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Costa Rica: 2004 Article IV Consultation—Staff Report; Staff Statement; 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 2004 Article IV consultation with Costa Rica, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 14, 2004,** 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 July 18, 2004.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **July 2, 2004** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 2, 2004 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.

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INTERNATIONAL MONETARY FUND

COSTA RICA

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Consultation with Costa Rica

Approved by Markus Rodlauer and Carlos Muñiz

June 18, 2004

- **Discussions.** Article IV consultation discussions were held in San José during May 4–14, 2004. The staff team met with Central Bank President Francisco de Paula Gutiérrez, Finance Minister Alberto Dent, Chief Economic Advisor of the Presidency Ronulfo Jiménez, Trade Minister Alberto Trejos, other senior officials, legislators, labor unions, private sector representatives, and political leaders, including former president Oscar Arias and former presidential candidate Ottón Solís.
- **Staff team.** The team comprised M. Figuerola (Head), M. Garza, R. Adrogué, R. Guimarães, C. Macario (all WHD), F. Vázquez (MFD), and D. Velculescu (PDR). M. Rodlauer (WHD), L. Martí, and R. Simán (both OED) participated in the final discussions. The principal author of the Article IV report is M. Garza.
- **Last Article IV consultation** (March 3, 2003). Directors expressed concern over the growing macroeconomic vulnerabilities, and called for a stronger fiscal stance, improvements in monetary management, greater exchange rate flexibility, and banking reforms to address fragilities identified in the 2001 FSAP.
- **Fund relations.** Costa Rica accepted the obligations of Article VIII, Sections 2, 3, and 4 in 1993 and maintains an exchange system free of restrictions on payments and transfers for current international transactions. It has a crawling peg to the U.S. dollar (at a current rate of about 9 percent per year in 2004). Costa Rica is on the standard 12-month cycle for Article IV consultation.

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EXECUTIVE SUMMARY

- **The economic situation has improved since the last Article IV consultation.** Growth has rebounded, led by investment and exports, and the fiscal deficit has narrowed owing to temporary tax measures and expenditure control. Inflation has remained around 10 percent, in line with the exchange rate crawl. The external current account deficit has declined and international reserves have increased.

- **Despite these improvements, the Costa Rican economy continues to face significant vulnerabilities.** Fiscal and external imbalances remain large, international reserves should be strengthened; the public debt and the external debt are high; financial dollarization is growing; and the banking system has some weaknesses that need to be addressed.

- **Several reforms are under consideration that would start addressing these vulnerabilities.** A tax reform before congress is designed to raise revenues by about 2 percent of GDP, and approval of CAFTA and associated reforms would help support an improved growth outlook. The authorities are also planning to strengthen the central bank and the banking system's supervisory and regulatory framework.

- **While welcoming these initiatives, the staff recommended the adoption of a comprehensive reform agenda to ensure sustained rapid growth in an environment of financial stability.**

  - **Fiscal consolidation.** The fiscal primary surplus should be raised to about 3½ percent of GDP over the medium term (from a projected 0.3 percent in 2004) to ensure sustainable debt dynamics. To this end, the staff urged prompt approval of the tax reform, a strengthening of tax administration, public enterprise reforms, a rollback of revenue earmarking, and pension reform. The staff supports the authorities' plan to recapitalize the central bank to shift its quasi-fiscal deficit to the budget.

  - **Improving monetary management and greater exchange rate flexibility.** The staff endorses the authorities' aim to reduce inflation to the low single digits, supported by improved monetary management and eliminating the central bank's quasi-fiscal deficit. The staff recommended a gradual move toward greater exchange rate flexibility and adoption of inflation targeting. The authorities believe that the crawling peg regime has served Costa Rica well, but agreed that the options for the monetary framework should be kept under review as fiscal policy and the central bank are strengthened.

  - **Financial sector reforms.** The staff urged the authorities to speed up the implementation of banking reforms to alleviate systemic risks and help reverse dollarization. The authorities are planning a focused effort to implement the priorities identified in the 2001 FSAP and subsequent TA missions, including effective implementation of consolidated supervision, strengthening the superintendency of banks' supervisory and enforcement powers, and improving the bank resolution framework.

I. Background

A. Political and Social Environment

1. **Costa Rica has a long record of political stability under a system that operates largely by consensus.** The benefits of this system are evident in a broad national agreement on core institutional pillars of stability and social peace, but it also grants large influence to special interest groups that tend to oppose reforms. In mid-2003, a long strike by public sector unions over pensions and government control of public enterprises led to the resignation of the finance minister and to delays in the implementation of reforms.

2. **President Pacheco—whose four-year term expires in May 2006—remains popular, but the government does not have a majority in congress**. The ruling party (*Unidad Social Cristiana*) holds only one-third of seats in congress, and the political landscape has become more fragmented after the constitutional court lifted the ban on presidential reelection in 2003. Nonetheless, there are signs that the main opposition party (led by former President Arias) supports key reform legislation in congress. The next presidential and legislative elections are scheduled for February 2006.

3. **Costa Rica has the best social indicators in Central America.** Costa Rica made substantial progress in reducing poverty in the 1990s.[1] Education levels are high and health indicators strong, with high life expectancy, low infant mortality, and wide access to sanitation and safe water (Table 11).

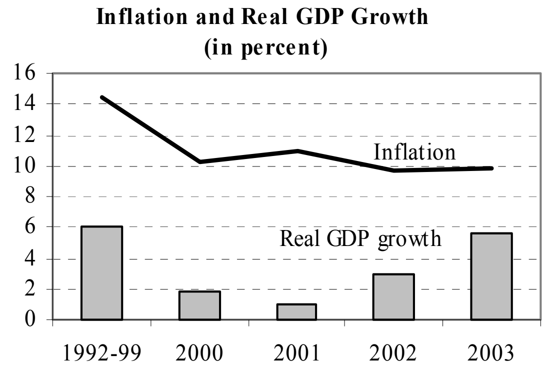
Costa Rica: Social Indicators

	Costa Rica	Other CA countries (average)
Rank in UNDP Human Development Index out of 175 countries (2003)	42	115
GDP per capita in PPP, US$ (2001)	9,460	3,735
Life expectancy at birth (years) (2001)	77.9	68.4
Infant mortality (per 1000 births)(2001)	9	36
Adult illiteracy rate (percent) (2001)	4.3	27.3
Primary school enrollment (2000/01)	91	84
Gini index (HDR, 2003)	45.9	56.5
Poverty rate (2003)	18.5	45.8

[1] Poverty declined from 31.9 percent of population in 1991 to 18½ percent in 2003.

B. Recent Economic Developments

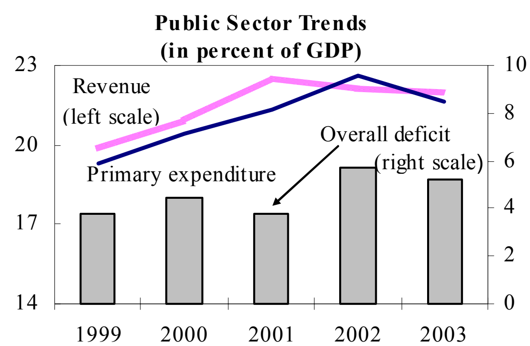
4. **From 1999 to 2002, growth decelerated while macroeconomic vulnerabilities deepened**. Real GDP growth slowed to an annual average of 2 percent in 2000–02 (no growth in per capita income), the external current account deficit widened steadily to close to 6 percent of GDP in 2002, and annual inflation averaged about 10 percent. The public finances deteriorated owing to a steady increase in current expenditure (wages and pensions), and the public debt rose to over 50 percent of GDP by end-2002. Financial dollarization increased, and an FSAP in 2001 identified a number of weaknesses in the prudential framework (¶33). Net international reserves (NIR) remained at around two months of imports.[2]



5. **The economic situation improved in 2003, supported by the favorable external environment.** Real GDP grew by 5½ percent, boosted by a recovery of exports and private investment. Inflation declined slightly to under 10 percent, although the rate of crawl was raised to 10½ percent, and unemployment fell to 6 percent. The external current account deficit declined to 5¼ percent of GDP. The rate of crawl was reduced to 9 percent at the start of 2004.

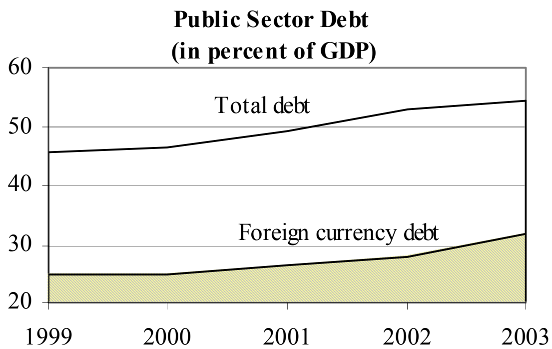
6. **However, progress with reforms has been limited.** During the last Article IV consultation, the authorities indicated their intention to introduce a number of reforms in the fiscal and financial sectors. Several reform proposals have since been presented to congress, but most of them have yet to be approved, as summarized in Table 12.

7. **The overall public sector deficit narrowed to 5.2 percent of GDP in 2003 (5.7 percent in 2002).** The primary balance shifted to a surplus of 0.3 percent of GDP (deficit of ½ percent in 2002). Despite temporary tax measures, revenue fell relative to GDP reflecting weak tax administration and the concentration of growth in tax-exempt sectors. To contain the deficit, the

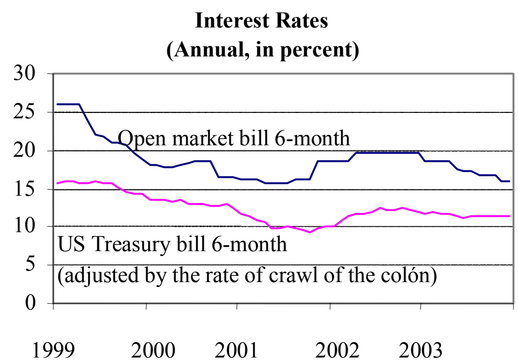


[2] At end-2002, NIR covered 60 percent of banks' foreign currency deposits and 80 percent of gross external financing needs, plus short-term foreign currency domestic public debt.

authorities relied on strict control over central government spending, especially transfers. Investment in the public enterprises rose significantly (by 2½ percentage points of GDP), but this was not fully reflected in the fiscal accounts as enterprises, in particular the large state electricity and telecommunications company (ICE), relied mainly on public-private partnerships (PPPs) to carry out these projects.[3]



8. **Public debt reached a new high of nearly 55 percent of GDP in 2003.** Borrowing rose sharply as the government took advantage of favorable market conditions to pre-finance some of its 2004 needs (1 percent of GDP). The share of foreign-currency debt rose to 59 percent at end 2003 (58 percent excluding the pre-financing; Appendix I).



9. **Large operating losses of the central bank continue to burden monetary policy.** The losses, which stem from a combination of a large debt and significant non-earning assets,[4] have impeded sustained disinflation. The losses have been the main source of expansion of central bank net domestic assets, preventing a reduction in monetary expansion and the rate of crawl, which has been kept at around 10 percent per annum in recent years.[5] In an effort to contain the losses, the central bank in 2003 raised (nonremunerated) reserve requirements from 5 to 10 percent, while lowering its policy interest rate to 16 percent (from 20 percent). Credit to the private sector continued to grow rapidly (by nearly 10 percent in real terms), but the growth of broad money decelerated as private capital inflows slowed following a narrowing of interest rate differentials. By end-2003, 55 percent of private sector credit was denominated in foreign currency.

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[3] ICE carried out most of its telecommunication projects (about 2 percent of GDP in 2003) through operational leases that are excluded from the fiscal accounts. Electricity projects carried out through financial leases are included in the fiscal accounts.

[4] Includes short-term trade credits to Nicaragua (3 percent of GDP) and the cost of the liquidation of a state-owned bank (1 percent of GDP).

