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Costa Rica: 2006 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Costa Rica

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with Costa Rica, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on August 1, 2006, 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 October 12, 2006. 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 supplement of October 24, 2006 updating information on recent developments;

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 30, 2006 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for Costa Rica.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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COSTA RICA

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation with Costa Rica

Approved by Markus Rodlauer and Adnan Mazarei

October 12, 2006

- **Discussions**. The 2006 Article IV consultation discussions were held in San José during July 19–August 1, 2006. The mission met with President Oscar Arias, Vice-President Kevin Casas, Minister of the Presidency Rodrigo Arias, Central Bank Governor Francisco Gutiérrez, Finance Minister Guillermo Zúñiga, Minister of Foreign Trade Marco V. Ruiz, other senior public sector officials, political leaders and representatives of congress, the private sector, academia, and labor unions.

- **Staff team**. The team comprised D. Desruelle (head), O. Hendrick, and R. Cubero (all WHD), I. Vladkova-Hollar (PDR), A. Segura-Ubiergo (FAD), and J. Vacher (MCM). A. Schipke (Regional Resident Representative in Guatemala) assisted the mission. N. Conrado (OED) participated in the final discussions.

- **Previous Article IV consultation** (July 2, 2004). Directors commended the country's strong record of social development. They encouraged the authorities to address significant remaining vulnerabilities in the fiscal, external, and financial sectors. Directors also endorsed the authorities' intention to focus monetary policy on the objective of reducing inflation.

- **Focus of the 2006 Article IV consultation**. Discussions centered on the new administration's strategy to reduce vulnerabilities and boost growth, which focuses on strengthening the fiscal position while increasing social and investment spending, reducing inflation, increasing the resilience of the financial system, and enhancing integration with the world economy.

- **Exchange arrangement**. Costa Rica maintains a crawling peg to the U.S. dollar. The colon has depreciated by about 7 percent against the U.S. dollar in the year to September. Costa Rica has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system free of restrictions on payments and transfers for current transactions.

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EXECUTIVE SUMMARY

Costa Rica's economic performance since the last consultation has been strong. Despite the oil price shock, growth has been high, supported by robust external demand and favorable conditions in international capital markets. The short-term outlook is favorable. However, the economy continues to face important vulnerabilities, including double-digit inflation, high public debt, and financial dollarization.

President Arias' administration, which assumed office in May, has set out an ambitious reform agenda. Adoption of key reforms, such as the fiscal plan and ratification of the U.S.-Central America Free Trade Agreement (CAFTA-DR), will require substantial efforts, given the administration's lack of majority in congress.

Discussions focused on the policies needed to reduce Costa Rica's vulnerabilities, enhance growth, and reduce poverty in a lasting way. The staff supported the authorities' strategy, which includes a major tax reform, recapitalization of the central bank and greater exchange rate flexibility, strengthened financial sector regulation, and ratification of CAFTA-DR. Supportive global conditions provide a good opportunity to advance the reform process.

Passage of a substantial tax reform is essential. It will allow additional spending in infrastructure, education, and social areas, while achieving a sound overall fiscal position to further reduce public debt, and support monetary policy. The staff recommended focusing the tax reform on the income tax and the VAT and urged the authorities to achieve a primary surplus of 2½ percent of GDP over the medium term.

To bring inflation down to low single digits, the authorities plan to recapitalize the central bank and move gradually to a more flexible exchange rate regime. The staff endorsed this approach, which would boost the effectiveness of monetary policy. As a first step, the authorities plan to shift from a crawling peg to a narrow crawling band.

The health of the financial sector has improved, but important challenges remain. Key areas for action include stepped-up management of foreign exchange risk in the banking system and strengthened supervision of offshore banking activities. Staff also recommended leveling the playing field between public and private banks.

The staff welcomed the authorities' determination to seek ratification of CAFTA-DR and approval of complementary reforms. The staff also supported efforts to strengthen trade links with other partners and to address structural obstacles that affect competitiveness.

I. Introduction

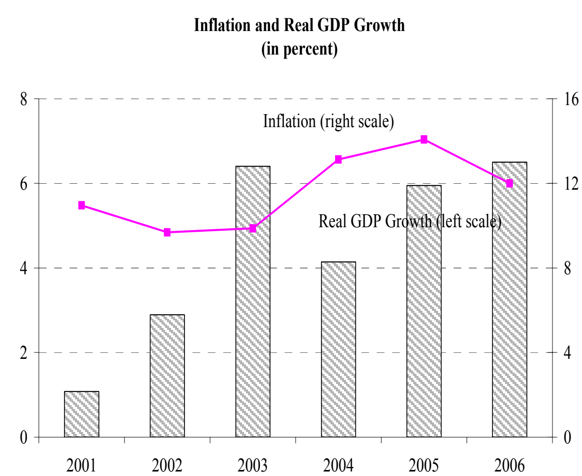
1. **This Article IV consultation provides an important opportunity to take stock of Costa Rica's achievements and the challenges ahead**. Costa Rica is a country with a long history of political stability and strong institutions. Since the last Article IV consultation in 2004, the economy has grown rapidly, spurred by rising investment and exports. However, high public debt, double-digit inflation, financial sector vulnerabilities, gaps in public infrastructure and education, and enduring poverty remain well-recognized challenges.

2. **A broad consensus exists on the fundamental goal of placing the economy on a faster growth path and on the strategy to achieve this goal**. Staff's interlocutors put particular emphasis on enhancing macroeconomic stability, enabling the private sector to create more employment, boosting public efforts in infrastructure and education, and making further efforts to address social needs. Most also supported closer integration of Costa Rica with the world economy, although some were leery of the form it would take and its potential impact on long-standing institutions.

3. **The main challenge facing the new administration of President Arias is to galvanize this broad consensus and implement on the reform agenda**. Since the May 2006 inauguration, investor and consumer confidence has surged on the expectation that long-stalled reforms would now move forward. While President Arias' party only holds 25 of the 57 parliamentary seats, local observers widely credit the new administration with the talent and experience needed to secure passage of key legislation. Nevertheless, given the complexity of Costa Rican legislative procedures and political sensitivities, approval of major reforms is likely to remain challenging.

II. Recent Economic Developments

4. **Economic growth accelerated to close to 6 percent in 2005, despite the oil price shock, while inflation remained high.** Exports, including those of the electronics industry (Box 1), spearheaded this rise in output. Domestic demand followed suit, boosted by a substantial acceleration of private investment and robust private consumption. Stoked by high oil prices and large capital inflows, inflation edged up to 14 percent in 2005. Unemployment remained constant at 6½ percent (Table 1).



5. **In 2006, economic activity has remained strong and inflation has slowly declined.** Year-on-year GDP growth reached

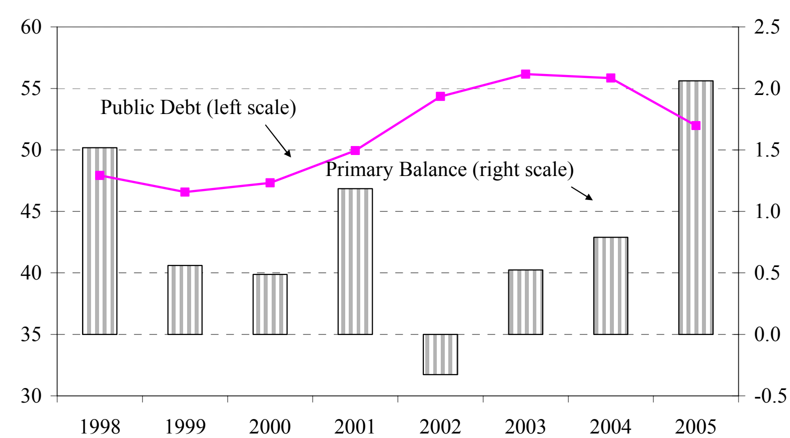
7 percent in the first quarter of this year, and the monthly index of economic activity (IMAE) showed a rate of growth slightly above 7 percent for the 12-month period ending in July 2006. Investment rose particularly strongly (19 percent year-on-year in the first quarter), fueled by large foreign direct investment inflows, including into real estate, and improved domestic business confidence. Growth has been broad-based, with the most dynamic sectors being agriculture, construction, assembly operations in free trade zones, telecommunications, and financial services. Inflation has decelerated, falling to 12 percent in July. In August 2006, according to the new consumer price index, it inched down further to 11½ percent.

The New Consumer Price Index

In August 2006, the National Institute of Statistics introduced a new consumer price index. It is based on an updated and expanded consumption basket, derived from a household survey conducted in 2004–05 (the previous index relied on a 1987–88 survey). As a result, education, transportation and other services gained much weight in the CPI, at the expense of food and clothing. The new index also incorporates many statistical improvements, including adjustments for quality changes. The old and new CPIs were spliced, using July 2006 as the base period. Hence, until June 2007, 12-month inflation measures will not be fully comparable, given methodological differences between the two series.

6. **The fiscal deficit declined to 3 percent of GDP in 2005, its lowest level in a decade**. The primary surplus reached a record level of 2.1 percent of GDP. The improvement was due to buoyant revenues, reflecting the growth dividend as well as improvements in tax and customs administration, and strict spending restraint. As a result, public debt fell to 52 percent of GDP at end 2005 (Figure 1 and Table 2.

Public Primary Balance and Debt
(In percent of GDP)



7. **The fiscal deficit fell further in early 2006, but it expected to widen for the year as a whole**. Thanks to continued tax buoyancy, capital spending restraint, and better performance of the social security and public enterprises, the fiscal deficit was near zero during the first five months of 2006, versus ½ percent of GDP in the same period in 2005. For the year as a whole, the fiscal deficit is expected to reach 3½ percent of GDP, due to

seasonality in expenditure and higher spending on the new administration's priorities, such as education, housing and minimum pensions for the poor, and public security.

Box 1. Intel's Impact On The Costa Rican Economy

Intel's operations in Costa Rica are large relative to the host economy. Operations started in 1998. By 1999, Intel accounted for 38.7 percent of Costa Rica's total goods exports and 17.7 percent of its goods imports. In 2005, its share of exports was still 20 percent.

Intel's accounts have been prone to volatility, reflected in Costa Rica's GDP, trade and FDI income figures. The table below shows Intel's contribution to the growth and volatility of GDP and external trade over the period 1996–03.

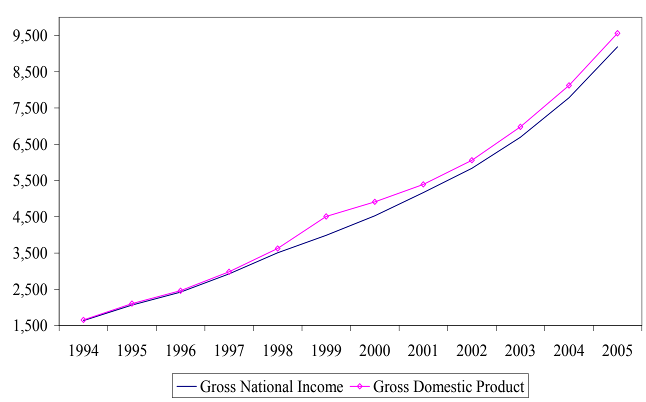
GDP, Exports and Imports
(percentage changes, 1996-03)

	Mean	Std. deviation
Real GDP	4.3	3.1
Real GDP without Intel	3.8	1.8
Exports	8.5	11.6
Exports without Intel	5.2	4.3
Imports	6.3	9.3
Imports without Intel	4.7	7.9

Source: Méndez, E, and A. Solera (2004), "Costa Rica: Volatilidad Macroeconómica y Vulnerabilidad", Banco Central de Costa Rica DIE-05-2004-DI

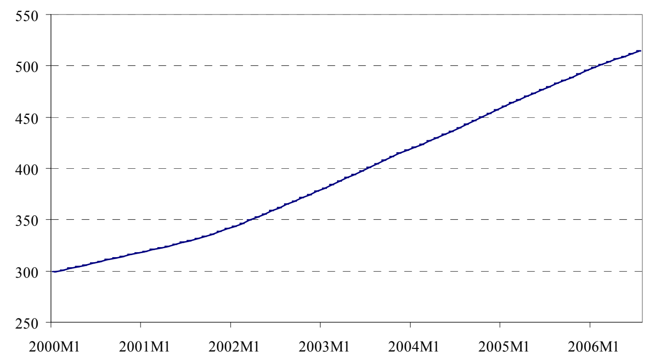
However, Intel has a more limited impact on the rest of the economy than its share in exports would suggest, because of its high import propensity, capital-intensive nature, and tax-free status. As the figure below shows, the arrival of Intel marked a widening of the GDP-GNI gap.

GDP and GNI
(in billions of 1991 colones)



8. **Despite a rising current account deficit, robust foreign direct investment and other private capital inflows have boosted international reserves**. In 2005, the large deterioration in the trade balance, driven by a sharp increase in oil imports, was partly offset by strong tourism receipts and a five-year low in profit remittances. Robust private capital inflows, including a surge in FDI into real estate and inflows into local bonds, resulted in a larger overall surplus for the balance of payments. In 2006, exports and imports continued to grow strongly, and the trade deficit widened further. Reserve accumulation has, nonetheless, continued, with NIR reaching US$2.4 billion at end-August, representing close to 4 months of nonmaquila imports and 100 percent of short-term external debt (Figure 2, Tables 3 and 7).

Bilateral Exchange rate: 2000-2006
(Colones per US$)



9. **Monetary aggregates have expanded rapidly, with monetary policy constrained by large central bank losses and the crawling peg regime.**[1] Currency issue and broad money grew at annual rates of 22 and 24 percent respectively, in the year to June 2006. Key contributing factors were the central bank's large operational deficit and sizeable accumulation of reserves, which could only be partially sterilized. Credit to the private sector expanded at a rate of 30 percent in the same period. As a share of GDP, credit is expected to rise from 35 percent in 2005 to 38 percent in 2006. The increased pace of credit growth reflected improved business expectations and a rise in investment demand, and was funded primarily through sustained deposit growth (Figure 3 and Table 4).

10. **The health of the financial sector has improved, supported by a favorable macroeconomic environment, but key vulnerabilities remain**. Bank profitability reached record levels, in both public and private banks. Reported asset quality indicators have improved markedly, with nonperforming loans down to 1½ percent of total loans (Tables 5 and 6). While the banking sector remains dominated by public banks, recent acquisitions of large private domestic banks by multinational banks have intensified the process of consolidation in the sector. Significant vulnerabilities remain, however, stemming from high

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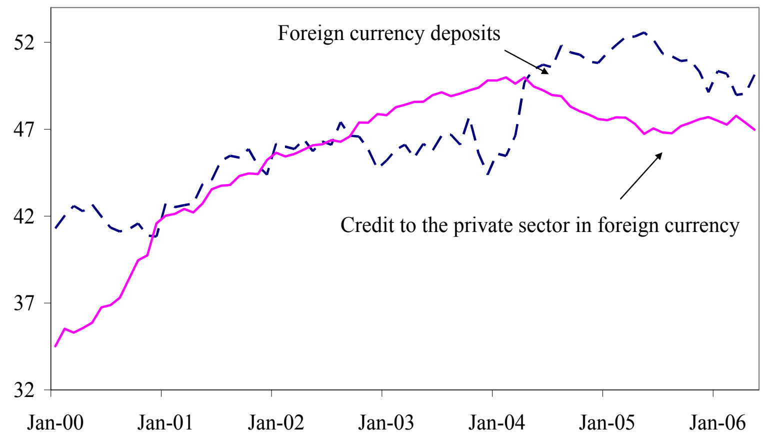
[1] The central bank maintains the rate of crawl by setting a daily reference exchange rate for intra-bank transactions, at which it commits to buying or selling any excess demand or supply by banks. From April 2006, a small spread was introduced between the buying and selling rates.

dollarization of assets and liabilities[2], sizeable and inadequately supervised offshore banking activities (equivalent, in terms of total assets, to one-fifth of the onshore banking sector), and large, albeit decreasing, holdings of public sector bonds by public banks. If sustained, the rapid increase in private credit growth could also have a negative effect on asset quality.

Financial Dollarization
(In percentage of total)



11. **While Costa Rica's social indicators compare well to those of the Central America region and income distribution has recently improved, poverty has remained significant**. Income, health, and sanitation levels are much higher and poverty rates much lower than in the region (Figure 4, Tables 8 and 9). Annual household surveys indicate that income inequality has steadily declined since 2001, partially reversing a sharp increase in inequality during the previous decade. Poverty has remained at around 20 percent in the last decade.

III. Outlook and Risks

A. Near-Term Outlook

12. **Economic growth is expected to exceed 6 percent in 2006 and then come down slightly to around 5 percent in 2007**. For the remainder of the year, activity will remain supported by strong exports and investment, as well as robust private consumption. In 2007, external demand growth, investor confidence, and a further rise of bank credit would

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[2] As Figure 3 shows, deposit and credit dollarization are still high (though they seem to have leveled), fueled mainly by a small premium for investing in local currency and a dollar lending rate that is well below the exchange-adjusted local currency rate. Liability dollarization may also have been fostered by the perception of relatively low currency risk associated with the long-standing crawling peg regime.

continue to foster a rapid pace of growth. The slight deceleration from 2006 would stem primarily from more subdued growth in the electronics sector and, possibly, a more restrictive fiscal stance.

