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Costa Rica: 2007 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 2007 Article IV consultation with Costa Rica, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 14, 2007, 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 January 31, 2008. 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 February 13, 2008 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 15, 2008 discussion of the staff report that concluded the Article IV consultation.

- 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.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

COSTA RICA

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with Costa Rica

Approved by David J. Robinson and Martin J. Fetherston

January 30, 2008

Discussions. The discussions were held in San José during December 3–14. The mission met with Minister of the Presidency Rodrigo Arias, Central Bank Governor Francisco Gutiérrez, Minister of Finance Guillermo Zúñiga, Minister of Foreign Trade Marco V. Ruiz, other senior public sector officials, parliamentarians, representatives of the private sector, and think tanks.

Staff team. The mission comprised D. Desruelle (head), R. Cubero, O. Hendrick (all WHD), and A. Thomas (PDR). A. Schipke (Regional Resident Representative) assisted the team. R. Zandamela (MCM) and A. Umaña (OED) participated in the final discussions.

Previous Article IV Consultation. In the last consultation, completed on October 30, 2006, Executive Directors welcomed efforts to ratify and implement CAFTA-DR and the decision to introduce a gradually widening exchange rate band. They called for maintaining a prudent fiscal stance, adopting a broad tax reform, and addressing remaining financial sector vulnerabilities. The authorities' economic policies have been consistent with these recommendations: over the last year, the authorities have, *inter alia*, secured ratification of CAFTA-DR, made the exchange regime more flexible, and reduced further the fiscal deficit.

Focus of the Consultation. In line with the 2007 surveillance decision, the discussions centered on external stability and the level of the real effective exchange rate, the authorities' strategy for disinflation, the short-term fiscal stance and fiscal reforms, and financial sector issues, based on the FSAP update.

2007 Surveillance Decision. The level of the real effective exchange rate and the authorities' exchange rate policies are consistent with the maintenance of external stability.

Exchange Arrangement. 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 account transactions. Costa Rica has had a crawling band regime since October 2006.

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EXECUTIVE SUMMARY

Background: The Costa Rican economy has grown at rapid rates in the last three years, underpinned by a robust world expansion, sound economic policies, and strong business and consumer confidence. Rising real incomes and well-targeted social transfers led to a sharp fall in poverty in 2007. However, the domestic boom is leading to overheating pressures, private sector credit is growing fast, and inflation is rising. Growth is expected to moderate in 2008 to slightly below potential. The main risk to the 2008 outlook relates to the intensity of the slowdown in the U.S. economy.

Challenges: Economic policies have been well oriented. The fiscal position has substantially improved. Significant steps have been taken toward inflation targeting, though monetary policy remains constrained by the exchange rate regime. The main short-term policy challenges are to contain inflationary pressures and to maintain the reform momentum following ongoing efforts to complete the CAFTA-DR implementation process.

Policy discussions

- **The exchange rate level and policies are consistent with the maintenance of external stability.** Medium-term projections show a sustainable current account position; the exchange rate level is within its estimated equilibrium range; and the dynamism of exports suggests that the exports sector remains competitive.

- **Staff and the authorities concurred that a monetary policy tightening and greater exchange rate flexibility are needed to bring down inflation.** An increase in interest rates should be complemented by greater reliance on market-determined interest rates as policy instruments, further progress toward greater exchange rate flexibility, and a recapitalization of the central bank through a one-step transfer of negotiable treasury securities.

- **Staff supports the neutral policy stance envisaged in the 2008 central government budget and plans for a substantive tax reform.** This fiscal stance should help disinflation efforts. Continued caution is recommended in the execution of current expenditure given potential demand pressures from long-delayed capital spending by public enterprises. Passage of income tax and VAT reforms would allow higher social and infrastructure spending while preserving a sound overall fiscal stance.

- **The authorities should push ahead with financial system reforms.** FSAP update recommendations include passing the consolidated supervision bill, issuing regulations to encourage banks to internalize fully foreign exchange risk and offer hedging instruments, strengthening the supervisor's capabilities and improving its funding model, and revamping the bank intervention and resolution framework.

I. Recent Economic Developments

1. **The Costa Rican economy has continued to grow rapidly, and poverty has fallen.** Real GDP growth reached 8.7 percent in 2006, the highest rate this decade, and is estimated to have been around 6.8 percent in 2007. This performance can be attributed to high levels of business and consumer confidence, falling real interest rates, a boom in construction, and still robust world growth. Soaring private domestic demand fueled growth in service industries, such as construction and finance, while external demand boosted manufactured good exports. Rising real incomes and an increase in social transfers pushed the poverty rate down to a record low of 16.7 percent in 2007 (Table 1 and Figures 1 and 2).

2. **The economy is showing signs of overheating, and inflation has risen recently:**

- ***After a steady decline through August 2007 (y/y), headline inflation has increased to 10.8 percent at end-2007***, above the central bank's goal of 8 percent. As in most Central and South American countries, inflation has been fueled by external factors, with oil and food price shocks contributing about two-fifths of headline inflation.[1] Domestic pressures have also been at play in Costa Rica: core and nontradable inflation bounced back in the last few months of 2007.

- ***Private sector credit is growing fast.*** Credit to the private sector grew at 35 percent (y/y) in September 2007, with credit to the construction and other service industries rising the fastest. This rise in credit has been fueled by rising confidence and by capital inflows that have pushed lending rates down by 800 basis points since early 2006 and deposit rates to negative levels in real terms (Table 2 and Figure 3).

- ***While domestic demand is booming, supply conditions are tight.*** Investment and private consumption have accelerated, with consumer goods imports growing at 26 percent y/y in October 2007. Moreover, economic growth is above trend for a third consecutive year; unemployment declined to 4.6 percent in 2007, its lowest level since 1994; and there is anecdotal evidence of labor scarcity in some sectors.

3. **The current account deficit rose to 6 percent of GDP in 2007, but remains fully financed by FDI inflows**. Broad-based export growth and a moderation in free trade zone imports led to a narrowing of the trade deficit despite the oil shock, but this was more than offset by a sharp increase in direct investment income payments (Table 3 and Figure 4). Meanwhile, FDI inflows are expected to reach over 7 percent of GDP in 2007, spurred by investment in the tourism sector and real estate. Strong capital inflows have led to a

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[1] On the role of fuel and food prices shocks, see also the November 2007 *Regional Economic Outlook: Western Hemisphere* and Chapter 1 of the October 2007 *World Economic Outlook*.

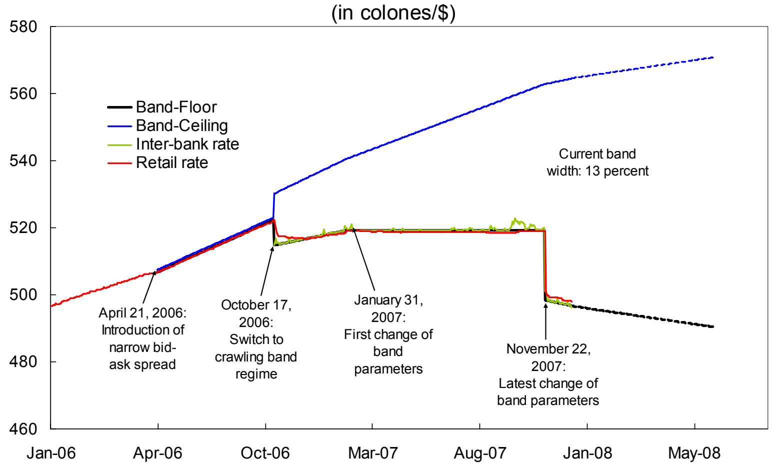
continued rise in international reserves to more than US$4 billion in December 2007, double their level two years earlier.

4. **Fiscal performance has been strong.** Thanks to administrative measures and economic growth, tax revenue grew by over 24 percent per year in the last two years, leading to an increase in the tax-to-GDP ratio of 1½ percentage points over that period (Table 4 and Figure 6). Higher tax revenue and a lower debt service cost allowed for both higher spending in priority areas and a reduction in the central government deficit to its lowest level in more than a decade.[2] As a result, public debt dropped from 56 percent of GDP in 2005 to an estimated 45 percent of GDP by end-2007.

5. **Significant steps were taken in 2007 to make the exchange rate regime more flexible, though monetary policy remains constrained by the need to defend the crawling band.**

- ***The exchange rate band, introduced in October 2006, was widened twice,*** with a view to creating more room for monetary policy action. The latest change took place in November 2007, when the authorities reduced both the level of the band's floor (most appreciated end, by 4 percent) and its slope (to turn it negative). However, persistent capital flows have kept the exchange rate almost continuously pegged to the band's floor, forcing the central bank to intervene. The exchange rate regime has been classified by the Fund as a *de facto* crawling band.[3]

Costa Rica: Exchange rates, Jan 2006-Jan 2008, and projection of crawling band to end-May 2008
(in colones/$)



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[2] At the time of the mission, the 2007 central government deficit was projected to amount to 0.7 percent of GDP, as shown in Tables 1 and 4. Preliminary revisions by the authorities suggest that the final outcome may have been even better.

[3] The Fund will review this classification in May/June 2008, taking into consideration the evolution of the exchange rate in the year since May 2007.

- ***The authorities lowered the policy interest rate twice during 2007 by 375 basis points to the current 6 percent.*** The changes were intended to bring the policy rate—the rate of a passive window on overnight deposits at the central bank—in line with market trends, and to reduce capital inflows and the corresponding quasi-fiscal losses from sterilized intervention.

6. **The recently completed FSAP update found a stronger and more diversified financial system than in the past, but also highlighted remaining vulnerabilities.** Prudential indicators point to low levels of nonperforming loans and relatively healthy levels of provisions, capital, and liquid assets (Table 5). Offshore banking operations have shrunk in importance, though still account for 42 percent of private banks' assets. Deposit and credit dollarization have slowly fallen, to around 44 percent as of September 2007. However, the banking system remains sensitive to interest rate, foreign exchange, and currency-induced credit risks. So far, Costa Rica has weathered well the recent turbulence in global financial markets, with capital inflows barely affected. Despite greater reliance on external credit lines, the main source of funding for banks is domestic deposits: their net foreign assets are small and positive, while the ratio of loans to deposits, though increasing, is still well below one. Thus, banks' high level of liquidity provides some cushion in the event of still tighter global financial conditions. Information collected by the supervisory authorities has not revealed direct exposure of the banking system to U.S. sub-prime instruments.

7. **CAFTA-DR was narrowly ratified in an October 7 referendum**. The agreement, however, does not come into effect for Costa Rica unless several implementation bills are passed by congress. The legislative agenda will be dominated by these bills in the coming months.

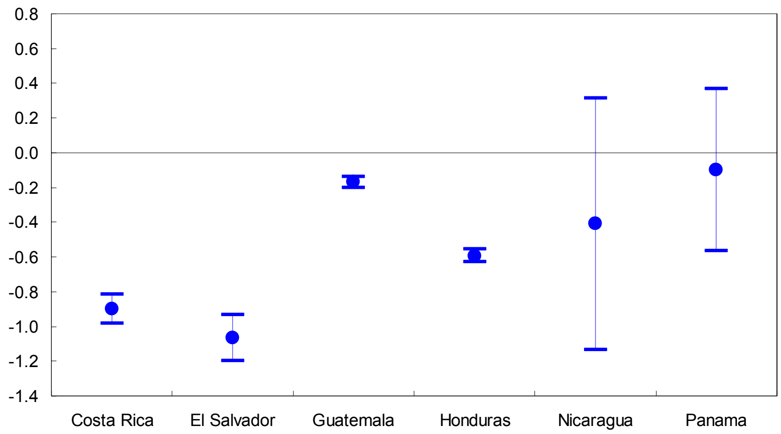
II. Outlook and Risks

8. **The outlook for 2008 is broadly favorable.** Based on current global economic projections, growth is expected to slow down gradually to about 5 percent by end-2008, reflecting the downturn in the U.S., a moderation in the global economy, and an expected tightening of domestic financial conditions. Consumer and business confidence, which was boosted by the ratification of CAFTA-DR, is expected to remain high. Strong import demand, coupled with higher oil prices, would keep the current account deficit at around 6 percent of GDP. Based on the current level of core inflation (8.7 percent), the latest projections of international oil and food prices, and the authorities' planned disinflation policies, headline inflation could slow to about 8 percent.

9. **The main risk to the 2008 outlook relates to the intensity of the slowdown in the U.S. economy**. Given that the U.S. is Costa Rica's main trading partner and its most important source of FDI, a sharper deceleration in the U.S. would have a direct negative impact on exports and investment, and would also affect exports to other regional partners. Staff research suggests that a one percent cyclical fall in U.S. growth leads to a direct contemporaneous decline of 0.9 percent in Costa Rica's growth rate, and would also have

strong negative effects on growth in El Salvador and Honduras (figure below).[4] On the other hand, domestic activity and external demand from Panama, linked to the expansion of the Panama Canal, could surprise on the upside. In turn, there is some evidence that continued robust growth in Costa Rica could support growth in other Central American markets, particularly through greater demand for labor in the construction and agro-industrial sectors and ensuing higher remittances.

Effect on GDP Growth of a One Percentage Point Cyclical Downturn in the U.S. (with a one std. dev. confidence range)



Source: Fund staff estimates.

10. **Over the medium term, staff projects growth of around 5–5½ percent.**[5] Growth is projected to be 5 percent between 2008–10, slightly below the country's estimated potential growth rate of 5.4 percent, which would allow the current output gap to close by 2010. The current account deficit would fall to slightly below 6 percent of GDP over the medium term, on account of a narrowing trade deficit relative to GDP and growing tourism receipts. The current account deficit would be almost fully financed by FDI inflows, expected to remain at around 5 percent of GDP. Under this scenario, public debt would gradually fall to about 37 percent of GDP by 2012, while external debt would stabilize at around 20 percent of GDP. Looking beyond the next five years, the current account would be expected to narrow on account of a sustained rise in exports of goods and services and current transfers, thanks

[4] For further analysis, see *Central America's Regional Trends and U.S. Cycles* by Shaun Roache, forthcoming (draft available on demand).