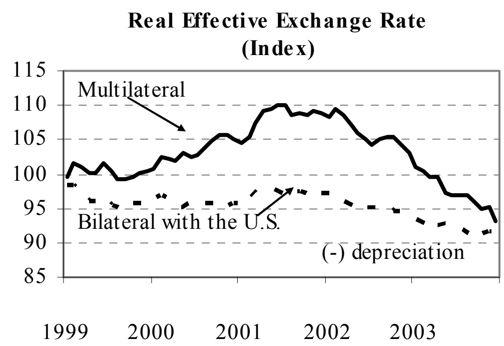
[5] Losses have not been fully sterilized over concerns of the impact on domestic interest rates.

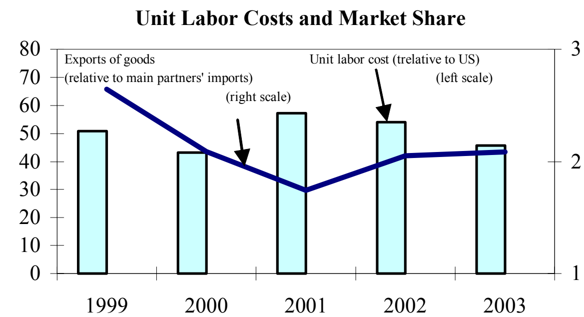
10. **Domestic investment funds managed by local banks experienced a sharp decline in their value in March–May 2004**.[6] The decline was triggered by the turning in the interest rate cycle in the United States and an associated correction in the price of Costa Rican sovereign bonds, which account for a sizable portion of funds' holdings. Investors in these funds experienced significant losses, as investments in these funds are valued on a marked-to-market basis. Investors also made sizable redemptions in anticipation of further losses. These redemptions went mainly into deposits at domestic banks, which increased their holdings of sovereign bonds (mostly marked-to-market in the banks' balance sheets). Banks also on-lent part of the redemptions to the investment funds, taking advantage of a temporary increase by the central bank of the funds' borrowing ceilings (from 10 percent to 30 percent of required capital). This allowed the funds more time to liquidate their assets. The price of sovereign bonds has stabilized since early June, and the funds have started to repay the loans received from banks. Since early March, the value of the funds has declined from about US$3 billion to US$1.5 billion (equivalent to about 25 percent of total bank deposits).

11. **The balance of payments strengthened in 2003.** A sharp increase in exports (mainly computer parts) more than offset higher profit remittances and imports (capital goods and oil). Foreign direct investment (FDI) amounted to 3¼ percent of GDP, covering 60 percent of the external current account deficit. Large borrowing by the public sector and short-term private capital inflows contributed to a buildup in NIR to US$1.6 billion at end-2003 (two-and-one-half months of imports).

12. **Although the level of the real exchange rate appears adequate, other indicators suggest that competitiveness needs to be strengthened**. The colón has declined by about 15 percent in real effective terms over the past two years, mainly reflecting the fall of the U.S. dollar since end-2001. Nonetheless, high relative unit labor costs and a decline in Costa Rica's market share suggests that external competitiveness, while not an immediate concern, should be strengthened. This is particularly important in preparation for the upcoming implementation of CAFTA, growing competition from East Asia, and the expiration of the Multi-Fiber Arrangement in 2005.

[6] Funds are separate financial entities (excluded from the balance sheet of banks), except for the fees for the management of these funds.





13. **Costa Rica reached a free-trade agreement with the United States and other Central American countries (CAFTA) in early 2004.** The agreement will consolidate the benefits enjoyed by Costa Rica under the Caribbean Basin Initiative and provide for other structural changes, including a gradual removal of state monopolies in telecommunication and insurance.[7] Costa Rica also concluded a free-trade agreement with the Caribbean countries (CARICOM) in early 2004.

Box 1. The Fund's Policy Advice and Implementation

- **Policy implementation in Costa Rica has been more gradual and less comprehensive than recommended by the Fund.** In recent Article IV consultations, Directors have repeatedly stressed the need for fiscal consolidation, improved monetary management, greater exchange rate flexibility, banking reform, removal of state monopolies, and further trade liberalization. In the event, the authorities have been able to deepen trade reform, but in light of political constraints, they opted for a more gradual and partial approach in other areas, especially with fiscal, monetary, and financial sector reforms. Implementation of Fund technical assistance recommendations has also been mixed, although progress has been made in the area of banking system and statistics.

- **The authorities acknowledged that there had been some differences of view with the Fund on the scope and pace of reforms, but noted that this had not prevented a fruitful policy dialogue and agreements in many policy areas.** They noted the challenge of approving often difficult reforms in a consensus-based society as Costa Rica, but expressed a strong commitment to addressing the vulnerabilities of the economy. The authorities also indicated their appreciation for the Fund's technical assistance and their intention to act fully on its recommendations, even if implementation may take time.

[7] Existing legislation grants a monopoly power to the government in the area of insurance. Legally there is no state monopoly in the telecommunication sector, but activities in these areas are de facto controlled by ICE.

II. Outlook and Risks

A. Near-Term Outlook

14. **While growth moderated somewhat in early 2004, the near-term economic outlook remains favorable.** Real GDP is expanding at a pace of 4 percent, boosted by the continued strength of the U.S. economy, although export growth (mainly computer parts) has slowed from the rapid pace of last year. Twelve-month inflation has risen to 11½ percent through May owing to higher oil prices, but core inflation remains stable at around 10 percent, broadly in line with the rate of crawl.

15. **The overall public sector deficit is projected to stay at 5.3 percent of GDP.** Congress is expected to approve a proposed tax reform by mid-2004 (see ¶24), which would help offset the expiration of the temporary tax measures at end-2003. The authorities have kept in place strict expenditure control as demonstrated by a limited wage adjustment granted in early 2004 (3½ percent for the first half of 2004). Use of the 2003 pre-financing would allow a small decline of the public sector debt (to 54 percent of GDP at end-2004).

Costa Rica: Macro Framework 2003-04

	2003	2004
Real GDP growth (percent)	5.6	3.8
Real per capita GDP growth (percent)	3.6	1.8
Inflation (percent, end period)	9.9	10.2
Overall public sector balance (percent GDP)	-5.2	-5.3
Primary balance (percent GDP)	0.3	0.3
Public sector debt (percent GDP)	54.5	54.0
External current account deficit (percent GDP)	-5.3	-5.3
Net international reserves (months imports)	2.6	2.2

16. **The external position would remain broadly unchanged.** The external current account deficit is projected to remain at about 5¼ percent of GDP as a decline in non-oil imports would compensate for a slowdown in exports and an increase in oil imports. While FDI would remain broadly unchanged, the capital account surplus would narrow reflecting a decline in borrowing by the public sector (after last year's pre-financing) and private capital inflows (owing to a correction in financial flows to emerging markets). As a result, NIR are projected to decline by US$150 million in 2004 (to US$1.5 billion or two months of imports).

B. Medium-Term Baseline

17. **Under current policies, the medium-term outlook would improve only moderately.** A baseline scenario prepared by the staff, which assumes passage by congress of the tax reform and CAFTA, points to real GDP growth of about 3 percent per year over the medium term, faster than in the early 2000s, but not yet at the 1990s pace, as failure to implement additional reforms would prevent Costa Rica from taking full advantage of the new trading opportunities. With unchanged monetary and exchange rate policies, inflation would remain at current levels of around 10 percent. The tax reform would raise the public sector primary surplus to some 2 percent of GDP, supporting a limited reduction in the public sector debt. With these assumptions, the external current account deficit, which has been largely associated with the fiscal deficit, would narrow to 4½ percent of GDP by 2008. FDI would continue to finance about 60 percent of the current account, but some deceleration in portfolio investment from recent high levels is likely. NIR would rise broadly in line with imports.

Costa Rica: Macroeconomic Framework under Baseline Scenario

		Projections				
	2003	2004	2005	2006	2007	2008
Real GDP growth (percent)	5.6	3.8	3.5	3.0	3.0	3.0
Inflation (percent)	9.9	10.2	9.5	9.5	9.5	9.5
Overall public balance	-5.2	-5.3	-4.5	-3.3	-3.1	-3.0
Primary balance public sector	0.3	0.3	0.7	2.0	2.0	2.0
Public sector debt	54.5	54.0	53.5	53.0	51.6	50.2
External current account balance (percent GDP)	-5.3	-5.3	-5.0	-4.7	-4.7	-4.5
NIR (months of imports)	2.6	2.2	2.0	2.0	2.0	2.1
External debt (percent of GDP)	33.8	33.9	32.7	33.1	33.1	33.0

18. **Significant vulnerabilities would remain under this baseline scenario.** In particular:

- **The public debt/GDP ratio would still be around 50 percent by 2008, leaving the fiscal position vulnerable to shocks.** According to staff simulations, a temporary shock combining slower real growth, a lower primary balance, and higher interest rates would raise the public debt by 6 percentage points of GDP by 2008 relative to the baseline.[8] A 10 percent depreciation of the colón would add 5 percentage points of GDP to the debt by 2008.

[8] One standard deviation shocks relative to the ten-year historical average affecting the economy in 2004–05 (Tables 15 and 16).

- **The external position would remain fragile in the face of shocks**. Staff simulations indicate that a temporary shock combining lower real growth, an increase in the non-interest current account deficit, an increase in the nominal external interest rate, and a decline in the GDP deflator growth rate (in U.S. dollars) would increase the external debt (both public and private debt) by about 4 percentage points of GDP by 2008 compared to the baseline scenario.[8]

- **The crawling peg would remain a source of vulnerability.** Financial dollarization is bound to continue as the exchange rate would remain the best predictor of inflation. At the same time, the peg is a vulnerability in the face of external shocks, especially in light of the relatively low level of international reserves.

- **The banking system would remain subject to risks.** In the absence of comprehensive reforms to strengthen prudential regulation and supervision, incentives would continue to exist for regulatory arbitrage, dollarization, and weak risk management. The banking system is mainly vulnerable to interest rate risks and to currency-induced credit risk from lending to non-dollar earners. Banks also are exposed to sovereign risk. Recent events in investment funds highlight the risks for the financial system of the changing global interest rate environment. There is also the challenge of bringing the substantial offshore operations under appropriate supervision.

19. **Failure to approve the tax reform and CAFTA would signal growing political paralysis, affect adversely growth prospects, and leave the fiscal and external outlook increasingly vulnerable.** In an adverse scenario without these two critical priority reforms, it would be difficult to sustain even the moderate levels of investment and total factor productivity observed in the early 2000s. Under these circumstances, real GDP growth could decelerate to around 1½ percent of GDP by 2008, in an environment of rising inflation. The primary balance would remain around zero and the public debt would rise steadily to over 60 percent by 2008. A rising fiscal imbalance would raise the external current account deficit, with external debt reaching 36 percent of GDP by 2008. Concerns about fiscal and external sustainability would be compounded by difficulties in continuing to attract FDI, decreasing international reserves, further dollarization, and banking sector weaknesses.

III. Policy Discussions

20. **The discussions centered on a comprehensive strategy to address Costa Rica's vulnerabilities and boost growth in a lasting way.** Such a strategy should aim at further fiscal consolidation, improvements in monetary and exchange rate management, banking system reforms, and steps to improve competitiveness and the investment climate. The measures recommended by staff and the proposed sequence are summarized in Table 14.

21. **Costa Rica is well positioned to benefit from such an effort.** A strengthened macroeconomic framework, further opening up the economy to private competition, and other reforms to improve the business climate and competitiveness would help boost investment, productivity, and growth. In an "active-policy scenario" prepared by the staff, the

implementation of tax reform, CAFTA, and other priority measures would signal strong political support for reforms and could lead to a rebound of GDP growth to close to 5 percent (the level recorded during the 1990s) based on increased domestic investment and exports. Measures to raise the primary surplus of the public sector to about 3½ percent of GDP, would set the public debt dynamics on a robust downward path (to 43 percent of GDP by 2008). A strengthened monetary framework, facilitated by the transfer to the budget of the central bank losses, would help bring inflation down to the low single digits, in an environment of increased exchange rate flexibility, and allow for a sustained buildup of international reserves.