Key Macroeconomic Indicators
(In percent of GDP, unless otherwise indicated)

					Prel	Proj	
	2001	2002	2003	2004	2005	2006	2007
Real GDP growth (in percent)	1.1	2.9	6.4	4.1	5.9	6.5	5.0
Inflation (percent, end of period)	11.0	9.7	9.9	13.1	14.1	12.0	9.0
Overall public sector balance	-3.8	-5.5	-5.1	-4.2	-3.0	-3.4	-2.6
Public sector primary balance	1.2	-0.3	0.5	0.8	2.1	1.8	2.6
Public sector debt	49.9	54.3	56.2	55.8	52.0	48.8	46.8
External current account balance	-3.7	-5.1	-4.8	-4.3	-4.7	-4.9	-4.8
Foreign Direct Investment	2.8	3.9	3.3	4.3	4.3	4.7	4.1
NIR (months of non-maquila imports)	3.0	3.0	3.6	3.2	3.5	3.4	3.5
Gross External Financing Requirements	16.9	18.0	18.3	17.4	16.9	16.3	16.2

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

13. **While risks are evenly balanced for the remainder of 2006, they appear somewhat tilted to the downside in 2007**.

- ***The Costa Rican economy is vulnerable to global downside risks, particularly a sharper-than-expected slowdown in U.S. activity, and to the fate of domestic reforms***. With strong linkages to the United States through trade, FDI, and capital flows, a decline in U.S. growth would weigh heavily on Costa Rica. A failure to deliver on the reform agenda could also have a significant negative impact on consumer and business confidence.

- ***Conversely, exports and investment could continue to surprise on the upside***. As noted, strength in these factors has boosted short-term indicators of activity, which have risen faster than forecast GDP growth for this year.

B. Medium-Term Outlook

Baseline Scenario

14. **The staff's medium-term baseline scenario assumes passage and implementation of key reforms in 2007, which would underpin growth and foster price stability**. A comprehensive fiscal reform and sound fiscal policy would allow for higher spending in priority areas and put public debt on a sustained downward path (Appendix I). Inflation would decline markedly, as the recapitalization of the central bank and a more flexible exchange rate regime increase the effectiveness of monetary policy. Implementation of CAFTA would deepen integration within the region and with the U.S. market, spur FDI, and boost exports.

Key Macroeconomic Indicators under Baseline Scenario
(In percent of GDP, unless otherwise indicated)

	Prel	Proj					
	2005	2006	2007	2008	2009	2010	2011
Real GDP growth (in percent)	5.9	6.5	5.0	5.0	5.0	5.0	5.0
Inflation (percent, end of period)	14.1	12.0	9.0	6.0	4.0	3.0	3.0
Overall public sector balance	-3.0	-3.4	-2.6	-2.3	-1.8	-1.4	-1.3
Public sector primary balance	2.1	1.8	2.6	2.5	2.5	2.5	2.4
Public sector debt	52.0	48.8	46.8	45.0	43.1	41.4	39.7
External current account balance	-4.7	-4.9	-4.8	-4.4	-3.6	-3.2	-3.1
Foreign Direct Investment	4.3	4.7	4.1	4.4	4.6	5.2	5.6
NIR (months of non-maquila imports)	3.5	3.4	3.5	3.4	3.3	3.2	3.2
Gross External Financing Requirements	16.9	16.3	16.2	16.4	16.1	14.4	13.7

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

No Reform Scenario

15. **However, in an alternative scenario characterized by the absence of reforms, significant vulnerabilities would remain, leading to a weaker medium-term outlook**. Failure to introduce fiscal reforms would lead to a deterioration of the fiscal position. It would also jeopardize the recapitalization of the central bank, potentially leaving in place large central bank losses. Failure to ratify and implement CAFTA-DR would prevent Costa Rica from taking full advantage of regional trading opportunities, affecting investor confidence and the country risk premium. Overall, lack of progress on major reforms would have a significant negative impact on investment, exports, growth, and poverty reduction.

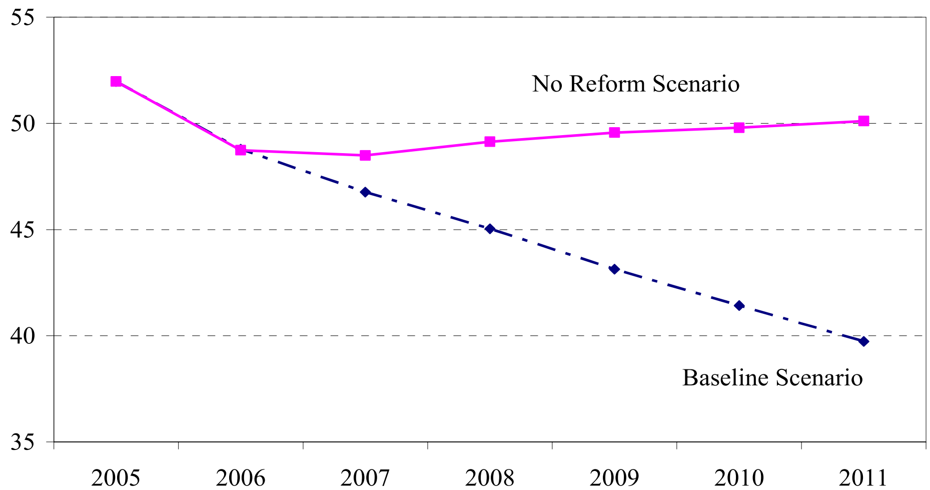
Key Macroeconomic Indicators under No Reform Scenario
(In percent of GDP, unless otherwise indicated)

	Prel	Proj					
	2005	2006	2007	2008	2009	2010	2011
Real GDP growth (in percent)	5.9	6.5	4.5	3.0	3.0	3.0	3.0
Inflation (percent, end of period)	14.1	12.0	10.0	10.0	10.0	10.0	10.0
Overall public sector balance	-3.0	-3.4	-4.2	-4.7	-5.0	-5.0	-5.1
Public sector primary balance	2.1	1.8	1.1	1.1	1.0	1.1	1.0
Public sector debt	52.0	48.7	48.5	49.1	49.6	49.8	50.1
External current account balance	-4.7	-4.9	-4.8	-4.5	-4.2	-4.1	-4.1
Foreign Direct Investment	4.3	4.7	4.1	4.0	4.0	4.0	4.0
NIR (months of non-maquila imports)	3.5	3.2	3.2	3.0	2.9	2.7	2.6
Gross External Financing Requirements	15.6	18.3	16.7	16.5	17.5	14.7	16.1

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

16. **Under this alternative scenario, the debt dynamics could become a source of risk**. Public debt would remain high, at around 50 percent of GDP by 2011, leaving the fiscal position vulnerable to shocks. Under various illustrative shocks, public debt would move above 60 percent of GDP; this would be the case following a permanent shock lowering growth by half its historical (ten-year) standard deviation, a real exchange rate depreciation of 30 percent, or a contingent-liabilities shock of 10 percent of GDP. A combination of such shocks would obviously have an even more severe impact on debt dynamics.

Public Debt Dynamics
(In percent of GDP)



IV. Policy Discussions

17. **Discussions centered on the authorities' strategy to address Costa Rica's vulnerabilities, boost growth, and reduce poverty in a lasting fashion**. The staff supported the authorities' overall strategy, which focuses on four policy areas: (i) strengthening the fiscal position while allowing for higher and more efficient spending in priority areas; (ii) recapitalizing the central bank and moving toward a more flexible exchange rate system; (iii) enhancing regulation and supervision of the financial sector; and (iv) ratifying and implementing CAFTA-DR. The authorities have submitted to Congress, or are finalizing for submission, several draft bills including on tax reforms and the opening of the telecommunication and insurance sectors.

18. **Recent years have seen a continuous and close dialogue between the Fund and the authorities, but progress in implementing key reforms has been limited since the last Article IV consultation.** The staff has had frequent and constructive policy exchanges with the authorities during the last two years. Substantial technical assistance has been provided by the Fund, which the authorities have found useful for the design of major reforms. However, due to political constraints, implementation of important reforms highlighted in the previous Article IV consultation has been limited.

A. Fiscal Policy

19. **The authorities and staff agreed that a comprehensive tax reform needs to be at the center of the reform agenda**. This reform has three main objectives: entrenching public debt sustainability, permitting recapitalization of the central bank, and allowing higher spending in priority areas. To achieve these goals, the authorities indicated that they would seek to increase tax revenue by 4 percentage points of GDP.

20. **The staff supported the thrust of the authorities' tax reform plan, with one exception**. The plan included: (i) transforming the existing sales tax into a broader-base value-added tax, while maintaining a tax rate of 13 percent; (ii) broadening the income tax base; (iii) a tax on luxury residences; (iv) a flat tax on business registration; and (v) a financial transactions tax (FTT). Staff recommended focusing efforts on reforms of the income tax and the VAT, given their potential to yield substantial additional revenue provided exemptions are strictly limited. It also noted that there was a potential to raise real estate taxes, which were low by international standards. Staff expressed strong reservations about the introduction of an FTT in light of international experience, which suggest that FTTs are often an unstable source of revenue and can have a sizeable negative impact on financial intermediation.

Key Elements of the 2006 Tax Reform

Tax Measures	Projected Yield percent of GDP
Total	**2.5**
Valued Added Tax (VAT)	1.2
Income Tax	0.8
Flat fee on business registration	0.2
Tax on "luxury" real estate	0.3

21. **Since the Article IV consultation mission, the authorities have submitted to congress three tax bills and kept in the legislative agenda one (on income tax) dating from the previous legislature. In staff's estimates, these bills could yield up to 2.5 percent of GDP**. About half of this amount would come from the VAT and another one-third from the income tax (this estimate does not include an FTT, which has not been submitted to parliament). Given the congressional agenda, approval of these bills is unlikely to occur before early 2007. Once adopted, some of the reforms, such as the VAT, would yield additional revenue beginning in 2007, while changes to the income tax would only have an impact in 2008. Thus, the tax reform could bring in additional revenues of about 1.5 percent of GDP in 2007 and the remaining 1.0 percent of GDP in 2008. Should the authorities wish to raise more revenue, staff suggested that consideration be given to raising the VAT rate by one or two percentage points.

22. **The authorities and the staff agreed that a public sector primary surplus of 2½ percent of GDP is needed over the medium term.**

- This would bring about a reduction in public debt to about 40 percent of GDP by 2011, which together with an improvement in debt structure, would reduce Costa Rica's vulnerability to exogenous shocks.

- The implied increase in primary surplus of 1 percent of GDP, compared with 2006, would be covered by the initial proceeds from the tax reform. Additional revenues could then be allocated to higher expenditure in education, infrastructure, and social need.

- Recapitalization of the central bank should be a priority. The necessary transfer of securities to the central bank would entail an estimated annual interest cost to the central government of around 1¼ to 1½ percent of GDP. The additional tax revenues from the tax reform would allow the central government to cover this annual cost, without affecting noninterest budgetary spending or recurring to higher borrowing.

23. **In complement to the tax reform, the authorities and the staff discussed other avenues to strengthen public finances:**

- **Strengthening tax administration**. Important measures have been taken in recent years to strengthen tax administration. Further steps will be critical to ensure that, once adopted by congress, the new tax laws can be effectively implemented. The Tax Administration Directorate is likely to require additional resources for this purpose.

- **Reducing public expenditure rigidities**. Constitutional mandates and extensive earmarking of revenues result in great rigidity of budget expenditures. To make it possible to reorient expenditure to priority areas, it would be useful to consider how existing rigidities can be alleviated and new constraints avoided. For instance, the legal framework could be strengthened to avoid unfunded spending mandates.

- **Developing a multiyear budget framework**. A medium-term framework would enhance policy transparency. In particular, it would clarify the links between the need for additional revenues, reducing public debt, and additional spending in priority areas.

- **Using efficient and transparent mechanisms to increase infrastructure investment**. A new public concessions law, which would reduce fiscal contingency risks and make the procurement process more efficient, is expected to be adopted soon. The authorities are committed to undertake spending on infrastructure in a transparent manner. In the context of the Fund pilot project on public investment, the staff evaluated two large public enterprises and concluded that, under current regulations, one of them posed little risk for public finances. Thus, this enterprise might be excluded from consolidated fiscal accounts, which could alleviate constraints on investment.

- **Further enhancing public debt management**. Significant progress has been made on this front, which has resulted in lengthened debt maturities and a higher share of debt at fixed interest rates. The policy of pooling all public funds in one account has also improved cash flow and debt management. The staff suggested revising the legal framework to facilitate pre-financing operations when market conditions are favorable.

- **Strengthening regional tax cooperation.** Efforts to attract investment should avoid eroding the tax base. In this regard, the staff encouraged continued efforts to develop a regional code of good practices on tax incentives for investment.[3]

24. **The draft 2007 budget recently submitted to parliament is consistent with the fiscal strategy outlined above, but not without some risk**. The budget, which in accordance with the law does not reflect any anticipated revenue from tax reforms not yet approved, envisages a broadly unchanged primary surplus. Additional spending, including a new program of conditional cash transfers for poor families with children of school age as well as increased outlays on social housing and roads, would be financed from savings on the interest bill and buoyant tax revenues. The staff saw a risk that tax revenues may be somewhat over-estimated and cautioned the authorities to maintain a prudent approach in executing the budget.

Costa Rica: Budget Proposals
Central Government

	(In billion colones)		(In percent of GDP)		
	2006	2007	2006	2007	Dif
Current Revenues	1,474	1,869	14.0	14.4	0.4
Tax revenues	1,411	1,802	13.4	13.9	0.5
Non-tax revenues	63	67	0.6	0.5	-0.1
Expenditure	1,780	2,164	17.0	16.7	-0.2
Non-interest expenditure	1,311	1,665	12.5	12.8	0.4
Interest	469	500	4.5	3.9	-0.6
Primary Surplus	163	205	1.5	1.6	0.0
Overall Balance	-306	-295	-2.9	-2.3	0.6
Memorandum Item					
Nominal GDP asumption	10,497	12,955			

Source: Ministry of Finance

B. Monetary and Exchange Rate Policies

25. **The staff endorsed the authorities' decision to move from a crawling peg to a crawling band in the near future, as a first step toward greater flexibility of the exchange rate**. The long-standing crawling peg regime has served to maintain the real exchange rate relatively stable, but its limitations have become apparent. In the face of increasing capital inflows, the peg has rendered monetary policy largely endogenous, with ensuing difficulties in the fight against inflation. The peg has also discouraged agents from

[3] A key goal of the code of conduct would be to limit tax incentives for investment in order to avoid harmful "tax competition" that would erode the (already) low revenue base of countries in the region.

hedging against exchange rate risk, thus stimulating liability dollarization and foreign-currency lending to non-foreign-currency earners (Box 2). Accordingly, the staff supported an initial switch to a relatively narrow band. As economic agents internalize currency risks, the band should be gradually widened and the exchange rate replaced by another nominal anchor. In light of the instability of money demand, an inflation target would ultimately be the most effective anchor, provided that associated pre-requisites are in place.[4] In the transition toward greater flexibility, the authorities could consider steps to increase the financial system's foreign currency liquidity coverage, as financial dollarization can only be expected to fall gradually (Box 2).

26. **The staff welcomed measures taken to facilitate the transition toward greater exchange rate flexibility**. In April 2006, a narrow bid-ask spread for foreign exchange transactions with the central bank was opened in order to foster development of the interbank market. The central bank has made progress in setting up a new electronic platform (MONEX) to conduct foreign exchange market transactions. The authorities have also issued new regulations to increase the limit on daily changes in banks' foreign currency positions and define the rules for central bank intervention in the exchange market. New regulations for the development of exchange market derivatives and hedging instruments are being prepared.

27. **In anticipation of the change in exchange rate regime, the authorities have taken steps to modify the monetary policy framework**. Since January 2006, the rate of crawl of the exchange rate has been set based on expected rather than past inflation; this may help anchor price expectations on the central bank's announced inflation objectives. Regulations on reserve requirements were amended to reduce day-to-day volatility. In March 2006, the central bank changed its policy interest rate from the 30-day deposit rate to the overnight deposit rate. Finally, the central bank decided to allow electronic deposits from the public into its short-term deposit facilities, to enhance the transmission of policy rate decisions to deposit rates in the banking system.

[4] The authorities are currently working, with assistance from the Fund, to put in place the pre-conditions that would eventually enable them to move to an inflation targeting framework.

Box 2. Financial Dollarization

Given the high level of financial dollarization in Costa Rica, the authorities are seeking to reduce the exposure of the public sector and private borrowers to exchange rate risk and that of the financial system to currency-induced credit and liquidity risks.

The banking system appears currently well-placed to cope with dollarization-related credit risk, which stems from foreign-currency lending to non-foreign-currency earners. Forex loans to nonforex earners account for 51 percent of credit by, and 370 percent of capital of, private banks. Thus, a small default rate by nonforex earners could have a substantial negative effect on banks' capital. However, cash flow analyses suggest that, given the relatively high average income of these borrowers, only severe forex shocks would significantly impair their loan repayment capacity.

The high degree of dollarization is an underlying source of vulnerability of the financial system, but does not pose a significant foreign-currency liquidity risk in the near term. The net liquid forex assets of the banking system exceed dollar demand deposits. However, when broader sources of potential dollar claims are included, the banking system's liquid reserve assets are found to be below those of other highly dollarized emerging markets. While there are no clear benchmarks for these indicators, this evidence suggests that Costa Rica might consider boosting its foreign-currency liquidity coverage (e.g., by enacting a liquidity requirement on foreign currency deposits), in parallel with regulatory measures to reduce financial dollarization.

