Costa Rica: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

September 3, 2009

The following item is a Letter of Intent of the government of Costa Rica, which describes the policies that Costa Rica intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Costa Rica, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.
San José, September 3, 2009

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

Dear Mr. Strauss-Kahn:

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

2. The global crisis has hit Costa Rica hard, but the economy continues to withstand the negative shock reasonably well. Economic growth during the first half of 2009 has been substantially weaker than anticipated, though there is some evidence that the real GDP decline is reaching an end. At the same time inflation has declined faster than expected, to a 30-year low of 5.7 percent (y/y) in August. Lower growth and inflation have had a negative impact on fiscal revenues, which declined by more than 8 percent through June. Prudent execution of the budget, however, allowed the central government to post a somewhat smaller than projected deficit during the same period. The external current account deficit has narrowed substantially, and the overall balance of payments was in surplus during the first half of 2009. The banking system has remained sound, despite some pick up in nonperforming loans and a decline in bank profitability.

3. Performance against the program targets was very strong. All quantitative performance criteria for end-June were met, most with significant margins. We also have implemented all three end-June structural benchmarks (the unification of money markets suffered a slight delay owing to operational difficulties).

4. In light of this performance and our continued commitment to the program, we request completion of the first review under the SBA. Our intention remains to treat the arrangement as precautionary. Given the sharp decline in tax revenues, we request revisions of the end-September quantitative performance criteria on the overall cash balance and the debt stock of the central government. Program implementation will continue to be monitored through quarterly reviews. The revised quantitative performance criteria for end-September, new performance criteria for end-December 2009, indicative targets, and structural benchmarks under the program are set out in Tables 1 and 2 of the attached supplement to the MEFP.
5. We believe that the policies described in the attached supplement to the MEFP are adequate to meet the objectives of our program. However, if needed, the government stands ready to take additional measures. In accordance with the Fund’s policies, we will be in continuous communication with the Fund with regard to policy actions related to this program.

Sincerely yours,

________________/s/_________________  ___________________/s/_________________

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

Attachments
This Technical Memorandum of Understanding (TMU) sets out the understandings between the government of Costa Rica and IMF staff regarding the definitions of quantitative and structural performance criteria and reporting requirements under the Precautionary Stand-By Arrangement (SBA).

Definitions

Program Exchange Rates

For the purposes of the program (and not as a target rate), the average exchange rate is set at 576.3 Costa Rican colones per U.S. dollar. The exchange rates against the SDR and Euro are provided in Table 1. The program rate for the inflation indexed unit (UDES) is set at 683.4 colones.

<table>
<thead>
<tr>
<th>Currency</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. dollar</td>
<td>576.3</td>
</tr>
<tr>
<td>SDR</td>
<td>886.1</td>
</tr>
<tr>
<td>Euro</td>
<td>792.0</td>
</tr>
<tr>
<td>UDES</td>
<td>683.4</td>
</tr>
</tbody>
</table>

Central Government

Numbers referring to the central government include the central government budget and extra budgetary funds. If the government establishes new extra budgetary funds, they will be consolidated within the central government system.

Combined Public Sector

For program purposes, the combined public sector includes the central government, the central bank, public enterprises (excluding the Instituto Costarricense de Electricidad (ICE)) and a number of decentralized institutions (Table 2).
Table 2. List of Public Agencies in the Combined Public Sector

**Public Enterprises**

Consejo Nacional de Produccion  
Instituto Costarricense de Acueductos y Alcantarillados  
Instituto Costarricense de Puertos del Pacifico  
Junta de Proteccion Social  
Refinadora Costarricense de Petróleo

**Decentralized Agencies**

Caja Costarricense de Seguro Social  
Consejo Tecnico de Asistencia Medico Social  
Fondo de Desarrollo Social y Asignaciones Familiares  
Instituto Costarricense de Turismo  
Instituto de Desarrollo Agrario  
Instituto Nacional de Aprendizaje  
Oficina de Cooperacion Internacional de la Salud

**Quantitative Performance Criteria, Indicative Targets, and Continuous Performance Criteria: Definitions and Reporting Standards**

**A. Floor on the Cash Balance of the Central Government**

The cash balance is defined as the difference between total revenues and expenditures. The floor on the cash balance of the central government will be monitored from above the line on a cash basis. The interest component of expenditures excludes the capitalized inflation component of inflation-indexed zero coupon bonds (TUDES).