Costa Rica: Macroeconomic Framework under Active Scenario

		Projections				
	2003	2004	2005	2006	2007	2008
Real GDP growth (percent)	5.6	3.8	5.0	5.0	5.0	5.0
Inflation (percent)	9.9	10.2	6.8	5.0	5.0	5.0
Overall public balance	-5.2	-5.3	-2.6	-1.0	-0.1	0.3
Primary balance public sector	0.3	0.3	2.0	3.0	3.5	3.5
Public sector debt	54.5	54.0	52.1	49.6	46.7	43.3
External current account balance (percent GDP)	-5.3	-5.3	-4.0	-3.2	-2.6	-2.5
NIR (months of imports)	2.6	2.2	2.0	2.5	3.3	3.9
External debt (percent of GDP)	33.8	33.9	30.5	27.3	25.0	22.1

22. **The authorities broadly agreed with the staff's assessment, although they envisaged a somewhat more gradual implementation of reforms than proposed by the staff.** With the presidential campaign starting in 2005, certain reforms may be difficult before the elections, especially in the area of government spending. This view was shared by the broad spectrum of representatives of congress, political parties, civil society, and the private sector that met with the staff. In these meetings, the staff noted growing awareness of Costa Rica's economic vulnerabilities and support for reforms, but also a consensus that the most difficult reforms would probably need to wait until after the 2006 elections.

A. Fiscal Policy

23. **The staff urged additional fiscal consolidation to ensure sustainable public debt dynamics.** To raise the primary surplus to about 3½ percent of GDP over the medium term, the proposed tax reform (2 percent of GDP) should be followed by reforms on tax administration on the expenditure side, and in public enterprises, to yield an additional 1½ percent of GDP. The authorities, while agreeing on the need for an additional fiscal effort, considered that a somewhat smaller primary surplus (around 3 percent of GDP or slightly less) could be sufficient to ensure debt sustainability, especially as they felt that with further reforms economic growth may be stronger than assumed in the staff's active scenario.

24. **Approval of the proposed tax reform is critical.** This reform proposal, prepared with assistance from FAD, would raise additional revenue from a broadening of the tax base and elimination of tax loopholes.[9] The proposed reform is supported by the main political parties and is making good progress in congress; the authorities expect final approval by July 2004.

Key Elements of Tax Reform

Measures	Projected yield percent of GDP
Total	**2.0**
Income tax	0.6
- Broadens base to include global and universal income	
- Phases out free-trade zone and other exemptions	
- Gradually reduces highest tax rate from 30 to 18 percent	
Value-added tax (VAT)	1.2
- Replaces sales tax by VAT (13 percent rate)	
- Limits exemptions to narrowly defined list of goods	
- Adds services to the base (some at 6 percent rate)	
Other	0.2
-Eliminates excise tax exemptions	
-Strengthens procedures for tax evasion and collection of arreas	

25. **Tax administration needs to be strengthened to ensure sustained revenue gains from the tax reform.** Based on recommendations of a recent FAD TA mission, staff urged the adoption of an action plan to tighten control of large taxpayers, eliminate cross-crediting between taxes, limit tax withholdings to reduce refunds (an area of leakage), and strengthen the tax agency, including by giving it special powers to collect tax arrears. The authorities agreed that improved tax administration is central to the tax reform and noted plans to implement FAD recommendations as soon as the tax reform is approved.

26. **Expenditure reforms will also need to contribute to the fiscal effort.** In particular, staff stressed the need to contain the upward trend of the wage bill, phase out revenue earmarking, and limit rising pension payments.[10] The authorities noted that steps are underway to contain expenditure growth by reducing wage indexation and strengthening procurement procedures, especially in the health care system. They agreed with the staff's recommendations for limiting revenue earmarking and pension reforms, although creating domestic consensus on these reforms might take time.

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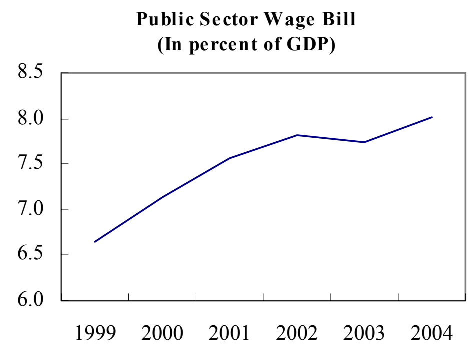
[9] The package before congress is broadly in line with FAD recommendations, except for proposals to introduce a limited dual VAT rate structure and a reduction in the maximum marginal corporate income tax rate.

[10] Expenditure reform is considered a key priority by both the World Bank and the IDB. The World Bank's country assistance strategy approved in May 2004, envisages a highly selective lending program focused on projects to enhance equity and efficiency of education, coverage and quality of water and sanitation, improvement of financial sustainability of the environment sector, and efficiency of government operations. Additionally, the CAS includes a substantial program of knowledge and advisory services and analytical work to support reforms in critical areas, such as public sector debt management, debt-market development, financial sector reform, and management of private participation in infrastructure.

- **Wages and employment.** The public sector wage increase for the first half of 2004 was held at 3½ percent (less than inflation), halting a long upward trend in real wages. The staff welcomed this action, but expressed concern about a 2 percent rise of public employment in 2003 that will push the wage bill up in 2004. The authorities noted that this was a one-time increase required by reforms in education and security. The staff stressed the need to gradually reduce the public sector wage bill in relation to GDP.



- **Rolling back revenue earmarking.**[11] The staff urged a reduction of widespread earmarking, which has contributed to substantial budget rigidity. The authorities noted that most of the legally-mandated earmarking has been suspended since mid-2003, although the constitutional court has recently called this suspension into question (a final decision is still pending). A more permanent solution could be provided by a 1999 bill still in congress that seeks to phase out earmarking. The authorities intend to revive the bill if the court were to reinstate the suspended earmarking.

- **Pension reform.** The authorities agreed with the staff on the need to halt the rapid increase of pension outlays. To strengthen the finances of the basic pension system (which faces an actuarial deficit), they are developing proposals to raise contributions and the retirement age, and lower the reference wage for pension payments. While these reforms do not require congressional approval, the authorities prefer to generate broad domestic consensus before proceeding with them. The staff urged similar reforms for the unfunded special regimes, where pension outlays are also growing rapidly.

27. **The performance of public enterprises also needs to improve.** CAFTA will contribute to this objective by fostering competition with the private sector in areas until now controlled by public enterprises, although additional measures are needed to strengthen the contribution of these enterprises to the fiscal effort.

- The authorities agreed with the staff that public tariffs should be adjusted in line with changes in operational and debt-service costs.

[11] Costa Rica has two kinds of revenue earmarking: (i) constitutionally-mandated earmarking for education (6 percent of GDP) and the judiciary (6 percent of tax revenue or 0.8 percent of GDP); and (ii) legally-mandated earmarking in a number of other areas, totaling almost 2 percent of GDP.

- They noted substantial progress in ensuring that public enterprises, especially ICE, operate within the overall strategy and financial goals approved by the government.[12] Within these parameters, the goal is to strengthen the enterprises' commercial orientation and make them compete with private operators on a level playing field.[13] The staff supported this overall strategy while cautioning against the risk of giving unreformed enterprises too much latitude, particularly in their employment, investment, and borrowing policies.

- The staff welcomed the increased reliance on operational PPPs to carry out investment projects, while stressing that they should entail meaningful efficiency gains with appropriate risk sharing, monitoring, and accounting. The authorities indicated that these operations are conducted with full transparency and under the control of the government, and reassured the staff that there have been no government guarantees or contingent liabilities related to them.

28. **The staff urged the authorities to proceed expeditiously with their intention to recapitalize the central bank and shift its quasi-fiscal losses to the budget.** The authorities agreed with the staff that this action, while not changing the consolidated fiscal outlook, is critical to enhance the central bank's capacity to implement monetary policy.[14] It would also enhance fiscal transparency, and help ease pressures on the government to allocate the yield of the tax reform to new spending programs. The authorities intend to submit a draft bill to this effect soon after the approval of the tax reform, although they noted that considerable efforts will be needed to explain this reform to the public.

29. **There is scope to further improve public debt management.** In recent years, the maturity debt structure and its currency composition has deteriorated, as efforts have been made to limit the financing cost of the public debt (see Appendix I). The authorities were confident about their ability to manage the gross financing needs of the public sector (nearly 20 percent of GDP in 2003). Staff recommended reduced reliance on foreign-currency short-term borrowing. Efforts are also needed to strengthen risk management, including of currency

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[12] The authorities have recently put in place a financing oversight committee (formed by the minister of finance, the president of the central bank, and the minister of planning) which will establish binding financial guidelines for all public sector entities.

[13] A proposal has been presented to congress to strengthen ICE's ability to compete with the private sector by giving it more flexibility in the conduct of its commercial operations.

[14] The staff estimated that a recapitalization of some 11 percent of GDP would be required to shift the central bank quasi-fiscal losses (about 1½ percent of GDP per year) to the budget.

risk, and further improve investor relations. The authorities agreed with the thrust of the recommendations, and explained that efforts were already underway in most of these areas. [15]

B. Monetary and Exchange Rate Policies

30. **The authorities agreed with the staff on the need to bring inflation down to low single-digit levels.** They expect fiscal consolidation and recapitalization of the central bank to ease the burden on monetary policy and allow a progressive slowdown of the rate of crawl, thus leading to a significant decline of inflation.[16] The staff welcomed the intention to bring down inflation and strengthen the central bank's ability to conduct monetary policy, in line with the recommendations of a recent MFD TA mission. These include further steps to take a more forward-looking approach to monetary policy, strengthen the central bank's inflation-forecasting abilities, and improve its understanding of monetary transmission mechanisms.

31. **The staff recommended a shift over time toward inflation targeting and greater exchange rate flexibility.** Such a shift would provide greater flexibility to deal with shocks and facilitate adjustment to structural change, while providing a new anchor for domestic price stability. The staff emphasized that the move to a new monetary and exchange rate framework would need to be well prepared and supported by reforms in other areas, particularly fiscal consolidation, strengthening the central bank's capacity to implement monetary policy, and developing exchange market infrastructure (including hedging instruments to cope with exchange rate volatility). A buildup of international reserves would also be needed to support the credibility of the new regime.

32. **The authorities felt that the crawling peg had served Costa Rica well and saw no need for change in the immediate future.** They noted that the regime had provided a strong anchor for confidence and expectations, and facilitated Costa Rica's development into a highly open economy (with trade of goods accounting for some three-fourths of GDP). Nonetheless, they agreed that the system should be kept under review, and expressed their intention to put in place the preconditions that would give the new government taking office in 2006 the option of moving to a different regime. They looked forward to continuing a close dialogue with the Fund in this area.

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[15] To support these efforts the authorities have requested participation in the World Bank's Program of *Country Assessment and Reform Plan in Debt Management and Domestic Debt Market Development*.

[16] The recapitalization of the central bank will have no effect on the debt sustainability assessment since the central bank debt is already included in Costa Rica's debt statistics.

C. Banking System

33. **Although progress has been made since the 2001 FSAP, the banking system remains vulnerable.** Steps have been taken to recapitalize banks, strengthen supervision, and reinforce the superintendency of banks. However, there are still a number of largely unsupervised offshore banks, weaknesses in the prudential and bank resolution framework, and inefficiencies in intermediation and risk management. Public banks are exposed to sovereign risk; banks are vulnerable to interest rate risk and to currency-induced credit risk from dollar loans to non-dollar earners; and rising dollarization has made the system more vulnerable to shocks.

