Country report

COSTA RICA

Summary

Thanks to considerable fiscal stimulus, Costa Rica has weathered the global economic crisis and the decline in US demand for its exports relatively well. As stimulus is not yet withdrawn and prospects for the US economy are improving, economic growth for the next years is expected to reach 4.3% on average. This comes at the cost of significant budget deficits that have to be addressed soon if the country wants to return to its comparatively low pre-crisis public debt load. Due to a narrow tax base, reforms to increase tax revenues are imperative. The election of Laura Chinchilla, a party member of former president Óscar Arias, in last year's presidential elections should guarantee the continuation of free-market policies, but the concurrent legislative elections did not provide her with a majority in Congress, which could delay important reforms. As the foreign debt ratio is on a declining trend and the current account deficit is fully financed, the external position is favorable.

Things to watch:

- Budget deficit and reforms to increase tax revenue
- Impact of commodity price hikes on the current account
- Possible increase in drug-related crime

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Costa Rica

National facts		
Type of government	Democratic Republic	
Capital	San Jose	
Surface area (thousand sq km)	51	
Population (millions)	4.6	
Main languages	Spanish	
Main religions	Roman Catholic (76%)	
	Evangelical (14%)	
	Jehovah's Witnesses (1%)	
Head of State (president)	Laura Chinchilla	
Head of Government (prime-minister)	Laura Chinchilla	
Monetary unit	colón (CRC)	
Economy		**2010**
Economic size	*bn USD*	*% world total*
Nominal GDP	35	0.06
Nominal GDP at PPP	49	0.07
Export value of goods and services	14	0.08
IMF quotum (in mln SDR)	164	0.08
Economic structure	*2010*	*5-year av.*
Real GDP growth	4.0	4.9
Agriculture (% of GDP)	6	7
Industry (% of GDP)	23	26
Services (% of GDP)	71	67
Standards of living	*USD*	*% world av.*
Nominal GDP per head	7601	78
Nominal GDP per head at PPP	10560	91
Real GDP per head	5322	66

Social and governance indicators	rank / total
Human Development Index (rank)	62 / 169
Ease of doing business (rank)	125 / 183
Economic freedom index (rank)	49 / 179
Corruption perceptions index (rank)	47 / 180
Press freedom index (rank)	29 / 178
Gini index (income distribution)	48.9
Population below $1 per day (PPP)	2.20%

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
US	37	US	26
China	11	Mexico	6
Netherlands	5	China	2
Panama	4	Venezuela	1

Main export products (%)	
Maquilla & zonas francas	18
Non-traditional agricultural	9
Bananas	7
Coffee	2
Main import products (%)	
Intermediate goods	55
Consumer goods	19
Capital goods	17
Openness of the economy	
Export value of G&S (% of GDP)	39
Import value of G&S (% of GDP)	42
Inward FDI (% of GDP)	4.7