[5] The medium-term projections are premised on the following assumptions: (i) full implementation of CAFTA-DR, and conclusion of other proposed trade negotiations; (ii) a moderate increase in public, social, and infrastructure spending, and implementation of existing plans to reduce red tape; (iii) completion of the transition to an inflation targeting framework; and (iv) a one-step recapitalization of the central bank. No tax reform is assumed, given the uncertainty about its substance and timing, though a rise in tax revenue will be needed to meet the authorities' objectives in social and infrastructure spending (see Section III.B). The projections reflect the fiscal impact of CAFTA-DR, which are estimated to be small (see Chapter III of *Central America: Global Integration and Regional Cooperation,* IMF Occasional Paper 243, 2005).

in turn to current and projected FDI inflows. FDI indeed largely goes to the (broadly defined) tradable sector, including manufacturing, upscale tourism projects, or housing for North American "snowbirds". In light of the authorities' medium-term disinflation strategy, inflation is expected to fall gradually to around 5 percent in 2010 and 3 percent in 2012, which is consistent with cross-country experience on transitions to an IT regime.[6]

Key Macroeconomic Indicators Under Baseline Scenario
(in percent of GDP, unless otherwise indicated)

	2006	2007 (prel)	Proj. 2008	2009	2010	2011	2012
Real GDP growth (in percent)	8.7	6.8	5.0	5.0	5.0	5.5	5.5
Inflation (percent, end of period)	9.4	10.8	8.0	6.0	5.0	4.0	3.0
Central government balance	-1.4	-0.7	-0.7	-0.9	-0.9	-0.8	-0.6
Overall public sector balance	-0.5	0.2	-0.9	-0.6	-0.7	-0.6	-0.4
Public sector debt (gross)	50.3	44.6	41.6	39.7	38.6	37.8	37.4
External current account balance	-4.5	-6.0	-6.5	-5.5	-5.8	-5.7	-5.8
Foreign direct investment	6.5	7.3	5.3	5.3	5.2	5.1	5.0
NIR (percent of STD on RM)	125.6	142.7	125.3	118.5	120.3	118.5	117.1

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

11. **The main risk to the medium-term outlook resides in domestic political challenges**. Complex legislative procedures may affect passage of further structural reforms, including a substantive tax reform, which would negatively affect private and public investment, exports, and growth. Furthermore, should financial sector reforms not be enacted as currently envisaged, existing vulnerabilities, such as the still high level of foreign exchange lending to unhedged borrowers, could eventually result in financial sector difficulties.

III. Policy Discussions

12. Against this background and in line with the 2007 surveillance decision, the discussions focused on:

- External stability and the level of the real effective exchange rate;
- The strategy for reducing inflation in the short term and progress in the transition to inflation targeting;

[6] For example, inflation in Colombia and Israel fell by an average of 5 percentage points to between 5 and 6 percent in the first 3 years following the introduction of IT.

- The short-term fiscal stance and tax reforms; and

- The recommendations of the recent FSAP update to strengthen financial supervision and regulation.

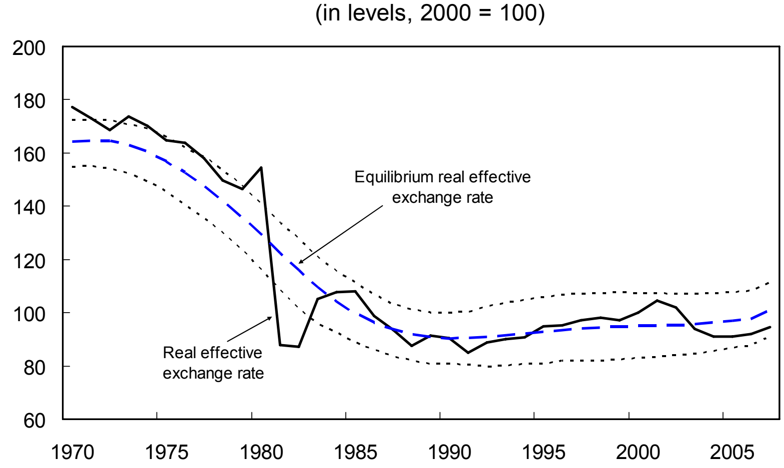
A. External Stability and the Real Effective Exchange Rate

13. **Staff considers that the real effective exchange rate (REER) is close to equilibrium.** This conclusion, which is shared by the authorities, is based on the following elements:

- ***The net external position is projected to evolve in a manner consistent with fundamentals***. The current account deficit through 2012 is expected to be roughly at its debt-stabilizing level. In addition, as indicated in paragraph 10, the increase in nondebt liabilities arising from FDI inflows over the next five years would be associated with greater export potential to service such liabilities.

- ***Econometric analysis by staff indicates that the REER was below its equilibrium value in 2007 (by about 6 percent), but well within the 95 percent confidence interval for the equilibrium estimate***. As shown in the figure below, the actual and equilibrium REER have appreciated in parallel over the last few years. The appreciation of the equilibrium REER was estimated to be mainly driven by an increase in relative productivity and a decline in the net foreign liability position relative to exports.

Actual and Equilibrium REER, 1970-2007
(in levels, 2000 = 100)

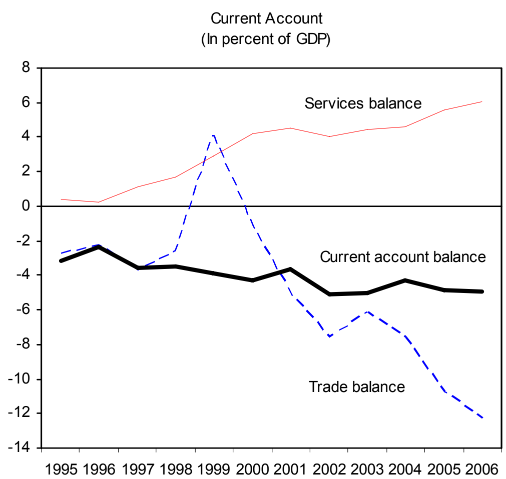


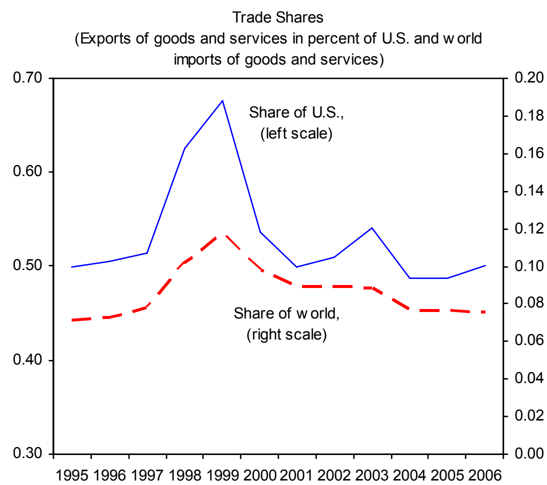
- ***The export sector remains competitive***, as evidenced by standard trade and competitiveness indicators (Box 1 and Figure 5).

Box 1. External Competitiveness

- **The current account deficit has remained broadly unchanged relative to GDP since 2002.** A widening of the trade deficit, partly reflecting the oil price shock, has been offset by a steady and significant increase in the services balance.

- **Export growth remains strong and broad-based.** Exports are rising at above 15 percent in the year to August. Both traditional (coffee, bananas, beef, sugar) and nontraditional exports (mainly manufactured goods, pineapples, and melon) are doing well. Despite the rise of China, Costa Rica's share in global trade has remained broadly stable and its share in the U.S. market has recovered in recent years. (The spike in trade shares in 1998–99 are explained by the operations of an Intel plant in the country).





Sources: Costa Rica authorities; and IMF, World Economic Outlook.

- **The country's position in competitiveness rankings has improved, but remains affected by red tape.** Costa Rica ranks relatively high in the *Global Competitiveness Index*, reflecting its traditional strengths (political stability, skilled workforce, relatively low corruption). However, the country continues to do poorly in the World Bank's *Doing Business Report* rankings, which focus more narrowly on regulatory costs for starting and operating a business.

Competitiveness Rankings

	Ease of Doing Business, 2008		Global Comp. Index 20007	
	2006	2007	2006	2007
Costa Rica	117	115	68	63
Dominican Republic	106	99	93	96
El Salvador	72	69	53	67
Guatemala	115	114	91	87
Honduras	126	121	90	83
Nicaragua	87	93	101	111
Panama	64	65	60	59

Sources: World Bank, Doing Business Report 2007–08; and World Economic Forum, Global Competitiveness Report 2007–08.

B. Disinflation

14. **The staff concurred with the authorities on the need for further action to bring down inflation.** Demand pressures, the impact on expectations of the recent increase in inflation, and inertial factors underscore the need to take further steps to reduce inflation. The measures to be considered over the next 12 months involve the choice of inflation objectives, the setting of policy instruments, the evolution of the exchange rate regime, and the recapitalization of the central bank.

15. **The disinflation effort should be anchored on feasible inflation objectives for 2008 and 2009.** Choosing a feasible inflation target, based on expected external shocks and the effectiveness of available instruments, is important to consolidate central bank credibility. Considering the uncertainty about global oil and food price shocks, and in line with international experience, the mission recommended setting a target range, instead of a point target.[7]

16. **The mission recommended tightening monetary policy in 2008 and introducing a new policy instrument.** The authorities should consider increasing the policy interest rate progressively, so that it returns to positive real levels over the course of 2008. Raising interest rates would help lower inflationary expectations, reduce overheating pressures, and stem credit growth. The staff and the authorities agreed on the need to switch in the near term the policy rate from a passive deposit rate to an active target rate (or range) on repurchase operations in the inter-bank money market and, generally, to replace central bank deposit facilities with reverse repos. This would enhance the ability of the central bank to affect market liquidity, thereby increasing the effectiveness of the policy rate as a policy signal, and contribute to the development of an efficient money market.

17. **The authorities and the mission agreed that greater reliance on market-determined interest rates as policy instruments and, generally, further progress toward inflation targeting, will require more flexibility in the exchange rate regime**. The timing and nature of measures toward greater exchange rate flexibility would depend on exchange rate developments and compliance with certain institutional requirements. Thus, it is important to move rapidly with the issuance of regulations for currency risk hedging instruments and the definition of transparent rules for exchange market intervention, and to take determined action to strengthen the financial supervisor (SUGEF)'s ability to monitor exchange and interest rate risks in the financial system.

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[7] Most IT countries use a range target as opposed to a point target. See *Inflation Targeting in Practice. Strategic and Operational Issues and Applications to Emerging Market Economies*, IMF, 2000; and *Implementing Inflation Targeting*, IMF WP/06/278, 2006.

18. **The mission welcomed the good progress made by the central bank in preparing for IT.** With Fund technical assistance, the central bank has strengthened its forecasting, analytical, and communications framework, adapted its organizational structure, and taken steps to prepare for the conduct of liquidity management operations.

19. **The mission concurs with the authorities on the need to recapitalize the central bank to underpin the disinflation strategy, and recommends doing it through a one-step stock operation.** In 2007, taking advantage of a legal provision from the late 1990s, the central government wrote off a portion of its deposits at the central bank for an amount equal to 0.6 percent of GDP. The authorities intend to submit to congress a bill authorizing a further recapitalization of the central bank which, under current plans, would aim to cover the difference between the central bank's losses and growth in base money demand. The mission argued that a one-step transfer of negotiable securities from the treasury to the central bank would have a more permanent impact on the bank's financial position and, thus, a stronger effect on inflationary expectations than period-by-period transfers.

C. Fiscal Policy

20. **The mission endorsed the policy stance envisaged in the 2008 central government budget.** The fiscal deficit entailed by the 2008 budget would match the strong 2007 performance (as projected at the time of the mission). This stance would support the authorities' disinflation efforts and permit a further reduction in public debt. The space generated by higher revenue and a lower interest bill is channeled in the budget to priority areas such as the hiring of more teachers and policemen, a sustained increase in noncontributive pensions and conditional cash transfers, and higher capital expenditure (table below).[8, 9]

21. **The staff and the authorities concurred on the need for continued caution in the execution of current expenditure.** Despite a further decline in the interest bill, the overall public sector deficit is projected to increase in 2008 by over 1 percent of GDP.[10] This reflects an increase in long-delayed capital spending, particularly on telecommunications and energy

[8] The budget envisages a moderate increase in the ratio of tax revenue to GDP, spurred by strong growth in direct taxes (Table 4). This is consistent with staff research, which points to a high income elasticity of direct taxes. In addition, administrative measures to be put in place in 2008 are expected to boost income tax collection, particularly from self-employed professionals.

[9] The increase in pension spending in 2008 reflects a legally-mandated, one-off adjustment of payments under special public sector pension regimes, to bring them in line with past increases in real wages.

[10] The interest bill is expected to fall even in the event of a substantial monetary policy tightening given the sharp reduction of the debt stock.

Central Government Balance: 2004–08
(percent of GDP)

	2004	2005	2006	Prel. 2007	2008	Proj. 1/ 2008
Revenue	**13.6**	**13.9**	**14.2**	**15.4**	**15.7**	**15.7**
o/w tax revenue	13.3	13.6	14.0	15.1		15.5
Expenditure	**17.0**	**16.7**	**15.7**	**16.0**	**16.4**	**16.4**
Current noninterest	11.1	10.7	10.5	10.9	11.7	11.7
Wages and salaries	5.0	4.9	4.6	4.5	4.8	4.8
Pensions and social security	2.4	2.3	2.4	2.4	2.9	2.9
Transfers and other	3.7	3.5	3.4	4.0	4.1	4.1
Interest	4.8	4.8	4.2	3.5	2.9	2.9
Capital	1.1	1.1	1.0	1.6	1.8	1.8
Primary balance	***1.3***	***2.0***	***2.7***	***2.9***	***2.2***	***2.2***
Overall balance	**-3.4**	**-2.8**	**-1.4**	**-0.7**	**-0.7**	**-0.7**

Sources: Ministry of Finance; and Fund staff.
1/ Based on the central government's 2008 budget.

infrastructure, which is essential to boost the country's growth potential.[11] To avoid any additional demand pressure, there was agreement that execution of current noninterest expenditure should be prudent to ensure that the deficit objective be met even if revenue were to fall short of projections. Staff and the authorities also agreed that any revenue in excess of budget projections should be saved, as was done in 2007. The mission endorsed the authorities' prudent attitude to raising inertial components of current spending, such as public employment and wages, given the nonnegligible contribution of the economic cycle to tax revenue (Box 2).

22. **The mission strongly supported the authorities' plan to pursue tax reforms in 2008.** These reforms are required to finance a substantial increase in public infrastructure (e.g., roads) and well-targeted social spending (e.g., conditional cash transfers), which would in turn boost growth, reduce poverty, and improve income distribution. The mission encouraged the authorities to prioritize passage of bills to widen the bases of the income tax and the sales tax, and turn the latter into a VAT. In meetings with various stakeholders, the staff stressed that such a tax and spending reform package would not only be efficient (from a tax perspective) but also clearly progressive.[12]

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[11] This planned increase in public investment is consistent with the recommendations of the Pilot II Country Study on Public Enterprises and Fiscal Risk, which concluded that ICE, the energy and telecommunications SOE, did not currently pose large fiscal risks and could be excluded from fiscal indicators (see Section IV of IMF Country Report No. 06/416.

[12] For an analysis of the impact of taxation and social spending on income distribution in Central America, see *Equity and Fiscal Policy in Central America* by R. Cubero and I. Vladkova Hollar, forthcoming (draft available on demand).