Costa Rica: Structure and Performance Banking System

	2001	2002	2003
(In percent unless otherwise stated)			
Number of banks	20	20	19
Of which: public banks	4	4	4
Share of public banks in total assets	67.5	67.3	64.9
Ratio of capital to risk-weighted assets	15.1	15.8	16.5
Ratio of NPL to total loans	2.4	3.2	1.7
Ratio of provision to NPL	113.2	102.6	145.9
Ratio of fx credit to total credit	51.6	54.3	56.5
Return on equity	18.7	17.1	19.5
Return on assets	1.9	1.8	2.1
Ratio of liquid assets to deposits	58.1	57.4	55.3

34. **The staff urged further reforms to complete the restructuring process recommended by the 2001 FSAP.** A comprehensive bank reform proposal has made little progress in congress since 2001. The authorities explained that the broad scope of the initiative made it difficult to achieve domestic consensus. For this reason, they have decided to give priority to the more urgent reforms, in line with the recommendations of a recent MFD mission. In particular, they are working on:

- A streamlined proposal to be submitted to congress in 2004 to: (1) provide for consolidated supervision of financial holdings; (2) strengthen sanctions for noncompliance with prudential regulations; and (3) improve the bank resolution framework, including a strengthening of the lender-of-last resort facility (LOLR).[17]
- Actions to reinforce further onshore supervisory controls and to broaden the scope and effectiveness of the agreements for joint supervision with other countries where offshore banks are located.
- Further strengthening the superintendency of banks, especially its ability to audit information and risk management systems.

35. **The staff welcomed these efforts, and encouraged several additional reforms.** In particular, a broader reform is needed to level the playing field between public and private banks, onshore and offshore banks, and colón and dollar intermediation. The staff also

[17] The LOLR function does not provide adequate protection to the central bank and suffers from other design and operational problems identified in the FSAP.

recommended strengthening liquidity management, including the payments system, interbank money market, and open market operations; creating buffers against systemic risks, including those associated with large holdings of sovereign debt; ensuring that banks' ongoing recapitalization programs remain on track; and granting no further forbearance on capital requirements. The authorities agreed with the thrust of these recommendations and reiterated their commitment to implement the needed reforms over time.

36. **The authorities agreed with staff on the importance of halting and eventually reversing financial dollarization.** While achieving this goal would be challenging and take time, the authorities and staff concurred on the key elements of a strategy to this end: (1) fiscal consolidation; (2) improving the capacity of monetary policy to deliver sustained low inflation; and (3) implementing the steps recommended by a recent MFD TA mission to restore the colón's ability to compete with the dollar and ensure full internalization of the risks of dollar-intermediation. In particular, the authorities noted that they have encouraged banks to promote (existing and new) price-indexed instruments to help foster colón intermediation.

37. **The situation of investment funds has stabilized.** The authorities explained that the systemic impact of the decline in the value of these funds has been limited and no central bank support was needed to help banks sustain their investment funds (except for the temporary relaxation of the funds' borrowing ceilings). Although sovereign bond prices stabilized, allowing funds to begin repaying bank loans, the increased bank exposure to sovereign risk and to the funds is a source of concern. The staff urged the authorities to encourage banks to build up buffers to absorb losses from changes in sovereign prices, and to strictly enforce mark-to-market valuation of bond holdings. The staff also recommended to reverse, as soon as possible, the relaxation of funds' borrowing ceilings to ensure rapid repayment of bank loans and to strengthen the firewall between banks and their funds. The authorities agreed on the need to make sure that investment funds transparently advertise the nature of their risks.

D. Trade and Competitiveness

38. **The staff welcomed the successful negotiation of CAFTA and a free-trade agreement with CARICOM.** These agreements will further deepen the openness that has served Costa Rica well and provide new impetus to growth. The average tariff (now 5.2 percent) will be reduced further, although a few agricultural products will continue to carry high tariffs (albeit lower than current levels of up to 150 percent).[18] With the exception

[18] Costa Rica has a rating of four on the Fund's trade restrictiveness index (scale of ten, with one for most open). Goods imported from the United States, which currently face the most-favored-nation tariff of 5.8 percent, would face a tariff of 3.5 percent the first year of CAFTA (2.2 percent by the fifth year).

of a minority party and some labor unions, there is broad support for these agreements, and the authorities expect them to come into effect by early 2005, following approval by the respective national legislatures.[19] Given the already low tariff rates, they will have only small fiscal costs.[20]

39. **The authorities are fully aware of the need for continued reforms to bolster competitiveness in the period ahead.** They viewed the recent real depreciation of the colón, flexible labor market legislation, especially in the areas of hiring and firing, a well-educated work force, and social peace as major assets in the global competition for jobs and investment.[21] However, they agreed with the staff on the need for continuous improvements in the investment climate, containing the relatively high cost of doing business in Costa Rica, elimination of state monopolies, and upgrades in infrastructure. The authorities are seeking support from the IDB and the World Bank for these efforts and taking steps to facilitate the adjustment of sectors affected by CAFTA.[22]

IV. Other Issues

40. **Costa Rica's economic statistics are adequate for surveillance purposes, although there is room for improvement in some areas.** The authorities explained that major progress has been made in improving economic statistics, noting that Costa Rica joined the SDDS in 2001 and is publishing comprehensive economic information on the internet. They also noted that, following a 2002 ruling by the constitutional court, the government has published all reports on Costa Rica prepared by international financial institutions. At the same time, they expressed their intention to address the main remaining deficiencies in areas such as government financing and public debt.

41. **The authorities remain committed to providing debt relief consistent with the enhanced HIPC initiative.** The authorities have been in touch with the Paris Club and Fund staff to explore the various modalities to provide the debt relief and expect to submit related proposals to congress shortly.

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[19] The timing of legislative approval in Costa Rica may also be influenced by the timing of legislative approval of the agreement in the other Central American countries.

[20] Staff estimates put the fiscal cost at around 0.2 percent of GDP in 2005 (nil onwards), in line with the 0.1–0.3 percent estimated by the United Nations Economic Commission for Latin America.

[21] According to the World Bank's 2003 World Development Indicators, Costa Rica's labor laws are more flexible than those in Panama and El Salvador.

[22] In FY05 the World Bank will implement an Investment Climate Assessment (ICA) that will formulate policy recommendations in this area.

V. Staff Appraisal

42. **Costa Rica's economic situation has improved since last year's Article IV consultation.** Growth recovered in 2003; international reserves have increased; and the fiscal deficit has narrowed owing to temporary tax measures and tight expenditure control. Inflation, anchored by the crawling peg regime, remains at a relatively high rate of around 10 percent a year.

43. **Despite these improvements, the economy continues to face significant vulnerabilities.** The fiscal deficit and public debt are still high, the external current deficit remains large, the financial system suffers from growing dollarization and prudential weaknesses; and international reserves should be strengthened given the currency peg and the banking system's dollar liabilities. Recent events in investment funds highlight potential vulnerability in the financial sector.

44. **An agenda of comprehensive and well-sequenced reforms is needed to address these vulnerabilities and allow Costa Rica to benefit fully from its growing integration with the global economy.** The staff welcomes several important initiatives planned by the authorities. In particular, it looks forward to early approval of the tax reform currently before congress, as well as of CAFTA and associated structural reforms. Implementation of these initiatives is critical to the outlook for continued growth and fiscal sustainability, and the staff welcomes the broad domestic consensus that appears to support them.

45. **However, these reforms by themselves would only make a limited improvement to the outlook.** To ensure a sustained increase of growth and more robust public debt dynamics, the staff recommends adoption of additional reforms with focus on tax administration, government spending, state enterprises, monetary management, and the financial sector.

46. **The authorities' medium-term fiscal program should aim at raising the primary surplus of the consolidated public sector to about 3½ percent of GDP.** To this end, the tax reform needs to be supported by a strengthening of tax administration; expenditure reforms should include pension reform, rolling back earmarking of tax revenues, and further strengthening wage policy in the public sector; and the performance of public enterprises needs to improve.

47. **The staff urges early implementation of the plan to recapitalize the central bank and shift its quasi-fiscal losses to the budget.** This initiative is essential for strengthening monetary policy and sustained disinflation, which in turn is key to reverse the trend of rising dollarization and restore confidence in the domestic currency.

48. **The staff supports the authorities' plans to strengthen debt management.** Fiscal consolidation will provide the scope for lengthening debt maturities, reducing reliance on foreign-currency instruments, and developing a market for colón instruments.

49. **Monetary policy should be geared toward a lasting reduction of inflation.** Over the medium term, the staff recommends that the central bank move toward inflation targeting, with a flexible exchange rate regime. In this context, the staff welcomes the authorities' intentions to further strengthen the central bank's inflation forecasting capabilities, monetary instruments, and the analysis of monetary transmission channels. Greater exchange rate flexibility will reduce the economy's vulnerability to shocks, support de-dollarization, and facilitate adjustment to structural change. The staff notes that the move toward greater flexibility would need to be gradual and well supported by progress on other fronts, including fiscal consolidation, strengthening the central bank, reducing dollar exposures of the private sector, and strengthening the international reserve position.

50. **While financial sector reforms have made progress in recent years, further efforts are needed.** The staff supports the authorities' intention to focus in the near term on the key outstanding reform priorities identified in the 2001 FSAP. However, they should not lose sight of the need for a comprehensive reform effort to strengthen the prudential and supervisory system. In particular, the staff urges steps to level the playing field between, respectively, public and private banks, and onshore and offshore banks; ensure consolidated supervision of financial holdings; strengthen the system of sanctions for noncompliance; and upgrade the bank resolution framework. The staff also strongly recommends that no further forbearance be granted on capital requirements, and encourages the authorities to strengthen liquidity and risk management and enhance the capabilities of the superintendency of banks. The stabilization of investment funds in recent weeks is welcome, and the authorities need to take steps to reverse the increased exposure of banks to investment funds and ensure a solid firewall between banks and their funds. The authorities also need to make sure the funds operate in line with relevant norms and transparency standards.

51. **Reversing the trend of rising financial dollarization will require a comprehensive and sustained effort to restore the colón's ability to compete against the dollar.** While this will take time, the staff agrees with the authorities that reducing dollarization is critical to the crisis-proofing of the economy and will require a sustained strengthening of macroeconomic policies and the prudential framework, especially with a view to internalizing fully the risks of dollar intermediation.

52. **The staff welcomes the successful negotiation of trade agreements with the United States (CAFTA) and Caribbean countries (CARICOM).** In addition to the greater trade opportunities offered by these agreements, CAFTA also provides for a broader participation of the private sector in telecommunications and insurance.

