 410 basis points, about 100 basis points higher than the previous Eurobond issue in January 2002. Receipts from these bonds are expected to cover most of the government's external financing needs for 2003. Net international reserves rose to US$1.5 billion at end-January 2003, largely reflecting the proceeds from these issues.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 03/29
FOR IMMEDIATE RELEASE
March 7, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Costa Rica

On March 3, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Costa Rica.[1]

Background

The Costa Rican economy developed successfully in the 1990s: economic growth averaged about 5 percent annually during the decade, reflecting high domestic investment and progress on structural reforms, large inflows of foreign direct investment, declining inflation, and a stable exchange rate regime.

However, since 2000, economic growth has slowed to around 2 percent, inflation has remained at 10 percent, and unemployment has remained at about 6 percent. The external current account deficit has increased to about 5.5 percent of GDP, reflecting a sharp increase in imports of capital goods by public enterprises, and a loss of dynamism of exports, associated in part with some weakening of international competitiveness. Net official international reserves have remained at about 2-2½ months of imports, covering only the public sector component of short term external debt.

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[1] 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 prepared a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of the Executive Directors, and this summary is transmitted to the country's authorities.

These developments reflected a combination of a weaker domestic policy framework and a deterioration in the external environment. The public sector deficit surged in recent years, reaching almost 6 percent of GDP in 2002 (from 3.8 percent in 2001). Current expenditures, mainly wages and pensions, rose by nearly 2 percentage points of GDP, while investment expenditures by public enterprises increased by about half of 1 percent of GDP. Costa Rica has been able to maintain ample access to capital markets, including the recent placement of two bonds for US$450 million in international capital markets. However, the rise in public debt to 52 percent of GDP in 2002 (two-thirds denominated in foreign currency), from 42 percent in the late 1990s, has contributed to an increase in domestic interest rates.

The rising difference between interest rates in colones and U.S. dollar terms combined with a crawling peg exchange rate regime have fueled large short-term capital inflows. Bank deposits have increased at an annual rate of nearly 20 percent during recent years, allowing rapid growth in credit to the private sector (25 percent annual increase).

There is a need for further steps to strengthen the health of the financial sector, although some progress has already been made in implementing the recommendations of the 2001 FSAP mission, especially in the area of supervision. Public sector banks will need to be kept fully capitalized, weaknesses in prudential regulations as well as risk and liquidity management will need to be eliminated, and bank supervision, especially of the large offshore banking system will need to be strengthened further. Steps also will be needed to minimize the risks arising from the high degree of dollarization of deposits and credit (about half of bank deposits and credit is denominated in foreign currency and about half of dollar credit is extended to non-dollar earners).

Progress in other areas of structural reform has also slowed in recent years. In particular, the privatization process lost dynamism following the failure in 2000 of efforts to open to private initiative the telecommunications sector and key economic sectors remain dominated by large public enterprises. Pension system reforms are also incomplete and there is a need to ensure that it does not become a serious burden on the public finances over the medium term.

The authorities are aware of the need to address potential vulnerabilities, advance structural reforms, and bolster further the health of the financial sector and have begun to take steps to re-orient economic policies. They intend to maintain full ownership of this effort and have not requested financial assistance from the Fund.

In the fiscal area, a number of temporary measures have been introduced since late 2002, including an increase in personal and corporate income tax rates and certain excises and stamp duties. A ceiling has been placed on nominal growth in discretionary government expenditures for 2003, and limits placed on public enterprise wage and investment spending. The authorities are facing strong resistance in implementing some of these measures, but they remain committed to achieving an important reduction of the fiscal deficit in 2003.

In the coming months, the authorities intend to complement these measures with a number of structural fiscal reforms, including a tax reform that aims at broadening the tax base, improvements in tax administration, a rationalization of public expenditure that seeks to limit revenue earmarking and wage indexation, and a strengthening of government control of public enterprises, especially of their wage and investment policies. These steps aim to raise the primary balance of the public sector to at least 2.5 percent of GDP over the medium term, which, together with a resumption of rapid economic growth, would help ensure debt sustainability.