Box 2. Recent Tax Revenue Growth: Structural vs. Cyclical

The tax to GDP ratio has increased substantially in recent years. Without any legal reforms, the ratio went up from 13.6 percent in 2005 to a projected 15.1 percent in 2007. Econometric analysis by staff suggests that the rise in the tax ratio can be attributed to two main causes:

a) The economic expansion. With an estimated long-run income elasticity of total tax revenue of about 1.1, the tax ratio increases as GDP grows. In turn, this growth contribution can be broken down into structural and cyclical components, depending on whether output is below or above its potential level.

b) An improvement in tax administration and, in particular, the gradual implementation since 2005 of an automated customs reporting system (TICA) that allows for cross-controls between different types of taxes. Other unobserved factors, such as a change in tax compliance behaviour, may also be at work.

Contribution of Different Factors to Tax Revenue
(percent of GDP)

	2003	2004	2005	2006	2007
Total tax to GDP ratio	13.6	13.3	13.6	14.0	15.1
Potential output	13.9	14.0	14.1	14.3	14.3
Cycle (output gap)	-0.4	-0.3	-0.2	0.2	0.4
TICA	0.0	0.0	0.8	0.8	0.8
Residual	0.1	-0.3	-1.1	-1.3	-0.5

Source: Fund staff estimates, based on data from the authorities.

Staff research indicates that, of the total tax ratio as of the third quarter of 2007, TICA contributes about 0.8 percent of GDP, while the economic cycle (the output gap) contributes about 0.4 percent of GDP. The rest is accounted for by potential output and a residual. Evidence for other Latin American countries indicates that the contribution of the cycle to noncommodity revenues is generally smaller than at present in Costa Rica, either because income elasticities of tax revenues are close to one, or because the output gap is narrow even when the long-run elasticity is well above unity (as in El Salvador and Peru).

23. **The mission welcomed the authorities' intention to develop a medium-term budget framework, and encouraged them to reduce spending rigidities.** The introduction of multi-year scenarios in the 2008 budget process is a positive first step. A move to a full-fledged medium-term budget framework would help link policy objectives, spending priorities, and revenue needs, as well as reduce pressures to use revenue earmarking.[13] The mission also encouraged the authorities to follow up on the key recommendations in the 2007 fiscal ROSC.[14]

[13] At its latest meeting in San José, Costa Rica, the Committee of Finance Ministers of Central America, Panama, and the Dominican Republic discussed how best to work on this issue in the region, with technical assistance from the Fund and other multilateral institutions.

[14] See *Costa Rica—Report on the Observance of Standards and Codes—Fiscal Transparency Module, IMF Country Report No. 07/372.*

D. Financial Sector

24. **The authorities broadly agreed with the main recommendations on the financial system by the FSAP update and the Article IV mission**, namely:

- ***Adopting the consolidated supervision bill,*** which would provide supervisors with legal powers to conduct effective consolidated supervision of financial groups and their offshore subsidiaries, strengthen the legal protection of supervisors, and harden the sanctions regime for regulatory noncompliance.[15] Passage of this bill would improve Costa Rica's compliance with a large number of Basel core principles of financial supervision and regulation.

- ***Modifying the prudential regulatory framework so that banks properly internalize foreign exchange risk***, by (i) applying higher risk-weight ratios for capital adequacy purposes to unhedged foreign currency borrowers; (ii) broadening the base of reserve requirements to include short-term foreign-currency lines of credit; and (iii) facilitating financial intermediaries' operations with hedging instruments under an adequate prudential regulatory and supervisory framework.

- ***Changing the funding arrangements for financial supervision,*** so that the supervisory entity (SUGEF) is mostly financed by the supervised institutions. This would enhance SUGEF's financial and operational autonomy, and enable it to cope with the challenges posed by the growing complexity of the financial system.

- ***Improving the bank resolution framework*** by: (i) revamping the prompt corrective action system, separating the triggers for corrective action from the CAMELS-based bank assessment criteria for supervision; and (ii) granting SUGEF more legal powers to intervene and resolve problem banks, including by allowing it to conduct partial asset transfers to other financial intermediaries, and to require the removal, if needed, of directors and the internal auditor of intervened public banks.

25. **The staff welcomed the authorities' current actions and plans to strengthen the financial system, which would constitute important initial steps in implementing the above recommendations.** These include: (i) efforts to encourage private financial groups to terminate offshore operations, as well as initiatives to reduce tax and regulatory incentives for their existence; (ii) seeking passage in 2008 of the consolidated supervision bill; (iii) issuance of regulations enabling financial institutions to deal with currency risk-hedging instruments; (iv) plans to strengthen SUGEF's capabilities to conduct risk-based supervision,

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[15] For an analysis of financial cross-border linkages in Central America, see Chapter VI of *Central America: Global Integration and Regional Cooperation,* IMF Occasional Paper 243, 2005; and *Central America: Structural Foundations for Regional Financial Integration*, IMF, 2006.

with Fund technical assistance; and (v) strengthening the financial reporting regime of the supervised entities.

IV. Staff Appraisal

26. **The near-term prospects for the Costa Rican economy remain favorable, but could be affected by external developments.** Buttressed by sound policies and favorable domestic sentiment while likely to feel the impact of the U.S. slowdown, the economy is set to expand at a still solid but more moderate pace. The main risk for the short-term outlook relates to the intensity of the slowdown in the U.S. economy.

27. **The authorities' main challenges are to bring down inflation and to complete their well-focused reform agenda.** Reform priorities include full implementation of CAFTA-DR; completing the transition to inflation targeting; passage of a substantial tax reform; and strengthening of financial regulation and supervision. These reforms would allow the economy to remain on a high growth path, continue to reduce poverty, and enhance macroeconomic resilience.

28. **Monetary policy needs to be tightened in the near term.** Domestic demand pressures, the lagged effects of external price shocks, and stubbornly high inflationary expectations are stoking inflation. To counteract this, short-term interest rates should be raised gradually to positive real levels. Adopting the overnight money market rate as the central bank's intermediate policy target should also be considered.

29. **The authorities and the staff agree that decisive progress toward the adoption of a full-fledged inflation targeting regime should be made in the next 18 months.** The staff welcomes the steps already taken by the central bank to make the exchange rate regime more flexible, but notes that more will need to be done to enhance the central bank's ability to bring inflation gradually down to low single digits. In this context, it is important to make rapid progress on the issuance of derivative regulations, the definition of rules for forex market intervention, and enhanced supervision of exchange risks in the financial system. Staff welcomes the partial recapitalization of the central bank conducted in 2007, and recommends that a more permanent recapitalization be pursued through a one-off transfer of negotiable securities.

30. **The level of the real effective exchange rate and the authorities' exchange rate policies are consistent with the maintenance of external stability.** Medium-term projections show a sustainable current account position; the exchange rate level is within its estimated equilibrium range; and the dynamism of exports suggests that the exports sector remains competitive.

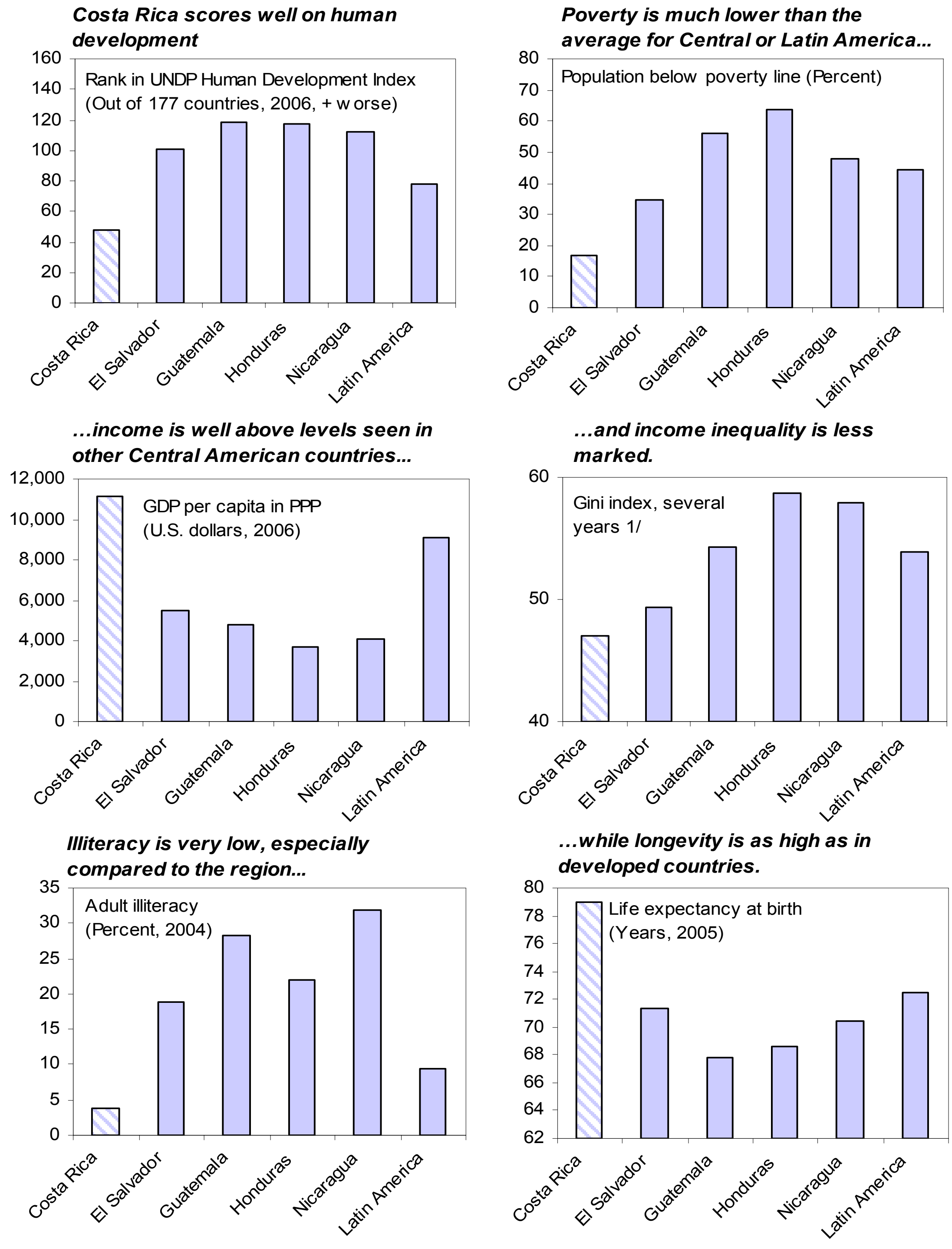
31. **Staff supports the fiscal stance envisaged in the 2008 budget and the authorities' plans for a substantive tax reform.** The roughly neutral fiscal position envisaged in the 2008 budget should help disinflation efforts, though continued caution is recommended in the execution of current expenditure. Passage of income tax and VAT reforms would

allow higher social and infrastructure spending while preserving a sound overall fiscal stance. Staff welcomes the authorities' interest in developing a medium-term budget framework.

32. **The authorities should press ahead with reforms to strengthen financial system supervision.** Approval of the consolidated supervision bill should remain a priority. The staff welcomes ongoing efforts by the authorities to reduce incentives for offshore banking, and encourages them to introduce regulations to ensure that banks fully internalize foreign exchange risk. Further reforms should be passed to allow for full financing of SUGEF by the supervised entities, and for an improved bank intervention and resolution framework.

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

Figure 1. Costa Rica: Social Indicators

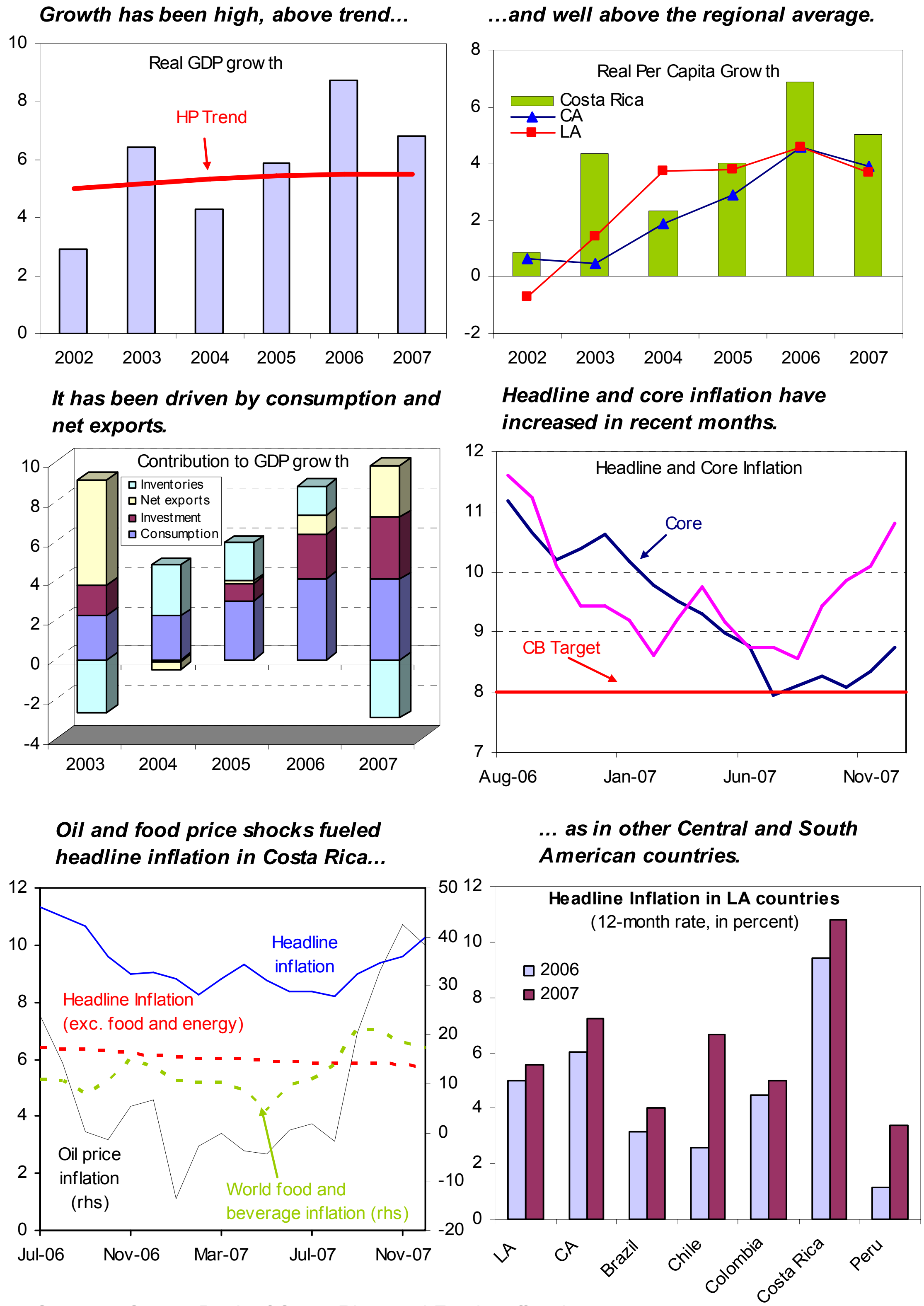


Sources: UNDP Human Development Report 2006, World Bank World Development Indicators.