**B. Floor on the Cash Balance of the Combined Public Sector**

The cash balance is defined as the difference between total revenues and expenditures. The floor on the cash balance of the combined public sector will be monitored from above the line on a cash basis. The balance of the central bank will be measured on an accrual basis. The interest component of expenditures excludes the capitalized inflation component of inflation-indexed zero coupon bonds (TUDES) held outside of the combined public sector.
C. Floor on Net International Reserves of the Central Bank of Costa Rica

Net international reserves (NIR) of the central bank of Costa Rica (BCCR) are defined as the U.S. dollar value of gross foreign assets minus gross foreign liabilities of the BCCR.

- Gross foreign assets are defined in conformity with the Special Data Dissemination Standard as readily available claims on nonresidents denominated in foreign convertible currencies. They include the BCCR’s holdings of monetary gold, SDRs, foreign currency cash, foreign currency securities, deposits abroad, and the country’s reserve position at the Fund. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered, claims on residents, claims in foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options), precious metals other than gold, assets in nonconvertible currencies, and illiquid assets.

- Gross foreign liabilities are defined as all short-term foreign exchange liabilities to nonresidents, including commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options) and all credit outstanding from the Fund.

D. Ceiling on Net Domestic Assets of the Central Bank of Costa Rica

Net domestic assets of the BCCR are defined as the difference between base money and the NIR of the BCCR converted at program exchange rates, where base money is defined as the sum of currency issued and domestic currency reserve deposits of deposit-taking financial intermediaries at the central bank.
E. Ceiling on the Debt Stock of the Central Government

The ceiling on the stock of central government debt shall apply to all debt defined as set forth in point no. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-00/85)1 Excluded from this performance criterion are normal short-term import credits. All foreign currency denominated debt will be converted into colones using the program exchange rates set out in Table 1. All domestic debt denominated in inflation indexed units (TUDES) will be converted into colones using the program rate set out in Table 1.

F. Continuous Performance Criteria on Nonaccumulation of External Arrears

The central government will accumulate no external debt arrears during the program period. For the purposes of this performance criterion, an external debt payment arrear will be defined as a payment by the central government system which has not been made within seven days after falling due under the contractual agreement, unless specified otherwise. The performance criterion will apply on a continuous basis.

G. Adjustors

The floor on the NIR will be adjusted upward and the ceiling on NDA downward by the amount of external financing contracted by the central bank, excluding funding used to provide liquidity support to the financial sector and IMF disbursements.

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1 The definition of debt set forth in point No. 9 of the IMF's guidelines reads as follows: “(a) For the purpose of this guideline, the term “debt” will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessee retains the title to the property. For the purpose of the Guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property. (b) Under the definition of debt set out in point 9(a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.”
Clarification of Structural Conditions

Benchmark for end-June 2009 on the establishment of a monthly monitoring report for the banking system: Preparation of a monthly report to monitor the liquidity position of the banking system on a bank-by-bank basis.

Benchmark for end-June 2009 on establishing a system of daily forecasting of systemic liquidity in the money market: Establish a daily liquidity forecasting exercise, containing a comprehensive assessment of liquidity supply and demand based on the compilation and consolidation of information on liquidity needs, a forecasting methodology, close communication with market participants and relevant parties, real-time monitoring of money market transactions, and an assessment of the size and scope of BCCR’s market intervention and its effectiveness.