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

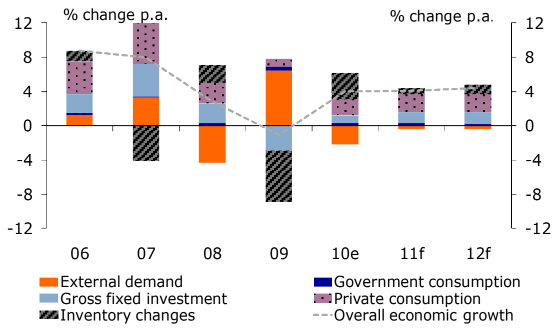
Economic structure and growth

Costa Rica is a small, open economy in Latin America with a total nominal GDP of USD 35bn (2010). With a population of 4.6 million, its nominal GDP per capita amounts to USD 7,601, or USD 10,560 in PPP terms, second only to Panama's in the Central American region. The country has a comparatively high level of human development and enjoys relatively strong public institutions. It is also renowned for its stability. Income inequality ranks amongst the lowest in Latin America and life expectancy at birth is comparable to more developed countries. In comparison to other Central American countries, Costa Rica does not compete with countries like China in manufacturing labor-intensive products. Benefitting from its well-educated population, Costa Rica was able to broaden its economy from traditional agricultural products and tourism to the production of high-tech exports, predominantly for the US market. The multinational technology giant Intel contributes considerably to Costa Rican exports as its computer parts and microprocessors accounted for more than 15% of total exports in the first five months of 2010. Exported goods are primarily produced in free trade zones (zonas francas). Given that the level of sophistication of exported produce is comparatively high, intermediary goods used for their production account for more than half of Costa Rica's imports. Other important imports are consumer products and capital goods. As Costa Rica does not have any noteworthy natural resources, these have to be imported.

While the institutional settings of the Costa Rican financial sector are comparatively solid, considerable deposit dollarization and lacking supervision of off-shore activities form risks. Deposit dollarization at the end of 2009 was estimated at 49.3%. Yet, given continuous colón appreciation, relatively low domestic inflation and considerable interest rate differentials with respect to the US,

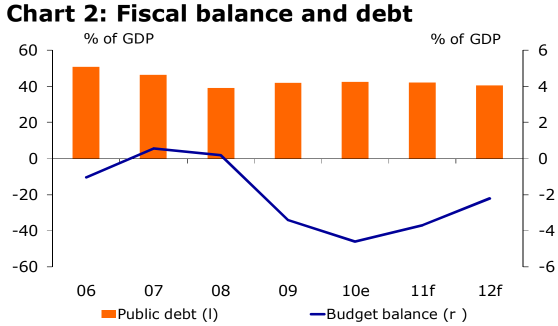
deposit dollarization may have declined moderately as deposit holders increasingly exchanged their dollar holdings for domestic currency. Still, given that the central bank has not yet established a solid track record of low inflation, we expect that dollarization levels will remain substantial, exposing banks to exchange rate risk in terms of repayment capacity of its debtor base as far as dollar-denominated loans are concerned. So far, the appreciation of the colón bode well for Costa Ricans borrowing in US-dollars, but an abrupt devaluation could result in rising delinquencies.
In contrast to other countries in the region that lean heavily on US demand, the fall in Costa Rican GDP of 1.1% in 2009 was rather limited, primarily owing to strongly falling imports compensating for the drag from inventory changes and declining investments. With 4% economic growth in 2010, the Costa Rican economy is expanding again, though at lower than pre-crisis rates. Driven by domestic demand, that is also supported by the *Plan Escudo* stimulus program (details provided below), as well as investments, economic growth of 4.1% in 2011 and 4.4% in 2012 can be expected. Still, developments in the US, Costa Rica's main trading partner, will dominate the course of the Costa Rican economy. A deteriorating US labor market might hurt the Costa Rican tourism sector, which also forms an important source of foreign exchange.

Chart 1: Growth performance



Source: EIU

Chart 2: Fiscal balance and debt



Source: EIU

Political and social situation

With Laura Chinchilla from the Partido Liberación Nacional (PLN) winning the February 2010 presidential elections in a landslide victory, a continuation of the sound free-market policies is to be expected. Benefitting from her predecessor's popularity, that is also due to the implementation of the *Plan Escudo*, Ms Chinchilla was elected by large margins. As indicated by its name, the intention of the *Plan Escudo* stimulus program, whose withdrawal is still pending, is to shield the Costa Rican economy from declining external demand as a consequence of the global economic downturn in 2009. Resting on the four pillars families, workers, enterprises and the financial sector, the plan provides financial and non-financial assistance to dampen the effects of the crisis, like for instance financial aid for families threatened by poverty, job and wage sharing arrangements or subsidized loans to small and medium-sized enterprises and financial institutions.
While the considerable popularity of the stimulus program helped Ms Chinchilla, her party did not succeed in getting a majority in the concurrent legislative elections, which will delay the passing of legislation. In Congress, the right-wing Partido Movimiento Libertario (ML) gained seats to the detriment of the centre-left Partido Acción Ciudadana (PAC). Though not officially forming a coalition with the ML, Ms Chinchilla's party signed institutional sharing agreements. According to these agreements, vacant public offices have been divided among candidates from both parties, leading to, for example, PLN support for ML candidates to chair the congressional committee on public spending. The ML and PLN also identified 27 areas of agreement, ranging from issues like improved public security services or the approval of infrastructure loans from the World Bank and