1/ A value of 0 represents perfect equality, a value of 100 represents perfect inequality.

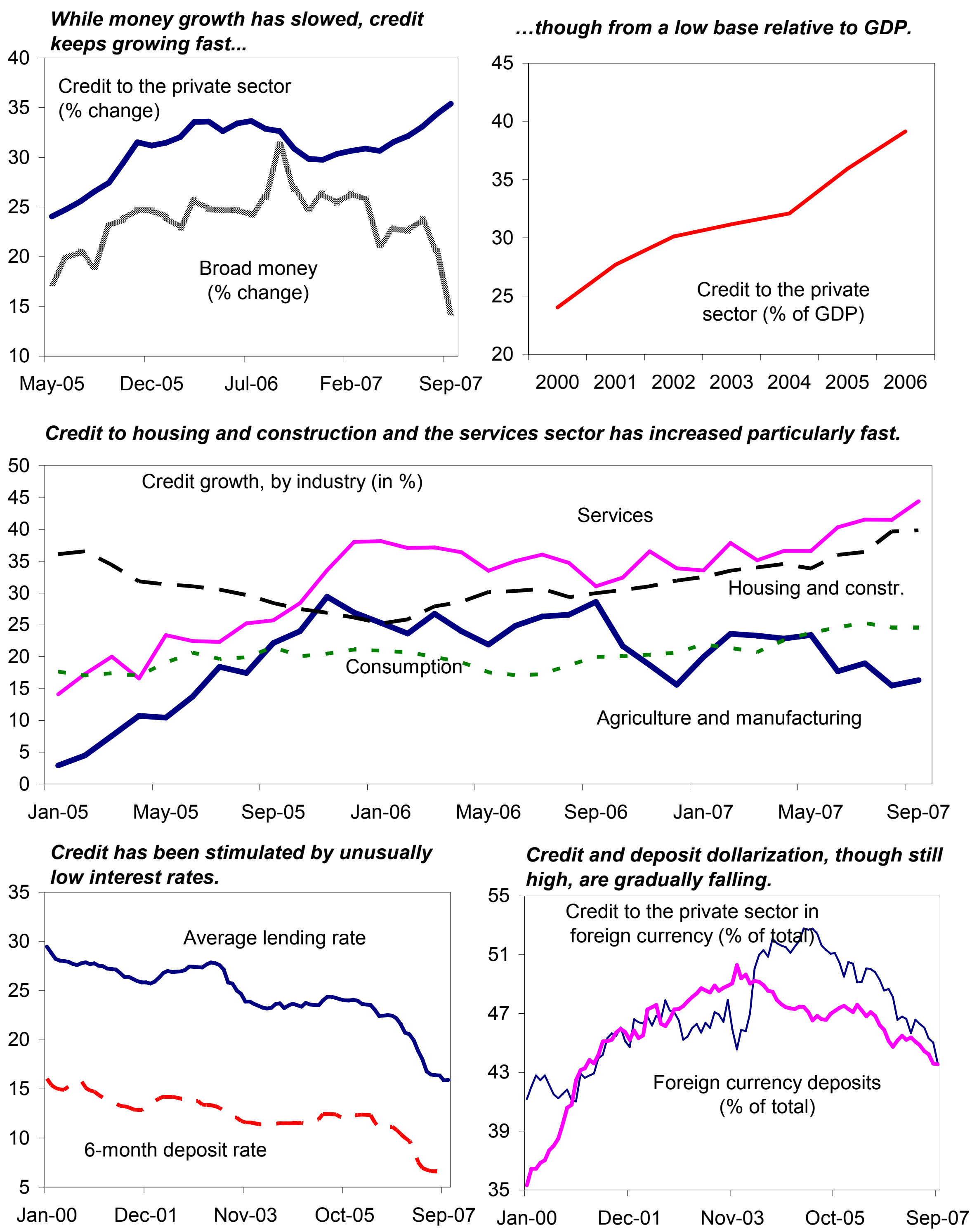
Figure 2. Costa Rica: Growth and Inflation

(annual percentage changes)



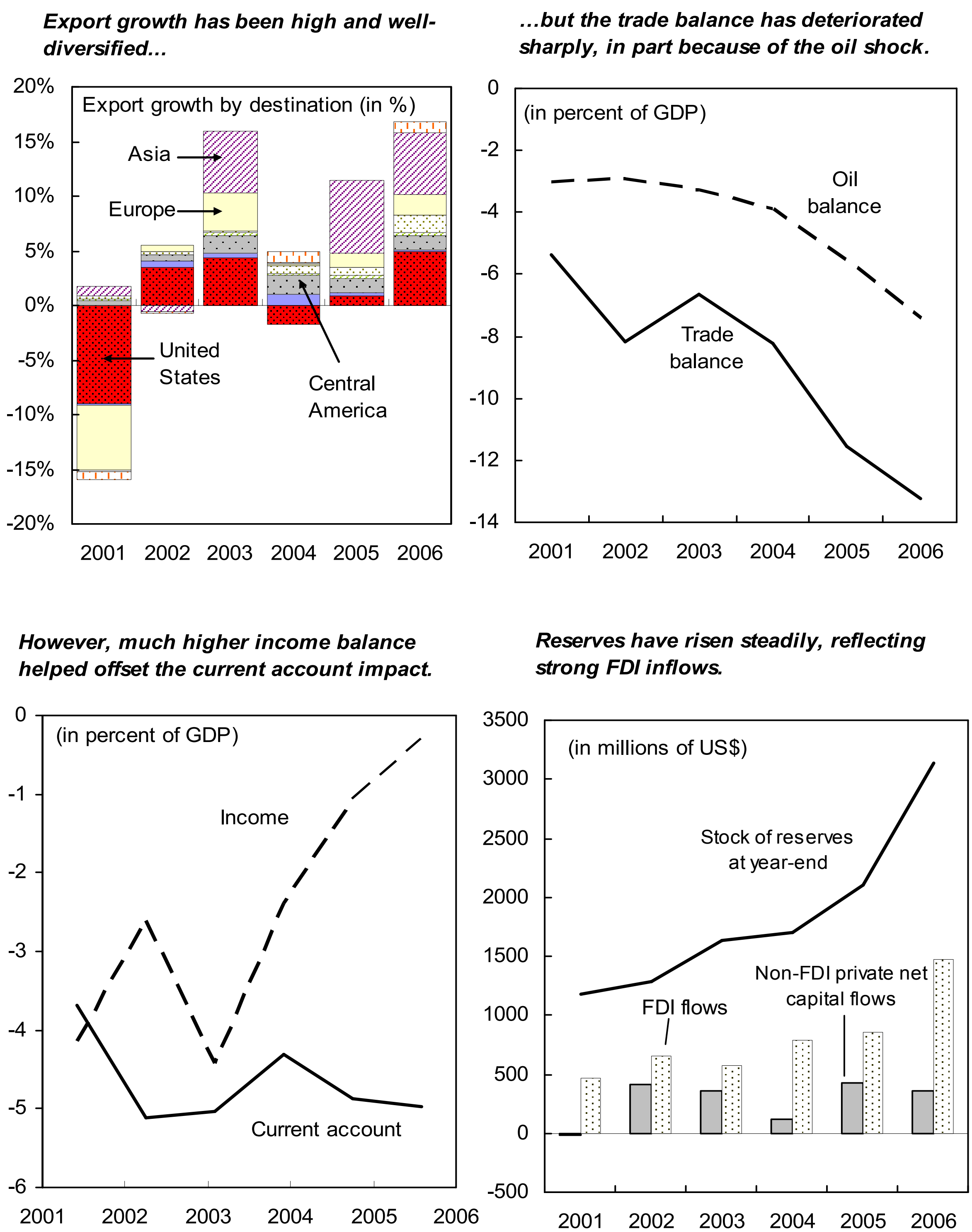
Sources: Central Bank of Costa Rica; and Fund staff estimates.

Figure 3. Costa Rica: Monetary and Financial Sector Developments



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

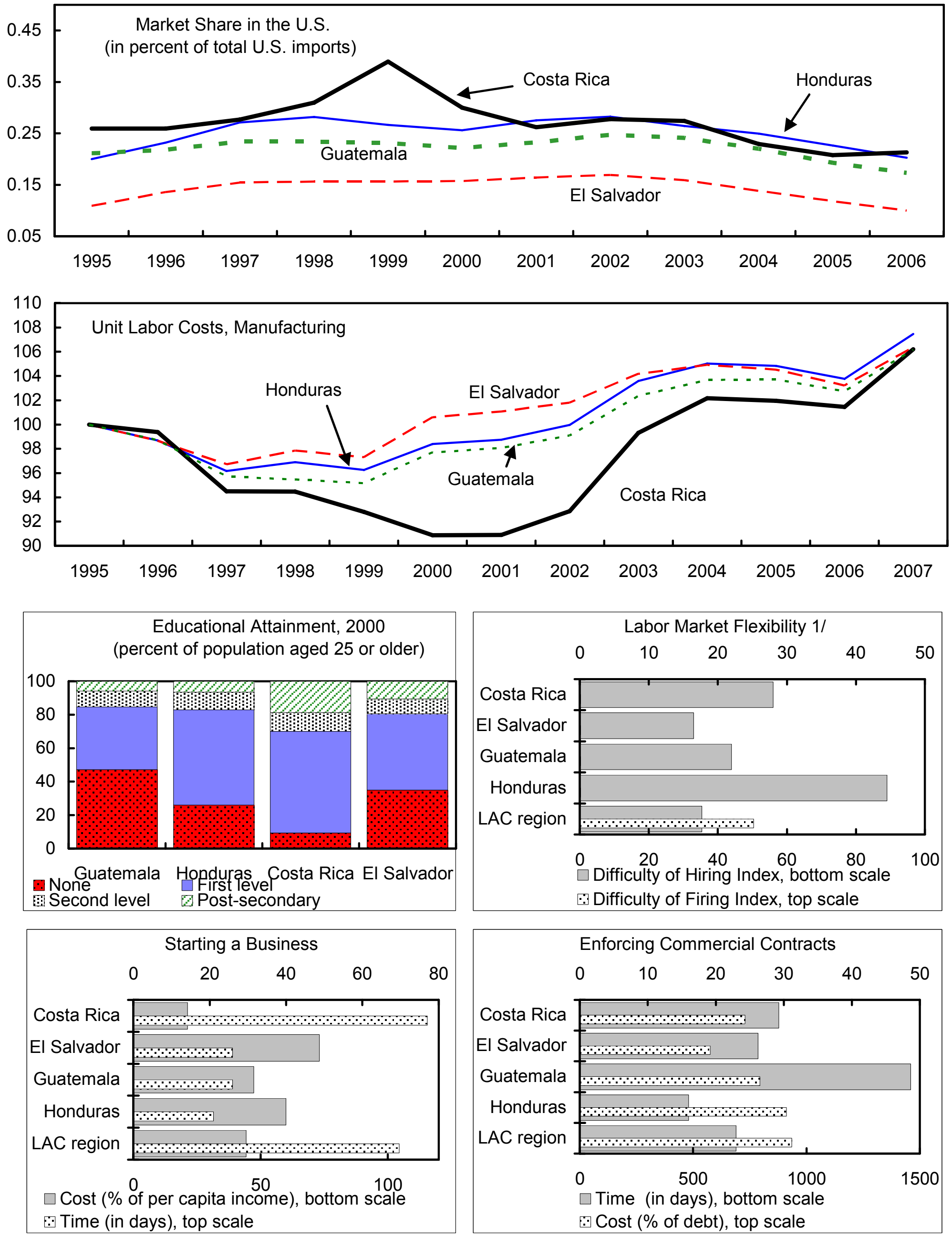
Figure 4. Costa Rica: External Sector



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

Figure 5. Costa Rica: Comparative Competitiveness Indicators

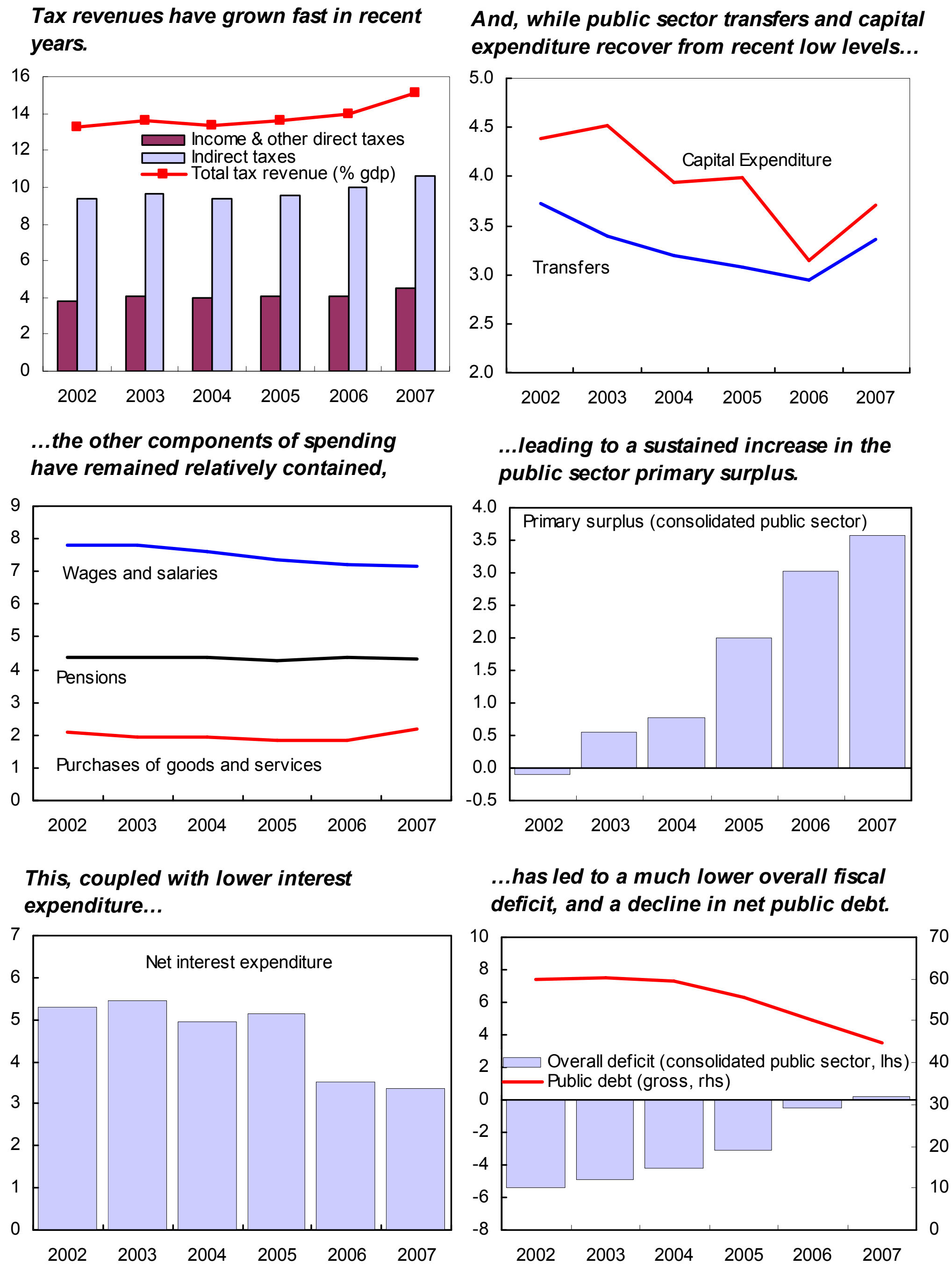
Costa Rica does relatively well, compared to the region, in a broad range of competitiveness indicators. But the costs of starting a business are high.