Benchmark for end-June 2009 on unification of the money market under a single platform: Establishment of an integrated liquidity market (MIL) that will include the following: (i) the introduction of a short-term lending facility that sets an interest rate ceiling to guide the market rate; (ii) the BCCR’s withdrawal from the interbank money market (MIB); and (iii) disallowing access for financial entities to the central bank’s deposit facility (Central Director) for maturities of 30 days or less, except for deposits with maturities that mirror the maturities offered by the MIL lending facility.

Benchmark for end-December 2009 on submission to parliament of a draft law to strengthen the bank resolution framework: The draft law should provide for a more robust bank resolution framework. This framework should allow for the orderly transfer of assets and liabilities of an insolvent bank to another institution, while imposing first losses on shareholders and subordinated creditors before any of the general creditors, the deposit insurance scheme, or the government incur costs.

Benchmark for end-December 2009 on submission to parliament of a draft law to create a limited deposit insurance scheme: The draft law should establish a deposit insurance scheme, which includes the following elements: contain a clear ex ante funding mechanism, provide for rules to allow for the swift compensation of depositors in the event of a bank failure, and describe the linkages to the bank resolution framework.
Program Reporting Requirements

The following information will be provided to the Western Hemisphere Department of the IMF within the time frame indicated.

- Data on the cash balance of the central government will be provided within 6 weeks of the end of the month to which the cash balance is calculated.

- Data on the cash balance of the nonfinancial public sector will be provided within 8 weeks of the end of the month to which the cash balance is calculated.

- NIR will be provided on a daily basis

- NDA will be provided on a daily basis.

- Data on the total stock of debt of the central government system will be provided on a quarterly basis within one month of the end of each quarter.
SUPPLEMENT TO THE MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

September 3, 2009

6. Recent Developments. During the first half of 2009, economic growth was substantially weaker than anticipated at the inception of the program. At the same time, vulnerabilities declined as the main domestic and external imbalances corrected in a relatively orderly way. Real GDP contracted by 4.8 percent (y/y) during the first quarter, driven by a sharp fall in inventories and reflecting mainly a decline in sectors dependent on external conditions (manufacturing, residential construction catering to foreigners, agriculture, and hotels). During the second quarter, the index of economic activity (IMAE) declined by 2.9 percent (y/y) but rose by 1.2 percent (q/q) on a seasonally adjusted basis, suggesting that the economy may have touched bottom. Reflecting the economic slowdown, improved terms of trade, and prudent monetary policy, inflation fell to the lowest level in several decades (5.7 percent (y/y) in August) and the external current account deficit in the first half of the year narrowed much more than expected (to 0.2 percent of GDP vs. 2.6 percent of GDP in the original program). Net capital inflows also declined, reflecting in part the repayment of credit lines by domestic banks and corporates, but were enough to cover the current account deficit and allow for an accumulation of net international reserves (NIR) of US$137 million (compared to a US$285 million decline allowed in the program). The banking system remained sound overall. While the nonperforming loan ratio rose and bank profitability declined, liquidity and solvency indicators remained adequate.

7. Performance under the program. All end-June quantitative performance criteria and structural benchmarks have been met.

- **Quantitative performance criteria.** Despite sharply lower tax revenues, the cash balance of the central government during the first six months of 2009 was C106 billion above the program floor, reflecting cautious spending execution.

- **Structural benchmarks.** The daily exercise to forecast systemic liquidity and the preparation of monthly monitoring reports of the banking system were implemented

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1 The indicative target for the cash balance of the combined public sector was also met with a margin.
significantly ahead of the end-June target date. The unification of the money market was slightly delayed, but the integrated platform for liquidity operations (MIL) finally became operational in early August and the BCCR now only conducts liquidity injections through this market.

8. **Revised macroeconomic framework.** We have adjusted the macroeconomic framework to take into account the outcome of the first half of 2009 and the revised forecasts for commodity prices and global growth. Overall, the outlook for Costa Rica’s economy remains for a gradual recovery, in line with the turnaround expected for our trading partner countries.