53. **The staff encourages the authorities to work toward completing the process of providing debt relief to Nicaragua and Honduras, consistent with the enhanced HIPC initiative.**

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

Table 1. Costa Rica: Selected Economic and Financial Indicators

	1999	2000	2001	2002	Prel. 2003	Proj. 2004
(Annual percentage change)						
National income and prices						
GDP at constant prices	8.2	1.8	1.0	2.9	5.6	3.8
Nominal GDP	24.5	9.0	9.6	12.4	15.6	13.5
Consumer prices (end of period)	10.1	10.2	11.0	9.7	9.9	10.2
Consumer prices (average)	10.0	11.0	11.3	9.2	9.4	10.0
External sector						
Export of goods (f.o.b.)						
Value	18.7	-11.6	-15.3	6.8	16.6	0.7
Volume	17.1	-13.5	-17.3	5.2	14.7	-0.2
Import of goods (c.i.f.)						
Value	1.0	0.6	-4.4	13.6	10.8	2.8
Volume	-0.5	-1.6	-6.6	11.9	9.0	1.9
Terms of trade (deterioration -)	-5.6	-2.7	-3.6	0.7	0.4	...
Real effective exchange rate (end of period; depreciation -)	1.7	4.7	3.6	-5.4	-9.4	...
Central government						
Total revenue and grants	14.1	14.3	17.8	10.7	15.7	17.0
Total expenditure	19.3	14.9	14.3	19.5	11.3	17.5
Banking system						
Net domestic assets	8.4	24.8	10.9	15.5	5.9	13.8
Of which						
Credit to public sector	-26.5	-12.9	-63.5	103.1	-0.1	-1.0
Credit to private sector	18.2	31.3	22.9	20.6	19.7	14.7
Broad money	9.5	20.9	11.0	19.8	13.6	13.3
Private financial assets	23.5	17.9	18.7	17.1	17.9	13.2
Lending interest rate (end of period)	29.2	27.0	25.8	27.9	29.2	...
Six-month government bonds interest rate (end of period)	14.2	16.1	17.5	17.6	18.7	17.6
(In percent of GDP)						
Overall public sector balance	**-3.7**	**-4.4**	**-3.8**	**-5.7**	**-5.2**	**-5.3**
Overall primary public sector balance	**0.6**	**0.5**	**1.2**	**-0.5**	**0.3**	**0.3**
Nonfinancial public sector balance	-2.2	-2.7	-2.6	-4.3	-3.6	-3.8
Central government	-2.9	-3.7	-3.8	-5.0	-3.9	-4.0
Rest of nonfinancial public sector	0.8	1.1	1.3	0.7	0.2	0.2
Central bank losses (-)	-1.6	-1.8	-1.2	-1.4	-1.6	-1.5
Gross domestic investment	**17.1**	**17.1**	**20.1**	**21.9**	**20.5**	**21.3**
Private	13.7	13.6	14.1	14.6	15.9	16.9
Public	4.3	4.2	4.0	4.5	4.2	4.7
Gross national savings	**12.8**	**12.6**	**15.6**	**16.1**	**15.2**	**16.0**
Private	12.3	12.9	15.4	17.4	16.2	16.6
Public	0.5	-0.3	0.2	-1.3	-1.0	-0.6
External current account balance	**-4.3**	**-4.4**	**-4.5**	**-5.7**	**-5.3**	**-5.3**
Total public debt	**45.7**	**46.5**	**49.0**	**52.8**	**54.5**	**54.0**
Of which: external public debt (end of period)	19.4	19.8	19.8	19.8	21.2	21.1
(In percent of exports of goods and services)						
External public debt service	24.3	25.9	28.5	26.8	36.8	28.0
Of which: interest	7.7	8.7	11.0	10.3	9.8	9.8
(In millions of U.S. dollars, unless otherwise specified)						
Change in net international reserves (increase -)	-480	152	-13	-163	-341	150
Net international reserves 1/	1,240	1,086	1,098	1,261	1,602	1,452
Net international reserves (months of imports of goods)	2.5	2.3	2.0	2.1	2.6	2.2

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

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

Table 2. Costa Rica: Summary of Combined Public Sector 1/

	1999	2000	2001	2002	Prel. 2003	Proj. 2004
(In percent of GDP, unless otherwise stated)						
Revenues	**19.9**	**20.9**	**22.5**	**22.1**	**22.0**	**22.8**
Tax revenue	11.9	12.4	13.3	13.2	13.1	13.4
Direct taxes	3.5	3.4	3.7	3.8	4.0	3.9
Imports	2.6	2.7	2.1	1.7	1.5	1.5
Sales tax	5.8	6.3	7.4	7.7	7.6	8.0
Nontax revenue	0.1	0.1	0.2	0.1	0.3	0.3
Contributions to social security 2/	5.5	5.9	6.2	6.4	6.1	6.2
Operating surplus of the public enterprises	2.3	2.5	2.8	2.4	2.6	2.9
Expenditure	**19.3**	**20.5**	**21.3**	**22.6**	**21.7**	**22.6**
Wages and salaries	6.6	7.1	7.6	7.8	7.7	8.0
Goods and services	1.6	1.7	1.8	2.1	1.9	1.9
Pensions	3.5	3.9	4.4	4.4	4.3	4.5
Transfers and others	3.2	3.4	3.3	3.7	3.3	3.3
Central bank primary losses	0.1	0.2	0.2	0.2	0.2	0.2
Capital expenditure	4.3	4.2	4.0	4.5	4.2	4.7
Primary balance	**0.6**	**0.5**	**1.2**	**-0.5**	**0.3**	**0.3**
Net interest payments	**4.3**	**4.9**	**5.0**	**5.2**	**5.5**	**5.6**
Overall balance	**-3.7**	**-4.4**	**-3.8**	**-5.7**	**-5.2**	**-5.3**
Nonfinancial public sector	-2.2	-2.7	-2.6	-4.3	-3.6	-3.8
Central government	-2.9	-3.7	-3.8	-5.0	-3.9	-4.0
Rest of nonfinancial public sector	0.8	1.1	1.3	0.7	0.2	0.2
Central bank	-1.6	-1.8	-1.2	-1.4	-1.6	-1.5
Total financing	**3.7**	**4.4**	**3.8**	**5.7**	**5.2**	**5.3**
External	1.6	0.7	0.4	1.4	1.6	1.9
Domestic	2.1	3.7	3.4	4.3	3.6	3.4
Of which						
Central bank	1.3	0.8	-2.1	1.7	1.8	0.8
Bonds	0.7	2.3	3.5	0.7	0.4	1.0
Memorandum items:						
ICE operational leases (PPPs)	0.0	0.0	0.0	0.0	1.8	0.0
Total public sector debt	45.7	46.5	49.0	52.8	54.5	54.0
External	19.4	19.8	19.8	19.8	21.2	21.1
Domestic	26.4	26.8	29.2	33.0	33.2	32.9
Of which						
Foreign-currency denominated	5.3	5.4	5.8	6.6	11.6	9.5
Gross financing needs	18.6	17.1	16.0	18.9	19.9	21.5
Effective external interest rate (percent)	6.6	6.8	7.5	7.1	6.6	6.7
Effective domestic interest rate (percent)	14.2	16.1	17.5	17.6	18.7	17.6
Nominal GDP (in billions of colones)	4,513	4,918	5,388	6,058	7,005	7,950

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Assumes approval of tax reform and CAFTA in 2004.
2/ Includes health and pension systems.

Table 3. Costa Rica: Public Sector Debt

	1999	2000	2001	2002	2003	Proj. 2004
	(In millions of U.S. dollars)					
Total debt of the public sector	**7,216**	**7,417**	**8,014**	**8,885**	**9,622**	**9,812**
Domestic debt (in billions of colones)	1,190	1,316	1,571	1,998	2,343	2,612
Of which: central bank	522	501	492	677	848	851
External debt	3,057	3,151	3,243	3,338	3,753	3,838
Nonfinancial public sector	2,147	2,309	2,463	2,680	3,121	3,476
Central bank	887	811	753	621	523	256
Financial public sector	23	31	26	37	109	106
	(In percent of GDP)					
Total	**45.7**	**46.5**	**49.0**	**52.8**	**54.5**	**54.0**
Domestic debt	26.4	26.8	29.2	33.0	33.2	32.9
Nonfinancial public sector	14.8	16.6	20.0	21.8	21.2	22.1
Central bank	11.6	10.2	9.1	11.2	12.0	10.7
External debt	19.4	19.8	19.8	19.8	21.2	21.1
Nonfinancial public sector	13.6	14.5	15.0	15.9	17.7	19.1
Central bank	5.6	5.1	4.6	3.7	3.0	1.4
Financial public sector	0.1	0.2	0.2	0.2	0.6	0.6
Memorandum items:						
Short-term debt	29.4	24.7	24.3	27.2	30.7	28.0
Foreign currency debt	25.1	25.0	26.4	27.8	32.1	26.9

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

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

	1999	2000	2001	2002	Prel. 2003	Proj. 2004
(End-of-period stocks; in billions of colones unless otherwise specified)						
I. Central Bank						
Net international reserves 1/	**350**	**335**	**361**	**454**	**639**	**635**
(In millions of U.S. dollars)	1,240	1,086	1,098	1,261	1,602	1,452
Medium- and long-term foreign liabilities	**-264**	**-267**	**-232**	**-217**	**-208**	**-112**
(In millions of U.S. dollars)	-936	-866	-705	-604	-522	-256
Net domestic assets	**793**	**817**	**720**	**823**	**930**	**1,050**
Nonfinancial public sector 2/	239	213	16	25	36	-10
Commercial banks	8	4	3	1	1	2
Stabilization bonds (BEM and ICP, OMOs)	-585	-564	-536	-714	-885	-1,032
Operational losses (quasi-fiscal)	280	367	431	517	621	741
Other	270	236	274	283	271	318
Base money	**274**	**292**	**282**	**306**	**379**	**441**
Foreign currency (legal) deposits	20	28	32	40	97	101
II. Commercial Banks						
Net foreign assets (including medium- and long-term liabilities)	**-52**	**-76**	**-138**	**-173**	**-205**	**-277**
(In millions of U.S. dollars)	-186	-246	-419	-480	-515	-633
Net claims on the central bank	**432**	**450**	**397**	**509**	**508**	**675**
Net domestic assets	**751**	**1,025**	**1,295**	**1,543**	**1,837**	**2,034**
Nonfinancial public sector	42	32	73	157	145	189
Private sector	765	1,004	1,234	1,488	1,782	2,044
Domestic currency	490	540	612	700	797	899
Foreign currency	275	464	622	789	985	1,144
(In millions of U.S. dollars)	976	1,506	1,892	2,192	2,469	2,618
Other	-55	-11	-13	-102	-90	-199
Deposits	**1,131**	**1,399**	**1,554**	**1,880**	**2,139**	**2,432**
Domestic currency	611	741	777	941	1,054	1,173
Foreign currency	520	658	777	939	1,085	1,260
(In millions of U.S. dollars)	1,845	2,135	2,363	2,610	2,721	2,881
III. Banking System						
Net foreign assets (including medium- and long-term liabilities)	**34**	**-8**	**-8**	**64**	**226**	**246**
Net domestic assets	**1,245**	**1,554**	**1,723**	**1,990**	**2,108**	**2,398**
Nonfinancial public sector	281	245	89	181	181	179
Private sector	765	1,004	1,234	1,488	1,782	2,044
Central bank quasi-fiscal losses	280	367	431	517	621	741
Stabilization bonds (BEMs)	-401	-418	-507	-687	-885	-1,032
Other	-80	-62	-31	-197	-477	-565
Broad money 3/	**1,279**	**1,546**	**1,715**	**2,054**	**2,333**	**2,645**
(Percent changes)						
Memorandum items						
Base money	12.8	6.8	-3.6	8.7	23.9	16.3
Central bank net domestic assets	10.7	3.0	-11.8	14.3	12.9	13.0
Banking system credit to the private sector	18.2	31.3	22.9	20.6	19.7	14.7
Domestic currency	7.3	10.3	13.3	14.4	14.0	12.8
Foreign currency	44.1	68.7	34.1	26.8	24.8	16.2
Private financial assets	23.5	17.9	18.7	17.1	17.9	13.2
Of which: Broad money	9.5	20.9	11.0	19.8	13.6	13.3
(In percent of GDP)						
Private financial assets	42.9	46.5	50.3	52.4	53.1	53.3
Of which: Broad money	28.3	31.4	31.8	33.9	33.1	33.3
(In percent, unless otherwise indicated)						
Net international reserves/deposits in foreign currency	67.3	50.8	46.5	48.4	58.9	50.4
Short-term foreign assets of the banking system/deposits in foreign currency	66.8	49.0	38.3	41.5	51.8	40.3
Deposits in foreign currency/total deposits	46.0	47.0	50.0	50.0	50.7	51.8
Credit in foreign currency/total credit	36.0	46.2	50.4	53.0	55.3	56.0

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

1/ Excludes claims on Nicaragua equivalent to US$232 million.
2/ Excludes holdings of stabilization bonds.
3/ Comprises money and quasi-money. Excludes public securities.