Sources: International Financial Statistics; World Economic Outlook; Barro and Lee (2000); World Bank Doing Business Database 2007; and Fund staff calculations.

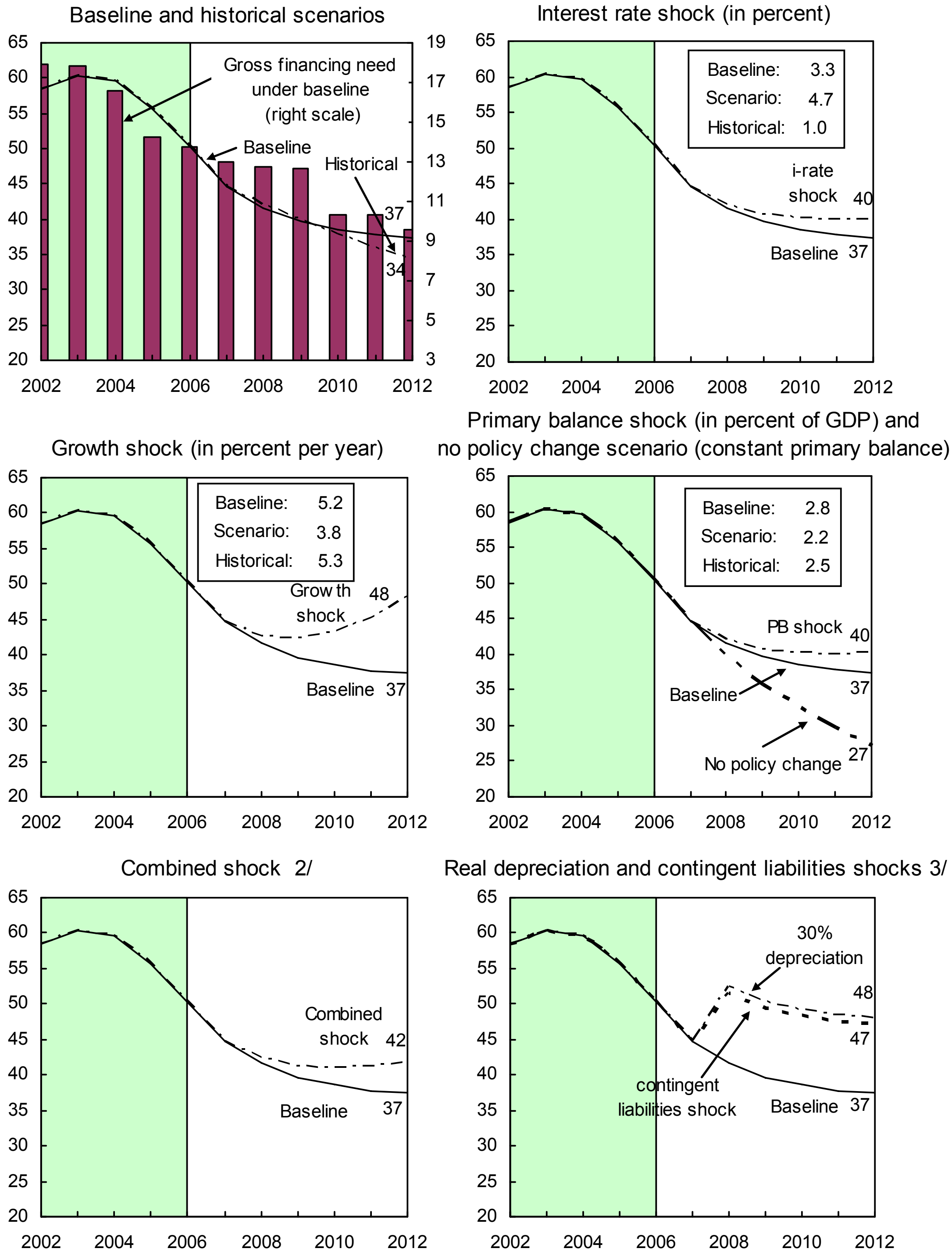
1/ The value for the Difficulty of Firing Index for Costa Rica, El Salvador, Guatemala, and Honduras is zero (0): fully flexible.

Figure 6. Costa Rica: Fiscal Developments
(percent of GDP)



Sources: Costa Rican Ministry of Finance; and Fund staff estimates.

Figure 7. Country: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



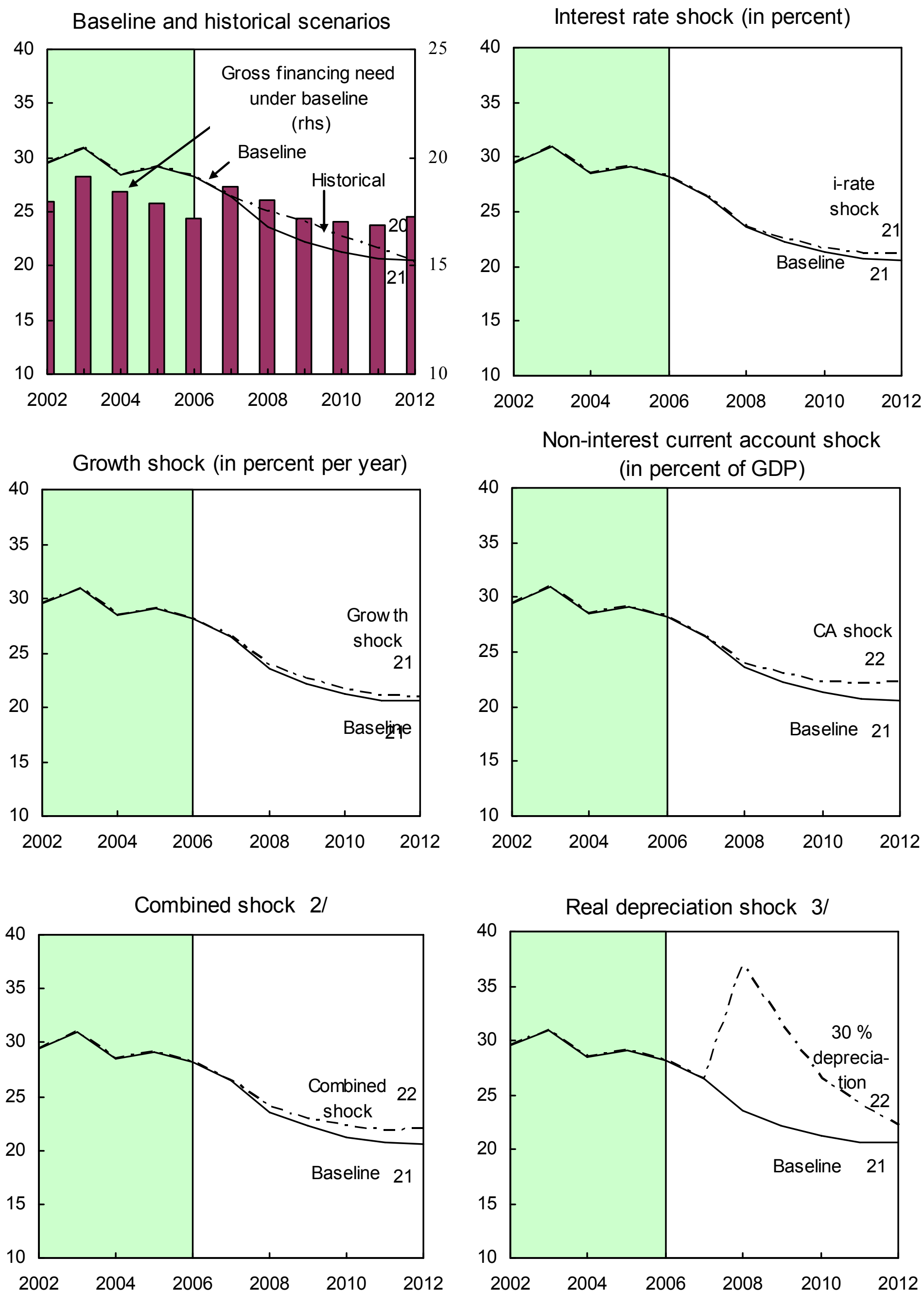
Sources: International Monetary Fund; country desk data; and Fund staff estimates.

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 show n.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, grow th rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, w ith real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local

Figure 8. Costa Rica: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data; and Fund 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 2008.

Table 1. Costa Rica: Selected Social and Economic Indicators

I. Social Indicators

Per capita income (2007, in U.S. dollars)	5,793	Unemployment rate (2007, percent of labor force)	4.6
Population (July 2007, millions)	4.5	Poverty (2007, percent of households)	16.7
Life expectancy (2005, years)	79.1	Extreme poverty (2007, percent of households)	3.3

II. Economic Indicators

							Proj	
	2001	2002	2003	2004	2005	2006	2007	2008
(Annual percentage change, unless otherwise noted)								
National income and prices								
GDP at constant prices	1.1	2.9	6.4	4.3	5.9	8.7	6.8	5.0
Implicit deflator	8.6	9.2	8.3	11.9	10.3	11.2	9.0	9.5
Consumer prices (end of period)	11.0	9.7	9.9	13.1	14.1	9.4	10.8	8.0
Consumer prices (average)	11.3	9.2	9.4	12.3	13.8	11.5	9.4	9.5
External sector								
Exports of goods, excl. goods for processing (f.o.b.)	2,307.6	2,278.8	8.3	8.6	10.2	17.4	11.0	7.0
Imports of goods, excl. goods for processing (c.i.f.)	4,063.2	4,708.4	12.2	12.5	16.3	14.3	22.6	12.9
Terms of trade (-) deterioration	96.4	96.2	-0.6	-3.8	-5.1	-4.1	-1.4	-1.8
Real effective exchange rate eop (depreciation -) 1/	3.9	-2.3	-6.6	-3.1	0.0	0.9	1.8	..
Banking system								
Net domestic assets	11.8	16.0	12.6	24.8	7.7	14.9	16.1	17.3
Of which: Credit to private sector	24.2	21.9	20.5	18.9	30.6	28.7	35.3	30.0
Broad money	11.1	20.4	18.2	32.9	22.2	22.8	17.0	15.0
Lending interest rate (end of period) 1/	25.8	27.4	23.7	23.3	24.0	20.7	16.3	..
(In percent of GDP)								
Public Sector								
Overall primary public sector balance	1.2	-0.1	0.6	0.8	2.0	3.0	3.6	1.5
Overall public sector balance	-3.3	-5.4	-4.9	-4.2	-3.1	-0.5	0.2	-0.9
Nonfinancial public sector balance	-2.1	-4.0	-3.3	-2.9	-1.7	0.7	1.0	-0.4
Central government	-3.4	-4.7	-3.4	-3.4	-2.8	-1.4	-0.7	-0.7
Total revenue and grants	13.9	13.9	13.9	13.6	13.9	14.2	15.4	15.7
Total expenditure	17.5	17.5	17.3	17.0	16.7	15.7	16.0	16.4
Rest of nonfinancial public sector	1.3	0.7	0.1	0.6	1.1	2.1	1.7	0.3
Central bank losses (-)	-1.2	-1.4	-1.6	-1.3	-1.4	-1.1	-0.8	-0.5
Gross domestic investment	**20.3**	**22.6**	**20.6**	**23.1**	**24.8**	**26.4**	**24.7**	**26.3**
Gross national savings	**16.6**	**17.5**	**17.1**	**18.8**	**20.1**	**21.9**	**18.7**	**19.8**
External current account balance	**-3.7**	**-5.1**	**-3.6**	**-4.3**	**-4.6**	**-4.5**	**-6.0**	**-6.5**
Total public debt (gross)			**60.3**	**59.7**	**55.7**	**50.3**	**44.6**	**41.6**
Total public debt (net) 2/	**48.9**	**52.7**	54.6	54.1	50.4	44.5	38.4	35.9
Of which:								
External public debt (end of period)	19.8	14.5	15.8	13.7	13.4	11.9	10.6	9.0
(In percent of exports of goods and services)								
External public debt service 3/	12.5	10.7	18.5	12.9	9.2	7.2	6.6	7.6
Of which: interest 3/	3.3	3.1	3.5	2.9	2.5	2.7	2.3	2.2
(In millions of U.S. dollars, unless otherwise specified)								
Change in net international reserves (increase -)	-13	-163	-339	-80	-393	-1,037	-1,000	-100
Net international reserves (NIR) 4/	1,102	1,265	1,604	1,684	2,078	3,114	4,114	4,214
NIR (months of nonmaquila imports)	3.1	3.0	3.6	3.2	3.4	4.2	4.9	4.7
Memorandum items:								
GDP (in billions of colones)	5,395	6,061	6,982	8,144	9,512	11,507	13,396	15,403
GDP (in millions of U.S. dollars)	16,403	16,843	17,513	18,598	19,909	22,506	25,933	30,752

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

1/ As of September 2007 for REER, and as end-December 2007 for interest rates.
2/ Gross public debt minus central government debt held by the nonfinancial public sector.
3/ Excludes *maquila* exports.
4/ In 2007 one-off adjustment of 175 million dollars for reclassification of capital contribution to FLAR.