- **Real GDP** in 2009 is now expected to decline by 1–1.5 percent (compared to the 0.5 percent growth envisaged at program approval). This forecast takes into account the recent signs of a stabilization in output and a more positive outlook for manufacturing exports in the second half of the year. Real GDP growth for 2010 has been revised upward (to 2.25–2.75 percent), reflecting the improved outlook for growth in the United States and other trading partners.

- End-year inflation is now projected to be around 5 percent in 2009 (8 percent in the original program). The program’s inflation goal for 2010 has been revised to 5 percent, in line with the mid-point of the BCCR’s target range.

- The **external current account deficit** for 2009 is now projected at 3.6 percent of GDP (down from 5.3 percent of GDP at program approval). The balance of payments is expected to remain in overall balance (excluding the inflows from the special and general SDR allocations), as the net repayment of external credit lines by banks and lower disbursements of official loans are projected to reduce the capital account surplus by broadly the same amount as the decline in the current account deficit. In 2010, the external current account deficit would widen to 4.8 percent of GDP, as international oil prices are expected to increase and non-oil import growth bounces back with the recovery.

9. **Fiscal policy.** The lower than projected growth and inflation will compromise the achievement of our original revenue targets. For 2009 as a whole, we anticipate a revenue shortfall of C290 billion from the original program projection of C2,722 billion. Part of the lower revenue will be passed on to the deficit of 2009. This will allow us to protect social spending and provide sufficient support to domestic demand, while keeping the increases in the domestic borrowing requirement and the debt-to-GDP ratio within reasonable margins. Overall, the revised program will target a central government deficit of C680 billion or 4.1 percent of GDP in 2009. The revised deficit of the combined public sector will increase by slightly less than the deficit of the central government, and remain well under 5 percent of GDP. To finance the additional deficit, we will increase our domestic borrowing and, if necessary, resort to the central government’s accumulated cash reserves (1.2 percent of GDP as of late August 2009). For 2010, we will target a central government deficit of 4.1 percent of GDP (C140 billion higher than in the original program), and a combined public sector deficit of 4.7 percent of GDP. To avoid
crowding out private sector credit, we will seek to finance a substantial share of next year’s fiscal deficit with resources from abroad, including by drawing on the $500 million contingent credit line from the World Bank that is currently awaiting approval in the Legislative Assembly.

10. **Monetary and external sector policies.** The stronger external position and the sharp deceleration of inflation have created some room for monetary easing. Correspondingly, the BCCR reduced in mid-July the policy interest rate from 10 percent to 9 percent and the overnight deposit rate from 7.75 percent to 7.25 percent. In the period ahead, we will continue to monitor closely domestic liquidity conditions and the attractiveness of the colon to gauge the appropriateness of our interest rate level. We remain committed to adjusting interest rates as necessary to achieve the end-2010 inflation target and maintain orderly conditions in the foreign exchange market. To further bolster our international reserves position, we intend to save the additional SDR allocation of the IMF (about US$205 million).

11. **Financial sector policies.** Despite the resilience that the banking system has displayed so far, we will remain vigilant and continue the intensive monitoring of the banking sector. We remain committed to working closely with our Legislative Assembly to obtain approval of the draft laws to establish consolidated supervision of financial conglomerates and recapitalize the BCCR. We will also continue to address remaining gaps in the financial sector safety net, including through the submission to the Legislative Assembly of draft laws to establish a bank resolution framework in line with international best practice and create a deposit insurance scheme (both now benchmarks for end-December 2009).

12. **Safeguards assessment.** A safeguards assessment of the BCCR was completed in July 2009. The assessment found that the bank has a sound operating control environment, in particular covering the management of official reserves and internal audit functions, and made a number of recommendations to further strengthen the BCCR’s safeguards framework. Key recommendations include the appointment of an external auditor to conduct annual audits of the BCCR financial statements from 2008 onwards, the implementation of International Financial Reporting Standards (IFRS) by 2011, and the establishment of Audit Committee functions. We are committed to implementing the assessment’s recommendations; in particular, the BCCR has already initiated the process to select an external auditor and will include in the services to be contracted an analysis of the existing gaps between the BCCR’s accounting practices and IFRS, in order to establish an action plan for the implementation of IFRS.