Table 5. Costa Rica: Balance of Payments

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

	1999	2000	2001	2002	Prel. 2003	Proj. 2004
Current account	**-681**	**-707**	**-737**	**-960**	**-937**	**-961**
Trade balance	580	-210	-820	-1,275	-1,114	-1,269
Trade balance goods for processing	2,022	1,468	1,055	1,054	1,492	1,512
Export of goods (f.o.b.)	6,576	5,813	4,923	5,259	6,132	6,177
General merchandise and others	2,592	2,458	2,209	2,287	2,516	2,614
Goods for processing	3,985	3,355	2,714	2,972	3,616	3,563
Of which: INTEL	2,562	1,657	912	930	1,409	1,189
Import of goods (f.o.b.)	5,996	6,024	5,743	6,535	7,245	7,445
General merchandise and others	4,034	4,137	4,084	4,616	5,121	5,395
Goods for processing	1,962	1,887	1,659	1,918	2,124	2,051
Of which: INTEL	985	781	647	877	1,148	990
Services	458	664	728	679	810	902
Of which: travel	651	817	809	816	928	993
Income	-1,822	-1,252	-793	-532	-831	-805
Of which: interest on external public debt	198	212	242	235	244	256
Current transfers	102	92	148	169	197	211
Financial and capital account	**1,161**	**555**	**750**	**1,123**	**1,278**	**811**
Direct investment	614	400	445	637	587	556
Portfolio investment	328	-241	39	350	691	255
Public sector	105	139	12	43	278	88
Disbursements	528	559	394	418	954	561
Amortizations	-423	-420	-382	-375	-676	-473
Private net capital	223	-380	27	307	413	167
Errors and omissions	219	395	266	135	0	0
Change in net reserves (- = increase)	**-480**	**152**	**-13**	**-163**	**-341**	**150**
(Annual percentage change)						
Export of goods (f.o.b.)						
Value	18.7	-11.6	-15.3	6.8	16.6	0.7
Volume	17.1	-13.5	-17.3	5.2	14.7	-0.2
General merchandise (excludes goods for processing)						
Value	-14.8	-6.8	-7.5	-1.2	9.0	3.5
Volume	-16.0	-8.8	-9.6	-2.7	7.2	2.5
Import of goods (c.i.f.)						
Value	1.0	0.6	-4.4	13.6	10.8	2.8
Volume	-0.5	-1.6	-6.6	11.9	9.0	1.9
General merchandise (excludes goods for processing)						
Value	-5.8	2.6	-1.1	12.8	10.8	5.3
Volume	-7.2	0.4	-3.4	11.1	9.0	4.2
(In percent of GDP)						
Current account balance	**-4.3**	**-4.4**	**-4.5**	**-5.7**	**-5.3**	**-5.3**
Export of goods	41.7	36.5	30.1	31.3	34.7	34.0
Import of goods	38.0	37.8	35.1	38.9	41.0	40.9
Direct investment	3.9	2.5	2.7	3.8	3.3	3.1
Memorandum items:						
Net international reserves (US$ million)	1,240	1,086	1,098	1,261	1,602	1,452
Net international reserves (months of imports)	2.5	2.3	2.0	2.1	2.6	2.2
External debt	28.5	28.8	29.8	31.3	33.8	33.9
External private sector debt	9.1	9.1	10.0	11.5	12.5	12.8
External public sector debt	19.4	19.8	19.8	19.8	21.2	21.1
Public external debt service (US$ million)	629	636	630	614	926	733
Public external debt service to exports ratio 1/	24.3	25.9	28.5	26.8	36.8	28.0
Of which: interest	7.7	8.7	11.0	10.3	9.8	9.8

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

1/ Excludes maquila exports.

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

(In percent unless otherwise indicated)

	1999	2000	2001	2002	2003
Number of banks	25	22	20	20	19
Private banks	21	18	16	16	15
Total assets of private banks					
(as percentage of GDP)	9.5	12.4	14.3	15.5	17.5
Public banks	4	4	4	4	4
Total assets of public banks	27.5	29.9	29.7	31.9	32.4
(as percentage of GDP)					
Capital					
Ratio of capital to risk-weighted assets	17.5	16.7	15.1	15.8	16.5
Asset quality					
Ratio of loans more than 90 days					
past due to total loans	2.7	3.5	2.4	3.2	1.7
Provision coverage					
Ratio of provisions to total loans	3.4	3.5	2.8	3.3	2.5
Ratio of provisions to loans more than					
90 days past due	126.8	100.8	113.2	102.6	145.9
Ratio of foreign currency credit to total private cre	38.0	47.2	51.6	54.3	56.5
Ratio of real estate loans to total loans	17.1	17.4	21.9	27.5	26.8
Management					
Ratio of administrative expenses					
to total assets	6.0	5.5	5.8	5.6	5.4
Profitability					
Pre-tax return to average equity	15.9	16.3	18.7	17.1	19.5
Pre-tax return to average total assets	1.5	1.7	1.9	1.8	2.1
Liquidity					
Ratio of loans to deposits	65.9	70.3	79.7	77.8	79.0
Ratio of liquid assets to deposits	64.8	61.2	58.1	57.4	55.3

Source: Superintendency of Financial Institutions.

1/ Excludes offshore banks and other nonbank financial institutions.

Table 7. Costa Rica: Indicators of External Vulnerability

	1999	2000	2001	2002	Prel. 2003	Proj. 2004
Merchandise exports (12-month percent change) 1/	-14.8	-6.8	-7.5	-1.2	9.0	3.5
Merchandise imports (12-month percent change) 1/	-5.8	2.6	-1.1	12.8	10.8	5.3
Terms of trade (percentage change)	-5.6	-2.7	-3.6	0.7	0.4	...
External current account balance (in percent of GDP)	-4.3	-4.4	-4.5	-5.7	-5.3	-5.3
Central bank net international reserves (NIR) (in US$ millions) 2/	1,240	1,086	1,098	1,261	1,602	1,452
In months of next year's imports of goods	2.5	2.3	2.0	2.1	2.6	2.2
In percent of base money	128	114	128	148	169	144
In percent of base money and US$ deposits of commercial banks at the central bank	119	104	115	131	134	117
In percent of M2	27.4	21.6	21.0	22.1	27.4	24.0
In percent of deposits in foreign currency	67.3	50.8	46.5	48.4	58.9	50.4
NIR excluding commercial bank U.S. dollar deposits at the central bank (in US$ millions) 3/	481	466	413	564	981	522
Commercial banks foreign assets (in US$ millions)	211	161	47	79	54	116
Commercial banks foreign liabilities (in US$ millions)	177	206	226	299	320	342
Short-term foreign assets of the banking system/deposits in foreign currency (in percent)	66.8	49.0	38.3	41.5	51.8	40.3
Public sector external debt (in percent of GDP)	19.4	19.8	19.8	19.8	21.2	21.1
NFPS external interest payments to merchandise exports 4/	5.0	6.0	8.0	8.1	8.2	9.3
NFPS external amortization payments to merchandise exports 4/	8.0	7.6	11.4	9.2	16.8	8.0
REER appreciation (+) (12-month percentage change) 5/	-1.3	3.1	4.8	-2.2	-8.1	…

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

1/ In value terms, excludes maquila.

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

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

4/ Excludes merchandise exports associated with the free-trade zones.

5/ Average.

Table 8. Costa Rica: Medium-Term Balance of Payments

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

	Prel.	Projections				
	2003	2004	2005	2006	2007	2008
Current account	**-937**	**-961**	**-953**	**-954**	**-988**	**-1008**
Trade balance	-1,114	-1,269	-1,199	-1,176	-1,161	-1,151
Trade balance goods for processing	1,492	1,512	1,739	1,844	2,008	2,217
Export of goods (f.o.b.)	6,132	6,177	6,569	6,991	7,489	8,029
General merchandise and others	2,516	2,614	2,693	2,796	2,963	3,136
Goods for processing	3,616	3,563	3,876	4,195	4,526	4,893
Of which: INTEL	1,409	1,189	1,308	1,635	1,880	2,012
Import of goods (f.o.b.)	7,245	7,445	7,768	8,167	8,650	9,180
General merchandise and others	5,121	5,395	5,630	5,816	6,132	6,504
Goods for processing	2,124	2,051	2,138	2,351	2,518	2,676
Of which: INTEL	1,148	990	1,030	1,143	1,224	1,301
Services	810	902	983	1,000	1,024	1,070
Of which: travel	928	993	1,061	1,100	1,137	1,207
Income	-831	-805	-959	-1,002	-1,076	-1,159
Of which: interest on external public debt	244	256	276	308	337	368
Current transfers	197	211	221	223	225	231
Financial and capital account	**1,278**	**811**	**853**	**1,054**	**1,088**	**1,108**
Direct investment	587	556	525	599	650	705
Portfolio investment	691	255	328	455	438	403
Public sector	278	88	195	156	170	170
Disbursements	954	561	470	421	421	625
Amortizations	-676	-473	-276	-265	-251	-455
Private net capital	413	167	134	299	269	234
Errors and omissions	0	0	0	0	0	0
Change in net reserves (- = increase)	**-341**	**150**	**100**	**-100**	**-100**	**-100**
	(Annual percentage change)					
Export of goods (f.o.b.)						
Value	16.6	0.7	6.3	6.4	7.1	7.2
Volume	14.7	-0.2	4.8	4.5	5.0	5.1
General merchandise (excludes goods for processing)						
Value	9.0	3.5	3.1	5.4	6.0	5.8
Volume	7.2	2.5	1.6	3.5	3.9	3.8
Import of goods (c.i.f.)						
Value	10.8	2.8	4.0	4.8	5.9	6.1
Volume	9.0	1.9	2.5	2.8	3.8	4.0
General merchandise (excludes goods for processing)						
Value	10.8	5.3	4.0	2.9	5.4	6.1
Volume	9.0	4.2	2.5	1.0	3.4	4.0
	(In percent of GDP)					
Current account balance	**-5.3**	**-5.3**	**-5.0**	**-4.7**	**-4.7**	**-4.5**
Export of goods	34.7	34.0	34.4	35.0	35.7	36.4
Import of goods	41.0	40.9	40.7	40.9	41.2	41.6
Direct investment	3.3	3.1	2.8	3.0	3.1	3.2
Memorandum items:						
Net international reserves (US$ million)	1,602	1,452	1,352	1,452	1,552	1,652
Net international reserves (months of imports)	2.6	2.2	2.0	2.0	2.0	2.1
External debt	33.8	33.9	32.7	33.1	33.1	33.0
External private sector debt	12.5	12.8	12.6	13.1	13.3	13.3
External public sector debt	21.2	21.1	20.1	20.0	19.8	19.6
Public external debt service (US$ million)	926	733	534	572	589	824
Public external debt service to exports ratio 1/	36.8	28.0	19.9	20.5	19.9	26.3
Of which: interest	9.8	9.8	10.3	11.0	11.4	11.7

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

1/ Excludes maquila exports.