Cross Country Reserve Coverage Indicators, Emerging Markets (EM), 2005

	Reserves to Short-Term External Debt on Remaining Maturity (1)	Reserves to Foreign Currency Deposits (2)	Reserves to M2 (3)	Augmented Reserves to Foreign Currency Deposits 1/ (4)	Augmented Reserves to M2 1/ (5)	Augmented Reserves to M2 and STEDRM 1/,2/ (6)
Costa Rica	**0.9**	**0.5**	**0.2**	**0.8**	**0.4**	**0.3**
Median for all Latin American (LA) EM	1.3	1.7	0.3	2.1	0.4	0.3
Median for dollarized LA 3/	1.4	0.8	0.5	1.2	0.8	0.6
Median for other dollarized EM in the world 3/	1.2	1.1	0.4	1.9	0.7	0.5

Source: IFS, country data, and IMF staff calculations
1/ Augmented reserves include international reserves of the central bank plus foreign assets of commercial banks.
2/ STEDRM is short-term external debt on remaining maturity.
3/ "Dollarized" economies are defined as those with foreign currency deposits greater than 30 percent of total deposits.

Public debt structure has significantly improved in recent years, but is still sensitive to exchange and interest rate movements. About half of public sector debt is denominated in foreign currency. The share of short-term debt on remaining maturity (24 percent) is high by international standards.

28. **The authorities emphasized the need to recapitalize the central bank to eliminate a large source of money creation**. Staff recommended that the recapitalization be done in one step through the transfer of standardized negotiable treasury securities, and in an amount sufficient to restore the long-run solvency of the central bank in a low-inflation environment. The staff also recommended that the recapitalization bill include a provision to limit growth in the central bank's operating expenditures and a rule on the transfer of eventual profits to the central government.

29. **The authorities and the staff saw some limited scope to tighten monetary policy, given the inflation objective for 2007**. Under the current monetary and exchange rate policy

framework, room for maneuver is small. However, the increase in U.S. interest rates in the first half of the year had opened some room to raise further domestic interest rates, without necessarily triggering additional capital inflows.

C. Banking System

30. **Reforms to enhance financial sector supervision have proceeded at a steady, albeit slow, pace**. In July 2006, a reform to prudential regulations introduced a capital requirement for pricing risk and raised the risk weighting for Costa Rican sovereign debt in capital adequacy requirements. This has: (i) enticed public banks to reduce their asset concentration in foreign currency denominated sovereign debt; and (ii) led to a downward adjustment of capital adequacy ratios, which better reflect banks' solvency.[5] Significant progress has also been achieved in the development of credit bureaus and the classification of loan portfolios, thus improving the assessment of asset quality.

31. **The staff urged the authorities to accelerate and broaden financial sector reforms**. As noted above, the financial system still exhibits substantial vulnerabilities, associated in particular with high levels of financial dollarization, offshore banking operations, and sizeable sovereign exposure. The staff stressed the importance of the long-planned strengthening in the supervision of offshore banking activities. The authorities noted that they were finalizing revisions to the package of banking supervision reforms previously submitted to congress to simplify it and hence facilitate approval. The mission encouraged the authorities to press ahead with measures to enhance financial institutions' preparedness for greater exchange rate flexibility, notably by facilitating the development of hedging instruments against currency and interest rate risk. It also recommended that the supervisory authority continue to strengthen the monitoring of banks' asset quality and foreign currency lending to non-foreign-currency earners. The staff suggested revisiting the regulatory provisions favoring public banks so as to level the playing field between public and private banks.

[5] In 2005, the full implementation of deductions from regulatory capital of investment in financial institutions led to a decrease in capital adequacy ratios, notably in public banks.

D. Trade and Competitiveness

32. **The authorities are moving toward greater trade liberalization on a regional and bilateral basis**. They are committed to seeking ratification of CAFTA-DR by congress and are hopeful that this can be achieved in late 2006 or early 2007. In parallel, they are pressing ahead with complementary reforms, such as the strengthening of ICE, the public electric and telecommunications utility, and the opening of the telecommunications and insurance sectors. Progress is being made within the Central American customs union on tariff, tax, and customs issues. Discussions between Central American countries and the European Union on an Association Agreement are to begin in 2007. The authorities are continuing discussions on a free trade agreement with Panama, and exploring bilateral agreements with several other countries.

33. **There is wide recognition of the main structural issues that must be addressed to support the competitiveness of the Costa Rican economy**. Deficiencies in infrastructure, education, contract enforcement, property rights, business start-up costs, and export procedures are well-identified (Figure 4). PROCOMER, the trade promotion agency, is making progress toward simplifying and automating the required procedures for exporters, and identifying targets for document clearance times. Nonetheless, lack of progress in reducing regulatory costs could begin to affect Costa Rica's relative attractiveness in the region and globally (Box 3).

E. Other Issues

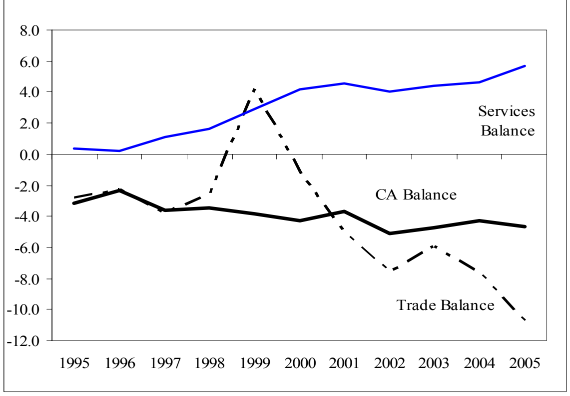
34. **The authorities informed staff that they stood by their commitment to deliver debt relief in the context of the enhanced HIPC initiative**. They mentioned that, following a recent contact from the debtor country, they were hopeful that bilateral discussions on debt relief terms would resume shortly. The authorities also noted that any provision of debt relief would need to be approved by the legislative assembly. The staff indicated its readiness to provide any assistance necessary on related technical matters.

V. Staff Appraisal

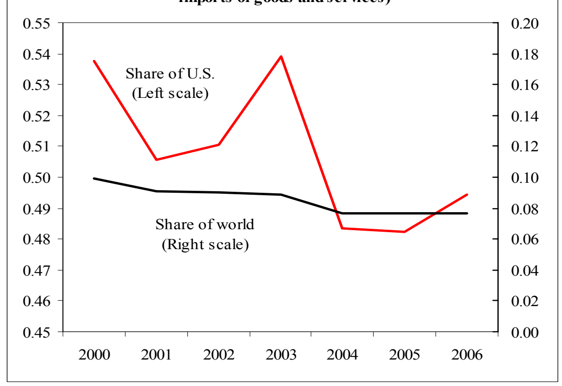
35. **Near-term prospects for the Costa Rican economy are favorable**. Barring a significant downturn in major partner countries, the economy is set to continue expanding at a solid pace in the remainder of 2006 and 2007. Strong external demand, favorable conditions in global financial markets, and improved domestic investor confidence has underpinned a rise in economic growth.

Box 3. External Competitiveness

- **The real effective exchange rate (REER) is below its average level in the last decade** (Figure 5). The REER has remained flat since 2004, a period when it was estimated to be slightly below its equilibrium level.
- **The current account deficit has deteriorated slightly over the past 10 years.** A worsening of the trade balance, partly explained by the oil price shock, has been offset by a dramatic increase in the services balance.
- **Exports have been rising rapidly in recent years and the export base has diversified**. Since 2003, annual export volume growth has averaged close to 8 percent. And despite China's ascension, Costa Rica's share in global trade has remained fairly stable in recent years, although its share in the U.S. market has declined.
- **Overall, existing evidence suggests that the exchange rate level is not misaligned**.



Current Account
(In percent of GDP)



Trade Shares
(exports of goods and services in percent of U.S. and world imports of goods and services)

- **Despite its key strengths, lack of progress in reducing regulatory costs could begin to affect Costa Rica's relative attractiveness in the region and globally.** Costa Rica's ranking in the Global Competitiveness Index is relatively high, underpinned by the country's traditional advantages (its generally better-educated workforce, political stability, and relatively low level of corruption). But the country fell sharply in the 2007 World Bank's *Doing Business Report* rankings, due to weak performance in areas such as the time needed to start a business, import a standardized shipment, register property, and obtain licenses.

Competitiveness Rankings

	Ease of Doing Business, 2007		Global Comp. Index 2006	
	2005	2006	2005	2006
Costa Rica	99	105	56	53
Dominican Republic	114	117	91	83
El Salvador	75	71	60	61
Guatemala	128	118	95	75
Honduras	107	111	97	93
Nicaragua	72	67	96	95
Panama	79	81	65	57

Source: World Bank's Doing Business Report 2007, and World Economic Forum's Global Competitiveness Report 2006–2007

36. **The key policy challenge is to keep the economy on a path of high growth, while increasing its resilience to adverse shocks and addressing social needs**. To achieve this, policy priorities include a comprehensive fiscal reform, recapitalization of the central bank, flexibilization of the exchange rate regime, strengthened financial regulation and supervision, and ratification of CAFTA-DR.

37. **The staff supports the ambitious reform agenda laid out by the Costa Rican authorities**. The tax reform bills already submitted to congress are important steps in the implementation of this strategy. Other bills, pertaining *inter alia* to the modernization and opening of the telecommunication and insurance sectors, have also been submitted to congress. Implementing these reforms will require continued strong efforts to consolidate support in congress and among the wider public.

38. **Adoption of a broad tax reform is critical to bring public debt down, finance priority expenditure, and support disinflation**. The staff recommends focusing the reform on the income tax and the VAT, given their revenue potential, and advised against introducing a financial transactions tax. A successful tax reform should allow achievement of a primary surplus of about 2½ percent of GDP, while also permitting higher expenditure on education, infrastructure, and social needs.

39. **The authorities will need to resist spending pressures until the benefits of the tax reform materialize**. The draft 2007 budget appears consistent with this policy direction. However, given some risk of overestimation of tax revenue, care will be needed in the budget execution to ensure that the primary surplus target is reached. The staff welcomes the authorities' commitment to undertake needed infrastructure spending in a transparent manner.

40. **The authorities' decision to move to a crawling band regime and their intention to recapitalize the central bank are well placed**. These measures will enhance the effectiveness of monetary policy in achieving a gradual reduction of inflation to low single digits. The move to a narrow crawling band is the first step toward greater exchange rate flexibility, and eventual adoption of an inflation target as a nominal anchor. Existing evidence suggests that the current level of the real effective exchange rate is not misaligned.

41. **Reforms to strengthen the financial sector should be pursued vigorously**. A clear priority is to enhance the supervision of offshore banking activities. Consideration should also be given to leveling the playing field between public and private banks. The staff welcomes the steps already taken by the authorities to facilitate management of exchange rate risk by financial institutions and supports further action in this area.

42. **The staff supports the authorities' drive to ratify and implement CAFTA-DR as soon as possible**. Together with efforts to liberalize trade in a multilateral context, measures to open up important sectors, and steps to simplify business regulations, implementation of

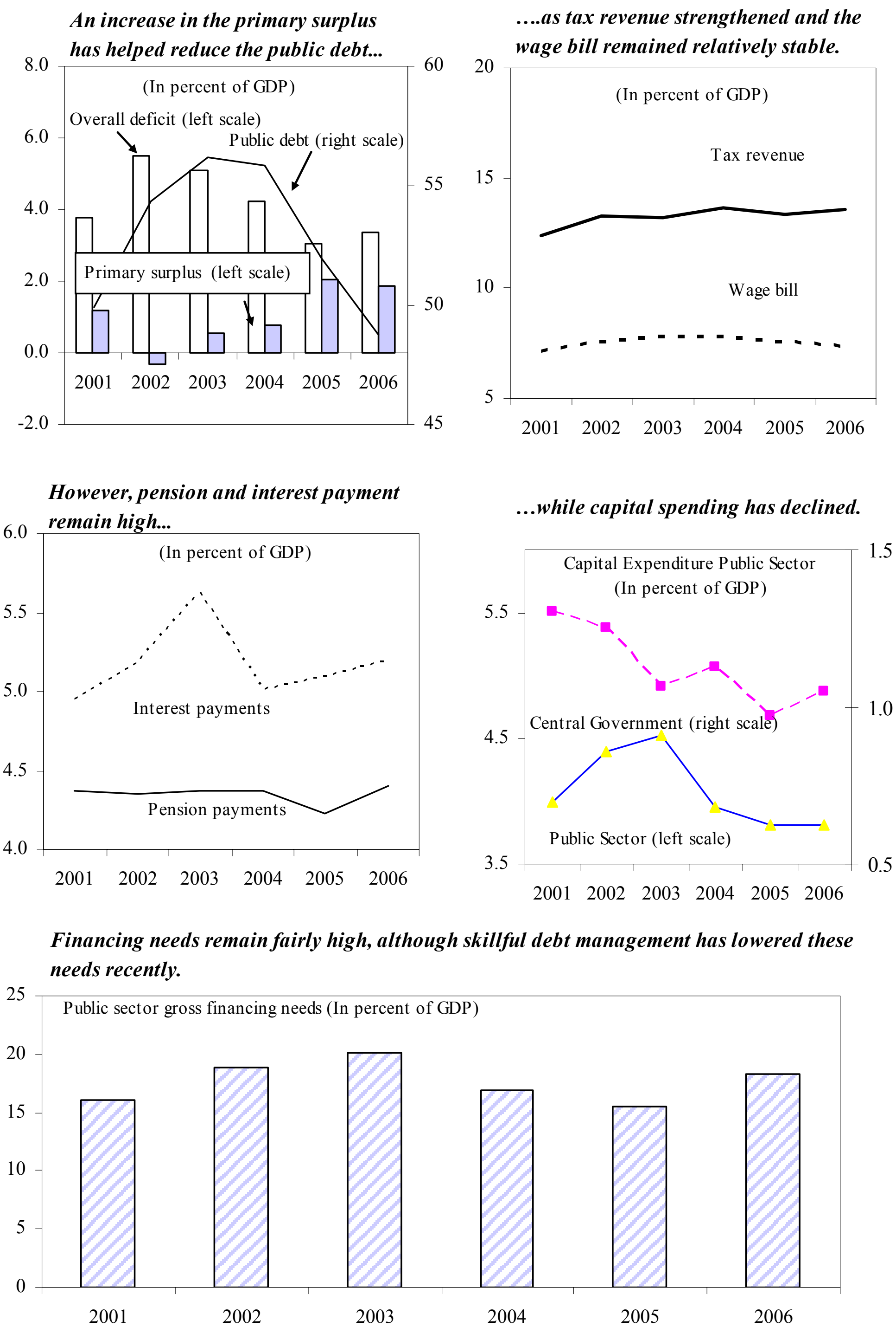
CAFTA-DR will further Costa Rica's integration with the world economy, thus boosting investment and growth prospects.

43. **Costa Rica should continue to play a strong and constructive role in fostering regional cooperation.** The staff encourages the authorities to promote a consensus on a code of conduct in tax incentives for investment, which would help forestall harmful tax competition among countries of the region. It welcomes Costa Rica's active participation in regional efforts to improve cross-border financial supervision and harmonize monetary and financial statistics.

44. **Costa Rica's economic statistics are adequate for surveillance purposes**. The staff welcomes the recent revision of the CPI, and supports ongoing efforts to improve the quality of national accounts, fiscal, and balance-of-payments statistics.

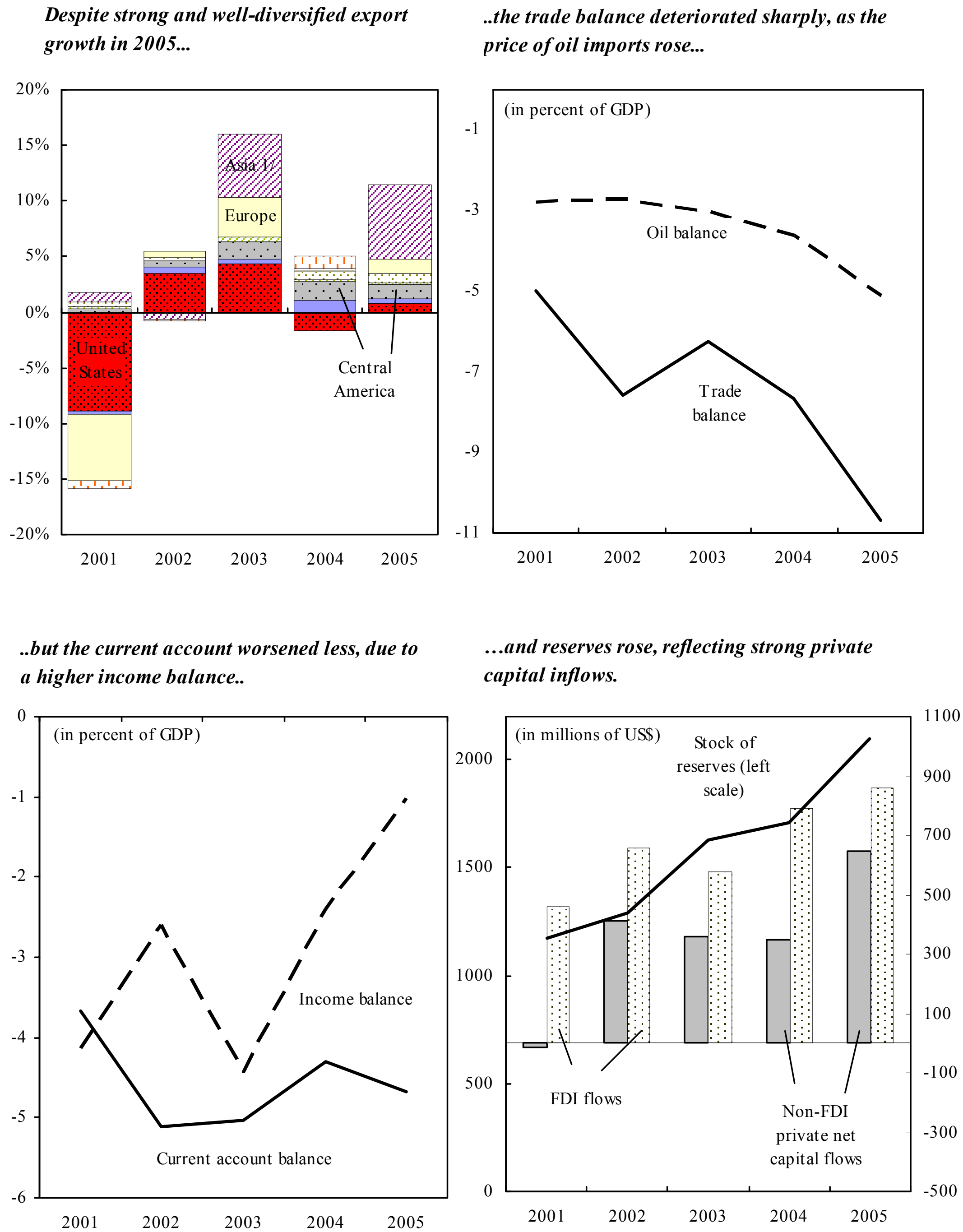
45. **It is recommended that the next Article IV consultation be held on the standard 12-month cycle**.