Table 2. Costa Rica: Summary Accounts of the Financial System

	2001	2002	2003	2004	2005	2006	Proj. 2007
(End-of-period stocks; in billions of colones unless otherwise specified)							
I. Central Bank							
Net international reserves 1/	**377**	**479**	**671**	**772**	**1,032**	**1,613**	**2,049**
(In millions of U.S. dollars)	1,102	1,265	1,604	1,684	2,078	3,114	4,114
Other net foreign assets	**-176**	**-132**	**-92**	**40**	**83**	**102**	**200**
Medium- and long-term foreign liabilities	-266	-248	-231	-121	-84	-48	-39
(In millions of U.S. dollars)	-779	-655	-552	-265	-168	-93	-78
Net domestic assets	**81**	**-41**	**-201**	**-366**	**-534**	**-980**	**-1,350**
Net claims on the nonfinancial public sector	17	25	37	-27	48	-39	-30
Credit to commercial banks	4	3	1	1	1	1	0
Monetary absorption instruments (BEM, ICP) 2/	-518	-705	-901	-930	-1,245	-1,535	-1,837
Deficit account	-803	-933	-1,050	-1,159	-1,062	-1,166	-1,178
Operating losses	-64	-87	-109	-106	-136	-131	-142
Other	1,381	1,569	1,712	1,749	1,724	1,759	1,695
Monetary base (domestic currency)	**282**	**306**	**379**	**446**	**581**	**735**	**899**
Commercial bank reserves in foreign currency	62	68	107	161	176	351	357
II. Commercial Banks and Other Depository Institutions							
Net foreign assets (including medium- and long-term liabilities)	**-141**	**-190**	**-270**	**-198**	**88**	**27**	**-174**
(In millions of U.S. dollars)	-413	-502	-646	-432	177	53	-349
Net claims on the central bank	**418**	**539**	**615**	**857**	**1,065**	**1,463**	**1,293**
Other net domestic assets	**1,528**	**1,853**	**2,281**	**2,875**	**3,176**	**3,807**	**5,061**
Credit to the nonfinancial public sector	197	329	443	801	646	645	393
Credit to the private sector	1,461	1,781	2,147	2,553	3,336	4,294	5,810
Domestic currency	800	929	1,078	1,338	1,744	2,349	3,315
Foreign currency	661	853	1,069	1,215	1,591	1,945	2,495
(in millions of U.S. dollars)	1,934	2,251	2,555	2,649	3,204	3,755	5,010
Other	-130	-258	-309	-480	-805	-1,132	-1,142
Deposits	**1,805**	**2,202**	**2,625**	**3,534**	**4,329**	**5,297**	**6,181**
Domestic currency	1,000	1,215	1,453	1,724	2,192	2,829	3,564
Foreign currency	804	988	1,172	1,809	2,137	2,468	2,616
(In millions of U.S. dollars)	2,354	2,608	2,801	3,945	4,302	4,766	5,253
III. Financial System							
Net foreign assets (including medium- and long-term liabilities)	**59**	**157**	**309**	**614**	**1,203**	**1,743**	**2,075**
Net domestic assets	**1,917**	**2,223**	**2,503**	**3,124**	**3,365**	**3,865**	**4,486**
Net credit to the nonfinancial public sector	215	354	479	774	694	606	363
Credit to the private sector	1,461	1,781	2,147	2,553	3,336	4,294	5,810
Other	241	88	-123	-204	-665	-1,035	-1,687
Broad money 3/	**1,969**	**2,380**	**2,812**	**3,738**	**4,568**	**5,608**	**6,561**
(Percent changes)							
Monetary base	-3.6	8.7	23.9	17.6	30.2	26.6	22.2
Credit to the private sector	24.2	21.9	20.5	18.9	30.6	28.7	35.3
Domestic currency	16.4	16.1	16.0	24.2	30.3	34.7	41.1
Foreign currency	35.1	29.0	25.4	13.6	31.0	22.2	28.3
Broad money	11.1	20.4	18.2	32.9	22.2	22.8	17.0
(In percent of GDP)							
Currency in circulation	2.9	2.8	2.7	2.5	2.6	2.7	2.8
Money	8.9	9.7	9.9	8.6	9.1	9.1	9.5
Broad money	36.6	39.3	40.3	45.9	48.0	48.7	49.0
Credit to the private sector	27.1	29.4	30.7	31.4	35.1	37.3	43.4
Memorandum items (in percent):							
Net international reserves/deposits in foreign currency	46.8	48.5	57.3	42.7	48.3	65.3	78.3
Short-term foreign assets of the banking system/deposits in foreign currency	54.3	55.7	65.7	55.5	72.1	87.2	96.9
Deposits in foreign currency/total deposits	44.6	44.8	44.7	51.2	49.4	46.6	42.3
Credit to the private sector in foreign currency/total credit	45.2	47.9	49.8	47.6	47.7	45.3	42.9

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 3. Costa Rica: Medium-Term Balance of Payments

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

	2005	2006	2007	2008	2009	2010	2011	2012
			Proj.					
Current account	**-925**	**-1,014**	**-1,545**	**-2,030**	**-1,888**	**-2,109**	**-2,241**	**-2,447**
Trade balance	-2,096	-2,692	-2,786	-3,487	-3,586	-3,742	-3,766	-3,849
Trade balance goods for processing	1,152	1,229	2,413	2,517	2,846	3,175	3,710	4,236
Export of goods (f.o.b.)	7,100	8,068	9,257	9,958	11,018	12,180	13,522	15,014
General merchandise and others	3,027	3,335	3,737	4,021	4,400	4,797	5,278	5,806
Goods for processing	4,072	4,732	5,520	5,937	6,618	7,383	8,245	9,208
Import of goods (f.o.b.)	9,195	10,760	12,043	13,446	14,604	15,922	17,288	18,863
General merchandise and others	6,274	7,256	8,935	10,126	10,832	11,714	12,754	13,891
Goods for processing	2,921	3,503	3,107	3,420	3,772	4,208	4,535	4,972
Services	1,115	1,340	1,559	1,796	1,817	1,926	2,049	2,185
Of which: Travel	1,201	1,246	1,365	1,505	1,589	1,718	1,875	2,044
Income	-215	-11	-797	-900	-755	-1,009	-1,252	-1,523
Of which: Interest on external public debt	-142	-169	-239	-112	-95	-82	-80	-80
Of which: FDI income	-170	-126	-915	-1,027	-1,041	-1,230	-1,411	-1,613
Current transfers	270	349	478	561	636	716	729	740
Financial and capital account	**1,319**	**2,050**	**2,545**	**2,130**	**2,088**	**2,309**	**2,491**	**2,747**
Direct investment	904	1,371	1,849	1,599	1,799	1,906	2,021	2,142
Capital flows	319	480	574	530	290	403	470	605
Public sector	-103	-155	-78	-105	-241	-265	-194	-193
Disbursements	260	108	221	311	241	100	100	101
Amortizations	-363	-263	-299	-416	-482	-344	-298	-294
Private net capital	422	635	652	635	530	668	664	798
Errors and omissions	143	200	122	0	0	0	0	0
Change in net reserves (- = increase)	**-393**	**-1,037**	**-1,000**	**-100**	**-200**	**-200**	**-250**	**-300**
(Annual percentage change)								
Export of goods (f.o.b.)								
Value	11.5	13.6	14.7	7.6	10.6	10.6	11.0	11.0
Volume	12.4	10.4	7.7	5.0	9.7	9.5	9.6	9.5
Import of goods (c.i.f.)								
Value	18.0	16.0	12.1	11.5	8.6	9.0	8.6	9.1
Volume	12.5	7.9	4.6	7.1	8.9	9.0	8.1	8.1
(In percent of GDP)								
Current account (% of GDP)	-4.6	-4.5	-6.0	-6.5	-5.5	-5.8	-5.7	-5.8
Export of goods (f.o.b.) (% of GDP)	35.7	35.8	35.7	32.0	32.3	33.2	34.2	35.4
Import of goods (f.o.b.) (% of GDP)	46.2	47.8	46.4	43.3	42.8	43.4	43.7	44.5
Direct investment (% of GDP)	4.3	6.5	7.3	5.3	5.3	5.2	5.1	5.0
Memorandum items:								
Net international reserves (US$ million)	2,078	3,114	4,114	4,214	4,414	4,614	4,864	5,164
Net international reserves (months of imports)	2.3	3.1	3.7	3.5	3.3	3.2	3.1	3.0
Net international reserves (months of nonmaquila imports)	3.4	4.2	4.9	4.7	4.5	4.3	4.2	4.1
Net international reserves (% of ST debt on RM) 1/	90.0	125.6	142.7	125.3	118.5	120.3	118.5	117.1
External debt (percent of GDP) 2/	29.1	28.2	26.8	23.8	22.5	21.5	20.8	20.5

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

1/ Public and private sector external debt. Includes trade credits.

2/ Includes private sector debt.

Table 4. Costa Rica: Summary of Public Sector Operations

	2005	2006	Proj. 2007	2008	2009	2010	2011	2012
	(In percent of GDP)							
Revenues	**22.7**	**22.7**	**24.4**	**25.1**	**25.4**	**25.5**	**25.6**	**25.7**
Tax revenue	13.6	14.0	15.1	15.5	15.6	15.7	15.8	15.9
Direct taxes	4.1	4.0	4.5	5.1	5.2	5.3	5.4	5.5
Sales tax	5.1	5.4	5.7	5.8	5.8	5.8	5.8	5.8
Customs and others	4.5	4.5	4.9	4.6	4.5	4.5	4.5	4.5
Nontax revenue	0.3	0.2	0.3	0.2	0.2	0.2	0.2	0.2
Contributions to social security	6.2	6.2	6.6	7.0	7.2	7.2	7.2	7.2
Operating surplus of public enterprises	2.6	2.3	2.4	2.4	2.4	2.4	2.4	2.4
Expenditure	**20.7**	**19.7**	**20.8**	**23.7**	**23.7**	**24.0**	**24.3**	**24.5**
Wages and salaries	7.4	7.2	7.2	7.4	7.3	7.3	7.2	7.1
Goods and services	1.8	1.8	2.2	2.3	2.4	2.4	2.4	2.4
Pensions	4.3	4.4	4.3	4.8	5.0	5.1	5.3	5.4
Transfers and others	3.1	2.9	3.4	3.3	3.5	3.6	3.7	3.7
Central Bank primary losses	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure	4.0	3.2	3.7	5.8	5.5	5.6	5.8	5.8
Primary balance	**2.0**	**3.0**	**3.6**	**1.5**	**1.7**	**1.5**	**1.3**	**1.2**
Net interest	**5.1**	**3.5**	**3.4**	**2.4**	**2.3**	**2.2**	**1.8**	**1.6**
Overall balance	**-3.1**	**-0.5**	**0.2**	**-0.9**	**-0.6**	**-0.7**	**-0.6**	**-0.4**
NFPS	-1.7	0.7	1.0	-0.4	-0.1	-0.2	-0.1	0.1
Central government	-2.8	-1.4	-0.7	-0.7	-0.9	-0.9	-0.8	-0.6
o/w: Adjustment for Inflation-indexed bonds	-0.7	-0.4	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2
Social Security Agency	1.3	1.9	1.6	1.8	2.0	2.1	2.3	2.4
Public enterprises	-0.2	0.2	0.1	-1.5	-1.3	-1.4	-1.5	-1.6
Central bank	-1.4	-1.1	-0.8	-0.5	-0.5	-0.5	-0.5	-0.5
Total Financing	**3.1**	**0.5**	**-0.2**	**0.9**	**0.6**	**0.7**	**0.6**	**0.4**
External	-0.2	-0.2	-0.2	-0.3	-0.7	-0.7	-0.5	-0.5
Internal	3.3	0.7	0.0	1.2	1.3	1.3	1.1	0.8
Memorandum item								
Nominal GDP (In billion colones)	9,512	11,507	13,396	15,403	17,303	19,168	21,131	23,036

Sources: Ministry of Finance; and Fund staff estimates.

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

(In percent unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	Nov. 2007
Number of banks	20	20	19	17	16	16	16
Private banks	16	16	15	13	12	12	12
Total assets of private banks (as percentage of GDP) 2/	14.3	15.5	17.5	18.0	19.7	20.6	20.3
Public banks	4	4	4	4	4	4	4
Total assets of public banks (as percentage of GDP) 2/	29.7	31.9	32.3	38.0	39.5	39.8	39.4
Capital							
Ratio of capital to risk-weighted assets	15.1	15.8	16.5	18.1	15.9	15.3	13.6
Asset quality							
Ratio of loans more than 90 days past due to total loans	2.4	3.2	1.7	2.0	1.5	1.5	1.3
Provision coverage							
Ratio of provisions to total loans	2.8	3.3	2.5	2.5	2.2	2.4	1.8
Ratio of provisions to loans more than 90 days past due	113.2	102.6	145.9	122.6	153.0	162.2	142.4
Ratio of foreign currency credit to total private credit	51.6	54.3	56.5	54.2	55.2	53.6	49.6
Ratio of real estate loans to total loans	21.9	27.5	26.8	21.2	23.1	25.2	26.7
Management							
Ratio of administrative expenses to total assets	5.8	5.6	5.4	5.0	4.7	4.7	4.7
Profitability							
Pre-tax return to average equity	18.7	17.1	19.5	20.7	25.0	24.4	22.6
Pre-tax return to average total assets	1.9	1.8	2.1	2.0	2.5	2.5	2.4
Liquidity							
Ratio of loans to deposits	79.7	77.8	79.0	69.4	73.5	80.0	90.8
Ratio of liquid assets to deposits	58.1	57.4	55.3	62.3	59.5	58.1	47.3

Source: Superintendency of Financial Institutions.

1/ Excludes offshore banks and other nonbank financial institutions.

2/ GDP figures for September 2007 are based on a linear extrapolation of projected GDP for 2007.

Table 6 . Costa Rica: Indicators of External Vulnerability, 2002–2007

	2001	2002	2003	2004	2005	2006	Proj. 2007
Merchandise exports (12-month percent change) 1/	-7.5	-1.2	8.3	8.6	10.2	17.4	11.0
Merchandise imports (12-month percent change) 1/	-10.6	15.9	11.6	12.6	16.3	15.6	23.1
Terms of trade (percentage change)	-0.4	-0.2	-0.6	-3.8	-5.1	-4.1	-1.4
Current account balance (in percent of GDP)	-3.7	-4.9	-3.6	-4.3	-4.6	-4.5	-6.0
Central bank net international reserves (in US$ millions)	1,102	1,265	1,604	1,684	2,078	3,114	4,114
In months of next year's imports of goods	2.0	2.2	2.5	2.2	2.3	3.1	3.7
In percent of base money	134	157	177	173	178	219	238
In percent of M2	19	20	24	21	23	29	33
In percent of deposits in foreign currency	47	48	57	43	48	65	82
Net international reserves (% of ST debt on RM) 2/	54	64	65	71	90	126	143
NIR excluding commercial bank liabilities (in US$ millions)	763	922	1336	1338	1719	2414	3352
Commercial banks foreign assets (in US$ millions)	363	335	384	644	1283	1260	1141
Commercial banks foreign liabilities (in US$ millions)	652	727	901	1009	1047	1179	1523
Public sector external debt (in percent of GDP)	19.8	14.5	15.8	13.7	13.4	11.9	10.6
NFPS external interest payments to exports 3/	4.7	3.6	3.5	2.9	2.5	2.7	2.3
NFPS external amortization payments to exports 3/	9.9	9.1	14.9	10.0	6.7	4.5	4.3
REER appreciation (+)	3.9	-2.3	-6.8	-3.1	0.0	0.9	…

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

1/ In value terms, excludes maquila raw materials.
2/ Includes short-term private sector external debt.
3/ Excludes merchandise exports associated to the free trade zone.