13. **Program monitoring.** The program will continue to be monitored on a quarterly basis, by quantitative performance criteria, indicative targets, and structural benchmarks. The phasing of access under the arrangement and the structural benchmarks of the program remain unchanged (Tables 1 and 2). The quantitative performance criteria and indicative targets for end-September 2009 and end-December 2009 are set out in Table 3 (quantitative performance criteria for March 2010 will be defined at the time of the second program review).
Table 1. Costa Rica: Quantitative Performance Measures

(2009 Program)
(In billion of colones, unless otherwise indicated)

<table>
<thead>
<tr>
<th></th>
<th>End-March /1</th>
<th>End-June</th>
<th>End-September</th>
<th>End-December</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>EBS/09/41</td>
<td>Actual</td>
<td>EBS/09/41</td>
<td>Actual</td>
</tr>
<tr>
<td><strong>Quantitative Performance Criteria</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Floor on cash balance of the Central Government (cumulative)</td>
<td>-210</td>
<td>-106</td>
<td>-312</td>
<td>-206</td>
</tr>
<tr>
<td>Ceiling on the debt stock of the Central Government</td>
<td>4,303</td>
<td>4,239</td>
<td>4,356</td>
<td>4,338</td>
</tr>
<tr>
<td>Ceiling on NDA of the Central Bank 2/</td>
<td>-915</td>
<td>-1,301</td>
<td>-786</td>
<td>-1,244</td>
</tr>
<tr>
<td>Floor on NIR of the Central Bank (million of US$) /2</td>
<td>3,500</td>
<td>4,167</td>
<td>3,350</td>
<td>3,936</td>
</tr>
<tr>
<td><strong>Continuous Performance Criteria</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accumulation of external debt arrears</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Indicative targets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Floor on cash balance of the combined public sector (cumulative)</td>
<td>-146</td>
<td>-43</td>
<td>-325</td>
<td>-179</td>
</tr>
<tr>
<td><strong>Memorandum item</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Base money</td>
<td>1,102</td>
<td>1,101</td>
<td>1,144</td>
<td>1,024</td>
</tr>
<tr>
<td>Program exchange rate (ask price)</td>
<td>576</td>
<td>558</td>
<td>576</td>
<td>569</td>
</tr>
</tbody>
</table>

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

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

2/ The floor on NIR and ceiling on NDA at end-September and end-December have been adjusted by $205 million compared to the levels set at program approval (IMF Country Report No. 09/134) to reflect the special and general SDRs allocations of 132.81 millions SDRs.
Table 2. Structural Benchmarks

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

Table 3. Schedule of Availability of Disbursements

<table>
<thead>
<tr>
<th>Amount</th>
<th>Date</th>
<th>Conditions for Disbursement</th>
</tr>
</thead>
<tbody>
<tr>
<td>SDR 328,200,000</td>
<td>April 10, 2009</td>
<td>Executive Board approval of the 18-month Stand-by Arrangement</td>
</tr>
<tr>
<td>SDR 41,025,000</td>
<td>September 23, 2009</td>
<td>Observance of performance criteria for end-June 2009 and completion of the first review under the Stand-by Arrangement</td>
</tr>
<tr>
<td>SDR 41,025,000</td>
<td>December 14, 2009</td>
<td>Observance of performance criteria for end-September 2009 and completion of the second review under Stand-by Arrangement</td>
</tr>
<tr>
<td>SDR 41,025,000</td>
<td>March 16, 2010</td>
<td>Observance of performance criteria for end-December 2009 and completion of the third review under the Stand-by Arrangement</td>
</tr>
<tr>
<td>SDR 41,025,000</td>
<td>June 17, 2010</td>
<td>Observance of performance criteria for end-March 2010 and completion of the fourth review under the Stand-by Arrangement</td>
</tr>
</tbody>
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