the Inter-American Development Bank to the ratification of free trade agreements with China and Singapore. Differences, however, remain as far as crucial issues like public spending and the expansion of social programs are concerned. Therefore, a formal alliance between the two parties is rather unlikely and the PLN will have to come to terms with other parties on these issues, which will delay the legislative process and postpone the crucial tax reform aiming at the widening of the revenue base.

The issue of public security played an important role during the elections as the perception of public safety has worsened in recent years. Since 2005, the homicide rate in Costa Rica has increased by 63%, while drug-related crime is on the rise. In 2010, Costa Rica was listed for the first time by the US among the 20 major illicit drug transit or producing nations. Given its geographical location, there has been an increasing tendency for Costa Rica to become a hub in drug trafficking networks, raising fears that gangs and drugs might spread into the country. So far, only the Sinaloa cartel, one of the most powerful Mexican drug cartels, seems to have established a presence in Costa Rica. Yet, Costa Rica's relatively limited resources and the absence of an army could attract other drug cartels as well. Consequently, Ms Chinchilla made public safety her top policy priority as she strives to maintain Costa Rica's reputation for being a relatively safe and peaceful country. In order to tackle these issues, Ms Chinchilla has promised to increase the public security budget and focus on crime prevention, which will improve the security outlook in the medium-term. The long-term security perspective for the country, though, depends on the success in the fight against drug cartels, for which Ms Chinchilla also relies on US assistance.

International relations in 2010 were overshadowed by a long-simmering border conflict with neighboring Nicaragua, that escalated in late 2010 when Nicaraguan troops occupied a stretch of land on the San Juan river that forms the eastern part of the bilateral border. In response, Costa Rica, that does not possess an army, deployed paramilitary forces to the border and constructed several heliports. An attempt at solving the border row via the Organization of American States (OAS) failed, after President Ortega of Nicaragua, with the backing of Venezuela, rejected an OAS resolution asking for the withdrawal of troops and the beginning of negotiations. At the time of writing this report, the case was brought before the International Court of Justice (ICJ), whose verdict is still pending. Given that president Ortega of Nicaragua is running for his third term in office and will likely benefit from rising nationalistic sentiment, we expect that the conflict will continue at least until Nicaraguan elections are held in November 2011. At worst, the conflict could result in the cessation of diplomatic relations. As bilateral levels of trade and investment are low, economic disruptions would be minimal.

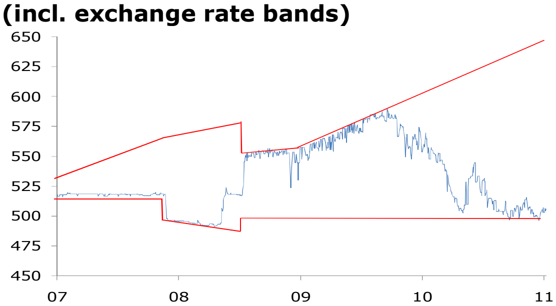
Economic policy

Despite the absence of a majority in Congress and the need for alliances, the election of Ms Chinchilla should guarantee the continuation of the free-market policies of her predecessor. Attracting foreign direct investments remains a policy priority. This continuity also implies that the additional spending in line with the *Plan Escudo*, which cushioned the effects of the global economic downturn in 2009, will be maintained for some time as economic growth at home and in the main export markets remains sluggish. Nevertheless, the need for fiscal consolidation is generally accepted, but the absence of a government majority in Congress will delay the passing of a tax reform aimed at the broadening of the revenue base. The reform proposal, which foresees raising tax revenues by 2.5% of GDP, has met considerable opposition, ranging from allies of Ms Chinchilla and business groups to the opposition parties.