Figure 1. Costa Rica: Fiscal Sector



Sources: Country authorities; and Fund staff estimates.

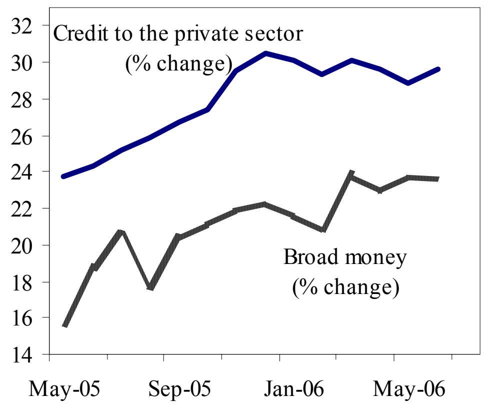
Figure 2. Costa Rica. External Sector



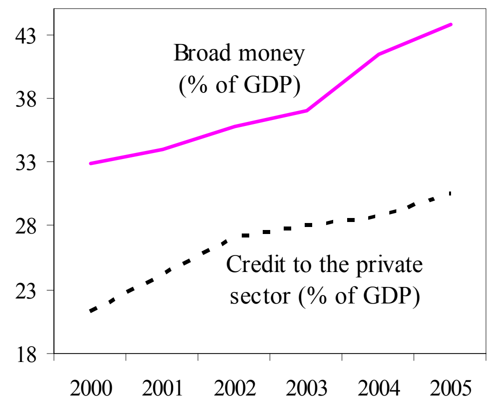
Sources: Central Bank of Costa Rica; and Fund staff estimates.
1/ Predominantly hi-tech industry exports.

Figure 3. Costa Rica: Monetary and Financial Sector Developments

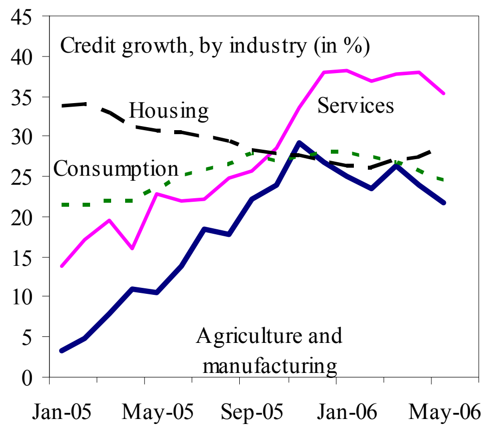
Money and credit have been growing fast...



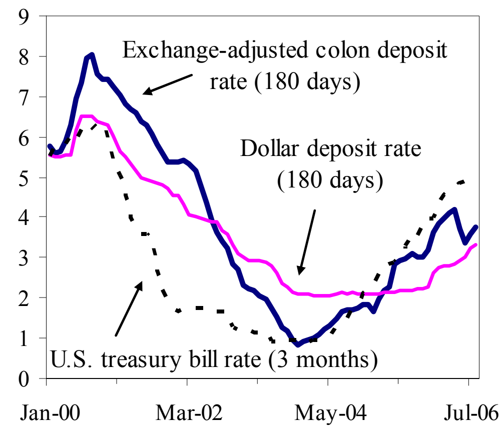
...but from a low base relative to GDP.



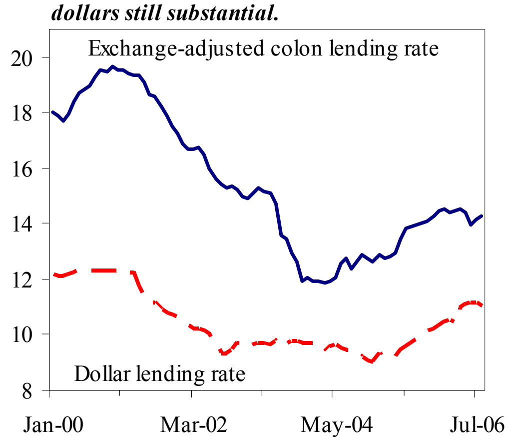
And it is corporate rather than consumer or mortgage credit that has accelerated.



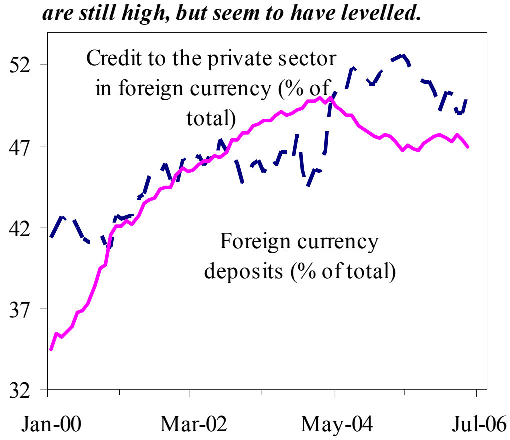
Interest rates have followed U.S. ones, but the premium for investi ng in colones is still small...



...and the incentives for borrowing in dollars still substantial.

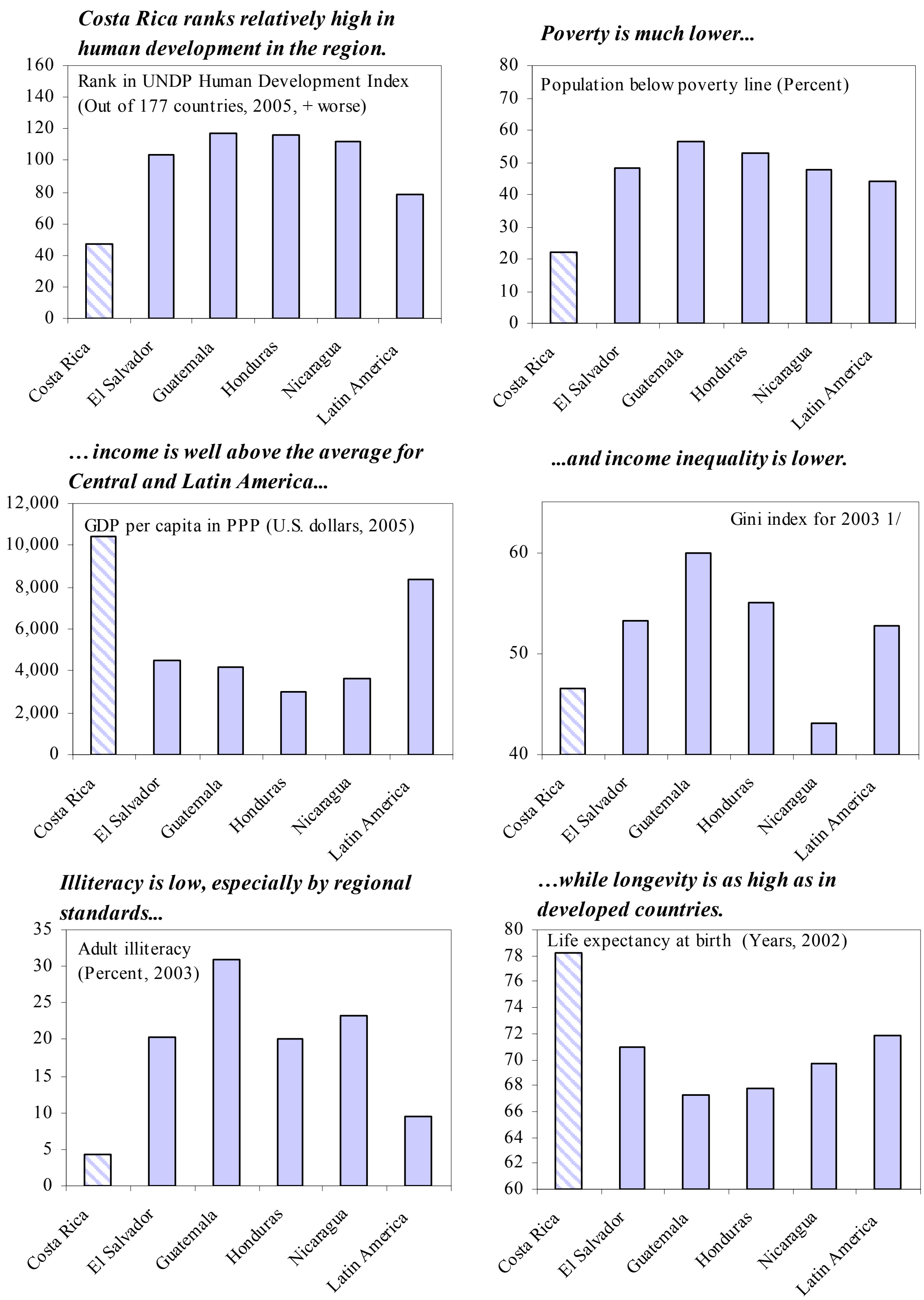


Therefore, deposit and credit dollarization are still high, but seem to have levelled.



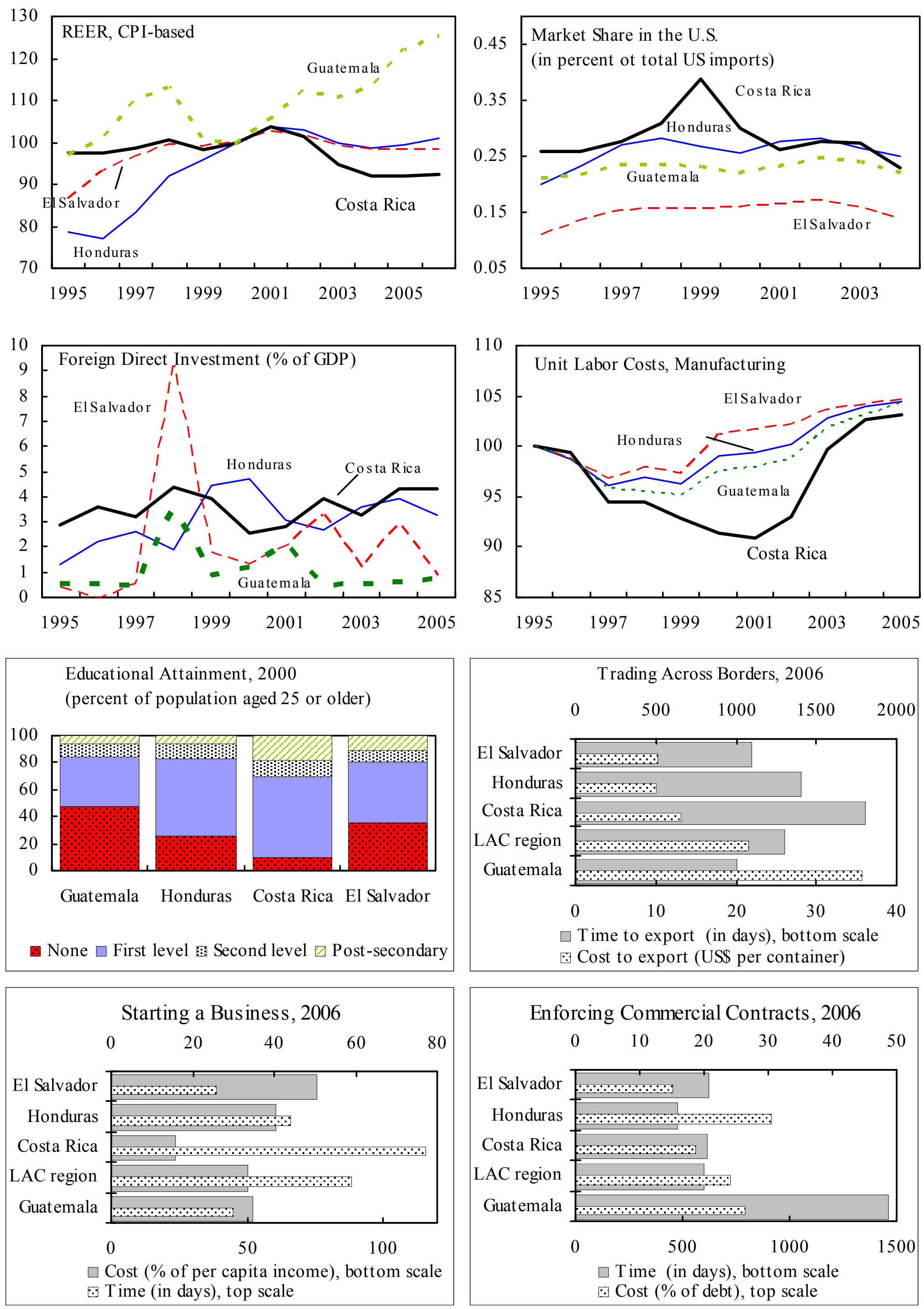
Sources: Central Bank of Costa Rica; and Fund staff estimates.

Figure 4. Costa Rica: Social Indicators



Source: UNDP Human Development Report 2005; and WEO.
1/ A value of 0 represents perfect equality, a value of 100 represents perfect inequality.

Figure 5. Costa Rica. Competitiveness Indicators



Source: International Financial Statistics, World Economic Outlook, Barro and Lee (2000), World Bank *Doing Business 2007* Database, and staff calculations.

Table 1. Costa Rica: Selected Social and Economic Indicators

I. Social Indicators

Per capita income (2005, in U.S. dollars)	4,820	Unemployment rate (2005, percent of labor force)	6.6
Population (end-2005, millions)	4.3	Poverty (2005, percent of households)	21.2
Life expectancy (2005, years)	79.1	Extreme poverty (2005, percent of households)	5.6

II. Economic Indicators

					Prel	Proj	
	2001	2002	2003	2004	2005	2006	2007 1/
(Annual percentage change, unless otherwise noted)							
National income and prices							
GDP at constant prices	1.1	2.9	6.4	4.1	5.9	6.5	5.0
Implicit deflator	8.6	9.2	8.3	11.8	11.1	11.5	8.6
Consumer prices (end of period)	11.0	9.7	9.9	13.1	14.1	12.0	9.0
Consumer prices (average)	11.3	9.2	9.4	11.7	13.6	13.0	10.4
External sector							
Exports of goods (f.o.b.)	-7.5	-1.2	8.3	8.6	10.3	15.0	10.5
Imports of goods (c.i.f.)	-9.7	16.7	14.8	8.8	15.8	13.8	8.6
Terms of trade (-) deterioration	5.5	-0.1	-10.0	-8.8	-3.3	-0.2	0.1
Real effective exchange rate (depreciation -) 2/	3.9	-2.3	-6.6	-3.1	0.0	1.5	..
Banking system							
Net domestic assets	12.8	16.2	13.3	25.5	8.5	21.2	23.3
Of which: Credit to private sector	24.2	21.9	20.5	18.9	30.6	29.5	20.0
Broad money	11.1	20.8	19.1	33.3	22.0	24.1	20.0
Lending interest rate (end of period) 2/	25.8	27.4	23.7	23.3	24.0	22.5	
(In percent of GDP)							
Public Sector							
Overall primary public sector balance	1.2	-0.3	0.5	0.8	2.1	1.8	2.6
Overall public sector balance	-3.8	-5.5	-5.1	-4.2	-3.0	-3.4	-2.6
Nonfinancial public sector balance	-2.6	-4.1	-3.5	-2.9	-1.6	-2.2	-2.4
Central government	-3.8	-4.8	-3.6	-3.5	-2.7	-3.0	-2.8
Total revenue and grants	13.4	13.3	13.7	13.6	13.8	13.7	15.4
Total expenditure	17.3	18.2	17.3	17.2	16.5	16.7	18.2
Rest of nonfinancial public sector	1.3	0.7	0.1	0.6	1.1	0.8	0.4
Central bank losses (-)	-1.2	-1.4	-1.6	-1.3	-1.4	-1.2	-0.2
Gross domestic investment	**20.3**	**22.6**	**20.6**	**22.9**	**25.5**	**24.7**	**23.0**
Gross national savings	**16.6**	**17.5**	**15.9**	**18.6**	**20.9**	**19.8**	**18.2**
External current account balance	**-3.7**	**-5.1**	**-4.8**	**-4.3**	**-4.7**	**-4.9**	**-4.8**
Total public debt	**49.9**	**54.3**	**56.2**	**55.8**	**52.0**	**48.8**	**46.8**
Of which:							
External public debt (end of period)	19.8	19.8	21.5	21.0	18.2	16.4	15.1
Foreign-currency denominated debt 3/	26.5	29.1	31.5	30.5	18.9	19.0	18.2
(In percent of exports of goods and services)							
External public debt service 4/	11.3	10.7	14.1	10.3	7.6	5.0	5.3
Of which: interest 4/	3.3	3.0	2.7	2.3	2.0	2.0	1.8
(In millions of U.S. dollars, unless otherwise specified)							
Change in net international reserves (increase -)	-13	-163	-339	-80	-391	-100	-250
Net international reserves (NIR) 5/	1,098	1,261	1,600	1,680	2,071	2,171	2,421
NIR (months of non-maquila imports)	3.0	3.0	3.6	3.2	3.5	3.4	3.5
Memorandum items:							
GDP (in billions of colones)	5,395	6,061	6,982	8,127	9,566	11,363	12,953
GDP (in millions of U.S. dollars)	16,403	16,843	17,513	18,560	20,022	22,248	23,624

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

1/ Baseline scenario
2/ As of June 2006 for the REER; as of end-August 2006 for interest rates.
3/ Percentage of central government debt denominated in foreign currency or indexed.
4/ Excludes *maquila* exports.
5/ Excludes bilateral claims under negotiation which in the official statistics are classified as part of international reserves.