The authorities are also taking steps to bolster the health of the financial system, including measures to reinforce prudential regulation and help level the playing field among private and public banks. Steps are also being taken to strengthen supervision of offshore banks, including through the introduction of consolidated supervision of financial holdings and information-sharing agreements with countries where offshore banks are located. Reforms are also being proposed to increase the operational autonomy of public banks and strengthen risk and liquidity management in the banking system.

At the same time, the authorities intend to continue with their efforts to broaden Costa Rica's export base. The authorities are hopeful that a free trade agreement with the United States (currently being negotiated jointly with the other central American countries) will be concluded soon.

Executive Board Assessment

Directors praised Costa Rica for being at the forefront of economic and social progress in Latin America and the Caribbean over the past few decades, achieving high rates of growth, and witnessing major improvements in its social indicators. They also commended the authorities on their long-standing traditions of democratic accountability, solid institutions, and rule of law and governance. Directors noted, however, that macroeconomic vulnerabilities have increased sharply in recent years, presenting the authorities with major policy challenges. Growth has been disappointing, continuing fiscal deficits have resulted in substantial growth in public debt, and large public sector financing requirements have maintained an upward pressure on domestic interest rates, discouraging private investment and encouraging a rapid dollarization of the banking system. These developments, combined with a sharp increase in the general perception of risk in emerging markets, highlighted the need for a rapid reorientation of economic policies. Directors therefore strongly endorsed the authorities' commitment to address these vulnerabilities through a significant and comprehensive strengthening of the reform process, as well as their desire to retain full ownership of the necessary adjustment effort.

Directors noted that the most urgent policy challenge was to bring about a significant and sustained increase in the primary fiscal balance, and thus to ensure medium-term debt sustainability. They welcomed the authorities' intention to reduce the fiscal deficit in 2003 in order to stop the growth of its public debt, and the measures implemented since end-2002 to achieve this objective, including increases in tax rates, a strengthening of tax administration, and limits on expenditures. However, some of these measures are temporary in nature, and would not suffice to produce a lasting turnaround in the public finances. Hence, Directors supported the authorities' intention to seek legislative approval for, and put in place, a number of fiscal reforms recommended by several high-level commissions, namely, broadening the tax base, further strengthening tax administration, and rationalizing expenditures through reducing revenue earmarking and wage indexation. These measures are designed to achieve a permanent increase in the primary surplus of the public sector over the medium term, to a level well above the average in the 1990s.

A strengthening of the finances of the public enterprises will also be essential to achieve the targeted increase in the primary surplus over the medium term. Directors agreed with the authorities' decision to strengthen government control over public enterprise operations, especially with regard to wage and investment spending, and their indebtedness. Directors noted the strong resistance faced by the authorities and urged them to persevere with their efforts in this area.

For medium-term fiscal sustainability, Directors also noted the need to strengthen the financial viability of the pension system through increasing minimum retirement ages and lowering replacement ratios, and encouraged the authorities to start building the national consensus necessary for these actions. They equally stressed the need for further progress in privatization to ease pressures on the public sector for providing much-needed improvements in the country's infrastructure. In this context, they encouraged the authorities to adopt a more ambitious privatization program, going beyond planned concessions in the areas of road works, ports, and airports.

Directors noted that improved debt management would help reduce the vulnerabilities stemming from current debt levels. They encouraged the authorities to keep markets well informed of developments in the country, improve risk management techniques, and rely more on domestic capital markets to cover the financing needs of the government.