As a consequence of DR-CAFTA (Dominican Republic-Central American Free Trade Agreement) membership, import tariffs have to be reduced gradually, resulting in revenues from import tariffs falling from 2.8% of GDP in 2009 to 1.9% in 2011. IMF projections show that absent further consolidation measures, the primary balance would remain negative for the entire projection period used for these calculations (i.e. until 2015) and the overall budget deficit would stabilize at 4% of GDP. Consequently, the public debt ratio would reach 44% of GDP by 2015. In a consolidation scenario involving measures equal to 2% of GDP p.a., the primary balance would return to surplus in 2012 and remain positive, while the budget deficit would gradually decline to a level of 1.4% of GDP in 2015. The public debt ratio would reach pre-crisis levels of about 35% of GDP, which would be consistent with the average pre-crisis public-debt-to-GDP ratio of investment grade countries in the BBB/A range. It would also provide the country with some fiscal policy space in case of another economic downturn. Since about one-third of central government debt is financed domestically, lower budget deficits would also reduce possible crowding out of private investments and thereby promote economic growth.

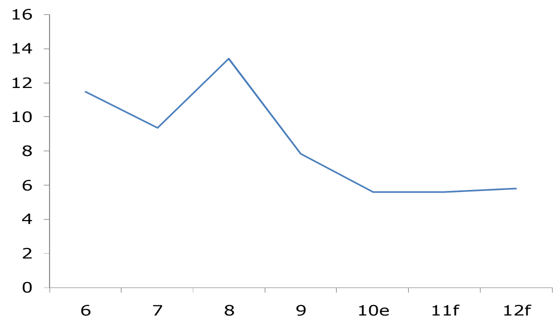
Additional policy objectives comprise the improvement of the country's infrastructure, the signing of free trade agreements with China and Singapore, as well as the further opening up of markets in line with DR-CAFTA. Despite being a policy priority, the actual realization of plans to improve the country's infrastructure cannot be taken for granted, as strained government finances might prevent large expenditures.

Chart 3: Colón exchange rate vs. USD (incl. exchange rate bands)



Source: EcoWin/IIF

Chart 4: Inflation rate



Source: EIU

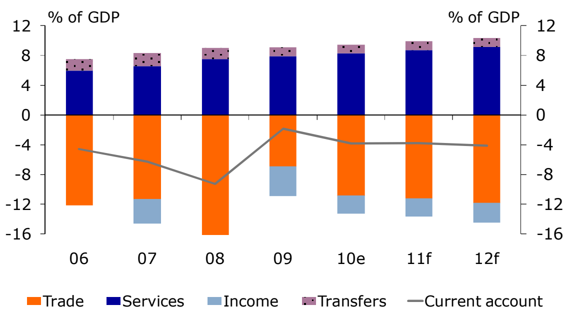
Monetary policy in Costa Rica is subject to the adherence of the local currency, the colón, to an exchange rate band with respect to the USD, resulting in limited policy space for the central bank. As the country strives for more monetary policy autonomy also involving a floating exchange rate, the exchange rate bands have been widened gradually over time. The currently low inflation rates resulting from more favorable terms of trade and slower growth of the monetary base should facilitate the change of the exchange rate regime. Yet, the still large degree of dollarization of the economy, estimated at nearly 50% by the IMF in 2009, illustrates that credibility of the central bank might still need to improve in order to let the currency float freely. Depending on domestic inflation, which might increase in line with economic growth and rising commodity prices, the exchange rate band may be maintained for some time as inflation expectations might not yet be sufficiently anchored. Also, administrative hurdles might cause some delay, postponing the adoption of a flexible exchange rate regime.

Given recent colón appreciation towards the lower band and comparatively low inflation levels, the central bank has repeatedly cut interest rates and also intervened in the foreign exchange market, resulting in increased foreign exchange reserves. So far, these interventions have not been sterilized, but their inflationary impact was partly compensated by increased demand for domestic currency. The impact of the colón appreciation on Costa Rica's competitiveness, which had been particularly strong for the agricultural and the tourism sector, has sparked a debate in Costa Rica on the future of the exchange rate regime. Suggestions ranged from the imposition of taxes on capital inflows to the complete dollarization of the economy.