Table 2. Costa Rica: Summary of Public Sector Operations, 2000–2006

					Prel	Proj	
	2001	2002	2003	2004	2005	2006	2007
	(In percent of GDP)						
Revenues	**22.5**	**22.3**	**22.7**	**22.1**	**22.6**	**22.6**	**24.4**
Tax revenue	13.3	13.2	13.6	13.4	13.6	13.6	15.2
Direct taxes	3.7	3.8	4.0	4.0	4.0	4.0	4.5
Sales tax	4.9	4.9	4.7	4.9	5.1	5.2	6.2
Customs and others	4.6	4.5	4.9	4.5	4.4	4.4	4.5
Nontax revenue	0.2	0.1	0.3	0.3	0.3	0.1	0.2
Contributions to social security	6.2	6.5	6.2	6.0	6.2	6.3	6.3
Operating surplus of public enterprises	2.8	2.4	2.6	2.4	2.6	2.6	2.6
Expenditure	**21.3**	**22.6**	**22.2**	**21.3**	**20.5**	**20.7**	**21.8**
Wages and salaries	7.6	7.8	7.8	7.6	7.3	7.3	7.3
Goods and services	1.8	2.1	1.9	1.8	1.7	1.8	1.9
Pensions	4.4	4.4	4.4	4.4	4.2	4.4	4.6
Transfers and others	3.3	3.7	3.4	3.3	3.2	3.2	3.4
Central Bank primary losses	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Capital expenditure	4.0	4.4	4.5	3.9	3.8	3.8	4.4
Primary balance	**1.2**	**-0.3**	**0.5**	**0.8**	**2.1**	**1.8**	**2.6**
Net interest	**4.9**	**5.2**	**5.6**	**5.0**	**5.1**	**5.2**	**5.2**
Overall balance	**-3.8**	**-5.5**	**-5.1**	**-4.2**	**-3.0**	**-3.4**	**-2.6**
NFPS	-2.6	-4.1	-3.5	-2.9	-1.6	-2.2	-2.4
Central government	-3.8	-4.8	-3.6	-3.5	-2.7	-3.0	-2.8
Of which: Capitalized interest	-0.9	-0.8	-0.7	-0.7	-0.7	-0.6	-0.4
Social Security Agency	0.9	0.8	0.4	0.9	1.3	1.0	1.0
Public enterprises	0.4	-0.2	-0.4	-0.3	-0.2	-0.2	-0.6
Central bank	-1.2	-1.4	-1.6	-1.3	-1.4	-1.2	-0.2
Total Financing	**3.8**	**5.5**	**5.1**	**4.2**	**3.0**	**3.4**	**2.6**
External	0.4	1.4	1.6	5.8	3.6	-0.1	-0.3
Internal	3.4	4.1	3.5	-1.6	-0.6	3.4	2.8
Memorandum item							
Nominal GDP (In billion colones)	5,395	6,061	6,982	8,127	9,566	11,364	12,955

Sources: Ministry of Finance; and Fund staff estimates.

Table 3. Costa Rica: Balance of Payments

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

	2001	2002	2003	2004	2005	Proj. 2006	Proj. 2007
Current account	**-602**	**-860**	**-834**	**-798**	**-936**	**-1086**	**-1130**
Trade balance	-820	-1,278	-1,044	-1,422	-2,143	-2,026	-2,023
Trade balance goods for processing	677	797	1,415	1,217	1,090	1,616	1,841
Export of goods (f.o.b.)	4,923	5,269	6,163	6,369	7,100	8,370	9,191
General merchandise and others	2,210	2,285	2,528	2,748	3,036	3,491	3,884
Goods for processing	2,714	2,985	3,635	3,621	4,064	4,879	5,307
Import of goods (f.o.b.)	5,743	6,547	7,208	7,791	9,242	10,396	11,214
General merchandise and others	3,707	4,360	4,987	5,387	6,268	7,132	7,748
Goods for processing	2,036	2,188	2,220	2,404	2,974	3,264	3,466
Services	747	681	777	857	1,140	1,212	1,297
Of which: Travel	809	816	940	1,053	1,300	1,315	1,414
Income	-679	-439	-775	-445	-204	-580	-737
Of which: Interest on external public debt	155	149	159	145	132	159	160
Of which: FDI income	566	347	643	330	176	590	757
Current transfers	150	176	209	212	270	307	333
Financial and capital account	**616**	**1,023**	**1,173**	**879**	**1,327**	**1,186**	**1,380**
Direct investment	451	625	548	733	904	1,051	967
Capital flows	-2	455	637	169	316	135	413
Public sector	12	43	278	-4	-103	11	-83
Disbursements	394	418	954	489	260	247	223
Amortizations	-382	-375	-676	-493	-363	-236	-306
Private net capital	-14	412	359	173	420	124	496
Errors and omissions	169	-56	33	-24	108	0	0
Change in net reserves (- = increase)	**-13**	**-163**	**-339**	**-80**	**-391**	**-100**	**-250**
	(Annual percentage change)						
Export of goods (f.o.b.)							
Value	-15.8	7.0	17.0	3.3	11.5	17.9	9.8
Volume	-17.8	5.2	14.6	0.7	8.4	15.1	8.4
General merchandise (excludes goods for processing)							
Value	-7.5	-1.2	8.3	8.6	10.3	15.0	10.5
Volume	-9.7	-2.9	6.1	5.9	7.3	11.8	8.3
Import of goods (c.i.f.)							
Value	-4.5	13.6	10.6	8.6	18.1	12.6	7.9
Volume	-6.7	11.6	8.4	5.9	14.9	9.5	5.8
General merchandise (excludes goods for processing)							
Value	-9.7	16.7	14.8	8.8	15.8	13.8	8.6
Volume	-11.8	14.7	12.5	6.0	12.6	10.7	6.5
	(In percent of GDP)						
Current account (% of GDP)	-3.7	-5.1	-4.8	-4.3	-4.7	-4.9	-4.8
Export of goods (f.o.b.) (% of GDP)	30.0	31.3	35.2	34.3	35.5	37.6	39.0
Import of goods (f.o.b.) (% of GDP)	35.0	38.9	41.2	42.0	46.2	46.8	47.5
Direct investment (% of GDP)	2.8	3.9	3.3	4.3	4.3	4.7	4.1
Memorandum items:							
Net international reserves (US$ million)	1,098	1,261	1,600	1,680	2,071	2,171	2,421
Net international reserves (months of imports)	2.0	2.1	2.5	2.2	2.4	2.3	2.4
Net international reserves (months of non-maquila imports)	3.0	3.0	3.6	3.2	3.5	3.4	3.5
Net international reserves (% of ST debt on RM) 1/ 2/	53.8	64.1	67.6	75.3	90.6	89.0	95.3
External debt (percent of GDP) 1/	27.8	30.9	30.8	29.9	29.1	26.8	27.0
External private sector debt (percent of GDP)	8.0	11.1	9.4	8.9	10.9	10.4	11.9
External public sector debt (percent of GDP)	19.8	19.8	21.4	20.9	18.2	16.4	15.1
Public external debt service (US$ million)	543	528	841	642	510	396	467
Public external debt service to exports ratio 3/	24.6	23.1	33.3	23.4	16.8	11.3	12.0
Of which: Interest	7.1	6.6	6.4	5.3	4.4	4.6	4.1

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

[1] Includes private sector debt.

[2] Public and private sector external debt. Includes trade credits.

[3] Excludes maquila exports.

Table 4. Costa Rica: Summary Accounts of the Banking System

	1999	2000	2001	2002	2003	2004	2005	Proj 2006
(End-of-period stocks; in billions of colones unless otherwise specified)								
I. Central Bank								
Net international reserves 1/	**370**	**345**	**375**	**478**	**670**	**770**	**1,029**	**1,157**
(In millions of U.S. dollars)	1,240	1,086	1,098	1,261	1,600	1,680	2,071	2,171
Other net foreign assets	**-201**	**-194**	**-176**	**-132**	**-92**	**40**	**83**	**155**
Medium- and long-term foreign liabilities	-292	-289	-259	-259	-246	-138	-100	-45
(In millions of U.S. dollars)	-981	-908	-759	-685	-587	-301	-202	-84
Net domestic assets	**105**	**141**	**83**	**-39**	**-199**	**-364**	**-531**	**-628**
Net claims on the nonfinancial public sector	246	214	17	25	37	-27	48	25
Credit to commercial banks	8	4	3	1	1	1	1	0
Monetary absorption instruments (BEM, ICP) 2/	-405	-420	-518	-705	-901	-930	-1,245	-1,218
Deficit account	-535	-667	-803	-933	-1,050	-1,159	-1,062	-1,198
Operating losses	-71	-88	-64	-87	-109	-106	-136	-136
Other	791	1,011	1,384	1,572	1,714	1,752	1,728	1,762
Monetary base (domestic currency)	**274**	**292**	**282**	**306**	**379**	**446**	**581**	**683**
Commercial bank reserves in foreign currency	216	180	62	68	107	161	176	320
II. Commercial Banks and Other Depository Institutions								
Net foreign assets (including medium- and long-term liabi	**-45**	**-70**	**-137**	**-184**	**-257**	**-187**	**75**	**260**
(In millions of U.S. dollars)	-151	-220	-402	-487	-614	-407	152	487
Net claims on the central bank	**376**	**413**	**351**	**459**	**525**	**785**	**980**	**1,243**
Other net domestic assets	**986**	**1,270**	**1,591**	**1,928**	**2,357**	**2,935**	**3,274**	**3,888**
Credit to the nonfinancial public sector	139	170	197	329	443	801	646	663
Credit to the private sector	911	1,176	1,461	1,781	2,147	2,553	3,336	4,319
Domestic currency	615	687	800	929	1,078	1,338	1,744	2,250
Foreign currency	297	489	661	853	1,069	1,215	1,591	2,068
(in millions of U.S. dollars)	995	1,538	1,934	2,251	2,555	2,649	3,204	3,450
Other	-64	-76	-68	-183	-233	-419	-708	-1,094
Deposits	**1,317**	**1,613**	**1,805**	**2,202**	**2,625**	**3,534**	**4,329**	**5,390**
Domestic currency	764	947	1,000	1,215	1,453	1,724	2,192	2,836
Foreign currency	553	666	804	988	1,172	1,809	2,137	2,555
(In millions of U.S. dollars)	1,856	2,093	2,354	2,608	2,801	3,945	4,302	4,795
III. Banking System								
Net foreign assets (including medium- and long-term liabi	**123**	**81**	**62**	**161**	**321**	**623**	**1,187**	**1,571**
Net domestic assets	**1,359**	**1,697**	**1,914**	**2,225**	**2,520**	**3,163**	**3,432**	**4,161**
Net credit to the nonfinancial public sector	385	384	215	354	479	774	694	688
Credit to the private sector	911	1,176	1,461	1,781	2,147	2,553	3,336	4,319
Other	62	137	239	90	-106	-164	-597	-846
Broad money 3/	**1,482**	**1,779**	**1,976**	**2,386**	**2,841**	**3,786**	**4,620**	**5,733**
(Percent changes)								
Monetary base	12.8	6.8	-3.6	8.7	23.9	17.6	30.2	17.6
Banking system's net domestic assets	5.5	24.9	12.8	16.2	13.3	25.5	8.5	21.2
Credit to the private sector	17.6	29.1	24.2	21.9	20.5	18.9	30.6	29.5
Domestic currency	7.7	11.8	16.4	16.1	16.0	24.2	30.3	29.0
Foreign currency	45.3	64.9	35.1	29.0	25.4	13.6	31.0	30.0
Broad money	17.8	20.0	11.1	20.8	19.1	33.3	22.0	24.1
(In percent of GDP)								
Currency in circulation	3.1	2.9	2.9	2.8	2.7	2.5	2.6	2.6
Money	8.3	8.9	8.9	9.7	9.9	8.6	9.0	9.1
Broad money	32.8	36.2	36.6	39.4	40.7	46.6	48.3	50.5
Credit to the private sector	20.2	23.9	27.1	29.4	30.7	31.4	34.9	38.0
Memorandum items (in percent):								
Net international reserves/deposits in foreign currency	66.8	51.9	46.6	48.3	57.1	42.6	48.1	45.3
Short-term foreign assets of the banking system/deposits in foreign currency	75.5	59.4	57.2	56.7	66.6	56.1	72.6	76.4
Deposits in foreign currency/total deposits	42.0	41.3	44.6	44.8	44.7	51.2	49.4	47.4
Credit to the private sector in foreign currency/total credit	32.6	41.6	45.2	47.9	49.8	47.6	47.7	47.9

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

1/ Excludes claims on Nicaragua equivalent to US$231.9 million.
2/ Comprises central bank bonds (BEM) and short-term investments (ICP) in domestic and foreign currency.
3/ Money plus quasi-money (excludes bank deposits held by the central government).

Table 5. Costa Rica: Structure and Performance of the Banking Sector 1/

(In percent unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	Aug-06
Number of banks	22	20	20	19	17	16	16
Private banks	18	16	16	15	13	12	12
Total assets of private banks (as percentage of GDP) 2/	12.4	14.3	15.5	17.5	18.1	19.8	20
Public banks	4	4	4	4	4	4	4
Total assets of public banks (as percentage of GDP) 2/	29.9	29.7	31.9	32.3	38.1	39.8	39.7
Capital							
Ratio of capital to risk-weighted assets	16.7	15.1	15.8	16.5	18.1	15.9	14.8
Asset quality							
Ratio of loans more than 90 days past due to total loans	3.5	2.4	3.2	1.7	2.0	1.5	1.6
Provision coverage							
Ratio of provisions to total loans	3.5	2.8	3.3	2.5	2.5	2.2	2.3
Ratio of provisions to loans more than 90 days past due	100.8	113.2	102.6	145.9	122.6	153.0	145.7
Ratio of foreign currency credit to total private credit	47.2	51.6	54.3	56.5	54.2	55.2	54.5
Ratio of real estate loans to total loans	17.4	21.9	27.5	26.8	21.2	23.1	23.9
Management							
Ratio of administrative expenses to total assets	5.5	5.8	5.6	5.4	5.0	4.7	4.8
Profitability							
Pre-tax return to average equity	16.3	18.7	17.1	19.5	20.7	25.0	24.3
Pre-tax return to average total assets	1.7	1.9	1.8	2.1	2.0	2.5	2.5
Liquidity							
Ratio of loans to deposits	70.3	79.7	77.8	79.0	69.4	73.5	73.9
Ratio of liquid assets to deposits	61.2	58.1	57.4	55.3	62.3	59.5	58.9

Source: Superintendency of Financial Institutions.

1/ Excludes offshore banks and other nonbank financial institutions.
2/ GDP figures for August 2006 are based on a linear extrapolation of projected GDP for 2006.

Table 6. Costa Rica: Indicators of External Vulnerability

	2001	2002	2003	2004	2005	Proj. 2006
Merchandise exports (12-month percent change) 1/	-7.5	-1.2	9.0	8.6	10.3	15.0
Merchandise imports (12-month percent change) 1/	-10.6	17.6	14.4	8.0	16.4	13.8
Terms of trade (percentage change)	5.5	-0.1	-10.0	-8.8	-3.3	-0.2
External current account balance (in percent of GDP)	-3.7	-5.1	-4.8	-4.3	-4.7	-4.9
Central bank net international reserves (NIR) (in US$ millions) 2/	1,098	1,261	1,600	1,680	2071	2171
In months of next year's imports of goods	2.0	2.1	2.5	2.2	2.4	2.3
In percent of base money	107	125	132	120	177	170
In percent of M2	19	20	24	21	22	20
In percent of deposits in foreign currency	47	49	59	44	48	45
In percent of short-term debt on remaining maturity 3/	54	64	68	75	91	89
NIR excluding commercial bank U.S. dollar deposits at the central bank (in US$ millions) 4/	916	1,082	1,345	1,330	1,716	1,682
Commercial banks foreign assets (in US$ millions)	363	335	384	644	1,283	…
o/w short term	175	188	237	505	1,024	…
Commercial banks foreign liabilities (in US$ millions)	652	727	901	1009	1,047	…
o/w short term	588	670	791	917	916	…
Short-term foreign assets of the banking system/deposits in foreign currency (in percent)	63.3	59.7	70.5	59.2	73.1	…
Public sector external debt (in percent of GDP)	19.8	19.8	21.2	21.0	18.4	17.1
NFPS external interest payments to merchandise exports 5/	8.0	8.1	8.2	4.9	4.1	4.5
NFPS external amortization payments to merchandise exports 5/	9.9	9.2	16.9	7.8	10.1	4.9
REER appreciation (+) (12-month percentage change) 6/	3.9	-2.3	-6.6	-3.1	0.0	1.5

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

1/ In value terms, excludes maquila.

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

3/ Includes private sector external debt.

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

5 Excludes merchandise exports associated with the free-trade zones.

6/ Average.