Table 7. Costa Rica: Public Sector Debt Sustainability Framework, 2002–2012

(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Debt-stabilizing primary balance 10/
1	**Baseline: Gross public sector debt 1/**	58.5	60.3	59.7	55.7	50.3	**44.6**	**41.6**	**39.7**	**38.6**	**37.8**	**37.4**	**0.0**
	o/w foreign-currency denominated	19.5	21.3	32.6	27.0	22.5	17.9	14.6	11.9	11.6	11.3	11.2	
2	Change in public sector debt	1.6	1.8	-0.7	-4.0	-5.4	-5.7	-3.0	-1.9	-1.1	-0.8	-0.4	
3	Identified debt-creating flows (4+7+12)	1.3	-0.8	-2.4	-2.9	-8.1	-7.3	-4.9	-4.0	-3.2	-3.0	-2.7	
4	Primary deficit 2/	-1.2	-1.6	-2.0	-3.3	-5.0	-4.9	-2.7	-3.0	-2.8	-2.7	-2.6	
5	Revenue and grants	34.1	34.6	34.7	35.4	37.5	38.5	39.3	39.6	39.7	39.9	40.0	
6	Primary (noninterest) expenditure	32.9	33.1	32.7	32.1	32.6	33.7	36.6	36.6	36.9	37.3	37.4	
7	Automatic debt dynamics 3/	2.5	0.8	-0.4	0.4	-3.2	-2.4	-2.2	-1.0	-0.4	-0.4	-0.1	
8	Contribution from interest rate/growth differential 4/	0.4	-1.3	-2.4	-2.2	-4.2	-2.4	-2.2	-1.0	-0.4	-0.4	-0.1	
9	Of which contribution from real interest rate	1.9	2.0	-0.2	0.8	-0.2	0.5	-0.2	0.9	1.4	1.5	1.8	
10	Of which contribution from real GDP growth	-1.5	-3.3	-2.2	-3.0	-4.0	-2.9	-1.9	-1.9	-1.8	-1.9	-1.9	
11	Contribution from exchange rate depreciation 5/	2.1	2.0	2.1	2.6	1.1	...	...	...	...	...	...	
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) 6/	0.3	2.6	1.7	-1.1	2.8	1.6	1.8	2.0	2.1	2.3	2.4	
	Public sector debt-to-revenue ratio 1/	171.6	174.3	172.0	157.5	134.1	115.9	105.8	100.2	97.1	94.8	93.5	
	Gross financing need 7/	17.9	17.8	16.6	14.3	13.8	13.0	12.8	12.6	10.3	10.4	9.6	
	in billions of U.S. dollars	3.0	3.1	3.1	2.8	3.1	3.4	3.9	4.3	3.8	4.1	4.1	
	Scenario with key variables at their historical averages 8/						**44.6**	**42.1**	**39.9**	**37.9**	**36.0**	**34.4**	**-1.3**
	Scenario with no policy change (constant primary balance) in 2007-2012						**44.6**	**39.7**	**35.8**	**32.7**	**29.8**	**27.2**	**0.0**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	2.9	6.4	4.3	5.9	8.7	6.8	5.0	5.0	5.0	5.5	5.5	
	Average nominal interest rate on public debt (in percent) 9/	13.2	12.7	11.9	12.6	11.8	10.8	9.4	9.7	9.7	9.2	8.6	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.0	4.5	0.1	2.3	0.5	1.8	-0.1	2.7	4.1	4.7	5.3	
	Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-9.8	-9.5	-8.7	-7.7	-4.1	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	9.2	8.3	11.9	10.3	11.2	9.0	9.5	7.0	5.5	4.5	3.3	
	Growth of real primary spending (deflated by GDP deflator, in percent)	11.7	7.0	3.1	4.0	10.5	10.3	14.2	5.0	6.0	6.4	6.0	
	Primary deficit 2/	-1.2	-1.6	-2.0	-3.3	-5.0	-4.9	-2.7	-3.0	-2.8	-2.7	-2.6	

1/ Public sector includes the nonfinancial public sector and the central bank.

2/ Public sector balance minus gross interest expenditure (does not coincide with primary deficit defined by substracting net interest payments).

3/ 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).

4/ 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.

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

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

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

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

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

10/ 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.

Table 8. Costa Rica: External Debt Sustainability Framework, 2002–2012

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	**Debt-stabilizing non-interest current account** 6/
Baseline: External debt	29.5	30.9	28.5	29.1	28.2	**26.4**	**23.6**	**22.2**	**21.3**	**20.7**	**20.5**	**-5.6**
Change in external debt	1.7	1.4	-2.5	0.6	-0.9	-1.8	-2.9	-1.3	-1.0	-0.6	-0.1	
Identified external debt-creating flows (4+8+9)	0.5	-0.7	-1.5	-1.8	-4.9	-2.8	0.3	-0.8	-0.4	-0.5	0.0	
Current account deficit, excluding interest payments	3.6	2.2	3.1	3.3	3.3	4.5	5.4	4.4	4.9	4.8	5.2	
Deficit in balance of goods and services	-3.3	-0.3	-3.0	-10.5	-11.8	-10.5	-8.7	-9.0	-8.9	-8.6	-8.3	
Exports	42.4	46.7	46.3	43.3	43.2	42.5	40.3	39.7	40.5	41.2	42.3	
Imports	-45.7	-47.1	-49.3	-53.7	-55.0	-53.0	-49.0	-48.7	-49.4	-49.8	-50.6	
Net nondebt creating capital inflows (negative)	-3.7	-3.1	-3.9	-4.5	-6.1	-7.1	-5.1	-5.3	-5.2	-5.1	-5.0	
Automatic debt dynamics 1/	0.5	0.3	-0.6	-0.5	-2.2	-0.3	0.0	0.1	-0.1	-0.2	-0.2	
Contribution from nominal interest rate	1.3	1.4	1.2	1.3	1.2	1.4	1.1	1.2	0.9	0.9	0.9	
Contribution from real GDP growth	-0.8	-1.8	-1.2	-1.6	-2.3	-1.7	-1.1	-1.1	-1.0	-1.1	-1.1	
Contribution from price and exchange rate changes 2/	0.1	0.7	-0.6	-0.3	-1.1	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	1.3	2.1	-1.0	2.4	4.0	1.1	-3.2	-0.5	-0.5	-0.1	-0.1	
External debt-to-exports ratio (in percent)	69.7	66.2	61.5	67.3	65.3	62.2	58.5	56.0	52.5	50.1	48.5	
Gross external financing need (in billions of U.S. dollars) 4/	3.0	3.3	3.4	3.6	3.9	4.8	5.6	5.9	6.2	6.7	7.3	
in percent of GDP	17.9	19.1	18.4	17.8	17.2	18.7	18.1	17.2	17.0	16.9	17.3	
Scenario with key variables at their historical averages 5/						**26.4**	**25.1**	**24.1**	**22.6**	**21.6**	**20.4**	**-4.0**
Key Macroeconomic Assumptions Underlying Baseline												
Nominal GDP (U.S. dollars)	16.8	17.5	18.6	19.9	22.5	25.9	31.1	34.1	36.7	39.5	42.4	
Real GDP growth (in percent)	2.9	6.4	4.3	5.9	8.7	6.8	5.0	5.0	5.0	5.5	5.5	
GDP deflator in U.S. dollars (change in percent)	-0.2	-2.3	1.8	1.1	3.9	7.9	14.1	4.6	2.3	2.2	1.8	
Nominal external interest rate (in percent)	4.7	4.9	4.1	5.0	4.6	5.8	5.1	5.5	4.4	4.6	4.7	
Growth of exports (U.S. dollar terms, in percent)	4.1	14.7	5.2	12.9	13.4	13.5	8.1	9.6	9.8	10.3	10.3	
Growth of imports (U.S. dollar terms, in percent)	11.2	7.1	11.3	16.6	15.6	11.0	10.8	9.0	9.1	8.7	9.1	
Current account balance, excluding interest payments	-3.6	-2.2	-3.1	-3.3	-3.3	-4.5	-5.4	-4.4	-4.9	-4.8	-5.2	
Net nondebt creating capital inflows	3.7	3.1	3.9	4.5	6.1	7.1	5.1	5.3	5.2	5.1	5.0	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 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 noninterest current account and nondebt 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 nondebt inflows in percent of GDP) remain at their levels of the last projection year.

INTERNATIONAL MONETARY FUND

COSTA RICA

Staff Report for the 2007 Article IV Consultation

Supplementary Information

Prepared by the Western Hemisphere Department

Approved by David J. Robinson and Adnan Mazarei

February 13, 2008

1. **This supplement provides an update of economic and policy developments since the release of the staff report.**

2. Recent information confirms that fiscal performance was strong in 2007 and that inflation remains high.

- According to the latest though still preliminary figures, the central government posted a surplus of 0.4 percent of GDP in 2007, its best performance since the mid-1950s, while the overall public sector closed with a surplus of 0.6 percent of GDP.

- Headline inflation fell slightly from 10.8 percent (year-on-year) in December 2007 to 10.6 percent in January 2008, helped by a fall in transportation and clothing prices. Core inflation also moderated a bit to 8.5 percent. Inflation expectations for the 12 months ahead rose to 9.4 percent in January, compared to 9.1 percent in December.

- Progress has been made in passing CAFTA-DR implementation bills, but fewer than half of the 12 bills have been approved as of now. The government will ask other signatory countries for an extension of the end-February deadline.

3. Growth prospects for 2008 are somewhat weaker than previously expected.

- In its 2008–09 macroeconomic framework released on January 31, the central bank forecast a 3.8 percent real GDP growth for 2008.

- Staff also revised down its 2008 growth projections from 5 to 4.5 percent. This takes into account the recent revision to the U.S. outlook but also the continued boom in production for the local market. The monthly index of economic activity (IMAE) showed a slight upward trend in the fourth quarter of 2007 to a growth rate of 7.0 percent (year-on-year)

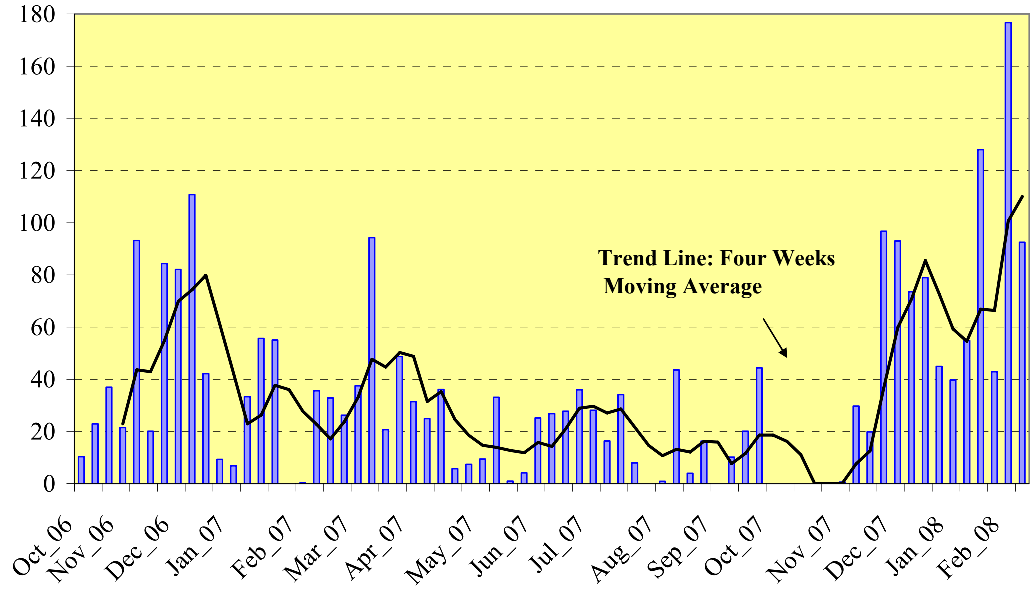
4. **On January 31, 2008, the central bank announced its inflation objectives for 2008–09 and reduced substantially the interest rates on its deposit facilities.**

- Mid-point inflation objectives for 2008 and 2009 were set at 8 and 6 percent respectively, with a range of ±1 percent around these figures.
- Interest rates on the central bank's one-night deposit facility were cut from 6 to 3½ percent. Rates on other deposit facilities were similarly reduced.
- In the first days following this central bank decision, commercial bank deposit rates fell by 180 basis points to 5.2 percent, while the rate on six-month sovereign bills came down from 6.4 percent to 4.8 percent.
- The exchange rate has remained at the floor of the crawling band (the most appreciated side).

5. The authorities emphasized that an interest rate cut was necessary given rapidly increasing foreign inflows, which could undermine their disinflation strategy.

- This interest rate cut took place following high levels of foreign exchange intervention: during the first four weeks of January, the central bank bought US$422 million (2.9 percent of GDP), the highest level since the exchange rate band was introduced in October 2006. In the authorities' views, this was due to two recent and mutually reinforcing developments, the successive reductions in the U.S. Fed funds rate to 3 percent and increased expectations of a colon appreciation, which greatly widened yield differentials between domestic and foreign currency instruments. This compounded the underlying pressure from sustained large FDI inflows into manufacturing, tourism, and real estate.
- In the authorities' view, if left unaddressed, this situation would have undermined their disinflation strategy, given the public perception that high levels of foreign exchange intervention translate into an inability to control monetary creation and inflation. Furthermore, in an environment where the central bank's quasi-fiscal losses continue to affect monetary conditions, the central bank saw a trade-off between the monetary impact of quasi-fiscal losses from sterilized intervention and the potential impact of lower interest rates.

Costa Rica: Weekly Intervention Oct 16, 2006-Feb 8, 2008
(In million US dollars)



6. **While the thrust of the staff appraisal is unchanged, the staff is concerned about the inflationary impact of this interest rate cut**, especially given the context of still high inflation, rapid private sector credit growth, and a tight labor market.

- The reduction in interest rates will create additional pressures on nontradable inflation, which, absent further macroeconomic policy adjustments, may push it up to levels inconsistent with the achievement of the 2008 headline inflation target.

- The authorities and staff agree that fiscal policy is key to containing demand pressures under the current monetary and exchange rate framework. In this period, staff recommends that the central government's fiscal position should at a minimum be as strong as the 2007 outcome, which implies a tightening of around 1 percent of GDP on an annual basis compared to the 2008 budget to be done through expenditure reductions, and every effort should be made to achieve an even stronger outcome.

- In addition, the authorities and staff also agree that there is greater urgency to move toward a regime that would allow greater exchange rate flexibility and the use of interest rates to bring down inflation. To that end, priority actions include the issuance of regulations for foreign exchange derivative instruments, the application of stricter regulatory standards for foreign currency lending to nonforeign-currency-earners, the introduction of liquidity requirements on short-term foreign-currency lines of credit, and further recapitalization of the central bank.