Balance of Payments

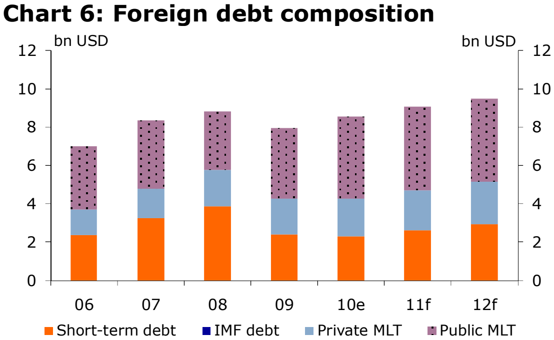
After having decreased considerably in 2009, the current account deficit increased to about 4% of GDP in 2010 and will stabilize at this level for the projection period (i.e. until 2012). With foreign direct investment inflows equalling 5% of GDP in 2011, the current account deficit will be completely covered and foreign exchange reserves will increase by about 1% of GDP. Also, foreign exchange interventions by the central bank in order to keep de colón within the exchange rate band could lead to additional foreign exchange reserve accumulation. Partly driven by higher commodity prices as well as stronger domestic demand, the trade balance will continue to deteriorate reaching a deficit of 11% of GDP in 2011, which will be largely mitigated by the constantly increasing surplus on the services balance. While tourism traditionally accounts for the largest part of the surplus, exports of call center services or the provision of financial services gain in importance. Tourist arrivals suffered from high US unemployment rates in 2009, but recovered to pre-crisis levels last year. Still, growth, both in terms of the number of visitors and generated income, will still be dampened in 2011, while exports of IT-related services and financial services are expected to increase.

Chart 5: Current account balance



Source: EIU

Chart 6: Foreign debt composition



Source: EIU

External Position

Costa Rica enjoys a relatively favorable external position as its comparatively low external debt load continues to decrease and its foreign exchange reserves remain at comfortable levels.
The foreign debt load of Costa Rica is on a downward trend since 2007, reaching a level of 24% of GDP in 2010. Despite the *Plan Escudo* stimulus program, this trend is primarily driven by improving external public debt ratios, while external private debt as a share of GDP will not change considerably in the upcoming years. We expect external private medium-to-long-term debt to hover around 5% of GDP during this period. The decline in external debt ratios will continue in the years to come, though at a slower speed. The debt service ratio will decrease to 18% in 2011 and increase slightly in the following year. One-fourth of the 2010 foreign debt load is short-term debt and this share is expected to increase to more than a third by 2012. Since a considerable part of the short-term debt is trade-related, its share rises in line with recovering trade.
The liquidity position of Costa Rica has recovered somewhat after reaching critical values in 2008, with the liquidity ratio remaining in the range of 110% in the coming years. Compared to its rating peers, the liquidity ratio is still rather low. The same holds for the import cover of foreign reserves, expected to amount to 3.7 months in 2011 and 2012. In case monetary policy in the main economies remains loose during the projection period, foreign exchange reserves will likely

increase as the central bank defends the lower band of the exchange rate mechanism, resulting in improved liquidity and import cover ratios. Even in the absence of these interventions, foreign exchange reserves by far exceed Costa Rica's debt service costs in the next two years.
Still, as about 30% of general government debt and 40% of public sector debt is denominated in USD, the government is exposed to a sudden sharp depreciation of the colón. Additionally, due to considerable dollarization, contingent liabilities in the private sector might materialize in this case, arguing for continuing foreign reserve accumulation to enhance resilience. In order to mitigate these vulnerabilities, the government of Costa Rica has received credit lines from various international multilateral institutions.