Table 7. Costa Rica: Medium-Term Balance of Payments

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

			Proj.					
	2004	2005	2006	2007	2008	2009	2010	2011
Current account	**-798**	**-936**	**-1086**	**-1130**	**-1099**	**-970**	**-925**	**-952**
Trade balance	-1,422	-2,143	-2,026	-2,023	-2,017	-1,953	-1,918	-1,958
Trade balance goods for processing	1,217	1,090	1,616	1,841	1,989	2,193	2,548	2,884
Export of goods (f.o.b.)	6,369	7,100	8,370	9,191	10,230	11,391	12,873	14,320
General merchandise and others	2,748	3,036	3,491	3,884	4,380	4,941	5,378	5,839
Goods for processing	3,621	4,064	4,879	5,307	5,850	6,450	7,495	8,481
Import of goods (f.o.b.)	7,791	9,242	10,396	11,214	12,247	13,344	14,791	16,278
General merchandise and others	5,387	6,268	7,132	7,748	8,386	9,087	9,844	10,681
Goods for processing	2,404	2,974	3,264	3,466	3,861	4,257	4,947	5,597
Services	857	1,140	1,212	1,297	1,421	1,541	1,675	1,816
Of which: Travel	1,053	1,300	1,315	1,414	1,510	1,608	1,712	1,821
Income	-445	-204	-580	-737	-844	-905	-1,037	-1,171
Of which: Interest on external public debt	145	132	159	160	112	95	82	80
Of which: FDI income	330	176	590	757	781	853	988	1,128
Current transfers	212	270	307	333	340	347	354	361
Financial and capital account	**879**	**1,327**	**1,186**	**1,380**	**1,249**	**1,120**	**1,075**	**1,102**
Direct investment	733	904	1,051	967	1,100	1,250	1,500	1,750
Capital flows	169	316	135	413	149	-130	-425	-648
Public sector	-4	-103	11	-83	-390	-448	-178	-390
Disbursements	489	260	247	223	16	8	0	0
Amortizations	-493	-363	-236	-306	-407	-456	-178	-390
Private net capital	173	420	124	496	539	318	-247	-258
Errors and omissions	-24	108	0	0	0	0	0	0
Change in net reserves (- = increase)	**-80**	**-391**	**-100**	**-250**	**-150**	**-150**	**-150**	**-150**
	(Annual percentage change)							
Export of goods (f.o.b.)								
Value	3.3	11.5	17.9	9.8	11.3	11.3	13.0	11.2
Volume	0.7	8.4	15.1	8.4	10.9	10.9	12.7	10.9
General merchandise (excludes goods for processing)								
Value	8.6	10.3	15.0	10.5	14.4	13.0	9.0	8.7
Volume	5.9	7.3	11.8	8.3	12.1	10.8	6.9	6.6
Import of goods (c.i.f.)								
Value	8.6	18.1	12.6	7.9	9.2	9.0	10.8	10.1
Volume	5.9	14.9	9.5	5.8	7.1	6.8	8.7	7.9
General merchandise (excludes goods for processing)								
Value	8.8	15.8	13.8	8.6	8.3	8.4	8.5	8.6
Volume	6.0	12.6	10.7	6.5	6.2	6.3	6.4	6.5
	(In percent of GDP)							
Current account (% of GDP)	-4.3	-4.7	-4.9	-4.8	-4.4	-3.6	-3.2	-3.1
Export of goods (f.o.b.) (% of GDP)	34.3	35.5	37.6	39.0	40.7	42.2	44.5	46.2
Import of goods (f.o.b.) (% of GDP)	42.0	46.2	46.8	47.5	48.8	49.5	51.2	52.5
Direct investment (% of GDP)	4.3	4.3	4.7	4.1	4.4	4.6	5.2	5.6
Memorandum items:								
Net international reserves (US$ million)	1,680	2,071	2,171	2,421	2,571	2,721	2,871	3,021
Net international reserves (months of imports)	2.2	2.4	2.3	2.4	2.3	2.2	2.1	2.1
Net international reserves (months of non-maqu	3.2	3.5	3.4	3.5	3.4	3.3	3.2	3.2
Net international reserves (% of ST debt on RM	75.3	90.6	89.0	95.3	87.4	82.4	89.5	92.2
External debt (percent of GDP)1/	29.9	29.1	26.8	27.0	26.0	23.7	20.6	17.1
External private sector debt (percent of GDP)	8.9	10.9	10.4	11.9	13.3	13.6	11.8	10.2
External public sector debt (percent of GDP)	20.9	18.2	16.4	15.1	12.6	10.1	8.8	7.0
Public external debt service (US$ million)	642	510	396	467	519	551	260	470
Public external debt service to exports ratio 3/	23.4	16.8	11.3	12.0	11.8	11.2	4.8	8.0
Of which: Interest	5.3	4.4	4.6	4.1	2.6	1.9	1.5	1.4

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

[1] Includes private sector debt.

[2] Public and private sector external debt. Includes trade credits.

[3] Excludes maquila exports.

Table 8. Central America: 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 177 countries) (2005)	**47**	104	117	116	112	n.a.
GDP per capita in PPP, U.S. dollars (2003)	**9,606**	4,781	4,148	2,665	3,262	7,404
People not expected to survive to age 40 (in percent of population) (2000-05)	**3.7**	9.9	15.9	15.8	10.1	n.a.
Life expectancy at birth (years) (2003)	**78.2**	70.9	67.3	67.8	69.7	71.9
Infant mortality (per 1,000 live births) (2003)	**8**	32	35	32	30	23
Population without access to safe water (2003)	**3**	18	5	10	19	n.a.
Per capita health exp. in PPP, US dollars (2002)	**743**	372	199	156	206	n.a.
Physicians per 100,000 people (1990-2004)	**173**	124	90	83	62	n.a.
Adult illiteracy (2003)	**4.2**	20.3	30.9	20.0	23.3	10.4
Primary school net enrollment (2002/03) (percent of relevant age of the population) 1/	**90**	90	87	87	86	n.a.
Secondary school net enrollment (2002/03) (percent of relevant age of the population) 2/	**53**	49	30	...	39	n.a.
Ratio of the per capita income of the richest 10 percent to the per capita income of the poorest 10 percent of the population 1/	**25.1**	47.4	55.1	49.1	15.5	n.a.
Gini index (Human Development Report, 2005) 1/	**46.5**	53.2	59.9	55.0	43.1	n.a.
Percentage of population below the poverty line (1990-2002) 2/	**22.0**	48.3	56.2	53.0	47.9	n.a.

Source: UNDP Human Development Report 2005.

1/ For Nicaragua the information refers to the 2001 survey; for Costa Rica, El Salvador and Guatemala to the 2000 surveys; for Honduras to the 1999 survey.

2/ National poverty line.

Table 9. Millennium Development Goals

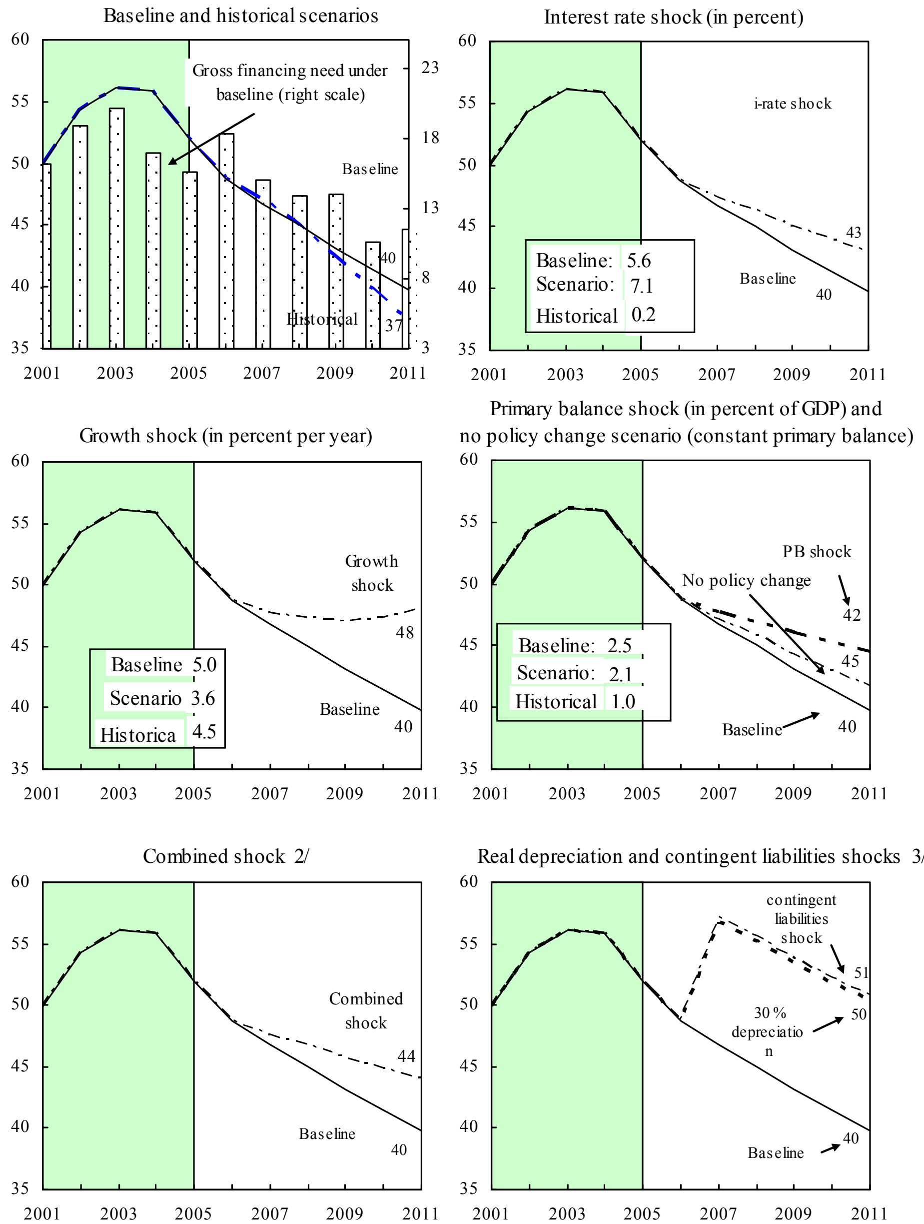
(In percent, unless otherwise noted)

Objective	1990 Benchmark 1/	2015 Goal	Latest Estimate	Status
1. Poverty				
Halve extreme poverty	11.7 (1991)	5.9	5.1 (2003)	Achieved
Halve malnutrition	6.0 (1985)	3.0	4.2 (2000)	On track
2. Education				
Achieve full enrollment in primary education	86.3	100.0	92.0 (2004)	On track
3. Gender equality				
Raise girl/boy ratio in primary and secondary education to 100 percent	95.8	100.0	101.2 (2004)	Achieved
4. Child mortality				
Reduce child mortality under 5 years of age by two-thirds	17.0	6.0	10.0 (2003)	On track
5. Maternal health				
Reduce maternal mortality rate (for each 100,000 live births) by three-fourths	...	9.0	43.0 (2000)	...
6. Environment				
Halve the proportion of individuals without access to improved water source	...	2.0	3.0 (2002)	On track
Halt forest degradation (forest area as a percent of total land)	50.0	50.0	47.0 (2004)	Off track

Source: World Bank, 2005

1/ Data refers to 1990 unless otherwise noted.

Figure 1. Costa Rica: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 15 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 1. Costa Rica: Public Sector Debt Sustainability Framework, 2001–2011
(In percent of GDP, unless otherwise indicated)

	Actual 2001	2002	2003	2004	2005	10-Year Historical Average	10-Year Standard Deviation	Projections 2006	2007	2008	2009	2010	2011	Debt-stabilizing primary balance 9/
1 **Baseline: Public sector debt 1/**	49.9	54.3	56.2	55.8	52.0			**48.8**	**46.8**	**45.0**	**43.1**	**41.4**	**39.7**	**0.7**
o/w foreign-currency denominated	26.5	29.1	31.5	30.5	18.9			19.0	18.2	13.5	12.9	12.4	7.9	
2 Change in public sector debt	2.6	4.4	1.8	-0.3	-3.9			-3.2	-2.0	-1.7	-1.9	-1.7	-1.7	
3 Identified debt-creating flows (4+7+12)	1.4	2.9	1.0	-0.8	-2.8			-4.6	-3.4	-2.6	-2.3	-1.9	-1.7	
4 Primary deficit	-1.2	0.3	-0.5	-0.8	-2.1			-1.6	-2.6	-2.5	-2.5	-2.5	-2.4	
5 Revenue and grants	22.3	22.0	22.5	21.9	22.4			22.6	24.2	25.3	25.9	26.0	26.0	
6 Primary (noninterest) expenditure	21.1	22.4	22.0	21.1	20.3			21.0	21.6	22.8	23.4	23.5	23.6	
7 Automatic debt dynamics 2/	2.6	2.5	1.5	0.0	-0.7			-3.0	-0.8	-0.1	0.2	0.6	0.7	
8 Contribution from interest rate/growth differential 3/	0.7	-0.3	-1.5	-2.9	-3.3			-3.0	-0.8	-0.1	0.2	0.6	0.7	
9 Of which contribution from real interest rate	1.2	1.0	1.5	-0.9	-0.5			-0.2	1.3	2.0	2.2	2.6	2.6	
10 Of which contribution from real GDP growth	-0.5	-1.3	-3.0	-2.0	-2.8			-2.8	-2.1	-2.1	-2.0	-2.0	-1.9	
11 Contribution from exchange rate depreciation 4/	1.8	2.9	3.1	2.9	2.6			...	...	...	...	...	...	
12 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	1.2	1.5	0.8	0.4	-1.1			1.4	1.4	0.9	0.4	0.1	0.1	
Public sector debt-to-revenue ratio 1/	224.3	246.7	249.1	255.4	232.1			216.3	193.6	177.9	166.8	159.6	152.7	
Gross financing need 6/	16.1	18.9	20.1	16.9	15.6			18.3	15.0	13.9	14.0	10.6	11.5	
in billions of U.S. dollars	2.6	3.2	3.5	3.1	3.1			4.1	3.5	3.5	3.8	3.1	3.6	
Scenario with key variables at their historical averages 7/								**48.8**	**47.1**	**45.0**	**42.5**	**39.9**	**37.3**	**-1.5**
Scenario with no policy change (constant primary balance) in 2006-2011								**48.8**	**47.8**	**47.0**	**46.1**	**45.3**	**44.6**	**0.8**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline														
Real GDP growth (in percent)	1.1	2.9	6.4	4.1	5.9	4.5	2.8	6.5	5.0	5.0	5.0	5.0	5.0	
Average nominal interest rate on public debt (in percent) 8/	11.5	11.7	11.9	10.4	10.7	11.6	1.2	11.9	12.1	11.4	10.4	9.8	9.6	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.9	2.5	3.7	-1.4	-0.4	0.2	3.0	0.3	3.5	5.1	5.7	6.7	6.9	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-6.9	-9.8	-9.7	-8.9	-8.4	-9.0	1.5	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	8.6	9.2	8.3	11.8	11.1	11.4	3.1	11.5	8.6	6.3	4.7	3.1	2.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	5.2	9.1	4.8	-0.3	2.2	5.2	3.3	10.0	7.8	11.1	7.7	5.5	5.5	
Primary deficit	-1.2	0.3	-0.5	-0.8	-2.1	-1.0	0.8	-1.6	-2.6	-2.5	-2.5	-2.5	-2.4	

1/ Gross public sector debt (Includes general government and the central bank).

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

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

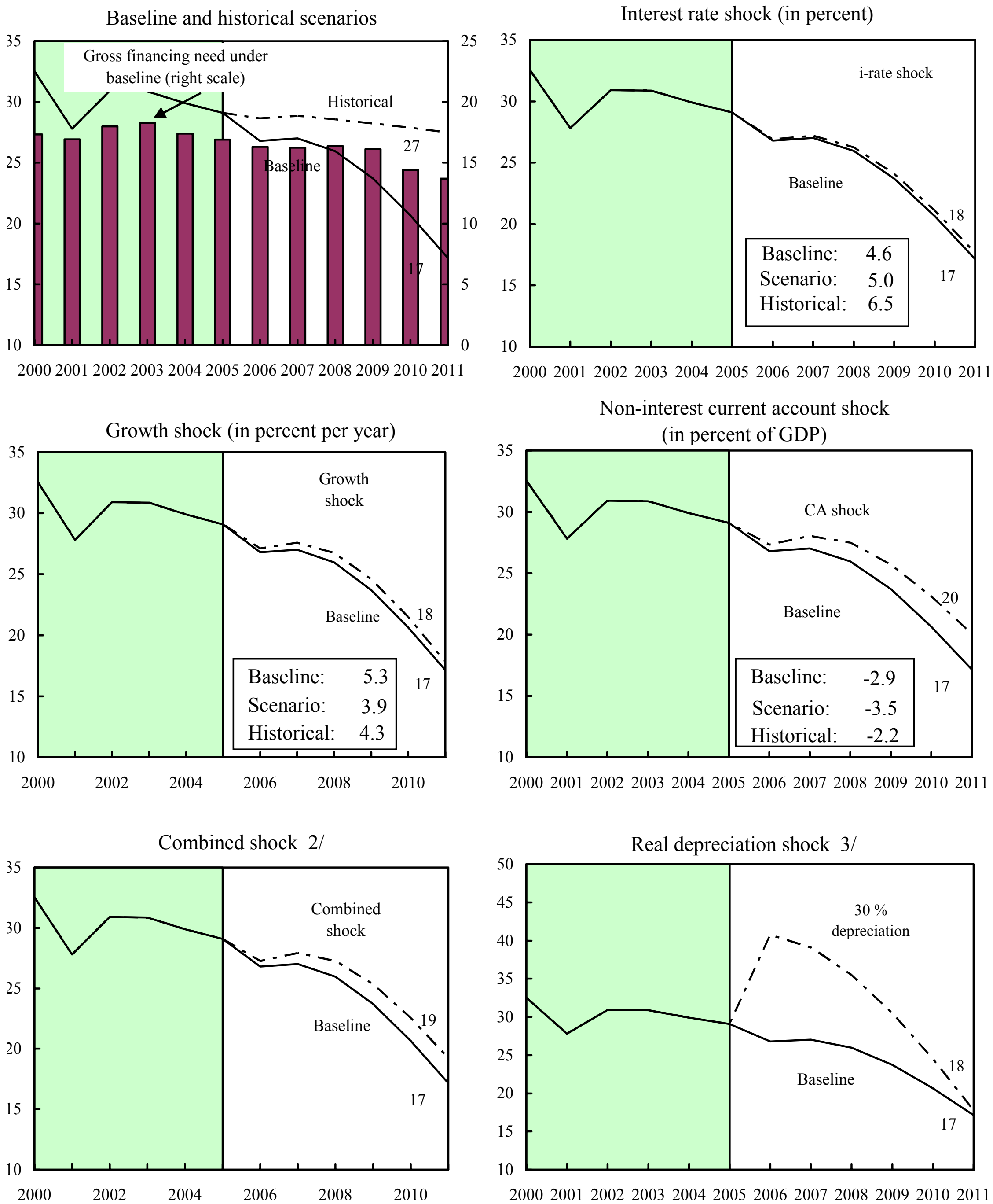
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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

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



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2006.