Directors urged the authorities to decisively address the weaknesses of the financial sector. They welcomed efforts under way to recapitalize a large public bank, to level the playing field between public and private banks, and to strengthen prudential regulation and supervision. Directors noted, however, that additional measures had been recommended by the 2001 FSAP mission. In this context, they urged the authorities to enhance the operational autonomy of public banks with a clearer separation between their commercial and development banking operations; remove the deposit requirements of private banks in public banks; establish a broadly-based but limited deposit insurance scheme; and sharply strengthen supervision of offshore banks. They also encouraged the authorities to strengthen risk and liquidity management. As regards the anti-money laundering regime, Directors noted that enforcement procedures on suspicious transactions have been improved, and encouraged the authorities to continue their efforts in this area.

Directors noted the adverse impact of the high degree of dollarization on the banking system and the public finances. They urged the authorities to take steps to address dollarization by strengthening the macroeconomic framework and by introducing appropriate changes in prudential bank regulations and removing distortions that favor lending in dollars.

In discussing the crawling peg exchange rate regime, Directors considered that progress in reducing fiscal and financial sector vulnerabilities would present a window of opportunity to explore more flexibility in exchange rate determination. The authorities were encouraged to start the preparations towards a monetary policy framework consistent with inflation targeting and an increasingly flexible exchange rate regime. In this connection, Directors recommended that attention be paid to a careful sequencing of the proposed reforms of the exchange system with reforms in the fiscal and financial sectors. More generally, Directors also considered it essential to strengthen the central bank's autonomy in the conduct of monetary policy, and to recapitalize the Bank and eliminate the source of its quasi-fiscal losses.

Directors noted the progress made by Costa Rica in opening new markets for its exports. They welcomed the start of the negotiations for a free trade agreement between the Central American countries and the United States, and pointed to the positive impact this agreement would have on export development, foreign direct investment, and economic growth. However, Directors stressed that Costa Rica's ability to take full advantage of the new foreign trade opportunities will depend largely on the progress made in addressing current vulnerabilities.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Costa Rica: Selected Economic and Financial Indicators

	1999	2000	2001	Prel. 2002	Proj. 2003
Real economy (change in percent)					
Real GDP	8.2	1.8	1.1	2.8	2.0
Consumer prices (end of period)	10.1	10.2	11.0	10.0	10.0
National savings (in percent of GDP)	12.0	12.6	13.2	15.5	12.8
Gross domestic investment (in percent of GDP)	17.1	17.1	17.8	21.0	18.1
Public finance (in percent of GDP)					
Combined public sector deficit	-3.7	-4.4	-3.8	-5.9	-4.0
Central government deficit	-2.9	-3.7	-3.8	-5.0	-4.0
Money and credit (end-year, percent change)					
Net domestic assets	5.9	21.4	8.6	12.4	10.8
Of which:					
Net claims on nonfinancial public sector	-26.5	-12.9	-63.8	70.1	-14
Credit to private sector	18.2	31.3	22.9	21.3	18.3
Liabilities to private sector	22.4	17.1	13.7	20.4	10.1
Interest rates (end of period)					
Deposit rate (time deposits)	13.9	12.7	11.6	12.6	13.6
Lending rate	27.3	27	25.8	27.9	29.2
External sector (in percent of GDP)					
Trade balance	3.2	-1.3	-5.0	-8.3	-5.3
Current account	-5.1	-4.4	-4.5	-5.5	-5.2
Change in net international reserves (in millions of U.S. dollars, increase -)	-480	154	-13	-165	0
Net international reserves (in millions of U.S. dollars) 1/	1,239	1,086	1,098	1,263	1,263
Gross reserves (in months of next year's imports of goods and services) 1/	2.5	2.3	2.1	2.4	2.2
External public debt (as percentage of GDP)	19.3	19.7	19.8	19.8	20.4
Real effective exchange rate (percent change, end-period; appreciation +)	1.7	4.7	3.8	-3.0	...

Sources: Central bank; Ministry of Finance; and IMF staff estimates.

1/ Excludes bilateral claims under negotiations with neighboring countries, which in the official statistics are classified as part of international reserves.