Costa Rica

Selection of economic indicators	2006	2007	2008	2009	2010e	2011f	2012f
Key country risk indicators							
GDP (% real change pa)	8.8	7.9	2.8	-1.1	4.0	4.1	4.4
Consumer prices (average % change pa)	11.5	9.4	13.4	7.8	5.6	5.6	5.8
Current account balance (% of GDP)	-4.5	-6.3	-9.2	-1.8	-3.8	-3.8	-4.1
Total foreign exchange reserves (mln USD)	3115	4114	3799	4066	4748	5160	5630
Economic growth							
GDP (% real change pa)	8.8	7.9	2.8	-1.1	4.0	4.1	4.4
Gross fixed investment (% real change pa)	10.8	18.2	9.9	-12.1	4.0	6.1	6.3
Private consumption (% real change pa)	5.7	7.5	3.9	1.5	2.8	3.2	3.2
Government consumption (% real change pa)	2.9	2.3	4.3	5.1	4.1	3.8	2.5
Exports of G&S (% real change pa)	10.3	9.9	-1.7	-9.2	7.4	6.9	7.4
Imports of G&S (% real change pa)	8.1	4.3	6.3	-21.1	13.6	8.1	8.5
Economic policy							
Budget balance (% of GDP)	-1.1	0.6	0.2	-3.4	-4.6	-3.7	-2.2
Public debt (% of GDP)	51	46	39	42	42	42	41
Money market interest rate (%)	24.8	17.0	25.0	23.0	21.4	21.0	19.8
M2 growth (% change pa)	29	30	13	11	9	16	21
Consumer prices (average % change pa)	11.5	9.4	13.4	7.8	5.6	5.6	5.8
Exchange rate LCU to USD (average)	511.3	516.6	526.2	573.3	526.3	516.2	523.6
Recorded unemployment (%)	6.0	4.6	4.9	8.4	7.3	6.6	6.1
Balance of payments (mln USD)							
Current account balance	-1023	-1646	-2752	-537	-1349	-1500	-1770
Trade balance	-2727	-2986	-5014	-2027	-3863	-4460	-5100
Export value of goods	8102	9300	9554	8847	9465	10510	11380
Import value of goods	10829	12285	14569	10874	13329	14970	16480
Services balance	1351	1734	2255	2308	2927	3470	3950
Income balance	4	-865	-434	-1177	-847	-990	-1160
Transfer balance	349	470	442	359	434	490	530
Net direct investment flows	1371	1634	2072	1339	1642	1990	2340
Net portfolio investment flows	-525	-136	684	-366	-96	-100	0
Net debt flows	220	866	436	-884	562	500	420
Other capital flows (negative is flight)	759	282	-756	716	-77	-480	-520
Change in international reserves	802	999	-315	268	681	420	470
External position (mln USD)							
Total foreign debt	6994	8342	8812	7966	8553	9080	9490
Short-term debt	2355	3234	3864	2383	2282	2600	2900
Total debt service due, incl. short-term debt	2889	3257	4796	4613	3181	3180	3540
Total foreign exchange reserves	3115	4114	3799	4066	4748	5160	5630
International investment position	-3474	-4534	-6763	-7896	n.a.	n.a.	n.a.
Total assets	9780	12030	12301	12179	n.a.	n.a.	n.a.
Total liabilities	13254	16563	19064	20075	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-12.1	-11.3	-16.8	-6.9	-10.9	-11.2	-11.8
Current account balance (% of GDP)	-4.5	-6.3	-9.2	-1.8	-3.8	-3.8	-4.1
Inward FDI (% of GDP)	6.5	7.2	7.0	4.6	4.7	5.0	5.4
Foreign debt (% of GDP)	31	32	30	27	24	23	22
Foreign debt (% of XGSIT)	55	58	59	60	55	52	50
International investment position (% of GDP)	-15.4	-17.2	-22.7	-27.0	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	23	23	32	34	20	18	19
Interest service ratio incl. arrears (% of XGSIT)	2	2	3	2	1	1	1
FX-reserves import cover (months)	3.0	3.5	2.8	4.0	3.8	3.7	3.7
FX-reserves debt service cover (%)	108	126	79	88	149	162	159
Liquidity ratio	105	104	93	104	111	112	110

Source: EIU