Table 2. Costa Rica: External Debt Sustainability Framework, 2000-2011
(In percent of GDP, unless otherwise indicated)

	Actual					Projections							
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	32.5	27.8	30.9	30.9	29.9	**29.1**	**26.8**	**27.0**	**26.0**	**23.7**	**20.6**	**17.1**	**-6.1**
Change in external debt	6.7	-4.7	3.1	0.0	-1.0	-0.8	-2.3	0.2	-1.0	-2.3	-3.1	-3.5	
Identified external debt-creating flows (4+8+9)	1.5	0.8	1.1	2.2	-1.3	-1.4	-1.5	-0.6	-1.3	-2.2	-3.1	-3.5	
Current account deficit, excluding interest payments	2.3	2.3	3.9	3.7	2.7	3.7	3.5	3.4	3.4	2.6	2.3	2.2	
Deficit in balance of goods and services	-2.9	0.6	3.4	2.0	3.0	5.0	3.7	3.1	2.4	1.5	0.8	0.5	
Exports	48.6	41.6	42.8	47.0	46.0	48.5	50.4	51.8	53.7	55.3	57.7	59.4	
Imports	45.8	42.2	46.2	48.9	49.0	53.5	54.1	54.9	56.1	56.8	58.5	59.9	
Net non-debt creating capital inflows (negative)	-2.5	-2.8	-3.8	-2.1	-4.0	-4.5	-4.7	-4.1	-4.4	-4.6	-5.2	-5.6	
Automatic debt dynamics 1/	1.8	1.2	1.0	0.6	0.0	-0.5	-0.3	0.1	-0.2	-0.2	-0.2	-0.1	
Contribution from nominal interest rate	2.0	2.1	1.7	1.8	1.7	1.1	1.4	1.4	1.0	1.0	0.9	0.8	
Contribution from real GDP growth	-0.5	-0.3	-0.8	-1.9	-1.2	-1.6	-1.7	-1.3	-1.3	-1.2	-1.1	-1.0	
Contribution from price and exchange rate changes 2/	0.2	-0.6	0.1	0.7	-0.5	...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	5.1	-5.5	2.0	-2.3	0.4	0.6	-0.7	0.8	0.2	0.0	0.0	0.0	
External debt-to-exports ratio (in percent)	66.9	66.8	72.3	65.7	65.0	60.0	53.2	52.2	48.3	42.9	35.8	28.9	
Gross external financing need (in billions of US dollars) 4/	2.8	2.8	3.0	3.2	3.2	3.4	3.6	3.8	4.1	4.3	4.2	4.2	
in percent of GDP	17.3	16.9	18.0	18.3	17.4	16.9	16.3	16.2	16.4	16.1	14.4	13.7	
Scenario with key variables at their historical averages 5/						**29.1**	**28.6**	**28.8**	**28.6**	**28.2**	**27.9**	**27.5**	**-3.1**
Key Macroeconomic Assumptions Underlying Baseline													
Real GDP growth (in percent)	1.8	1.1	2.9	6.4	4.1	5.9	6.5	5.0	5.0	5.0	5.0	5.0	
GDP deflator in US dollars (change in percent)	-0.9	1.8	-0.2	-2.3	1.7	2.0	4.3	1.1	1.4	2.2	2.1	2.2	
Nominal external interest rate (in percent)	7.8	6.7	6.4	6.1	5.8	4.0	5.4	5.5	4.0	4.1	4.2	4.3	
Growth of exports (US dollar terms, in percent)	-5.2	-12.0	5.5	14.2	3.7	13.9	15.4	9.0	10.5	10.5	11.8	10.5	
Growth of imports (US dollar terms, in percent)	1.5	-5.3	12.4	10.2	6.1	18.0	12.2	7.6	8.9	8.8	10.4	9.7	
Current account balance, excluding interest payments	-2.3	-2.3	-3.9	-3.7	-2.7	-3.7	-3.5	-3.4	-3.4	-2.6	-2.3	-2.2	
Net non-debt creating capital inflows	2.5	2.8	3.8	2.1	4.0	4.5	4.7	4.1	4.4	4.6	5.2	5.6	

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

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

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

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

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

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

INTERNATIONAL MONETARY FUND

COSTA RICA

Annex to the Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation with Costa Rica

Approved by Markus Rodlauer and Adnan Mazarei

October 12, 2006

Annex

ANNEX I. COSTA RICA: FUND RELATIONS

(As of September 30, 2006)

I. Membership Status:

Joined: January 08, 1946
Status: Article VIII

II. General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	164.10	100.00
Fund holdings of currency	144.11	87.82
Reserve Position	20.00	12.19
Holdings Exchange Rate		

III. SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	23.73	100.00
Holdings	0.05	0.20

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	02/28/97	52.00	0.00
Stand-by	04/19/93	02/18/94	21.04	0.00
Stand-by	04/08/91	09/30/92	33.64	25.64

VI. Projected Payments to Fund (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2006	**2007**	**2008**	**2009**	**2010**
Principal					
Charges/Interest	0.23	0.92	0.92	0.92	0.92
Total	**0.23**	**0.92**	**0.92**	**0.92**	**0.92**

VII. Exchange Rate Arrangements: 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. 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. Buying and selling exchange rates were 519.73 *colones* per U.S. dollar and 522.06 *colones* per U.S. dollar, respectively, as of September 30, 2006.

VIII. Last Article IV Consultation: Concluded on July 2, 2004 (Country Report No. 04/298). Costa Rica is on the standard 12-month cycle.

IX. FSAP Participation and ROSCs Assessments: FSAP conducted on October 22–30 and December 5–13, 2001. STA ROSC data module conducted on July 5–20, 2001, and follow up February 2004. FAD ROSC is pending.

X. Technical Assistance:

Department	**Dates**	**Purpose**
STA	September 2006	Balance of payments and IIP statistics.
	May 2006	Consumer prices/Producer prices
	April 2005	Consumer price statistics
	March 2005	Balance of payments statistics
	February 2004	Migration to Government Finance Statistics Manual 2001 methodology
	July 2003	Monetary and financial statistics
LEG	March 2004	Review of draft AML/CFT legislation
MFD	August 2006	Effective supervision under partial dollarization.
	March 2006	Operational aspects of monetary and exchange rate policies
	February 2006	Financial system supervision
	November 2005	Roadmap to adoption of inflation targeting
	June 2005	Assessment of monetary policy
	November 2004	Advice on implementation of AML/CFT financial supervision
	March 2004	Financial integrity and offshore banking regulations
	February 2004	Monetary policy and prudential response to growing dollarization
FAD	April/May 2006	Tax policy: Proposals for tax reform
	March 2004	Readiness of tax administration for planned tax reform
	October 2003	Tax policy, including establishment of VAT
INS	2001–2006	Frequent regional courses through the Joint Regional Training Center for Latin America (Brasilia, Brazil)

ANNEX II. WORLD BANK GROUP RELATIONS WITH COSTA RICA

The current Costa Rica Country Partnership Strategy (CPS) covering the period FY04–FY07 was approved by the Board in May 2004. In accordance with government interest, the CPS is a highly selective program of lending and AAA work focused more on knowledge transfer, and less on resource delivery to tackle second generation challenges in key sectors. The modest program includes six lending projects totaling $218 million spread over four years, and is supplemented by five Bank analytical reports and several AAA advisory programs. It supports reforms and initiatives critical to Costa Rica's continued growth, social equality, and sustainability, and is structured along four key pillars: maintaining macroeconomic stability, strengthening trade and competitiveness, maintaining social inclusion, and continuing environmental leadership.

Bank's Assistance: Preparation advanced on four of the original six CPS pipeline projects. The Board approved the education project in March 2005. Final preparation of Ecomarkets II (Mainstreaming Market-based Instruments for Environmental Management) moved on schedule during the transition period between administrations, indicating continuity in support by the new government. Preparation of the E-government project was started, and has recently been given new life by the higher profile the new administration has afforded this agenda. Preparation of the Port City Limon project has been modest reflecting slower than expected progress on the reform agenda in this area. Finally, activities under the water project preparation grant were not initiated and the government has decided to pursue a modified agenda with other financing sources.

In addition to the above lending operations, the CPS included technical assistance (TA) activities to support government agendas in trade and competitiveness focusing on improving telecommunications, insurance sector reform, debt management, and debt market development. These TA activities have been quite successful in supporting development efforts in these areas.

Analytical Reports. Five major reports were completed and shared with the authorities during FY05–06. The two broad reports: The Country Economic Memorandum (CEM) and the Poverty Assessment (PA) focused on topics relevant to the policy agenda of the new administration. This has also been the case for the other three more specialized technical reports, the Investment Climate Assessment (ICA), the Country Financial Accountability Assessment (CFAA) and the Country Procurement Assessment Report (CPAR). As such, the reports have been well received and provided a valuable tool for policy discussion with strong links to other proposed assistance. The new government has also indicated interest in the remaining report proposed in the CPS, a Public Expenditure Review, which will be prepared for delivery in early FY08.

The Bank and the new government have discussed the remaining CPS activities and a slightly revised program will be reflected in a CPS Progress Report that will be discussed by the Board in early November.

Costa Rica: Relations with the World Bank Group

I. Financial Relations

(in millions of U.S. dollars as of Aug 31, 2006)

IBRD Operations by Sector		Committed[1]		Disbursed		Undisbursed	
Education		30.0		0.0		30.0	
Environment		62.6		32.6		30.0	
Health and Social Services		14.0		1.8		12.2	
Total		**106.6**		**34.4**		**72.2**	
IBRD Loan Disbursements (US$ millions, as of Aug. 31, 2006)	2000	2001	2002	2003	2004	2005	2006
Gross disbursements	5.8	8.4	11.6	6.6	7.7	4.8	4.2
Principal Repayments (-)	33.3	27.2	22.9	18.3	16.8	17.1	8.4
Total Net Disbursements	**-27.4**	**-18.8**	**-11.3**	**-11.7**	**-9.1**	**-12.2**	**-4.2**
Interests and Fees (-)	0.0	10.3	8.1	6.2	3.9	2.9	2.4
Total Net Cash Flows	**-27.4**	**-29.1**	**-19.4**	**-18.0**	**-13.0**	**-15.2**	**-6.6**

1/ Net of cancellations.

ANNEX III. THE INTER-AMERICAN DEVELOPMENT BANK RELATIONS WITH COSTA RICA

RECENT ACTIVITIES

The IDB is preparing a new Country Strategy with Costa Rica for the period 2006–10, which is projected to be approved by the Board in December 2006. The Bank has maintained with the new Government a Policy Dialogue Meeting in May 2006 based on a policy dialogue paper that highlights main country challenges.

IDB has three operations awaiting legislative ratification, including a program for supporting competitiveness and two regional development lines of support.

FUTURE PLANS

The Bank is exploring operations in the infrastructure (electric, roads, and transport) and social sectors.

Operations (as of May 31, 2006)

(In millions of U.S. dollars)

	Approved	Disbursed	Obligated	Available
Loans in execution	**287**	**13**	**18**	**256**
Energy	40	1	5	34
Education	-	-	-	-
Health and sanitation	4.4	0.2	-	4.2
Land title register reform	65.0	6	10.0	49
Reform and public sector modernization	22.4	5.4	1	16
Agriculture and rural development	38.6	0.3	1.7	36.7
Competitiveness	116.8	-	-	116.8
Nonreimbursable technical cooperation	**27.9**	**11.5**	**-**	**16.4**
Total	**314.9**	**24.5**	**18**	**272.4**

Loan Disbursements

	1998	1999	2000	2001	2002	2003	2004	2005	2006[1]
Disbursements	58.3	62.1	83.3	31.5	45.1	88.4	100.2	41.6	32
Amortization	55.9	85.1	75.7	78.2	79.3	93.0	110.2	208.9	79.6
Interest and charges	57.8	57.7	58.4	50.2	44.1	46.8	42.7	41.2	27.4
Net cash flow	-55.4	-80.7	-50.8	-96.9	-78.3	-51.4	-52.7	-208.5	-75

1/ Projections

Lending Program for 2006–2007 (tentative)

Project	Amount (US$ mill)
Tourism Program in Protected Areas	20
Urban Poverty Alleviation	50
Electrical Development (ICE)	175
Strengthening of Environment Management Capacity	12
Sustainable Development Program for the Pacific Region	15
Procurement System Modernization	5
Total	**277**

ANNEX IV

COSTA RICA: STATISTICAL ISSUES

Economic and financial statistics are adequate for surveillance purposes. The quality of macroeconomic data has continued to improve in recent years. Further statistical improvements are being pursued, including in the real, monetary, fiscal, and balance of payments sectors. Costa Rica is in observance with the Special Data Dissemination Standards (SDDS). The Central Bank makes data available to the public through regular official publications at its website (http://www.bccr.fi.cr).

Real sector

A new consumer price index was introduced in August 2006 by the National Institute of Statistics. It is based on an updated and expanded consumption basket, derived from a household survey conducted in 2004–05. The new and old CPIs were spliced, using July 2006 as the base period. The 2005 real GDP growth estimate was subject to a large revision, driven largely by updated data from the high technology sector. The authorities are looking at ways to enhance the timeliness and quality of the data collected from this sector.

Government finance statistics

Progress has been made in compiling public finance data according to the IMF's *Government Finance Statistics Manual (GFSM 2001)*. A plan to migrate to *GFSM 2001* was designed in 2004, and the authorities have developed an integrated financial system for the budget and public debt, which provides an excellent point of departure. They are working to further integrate systems for accounting, budgeting, and debt management.

A number of weaknesses remain, including on consistency and availability of consolidated public sector data. These include discrepancies between above-the-line fiscal figures and the financing side; and the need to standardize fiscal information on an accrual basis. Nonfinancial public sector data are only published on an annual basis. A higher frequency would be critical to improve transparency and monitoring of the overall public sector.

Monetary statistics

Monetary and financial statistics are broadly in line with the IMF's *Monetary and Financial Statistics Manual (MFSM)*. After successive TA missions (1996, 1998, 2001, and 2003), several important improvements have been made to the classification, coverage, and timeliness of the money and banking statistics. The central bank has been also working with 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. A September 2006 mission reiterated that completion of this will be critical to improve coverage and consistency between the monetary data published by the central bank and those provided to the IMF, as well as the coverage and quality of the latter.

Balance of payments statistics

Substantial progress has been made in the estimation of quarterly balance of payments and international investment position statistics. Costa Rica has published quarterly balance of payment data since 1999 and annual international investment position (IIP) data since 1996. In 2005, Costa Rica initiated the compilation and dissemination of quarterly IIP data. The central bank is currently revising compilation in the area of foreign direct investment (FDI)—including: the high-tech sector and real estate; portfolio investment; and international reserves. Revised FDI data were published recently, including activity in the real estate market by nonresidents. A TA mission visited the central bank in September 2006 to follow up on the recommendation of the March 2005 TA mission in Balance of Payments and IIP statistics, and to provide assistance on this work. In September 2003, Costa Rica initiated the dissemination of quarterly external debt position data with one quarter lag on the central bank's website with a hyperlink to the Fund's website. In early-2006, the coverage of these data was improved significantly, by including the short-term and private sector external sector debt liabilities, and moving closer to the residence criteria recommended by *BPM5* and the *External Debt Statistics: Guide for Compilers and Users*.

COSTA RICA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of September 30, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	Sept 06	Sept 06	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Aug 06	Sept 06	M	M	M		
Reserve/Base Money	Aug 06	Sept 06	M	M	M	O, O, LNO, LO	LNO, O, LO, O
Broad Money	Aug 06	Sept 06	M	M	M		
Central Bank Balance Sheet	Aug 06	Sept 06	M	M	M		
Consolidated Balance Sheet of the Banking System	Aug 06	Sept 06	M	M	M		
Interest Rates[2]	Sept 06	Sept 06	D	D	D		
Consumer Price Index	Aug 06	Sept 06	M	M	M	O, O, LO, O	LO, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Dec 05	July 06	Y	Y	Y		
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	August 06	Sept. 06	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Aug 06	Sept.06	M	M	M		
External Current Account Balance	Mar 06	July 06	Q	Q	Q	O, O, O, LO	LO, O, LO, LNO
Exports and Imports of Goods and Services	Mar 06	July 06	Q	Q	Q		
GDP/GNP	Q1 06	Jun 06	Q	Q	Q	O, O, LO, O	LNO, LNO, LO, LNO
Gross External Debt	Mar 06	July 06	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discounts rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[7] Reflects the assessment provided in the data ROSC, published on August 16, 2002 and based on the findings of the mission that took place July 6-19, 2001, 2003) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revision studies.