Table 1. Costa Rica: Selected Social and Economic Indicators

I. Social Indicators

Per capita income (2007, in U.S. dollars)	5,905	Unemployment rate (2007, percent of labor force)	4.6
Population (July 2007, millions)	4.5	Poverty (2007, percent of households)	16.7
Life expectancy (2005, years)	79.1	Extreme poverty (2007, percent of households)	3.3

II. Economic Indicators

					Proj	
	2003	2004	2005	2006	2007	2008
(Annual percentage change, unless otherwise noted)						
National income and prices						
GDP at constant prices	6.4	4.3	5.9	8.8	6.8	4.5
Implicit deflator	8.3	11.9	10.3	11.3	10.2	10.0
Consumer prices (end of period)	9.9	13.1	14.1	9.4	10.8	8.0
Consumer prices (average)	9.4	12.3	13.8	11.5	9.4	9.5
External sector						
Exports of goods, excl. goods for processing (f.o.b.)	8.3	8.6	10.2	17.4	11.4	6.4
Imports of goods, excl. goods for processing (c.i.f.)	12.2	12.5	17.6	13.8	20.3	12.5
Terms of trade (-) deterioration	-0.6	-3.8	-5.1	-4.1	-1.4	-1.8
Real effective exchange rate eop (depreciation -) 1/	-6.6	-3.1	0.0	0.9	1.8	..
Banking system						
Net domestic assets	12.6	24.8	7.7	14.6	20.2	16.0
Of which: Credit to private sector	20.5	18.9	30.6	28.7	38.8	19.0
Broad money	18.2	32.9	22.2	22.8	15.3	15.0
Lending interest rate (end of period) 1/	23.7	23.3	24.0	20.7	16.3	..
(In percent of GDP)						
Public Sector						
Overall primary public sector balance	0.6	0.8	2.0	3.0	4.0	1.4
Overall public sector balance	-4.9	-4.2	-3.1	-0.5	0.6	-1.0
Nonfinancial public sector balance	-3.3	-2.9	-1.7	0.7	1.3	-0.5
Central government	-3.4	-3.4	-2.8	-1.4	0.4	-0.7
Total revenue and grants	13.9	13.6	13.9	14.2	15.5	15.5
Total expenditure	17.3	17.0	16.7	15.7	15.1	16.3
Rest of nonfinancial public sector	0.1	0.6	1.1	2.1	0.9	0.2
Central bank losses (-)	-1.6	-1.3	-1.4	-1.1	-0.7	-0.5
Gross domestic investment	**20.6**	**23.1**	**24.8**	**26.4**	**25.6**	**26.6**
Gross national savings	**17.1**	**18.8**	**20.1**	**21.9**	**19.6**	**20.0**
External current account balance	**-3.6**	**-4.3**	**-4.6**	**-4.5**	**-6.0**	**-6.5**
Total public debt (gross)	**60.3**	**59.7**	**55.7**	**50.3**	**43.0**	**40.1**
Total public debt (net) 2/	54.6	54.1	50.4	44.5	37.6	35.4
Of which:						
External public debt (end of period)	16.0	13.1	13.2	11.2	9.3	8.0
(In percent of exports of goods and services)						
External public debt service 3/	18.5	12.9	9.2	7.2	6.6	7.6
Of which: interest 3/	3.5	2.9	2.5	2.7	2.3	2.2
(In millions of U.S. dollars, unless otherwise specified)						
Change in net international reserves (increase -)	-339	-80	-393	-1,037	-1,000	-750
Net international reserves (NIR) 4/	1,604	1,684	2,078	3,114	4,114	4,864
NIR (months of nonmaquila imports)	3.6	3.2	3.4	4.2	5.0	5.5
Memorandum items:						
GDP (in billions of colones)	6,982	8,144	9,512	11,515	13,554	15,580
GDP (in millions of U.S. dollars)	17,513	18,598	19,909	22,522	26,238	31,686

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

1/ As of September 2007 for REER, and as end-December 2007 for interest rates.
2/ Gross public debt minus central government debt held by the nonfinancial public sector.
3/ Excludes *maquila* exports.
4/ In 2007 one-off adjustment of 175 million dollars for reclassification of capital contribution to FLAR.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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

IMF Executive Board Concludes 2007 Article IV Consultation with Costa Rica

On February 15, 2008, 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, Costa Rica's economy has continued to grow rapidly. Real GDP grew by 8.8 percent in 2006, and economic activity remained strong in 2007 driven by both domestic and external demand. Early estimates suggest that, for the year as a whole, growth was close to 7 percent. Unemployment declined to 4.6 percent, the lowest level since 1994.

Inflation steadily declined between late 2006 and mid-2007, thanks in part to the October 2006 switch to a crawling band regime and the subsequent widening of the exchange rate band. However, inflation rebounded in the second half of 2007, partly because of sharp rises in international oil and food prices, and ended at 10.8 percent in December 2007.

The current account deficit widened to 6.0 percent in 2007, driven by a surge in nonresident income on foreign direct investment. Both exports and imports grew strongly during the year. The current account was more than fully financed by foreign direct investment inflows. Net international reserves reached a historical high of over US$4 billion in December 2007.

[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.

Public finances continued to improve in 2007. According to the latest preliminary figures, the central government closed with a surplus of 0.4 percent of GDP, the best performance since 1957, while the overall public sector posted a surplus of 0.6 percent of GDP. In parallel, public debt fell to about 43 percent of GDP at end-2007. These results stemmed mainly from strong revenue growth due to administrative measures and the economic expansion.

Monetary aggregates have kept expanding rapidly. Private sector credit has been growing at over 30 percent (y/y) in 2007, fueled by a construction sector boom and strong consumption demand. Driven in part by sustained capital inflows, lending rates declined sharply, and deposit rates became negative in real terms.

The financial system has become stronger and more diversified, though important vulnerabilities remain. Judging by traditional prudential indicators, banks appear well capitalized, profitable, and highly liquid. Recent acquisitions of domestic private banks by large foreign banks have intensified the process of consolidation in the sector. Vulnerabilities include high dollarization of assets and liabilities, and still large offshore banking activities.

Executive Board Assessment

Directors commended the authorities for the strong performance of the Costa Rican economy in 2007, reflecting the continued implementation of sound economic policies. Directors welcomed the ratification of the Central America-Dominican Republic-United States Free Trade Agreement (CAFTA-DR) and the reduction in the poverty rate to a historical low. The near-term prospects for the Costa Rican economy remain favorable, based on robust domestic demand. At the same time, Directors stressed the need to be vigilant to downside risks, mainly related to the intensity of the slowdown in the U.S. economy.

Directors considered that the main policy challenges will be to lower inflation and take forward the authorities' well-focused structural reform agenda. Reform priorities include fully implementing CAFTA-DR, completing the transition to inflation targeting, passing legislation for a substantial tax reform, and strengthening financial regulation and supervision.

Directors praised the authorities for their impressive fiscal performance, which resulted from effective tax administration efforts and tight control of nonpriority spending. This policy has also contributed to a substantial reduction in public debt. Looking ahead, Directors considered that a prudent fiscal policy will be key to containing demand pressures. They encouraged the authorities to maintain the fiscal stance achieved in 2007—or even improve on it—to support the disinflation objective. Directors supported the authorities' plans for a substantial tax reform, which would permit higher spending in priority areas—including social and infrastructure spending—while preserving a sound overall fiscal stance. They welcomed the authorities' interest in developing a full-fledged medium-term budget framework.

Directors welcomed the steps already taken by the central bank toward greater exchange rate flexibility in the context of a gradual transition to a full-fledged inflation targeting framework.

They acknowledged the constraints on monetary policy imposed by continued large capital inflows under the current crawling band exchange rate regime, the appreciation pressures on the colón, and falling U.S. dollar interest rates. However, most Directors stressed that the recent substantial cut in interest rates—which has made interest rates even more negative in real terms—could give further impetus to the already robust level of aggregate demand, and compromise efforts to reduce inflation and subdue inflationary expectations. These Directors encouraged the authorities to put in place institutional conditions for greater exchange rate flexibility, including the adoption of regulations for hedging instruments, which would permit a needed monetary policy tightening. A few other Directors cautioned that raising interest rates could trigger further capital inflows and increase the pressure on the exchange rate.

Directors welcomed the initial step taken in 2007 to recapitalize the central bank, and called for a permanent recapitalization through a one-step stock operation that would also underpin the disinflation strategy.

Directors observed that the current account position is projected to be sustainable over the medium term, and that the real effective exchange rate appears to be in line with fundamentals and within the margins of the staff's estimated equilibrium range. The good performance of nontraditional exports and the diversification of export products and markets suggest that competitiveness is being maintained.

Directors welcomed the strengthening of the financial sector. Nevertheless, vulnerabilities remain, including risks associated with the relatively high level of dollarization and the lack of effective consolidated supervision of financial groups. Directors called on the authorities to move expeditiously to implement the remaining recommendations of the FSAP update. They encouraged the authorities to press ahead with the approval of the consolidated supervision bill and with the introduction of regulations to ensure that banks fully internalize foreign exchange risks. They supported reforms to change the funding arrangements for financial supervision and improve the bank resolution framework.

Costa Rica: Selected Economic Indicators

	2003	2004	2005	2006	Prel. 2007	Proj. 2008
(Annual percentage change, unless otherwise noted)						
National income and prices						
GDP at constant prices	6.4	4.3	5.9	8.8	6.8	4.5
Implicit deflator	8.3	11.9	10.3	11.3	10.2	10.0
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(In percent of GDP)						
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Overall public sector balance	-4.9	-4.2	-3.1	-0.5	0.6	-1.0
Nonfinancial public sector balance	-3.3	-2.9	-1.7	0.7	1.3	-0.5
Central government	-3.4	-3.4	-2.8	-1.4	0.4	-0.7
Central bank losses (-)	-1.6	-1.3	-1.4	-1.1	-0.7	-0.5
Gross domestic investment	**20.6**	**23.1**	**24.8**	**26.4**	**25.6**	**26.6**
Gross national savings	**17.1**	**18.8**	**20.1**	**21.9**	**19.6**	**20.0**
External current account balance	**-3.6**	**-4.3**	**-4.6**	**-4.5**	**-6.0**	**-6.5**
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Total public debt (net) 2/	54.6	54.1	50.4	44.5	37.6	35.4
Of which: External public debt (end of period)	16.0	13.1	13.2	11.2	9.3	8.0
(In millions of U.S. dollars, unless otherwise specified)						
Change in net international reserves (increase -)	-339	-80	-393	-1,037	-1,000	-750
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1/ As of September 2007 for REER, and as end-December 2007 for interest rates.
2/ Gross public debt minus central government debt held by the nonfinancial public sector.
3/ 2007 includes a one-off adjustment of 175 million dollars for reclassification of capital contribution to FLAR.

Statement by José Rojas, Executive Director for Costa Rica and Alvaro Umaña, Senior Advisor to Executive Director February 15, 2008

On behalf of the Costa Rican authorities we would like to convey our deep appreciation to the IMF staff and management for the constructive policy dialogue and valuable technical assistance that were provided by the Fund during last year. The discussions of the Article IV consultations were held in the first half of December of 2007. Since then, important decisions taken by the Federal Reserve of the United States, Costa Rica's main economic partner, have had a significant impact on capital inflows and this has required policy responses by the authorities that were not foreseen at the time of the Article IV discussions.

The authorities agree with staff that sound economic policies, as well as strong business and consumer confidence have allowed Costa Rica to benefit from world economic expansion and grow at its highest rate for a decade. During 2006 and 2007, the economy grew by 8.8 and 6.8 percent, respectively, while unemployment decreased to 4.6 percent, the lowest in a decade. Real wages and incomes rose significantly to levels above the Latin American average and poverty was reduced to a record low of 16.7 percent. This was achieved through economic growth and well targeted social transfers, including pensions and subsidies to poor families with children enrolled in secondary school. Inequality remains the lowest in Central America and well below the Latin American average. Costa Rica ranks well in the Human Development Index and life expectancy at birth has reached 79 years, a level comparable to developed nations.

Growth has been fueled by both internal demand and net exports, which are well diversified in terms of composition and destination, although the United States is by far its most important trading partner and source of FDI. Tourism continued its upward trend, and domestic demand in services such as construction and finance supported growth, in addition to strong external demand in agro industrial goods and electronics. The economic slowdown in the US is expected to generate an almost one-to-one decrease in Costa Rica's growth rate. The authorities agree with the staff that this slowdown in the US economy is the most important short-term risk.

The economy has been growing beyond its potential during the last two years and inflation rose above 10 percent in 2007. External factors such as rising food and fuel prices were significant in this increase but domestic factors also contributed. Private sector credit grew considerably and foreign direct investment (FDI) continued its upward trend, surpassing 7 percent of GDP in 2007. Although the current account deficit rose in 2007, it remains fully financed by FDI flows. International reserves have more than doubled during the last two years and presently stand at close to $4.5 billion.

Fiscal performance has been particularly strong in 2007 and tax revenues rose by over 25 percent in the last two years. The central government generated a surplus for the first time in fifty years. Public debt has dropped considerably and is expected to continue in this downward trend over the medium-term, reaching 37 percent in 2012. Given that the fiscal performance was even stronger than expected, as explained in the staff report's supplement, the authorities agree with the need to maintain a responsible fiscal policy in 2008. A substantive tax reform, including income tax and VAT will be pursued by the government during 2008. Also, a medium-term budget framework is being introduced this year.

We agree with the staff's assessment that the real effective exchange rate and exchange rate policies are consistent with external stability. Costa Rica has been moving towards a more flexible exchange rate system since 2006 when an exchange rate band was introduced. In the medium-term the country is moving to an inflation targeting regime. In 2007 the exchange rate band was widened twice, but capital inflows have continued to keep the exchange rate pegged to the band's floor and forcing the central bank to intervene.

The authorities are committed to move to an inflation targeting regime, but they recognize the existence of several prerequisites that need to be met before the central bank can do it. These include, among others, adoption of derivative regulations, hedging instruments, rules for forex market intervention and enhanced supervision of risks in the financial system. In the short term, given the current exchange rate regime, the quasi-fiscal problem of the central bank and the recent decision by the Federal Reserve to lower interest rates, the possibility of monetary tightening is limited.

The authorities agree with the outlook for 2008 and the medium-term. Growth is expected to be under 5 percent with an inflation target of 8 percent, and growth will remain near that level until 2010, while inflation decreases to 6 percent in 2009 and below that level in 2010. The current account deficit is expected to fall below 6 percent and FDI levels inflows are expected to remain near 5 percent of GDP

The authorities agree that the financial system has become stronger and more diversified and will move to start implementing the recommendations of the recently completed FSAP, some of which require legislative approval, like passage of a consolidated supervision bill. Other remaining tasks include issuing regulations to encourage banks to fully internalize foreign exchange risks and offer hedging instruments, providing the supervisor (SUGEF) with the capabilities and funding to take carry out the expanded responsibilities, and revamping the bank intervention and resolution framework.

The medium-term risks are associated with the passage of structural reforms and key legislation including substantive tax reform and financial sector reform. Efforts to increase competitiveness and reduce red tape are also important. CAFTA was approved by the first referendum in Costa Rica's history in October of 2007, but some of the legislation required to implement CAFTA is still under discussion in Congress. The legislation under discussion includes, among others, new laws opening the insurance and telecommunications sectors. It is expected that the Executive will request an extension from CAFTA signatories before the deadline expires on February 29, 2008. After approval of CAFTA related legislation, the government intends to seek a program of capitalization of the central bank.