Table 9. Costa Rica: Public Sector Debt Sustainability Framework
(In percent of GDP, unless otherwise indicated)

	Actual	Prel.	Projections				
	2002	2003	2004	2005	2006	2007	2008
I. Baseline Projections							
Public sector debt 1/	**52.8**	**54.5**	**54.0**	**53.5**	**53.0**	**51.6**	**50.2**
Of which: foreign-currency denominated	27.8	32.1	26.9	27.7	27.8	28.0	28.4
Primary deficit	0.4	-0.3	-0.3	-0.7	-2.0	-2.0	-2.0
Public sector debt-to-revenue ratio	240.2	249.6	238.3	229.8	221.2	214.8	208.2
Gross financing needs 2/	18.9	19.9	21.5	20.2	18.8	18.0	17.1
In billions of U.S. dollars	3.2	3.5	3.9	3.9	3.7	3.8	3.8
Key macroeconomic and fiscal assumptions							
Real GDP growth (in percent)	2.9	5.6	3.8	3.5	3.0	3.0	3.0
Average real interest rate (nominal rate minus change in GDP deflator, in percent) 3/	2.8	1.9	2.9	1.3	2.0	1.2	1.3
Inflation rate (GDP deflator, in percent)	9.3	10.2	8.6	9.8	9.0	9.7	9.6
Growth of real primary spending (deflated by GDP deflator, in percent)	9.4	1.0	8.2	4.3	0.5	2.9	3.6
II. Active Policy Scenario							
Public sector debt	**52.8**	**54.5**	**54.0**	**52.1**	**49.6**	**46.7**	**43.3**
Of which: foreign-currency denominated	27.8	32.1	26.9	27.0	26.8	27.3	28.0
Primary deficit	0.5	-0.3	-0.3	-2.0	-3.0	-3.5	-3.5
Public sector debt-to-revenue ratio	240.2	249.6	238.3	212.3	200.8	189.2	176.2
Gross financing needs 2/	18.9	19.9	21.5	18.0	15.6	13.3	11.2
In billions of U.S. dollars	3.2	3.5	3.9	3.5	3.2	3.0	2.7
Key macroeconomic and fiscal assumptions							
Real GDP growth (in percent)	2.9	5.6	3.8	5.0	5.0	5.0	5.0
Average real interest rate (nominal rate minus change in GDP deflator, in percent) 3/	2.8	1.9	2.9	1.7	2.0	3.0	2.7
Inflation rate (GDP deflator, in percent)	9.3	10.2	8.6	7.8	6.5	4.9	5.0
Growth of real primary spending (deflated by GDP deflator, in percent)	9.4	1.0	8.2	6.0	0.9	2.5	4.4

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

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

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

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

Table 10. Costa Rica: External Debt Sustainability Framework

(In percent of GDP, unless otherwise indicated)

	Actual	Prel.	Projections				
	2002	2003	2004	2005	2006	2007	2008
I. Baseline Projections							
External debt	**31.3**	**33.8**	**33.9**	**32.7**	**33.1**	**33.1**	**33.0**
Change in external debt	1.5	2.4	0.1	-1.1	0.4	0.0	-0.2
External debt-to-exports ratio (in percent)	74.0	73.0	73.8	70.5	70.4	69.6	68.3
Gross external financing need (in billions of U.S. dollars) 1/	1,456	1,734	1,411	1,295	1,277	1,345	1,498
In percent of GDP	8.7	9.9	7.8	6.8	6.3	6.4	6.7
Key macroeconomic assumptions							
Nominal GDP (in millions of U.S. dollars)	16,818	17,665	18,185	19,092	19,948	20,988	22,077
Real GDP growth (in percent)	2.9	5.6	3.8	3.5	3.0	3.0	3.0
Exchange rate appreciation (U.S. dollar value of local currency, change in percent)	-8.6	-9.8	-8.7	-7.6	-7.0	-6.8	-6.8
GDP deflator in U.S. dollars (change in percent)	-0.2	-1.2	-0.2	1.6	2.1	2.2	2.2
Nominal external interest rate (in percent)	6.0	5.6	5.2	5.4	5.9	6.2	6.4
Current account balance, excluding interest payments	-4.0	-3.6	-3.6	-3.3	-2.9	-2.8	-2.5
Net non-debt creating capital inflows	3.8	3.3	3.1	2.8	3.0	3.1	3.2
II. Active Scenario							
External debt	**31.3**	**33.8**	**33.9**	**31.9**	**29.4**	**26.8**	**23.6**
Change in external debt	1.5	2.4	0.1	-2.0	-2.5	-2.6	-3.2
External debt-to-exports ratio (in percent)	74.0	73.0	73.8	63.0	57.3	53.7	49.1
Gross external financing need (in billions of U.S. dollars) 1/	1456	1734	1411	1113	994	938	1075
In percent of GDP	8.7	9.8	7.8	5.7	4.7	4.2	4.5
Key macroeconomic assumptions							
Nominal GDP (in millions of U.S. dollars)	16,818	17,665	18,185	19,484	20,983	22,442	24,036
Real GDP growth (in percent)	2.9	5.6	3.8	5.0	5.0	5.0	5.0
Exchange rate appreciation (U.S. dollar value of local currency, change in percent)	-8.6	-9.8	-8.7	-6.0	-3.9	-2.9	-2.9
GDP deflator in U.S. dollars (change in percent)	-0.2	-1.2	-0.2	1.5	2.6	1.9	2.0
Nominal external interest rate (in percent)	6.0	5.6	5.2	4.4	5.7	6.6	7.4
Current account balance, excluding interest payments	-4.0	-3.6	-3.6	-2.6	-1.5	-0.8	-0.6
Net non-debt creating capital inflows	3.8	3.3	3.1	3.0	2.5	2.4	2.3
III. Debt Dynamics under Various Shocks							
1. Nominal interest rate is at historical average plus two standard deviations in 2004-05		33.8	34.7	34.4	34.7	34.7	34.6
2. Real GDP growth is at historical average minus two standard deviations in 2004-05		33.8	35.4	35.5	35.7	35.4	35.0
3. Change in U.S. dollar GDP deflator is at historical average minus two standard deviations in 2004-05		33.8	34.4	34.2	34.4	34.3	34.0
4. Non-interest current account is at historical average minus two standard deviations in 2004-05		33.8	35.4	36.2	36.5	36.5	36.3
5. Combination of 2-5 using one standard deviation shock		33.8	35.5	36.6	37.0	37.0	36.8
6. One time 30 percent nominal depreciation in 2004		33.8	41.3	38.8	38.5	37.7	36.8

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

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

Table 11. Central America: Comparative Social Indicators

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Average for Latin America and the Caribbean
Rank in UNDP Human Development Index (out of 175 countries) (2003)	**42**	105	119	115	121	65
GDP per capita in PPP, U.S. dollars (2001)	**9,460**	5,260	4,400	2,830	2,450	7,050
People not expected to survive to age 40 (in percent of population) (2000-05)	**3.7**	9.9	14.1	13.8	10.3	n.a.
Life expectancy at birth (years) (2001)	**77.9**	70.4	65.3	68.8	69.1	70.3
Infant mortality (per 1,000 live births) (2001)	**9**	33	43	31	36	28
Population without access to safe water (2000)	**5**	23	8	12	23	n.a.
Per capita health exp. in PPP, US dollars (2000)	**474**	391	192	165	108	n.a.
Physicians per 100,000 people (1990-2002)	**178**	121	90	83	61	n.a.
Adult illiteracy (2001)	**4.3**	20.8	30.8	24.4	33.2	10.8
Primary school net enrollment (2000/01) (percent of relevant age of the population) 1/	**91**	81	84	88	81	97
Secondary school net enrollment (2000/01) (percent of relevant age of the population) 2/	**49**	39	26	...	36	n.a.
Ratio of the per capita income of the richest 10 percent to the per capita income of the poorest 10 percent of the population (1997-98) 3/	**20.7**	33.6	29.1	91.8	70.7	n.a.
Gini index (Human Development Report, 2003) 3/	**45.9**	50.8	55.8	59.0	60.3	n.a.
Percentage of population below the poverty line (1987-01) 4/	**18.5**	45.0	37.4	53.0	47.9	n.a.

Source: UNDP Human Development Report 2003.

1/ For El Salvador the information refers to 1999/2000 school year.
2/ For El Salvador the information refers to 1998/99 school year.
3/ For El Salvador, Honduras, Guatemala, and Nicaragua the information refers to the 1998 surveys; for Costa Rica to the 1997 survey.
4/ National Poverty Line (1987-2000) for El Salvador, Honduras, and Nicaragua, and measured as $2 daily (1990-2001) for Guatemala, and World Bank estimate for Costa Rica.

Table 12. Costa Rica: Progress on Structural Reforms

Reforms and reversals	Responsible power	Status	Prospects	Comments
Temporary tax measures	Congress: bill submitted 2002	Approved: Dec.2002	Expired end-2003	
Tax reform	Congress: bill submitted April 02	Pending	Authorities expect approval by mid-2004	Agreement was reached between two parties with largest congressional representation
Tax administration	Gov./Tax Agency/Customs	Pending	Slow implementation likely	Implementation expected after tax reform
Expenditure rationalization	Gov. draft reform/Congress: no bill submitted yet	Pending	Delays likely	Concerns about backlash from public sector unions
Pension reform	Government/Congress	Pending	Deadlocked in congress	Attempts since 1992 have failed due to lack of political support
Special pension regime (teachers)	Constitutional court: favorable ruling 2003	Implemented		High fiscal cost
Revised special pension regime (teachers)	Proposed by congress	Pending	Deadlocked in congress	Concerns about fiscal impact
Reform of ICE	Congress: draft August 2003	Pending	In congress	Concerns about fiscal impact. Proposals for tighter government control have been resisted by management, labor unions, and public opinion for years.
Trade agreement (CAFTA)	Government: Approved/Congress: will submitted before end-2004	Pending	Approval likely owing to widespread support.	Opposed by the third largest political party for ideological reasons. However, votes from the two main parties should be sufficient for approval.
Recapitalization of Central Bank	Gov.: draft/Congress: bill submitted recently	Partially implemented	Full implementation will likely take time	Recapitalization made in 1999-2002 was insufficient. An additional proposal is being prepared.
Recapitalization of public banks	Government: Draft proposal	Pending	Slow negotiations	Proposals made in the mid-1990s opposed by public banks and civil society.
Onshore banking supervision	Superintendency: Approved partially	Partially implemented	Full implementation likely	Slow pace of implementation because of limited capabilities
Offshore banking supervision	Superintendency: Approved partially	Partially implemented	Delays likely	Lack of cooperation from banks
Prudential regulations	Central Bank: Approved partially	Partially implemented	Delays likely	Concerns about public banks and limited implementation capabilities

Source: Costa Rican authorities.

Table 13. Millennium Development Goals

(In percent, unless otherwise noted)

Objective	1990 Benchmark 1/	2015 Goal	Latest Estimate	Status
1. Poverty				
Halve extreme poverty	11.7 (1991)	5.9	5.1 (2003)	Achieved
Halve malnutrition	6.0 (1985)	3.0	4.7 (1996)	On track
2. Education				
Achieve full enrollment in primary education	86.3	100.0	91.0 (2001)	On track
3. Gender equality				
Raise girl/boy ratio in primary and secondary education to 100 percent	95.8	100.0	100.0 (2001)	Achieved
4. Child mortality				
Reduce child mortality under 5 years of age by two-thirds	17.0	6.0	11.0 (2001)	On track
5. Maternal health				
Reduce maternal mortality rate (for each 100,000 live births) by three-fourths	...	9.0	35.0 (1995)	...
6. Environment				
Halve the proportion of individuals without access to improved water source	...	2.0	5.0 (2001)	On track
Halt forest degradation (percent of total land)	41.6	41.6	45.4 (2000)	Achieved

Source: World Bank, 2004

1/ Data refers to 1990 unless otherwise noted.