INTERNATIONAL MONETARY FUND

COSTA RICA

Staff Report for the 2006 Article IV Consultation

Supplementary Information

Prepared by the Western Hemisphere Department

Approved by Markus Rodlauer and Adnan Mazarei

October 24, 2006

1. **This supplement provides an update of economic policy developments since the release of the staff report** (see www.imf.org). The thrust of the staff appraisal remains unchanged.

2. **Recent data confirm that economic activity is strong and inflation is slowing.**

- Real GDP rose by 7.1 percent in the second quarter of 2006 (year-on-year); and the monthly index of economic activity (IMAE) went up by 7.3 percent in August 2006 (year-on-year).

- Annual consumer price inflation fell to 11.2 percent in September from 11.6 percent in August, largely on account of lower fuel prices.

3. **On October 17, the central bank replaced the long-standing crawling peg regime with a crawling band**.

- The band is defined in terms of colones per U.S. dollar, and has an initial width of 3 percent. It will widen over time, as its floor and ceiling are set to crawl upward, at initial rates of around 3 and 6½ percent per year respectively.

- The change should progressively enhance the effectiveness of monetary policy. Greater exchange rate flexibility will increase monetary policy autonomy, and help shift price expectations away from the rate of exchange rate crawl and toward the central bank's announced inflation objectives. Combined with fiscal discipline and the recapitalization of the central bank, as the authorities intend, it should permit a gradual reduction of inflation.

- The regime change follows an intensive public information campaign and thorough preparations by the central bank. Throughout the year, the monetary authorities communicated to the public their intention to switch to the new regime, and a number of regulatory and operational changes have been implemented to facilitate the transition. The Fund has supported these efforts through close policy dialogue and extensive technical assistance.

- The first days of operations of the crawling band have gone smoothly. The colon initially moved to the floor of the band, implying a nominal appreciation of 1.5 percent, and has remained close to it since. Transaction volumes in the wholesale and retail foreign exchange markets have been normal.

Statement by Moises Schwartz, Executive Director for Costa Rica
and Nina Conrado, Senior Advisor to Executive Director
October 30, 2006

On behalf of the authorities of Costa Rica we would like to convey their appreciation to IMF staff and management for a constructive policy dialogue and valuable technical assistance. The discussions of the 2006 article IV consultation were held a couple of months after President Arias took office, providing for an excellent opportunity to discuss medium-term objectives and policies to be carried out by the new administration.

Economic activity in Costa Rica continues to be strong. Even in a context of a negative oil shock, the economy continues a broad base growth trend, supported by dynamism in investment and exports. Increases in FDI, exports and tourism have strengthen international reserves, compensating the expansion in the current account deficit resulting from a higher oil bill. High international oil prices have also affected inflation, which, although still in double digits, has started to decline. Credit growth has accelerated, in part reflecting an improvement in confidence and positive expectations.

To continue with this positive macroeconomic context and to further advance in addressing Costa Rica's medium-term challenges, the authorities intend to carry out a broad reform agenda, to continue with fiscal consolidation to reduce public debt, to fight persistent inflation, to strengthen the financial sector, and to continue to boost private sector led growth through further integration with the rest of the world.

Fiscal Policy

One of the main elements in the authorities' medium-term agenda is to further advance towards fiscal consolidation. The dynamism in economic activity, as well as improvements in tax and custom administration have resulted in a buoyant revenue performance. This has been coupled with a better control of expenditures and an improved debt management to strengthen the fiscal balance. In 2005, the fiscal deficit declined to its lowest level in a decade, resulting in a reduction in public debt. For 2006, initial estimates based on information up to September, suggest that the primary balance of the Central Government will be higher and its financial deficit will be lower than previously anticipated.

The government plans to lower the public debt level to about 40 percent in the medium term and, at the same time, allow for additional resources to capitalize the Central Bank and increase priority expenditures in the social sector and in infrastructure. To achieve these objectives, the fiscal consolidation strategy has been centered on a comprehensive tax reform. Taking into account Costa Rica's legislative procedures, instead of sending one tax package, the authorities have sent to the National Assembly three tax bills, which include reforms to the value added tax, real estate tax, and business registration tax. The income tax bill is still being negotiated and will be sent to the Assembly before the end of the year. The authorities agree with staff that the core elements of this reform rely on the VAT and income tax, and that, depending on the congressional agenda, the approval of these bills will be fully observed as additional revenues in 2008. However, if the VAT and the real state tax are approved in 2007, as it is expected, part of these revenues will be collected next year.

A draft 2007 budget has been submitted to Congress, in line with the objective of strengthening fiscal discipline and consistent with the medium-term objective of bringing down inflation. The proposal incorporates a prudent wage policy, additional efforts in terms of tax administration and a redistribution of resources towards education, health, security and public infrastructure.

Monetary Policy

As a first major step towards exchange rate flexibility, last week the Central Bank introduced a system of bands for the exchange rate. After more than two decades with a crawling peg regime, the new exchange rate system is oriented to regain control of monetary policy, with the main objective of reducing inflation. This reform is part of the medium-term strategy to move to a system of inflation targeting, for which the authorities are engaging in important reforms in Costa Rica’s monetary policy framework.

In the context of a strong position of international reserves, fiscal discipline, and financial stability, the Central Bank’s strategy has been based on two important blocks: gradualism and transparency. During last year, in order to allow for greater degrees of freedom in monetary policy, and to improve the transmission mechanism, monetary instruments have been modified, incorporating changes in policy interest rate and reserve requirements, and introducing an electronic window for direct investment in the Central Bank. In the foreign exchange market, to allow for an orderly move to the system of a narrow band, the Central Bank has issued new regulations, and a new electronic platform for foreign exchange market transactions is being launched. Additionally, important efforts are being made to enhance the Central Bank’s communication strategy.

The behavior of the foreign exchange market after the change in the system reflects a smooth transition. The Central Bank has decided to maintain a crawling band using expected inflation, and plans to gradually broaden the band. In the medium term, the Central Bank expects that this measure will also help reduce financial dollarization. The authorities recognize the presence of vulnerabilities in the financial sector, and are planning to continue to make the necessary reforms to change the regulatory and supervisory framework to strengthen banking supervision. They are also working on norms to allow for instruments to cover exchange rate risk. Important efforts are also being made to strengthen supervision of off-shore banking, including through regional initiatives.

The authorities believe that, in the medium term, the reforms being taken will allow them to better deal with the main challenges in terms of monetary policy, including persistent inflation and financial dollarization. These measures, coupled with the government's intention to capitalize the central bank and the resulting reduction of quasifiscal losses will enhance the credibility of the new system and reduce inflationary expectations.

Structural reforms

Regarding the structural reform agenda, the authorities of Costa Rica plan to enhance the country's integration with the rest of the world. High in the government's agenda is to support the ratification of the US-Central American Free Trade Agreement, and to promote other bilateral agreements such as the one being negotiated with Panama and the one that is under discussion with the UE.

To complement this policy, the authorities are carrying out reforms to strengthen the insurance sector and the public electric and telecommunications utility company (ICE). Last week, the President signed a decree giving more flexibility in financial and investments procedures of the enterprise, allowing it to invest up to US$ 435 millions in additional resources. This effort will allow for the needed investment to modernize this sector and make it more competitive.

Additionally, other efforts are being carried out to improve competitiveness and making the economy more resilient to shocks, such as the recently approved law providing incentives to organic agriculture.

Looking Forward

The authorities are aware of the challenges ahead, especially regarding gathering the necessary consensus for important reforms. Nevertheless, the authorities are committed to their reform agenda, which was clearly presented in their political platform and is now perceived as a public mandate. The authorities believe that carrying out the expected reforms will allow Costa Rica to continue growing at a steady rate, enhance macroeconomic stability through fiscal consolidation and reduce inflationary inertia and, more importantly, improve social indicators and allow for a reduction in poverty.

INTERNATIONAL MONETARY FUND
Public Information Notice

EXTERNAL
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DEPARTMENT

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

IMF Executive Board Concludes 2006 Article IV Consultation with Costa Rica

On October 30, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Costa Rica.[1]

Background

Since the last Article IV consultation, the economy has strengthened. Real GDP grew 5.9 percent in 2005, driven mainly by exports and private investment, while inflation rose to 14.1 percent, partially explained by higher world oil prices. The current account deficit widened to 4.7 percent of GDP in 2005. Strong export growth, particularly of electronics and tourism services, partially offset higher imports of oil and capital goods. Robust private capital inflows, including a surge in foreign direct investment, led to a substantial accumulation of net international reserves. Unemployment remained constant at 6.6 percent.

In 2006, economic activity has remained strong, supported by large foreign direct investment, improved domestic business confidence, and robust domestic consumption. Inflation is declining, albeit at a low pace. Early economic indicators suggest, for the year as a whole, real GDP growth could reach at least 6½ percent, while inflation would be between 11 and 12 percent at the end of the year.

[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 prepares 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 Executive Directors, and this summary is transmitted to the country's authorities.

The overall public sector deficit declined to 3 percent of GDP in 2005, the lowest figure in a decade, owing to improvements in tax and customs administration and expenditure restraint. In parallel, the primary surplus reached a record level of 2.1 percent of GDP and public debt fell to about 52 percent of GDP, still a high level. The central government deficit fell further in the first half of 2006, thanks to buoyant tax receipts and continued capital spending restraint.

Monetary aggregates are expanding rapidly. Currency issue and broad money grew at annual rates of 22 and 20 percent in the year to July 2006, while bank credit to the private sector expanded at a rate of 28 percent. Key contributing factors were the central bank's large operational deficit, sizeable accumulation of reserves, improved consumer confidence, and a rise in investment demand.

On October 17, the central bank replaced the long-standing crawling peg exchange rate regime with a crawling band. The band is defined in terms of colones per U.S. dollar, and has an initial width of 3 percent. It will widen over time, as its floor and ceiling are set to crawl upward, at initial rates of around 3 and 6½ percent per year, respectively.

The health of the financial sector has improved on the back of a favorable macroeconomic environment, though important vulnerabilities remain. Bank profitability reached record levels, in both public and private banks. Reported asset quality indicators have improved markedly, with nonperforming loans falling down to 1.5 percent of all loans. Although the banking sector remains dominated by public banks, recent acquisitions of large private banks by multi-national foreign banks have intensified the process of consolidation and ownership concentration in the sector. Vulnerabilities include high dollarization of assets and liabilities, and large offshore banking activities.

Executive Board Assessment

Directors welcomed Costa Rica's continued strong economic performance, with GDP growth underpinned by robust exports as well as a substantial acceleration in private investment. Private capital inflows, including foreign direct investment, have boosted international reserves, while the fiscal deficit has declined, with an attendant reduction in public debt. Directors noted, however, that the economy continues to face important vulnerabilities, including double-digit inflation, still high public debt, and financial dollarization.

Directors shared the Costa Rican authorities' analysis of the main challenges facing the economy, and commended them for their commitment to a broad reform agenda, including a comprehensive fiscal reform, greater exchange rate flexibility, recapitalization of the central bank, and strengthening of financial regulations and supervision. Implementation of these policies will go a long way toward laying the foundation for faster growth and poverty reduction.

Directors noted that the near-term outlook for the Costa Rican economy remains favorable, with growth expected to stay high and inflation to decline.
They considered the risks to the outlook as broadly balanced, while noting the need to deliver on the proposed reform agenda to maintain consumer and business confidence.

Directors emphasized that adoption of a broad tax reform is critical to reduce public debt; allow higher spending on education, infrastructure, and social needs; and provide the needed support to monetary policy to reduce inflation. They endorsed the authorities' efforts to obtain prompt legislative approval of the proposed tax reform. Directors encouraged the authorities to focus the reform on the VAT and the income tax, and advised against introducing a financial transactions tax. Directors underscored the need to complement this reform with measures to further strengthen tax administration and reduce public expenditure rigidities.

Directors praised the authorities for maintaining a prudent fiscal stance in 2006. While they recognized the need to increase spending in priority areas, they urged the authorities to limit expenditure growth until the benefits of the tax reform materialize. Directors observed that tax revenue projections in the draft 2007 budget appear ambitious, and recommended prudence in budget execution to ensure that the fiscal targets are reached.

Directors endorsed the authorities' recent move from the long-standing crawling peg to a crawling band regime. They welcomed the decision to allow for a gradual widening of the band, which will allow market participants to adjust progressively to an environment with greater exchange rate flexibility. The change in exchange regime should gradually enhance the autonomy of monetary policy, help anchor price expectations on target inflation, and enhance the economy's resilience to shocks. Directors generally saw this transition as a first step toward the eventual adoption of an inflation target as a nominal anchor. Several Directors emphasized the importance of the appropriate conditions being in place before such a move.

Directors supported the planned recapitalization of the central bank, which they considered would be an essential complement to a prudent fiscal stance and greater exchange rate flexibility in order to bring inflation gradually down to low-single digits.

Directors observed that the health of the financial sector has improved in recent years. To address the remaining vulnerabilities, Directors urged the authorities to accelerate and broaden financial sector reform, including by strengthening the supervision of offshore banking activities. They also recommended that the supervisory authority continue to enhance the monitoring of banks' asset quality and foreign currency lending to non foreign-currency earners.

Directors welcomed the authorities' determination to press ahead with ratification and implementation of CAFTA-DR. They observed that further trade liberalization, together with a reduction in the regulatory costs of doing business, should add to Costa Rica's growth potential through higher foreign direct investment and trade opportunities.

Directors encouraged the authorities to continue their efforts to foster regional cooperation. In particular, they urged continued efforts to reach consensus on a code of conduct in tax incentives for investment, in order to help forestall harmful tax competition in the region.

Costa Rica: Selected Economic and Financial Indicators

	2001	2002	2003	2004	Prel 2005	Proj 2006	Proj 2007 1/
(Annual percentage change, unless otherwise noted)							
National income and prices							
GDP at constant prices	1.1	2.9	6.4	4.1	5.9	6.5	5.0
Implicit deflator	8.6	9.2	8.3	11.8	11.1	11.5	8.6
Consumer prices (end of period)	11.0	9.7	9.9	13.1	14.1	12.0	9.0
Consumer prices (average)	11.3	9.2	9.4	11.7	13.6	13.0	10.4
External sector							
Exports of goods (f.o.b.)	-7.5	-1.2	8.3	8.6	10.3	15.0	10.5
Imports of goods (c.i.f.)	-9.7	16.7	14.8	8.8	15.8	13.8	8.6
Terms of trade (-) deterioration	5.5	-0.1	-10.0	-8.8	-3.3	-0.2	0.1
Real effective exchange rate (depreciation -) 2/	3.9	-2.3	-6.6	-3.1	0.0	1.5	..
Banking system							
Net domestic assets	12.8	16.2	13.3	25.5	8.5	21.2	23.3
Of which: Credit to private sector	24.2	21.9	20.5	18.9	30.6	29.5	20.0
Broad money	11.1	20.8	19.1	33.3	22.0	24.1	20.0
Lending interest rate (end of period) 2/	25.8	27.4	23.7	23.3	24.0	22.5	
(In percent of GDP)							
Public Sector							
Overall primary public sector balance	1.2	-0.3	0.5	0.8	2.1	1.8	2.6
Overall public sector balance	-3.8	-5.5	-5.1	-4.2	-3.0	-3.4	-2.6
Nonfinancial public sector balance	-2.6	-4.1	-3.5	-2.9	-1.6	-2.2	-2.4
Central bank losses (-)	-1.2	-1.4	-1.6	-1.3	-1.4	-1.2	-0.2
Gross domestic investment	**20.3**	**22.6**	**20.6**	**22.9**	**25.5**	**24.7**	**23.0**
Gross national savings	**16.6**	**17.5**	**15.9**	**18.6**	**20.9**	**19.8**	**18.2**
External current account balance	**-3.7**	**-5.1**	**-4.8**	**-4.3**	**-4.7**	**-4.9**	**-4.8**
Total public debt	**49.9**	**54.3**	**56.2**	**55.8**	**52.0**	**48.8**	**46.8**
Of which:							
External public debt (end of period)	19.8	19.8	21.5	21.0	18.2	16.4	15.1
Foreign-currency denominated debt 3/	26.5	29.1	31.5	30.5	18.9	19.0	18.2
(In percent of exports of goods and services)							
External public debt service 4/	11.3	10.7	14.1	10.3	7.6	5.0	5.3
Of which: interest 4/	3.3	3.0	2.7	2.3	2.0	2.0	1.8
(In millions of U.S. dollars, unless otherwise specified)							
Change in net international reserves (increase -)	-13	-163	-339	-80	-391	-100	-250
Net international reserves (NIR) 5/	1,098	1,261	1,600	1,680	2,071	2,171	2,421
NIR (months of non-maquila imports)	3.0	3.0	3.6	3.2	3.5	3.4	3.5
Memorandum items:							
GDP (in billions of colones)	5,395	6,061	6,982	8,127	9,566	11,363	12,953
GDP (in millions of U.S. dollars)	16,403	16,843	17,513	18,560	20,022	22,248	23,624

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

1/ Baseline scenario
2/ As of June 2006 for the REER; as of end-August 2006 for interest rates.
3/ Percentage of central government debt denominated in foreign currency or indexed.
4/ Excludes *maquila* exports.
5/ Excludes bilateral claims under negotiation which in the official statistics are classified as part of international reserves.