Table 14. Costa Rica: Sequence of Reforms Proposed by the Staff

Reforms	Sector	Responsible Power	Status	Chances of Implementation
		I. Immediate Measures (Next 6 Months)		
Tax reform	Fiscal (revenue)	Executive/Congress	Pending	High. Authorities and political parties understand that this is a critical priority. Approval expected by July 2004.
Strengthening of tax administration (including preparation for tax reform, action plan to strengthen controls and audit procedures, and strengthen powers and capabilities of tax agency and customs).	Fiscal (revenue)	Executive	Pending	High. Authorities indicated that a program proposed by FAD will begin to be implemented soon.
CAFTA	Trade	Congress (the government already signed it)	Pending	High. Will be submitted to Congress in the coming months. Approval is likely in early 2005 given widespread political support.
Further strengthening of the Superintendency of banks (risk management and information system).	Financial	Superintendency of Banks/Central Bank	Pending	High. But most likely process will not be completed before mid-2005.
Recapitalize the central bank.	Monetary/Fiscal	Executive/Congress	Pending	Medium. The authorities indicated that proposal will be presented to congress following approval of tax reform. However, passage will probably take time.
Approve legislation to allow greater private sector participation in telecoms and eliminate state-monopoly in insurance.	Public enterprises	Executive/Congress	Pending	High. Approval likely as these actions are linked to CAFTA.
Rationalization of the special pension regimes (improved management and stronger supervision).	Fiscal (expenditure)	Executive/Congress	Pending	Low. Not a top priority for the authorities. They share staff concerns about rising pension costs, but feel political feasibility is limited.
Improve the awarding, operation and regulation of private sector concessions.	Infrastructure	Executive/Congress	Pending	Low. No specific proposal is currently under consideration to be presented to Congress in the immediate future.
		II. Near-Term Measures (Next 1-2 Years)		
Contain wage-bill by tightening wage indexation and employment growth.	Fiscal (expenditure)	Executive	Pending	Low. The authorities feel that this is not a problem, as recent increases in the wage bill are mainly the result of the reform of the education sector and the judiciary. Wage indexation has already been brought under control according to the authorities.
Rollback of revenue earmarking.	Fiscal (expenditure)	Congress	Partially in place	Medium. The authorities are already doing it partially, but a court ruling may force them to reinstate it. In this case, the authorities may revive legislation in congress suspending earmarking. However, approval may be difficult.
Reform of the state pension system (IVM).	Fiscal (expenditure)	Executive	Pending	Low. A proposal is under consideration, not requiring congressional approval, but political support is tenuous and authorities may delay their implementation.

Table 14. Costa Rica: Sequence of Reforms Proposed by the Staff

Reforms	Sector	Responsible Power	Status	Chances of Implementation
Pension reform (Special Regimes).	Fiscal (expenditure)	Executive/Congress	Pending	Low. A proposal now in congress will actually increase fiscal cost and the authorities intend to oppose its approval. The authorities are concerned about the fiscal cost of these regimes, but this is a very sensitive topic politically, due to special interest groups and their support in congress.
Public enterprise reform to strengthen ability to compete with the private sector, ensure appropriate tariff policy and improved enterprise governance, within broad strategic goals set by the government.	Fiscal (rev./exp.)	Executive/Congress	Pending	High. A law has been presented to Congress to strengthen the operations of ICE. New procedures are being put in place to ensure public enterprises' financing is consistent with overall fiscal goals.
Changes in banking legislation.	Financial	Central Bank/Superintendency of Banks and Congress.	Pending	Medium. There is no political support for the comprehensive reforms proposed by the 2001 FSAP. A narrower proposal with most urgent actions may be presented to congress by the end of the year focusing on consolidated supervision of financial holdings, increases in sanctions, and a strengthening of bank resolution framework.
Change prudential regulations to eliminate bias against colón intermediation and discourage dollarization, while encouraging development of CPI indexed securities.	Financial	Central Bank.	Pending	Low. The authorities will consider this legislation in the coming months, but they have no immediate plans to implement it. However, the authorities are already encouraging the use of CPI indexed securities.
Improve monetary management.	Financial	Central Bank	In progress	High. The authorities have already began to implement the recommendations of a MFD-TA mission to make monetary policy more forward looking, improve their understanding of monetary transmission mechanisms, and strengthen policy instruments.
Develop exchange market infrastructure.	Financial	Central Bank	Pending	Medium. The authorities will consider steps to foster the development of mechanisms to deal with exchange rate volatility. But this is not a priority for them.
		III. Medium-Term Measures		
Banking system reform to level playing field (public/private banks, onshore/offshore).	Financial	Congress	Pending	Low. Current proposal has been in Congress since 2001 and no progress has been made.
Greater exchange rate flexibility and adoption of inflation-targeting framework.	Monetary	Central bank	Pending	Low. The authorities disagree on the need for this as they believe the crawling peg has served the country well. However, the authorities agree on the importance of ensuring that the pre-conditions for a smooth transition to a more flexible exchange rate regime are put in place.
Reforms to improve investment climate.	Competitiveness	Executive	Pending	High. The authorities are negotiating an IDB loan to assist them in their efforts.

Table 15. Costa Rica: Public Sector Debt Sustainability Framework

(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	1999	2000	2001	2002	2003			2004	2005	2006	2007	2008	
								I. Baseline Projections					Debt-stabilizing primary balance 1/
Public sector debt 2/	**45.7**	**46.5**	**49.0**	**52.8**	**54.5**			**54.0**	**53.5**	**53.0**	**51.6**	**50.2**	1.1
Of which: foreign-currency denominated	25.1	25.0	26.4	27.8	32.1			26.9	27.7	27.8	28.0	28.4	
Change in public sector debt	**-1.1**	**0.8**	**2.4**	**3.9**	**1.6**			**-0.5**	**-0.5**	**-0.4**	**-1.4**	**-1.3**	
Identified debt-creating flows	-3.3	2.3	1.5	2.9	0.3			1.6	0.2	-0.6	-1.0	-0.9	
Primary deficit	-0.6	-0.5	-1.2	0.5	-0.3			-0.3	-0.7	-2.0	-2.0	-2.0	
Revenue and grants	19.8	20.7	22.3	21.9	21.8			22.6	23.3	24.0	24.0	24.1	
Noninterest expenditure	19.2	20.2	21.1	22.4	21.5			22.4	22.5	22.0	22.0	22.1	
Automatic debt dynamics 3/	-2.7	2.8	2.7	2.4	0.6			1.8	0.9	1.4	1.0	1.1	
Contribution from interest rate/growth differential 4/	-4.9	1.2	0.9	-0.2	-2.0			-0.6	-1.2	-0.6	-1.0	-0.9	
Real interest rate	-1.8	1.9	1.3	1.1	0.6			1.2	0.4	0.8	0.4	0.5	
Real GDP growth	-3.1	-0.8	-0.4	-1.3	-2.5			-1.8	-1.7	-1.4	-1.4	-1.4	
Contribution from exchange rate depreciation 5/	2.2	1.6	1.8	2.6	2.6			2.4	2.2	2.0	2.0	2.0	
Residual, including asset changes	2.2	-1.5	0.9	0.9	1.4			-2.1	-0.7	0.2	-0.4	-0.4	
Public sector debt-to-revenue ratio	231.5	224.5	219.7	240.7	249.6			238.3	229.8	221.2	214.8	208.2	
Gross financing need 6/	18.6	17.1	16.0	18.9	19.9			21.5	20.2	18.8	18.0	17.1	
(In billions of U.S. dollars)	2.9	2.7	2.6	3.2	3.5			3.9	3.9	3.7	3.8	3.8	
Key macroeconomic and fiscal assumptions						10-Year Historical Average	10-Year Standard Deviation						Projected Average
Real GDP growth (in percent)	8.2	1.8	1.0	2.9	5.6	4.3	2.7	3.8	3.5	3.0	3.0	3.0	3.7
Average nominal interest rate on public debt (in percent) 7/	11.4	11.7	11.7	12.0	12.1	11.8	1.1	11.5	11.1	11.0	10.9	10.9	11.3
Average real interest rate (nominal rate minus change in GDP deflator deflator, in percent)	-3.6	4.7	3.2	2.7	1.9	-1.2	4.6	2.9	1.3	2.0	1.2	1.3	1.8
Nominal depreciation (decline in U.S. dollar value of local currency, in percent)	9.9	6.7	7.4	10.9	10.8	10.7	3.1	9.5	8.3	7.5	7.4	7.4	8.5
Inflation rate (GDP deflator, in percent)	15.0	7.0	8.4	9.3	10.2	13.0	4.5	8.6	9.8	9.0	9.7	9.6	9.5
Growth of real primary spending (deflated by GDP deflator, in percent)	3.7	7.3	5.4	9.4	1.0	5.8	8.7	8.2	4.3	0.5	2.9	3.6	3.4
Primary deficit	-0.6	-0.5	-1.2	0.5	-0.3	-0.6	1.3	-0.3	-0.7	-2.0	-2.0	-2.0	-1.2
								II. Stress Tests for Public Debt Ratio					Debt-stabilizing primary balance
A. Alternative Scenarios													
A1. Key variables are at their historical average in 2004-08 7/								50.8	48.3	46.5	44.3	42.2	-0.8
B. Bound Tests													
B1. Real interest rate is at historical average plus two standard deviations in 2004-05								56.2	59.0	58.7	57.3	56.1	1.2
B2. Real GDP growth is at historical average minus two standard deviations in 2004-05								57.9	62.5	64.5	65.5	66.6	1.4
B3. Primary balance is at historical average minus two standard deviations in 2004-05								56.2	58.5	58.2	56.9	55.7	1.2
B4. Combination of 1-3 using one standard deviation shocks								56.0	58.7	58.4	57.1	55.8	1.2
B5. One time 30 percent real depreciation in 2004 9/								67.6	67.3	67.3	66.1	65.0	1.9
B6. 10 percent of GDP increase in other debt-creating flows in 2004								64.0	63.6	63.5	62.2	61.1	1.3

1/ Assumes that key variables remain at the same level as in 2008.
2/ Gross public sector debt (includes general government and the central bank).
3/ Derived as [r - p(1+g) - g + ae(1+r)]/(1+g+p+gp) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = 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 - p (1+g) and the real growth contribution as -g.
5/ The exchange rate contribution is derived from the numerator in footnote 2 as ae(1+r).
6/ Public sector combined deficit plus amortization public sector debt.
7/ Nominal interest expenditure divided by previous period debt stock.
8/ Key variables include real GDP growth; real interest rate; and primary balance.
9/ Real depreciation is defined as nominal depreciation minus domestic inflation.

Table 16. Costa Rica: External Debt Sustainability Framework

(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	1999	2000	2001	2002	2003			2004	2005	2006	2007	2008	
								I. Baseline Projections					**Debt-stabilizing non-interest current account 1/**
External debt	**28.5**	**28.8**	**29.8**	**31.3**	**33.8**			**33.9**	**32.7**	**33.1**	**33.1**	**33.0**	-3.3
Change in external debt	**0.0**	**0.4**	**1.0**	**1.5**	**2.4**			**0.1**	**-1.1**	**0.4**	**0.0**	**-0.2**	
Identified external debt-creating flows	-3.0	1.3	0.8	0.8	0.3			1.0	1.1	0.8	0.7	0.4	
Current account deficit, excluding interest payments	2.6	2.4	2.4	4.0	3.6			3.6	3.3	2.9	2.8	2.5	
Deficit in balance of goods and services	-6.6	-2.8	0.6	3.5	1.7			2.0	1.1	0.9	0.7	0.4	
Exports	52.1	48.6	41.7	42.4	46.2			45.9	46.4	47.0	47.6	48.3	
Imports	45.5	45.8	42.2	45.9	47.9			47.9	47.5	47.9	48.2	48.6	
Net nondebt creating capital inflows (negative)	-3.9	-2.5	-2.7	-3.8	-3.3			-3.1	-2.8	-3.0	-3.1	-3.2	
Automatic debt dynamics (contribution)2/	-1.7	1.4	1.2	0.6	0.0			0.5	0.6	0.9	1.0	1.1	
Nominal interest rate	1.7	2.0	2.1	1.8	1.7			1.7	1.7	1.8	1.9	2.0	
Real GDP growth	-2.1	-0.5	-0.3	-0.8	-1.7			-1.2	-1.1	-0.9	-0.9	-0.9	
Price and exchange rate changes 3/	-1.3	-0.1	-0.6	-0.3	...			...	...	...	...	...	
Residual, including change in gross foreign assets 4/	3.0	-1.0	0.2	0.7	2.1			-0.9	-2.2	-0.5	-0.6	-0.6	
External debt-to-exports ratio (in percent)	54.6	59.3	71.6	74.0	73.0			73.8	70.5	70.4	69.6	68.3	
Gross external financing need (in billions of U.S. dollars) 5/	**1,058**	**1,137**	**1,261**	**1,456**	**1,734**			**1,411**	**1,295**	**1,277**	**1,345**	**1,498**	
(In percent of GDP)	6.7	7.1	7.7	8.7	9.9			7.8	6.8	6.3	6.4	6.7	
Key macroeconomic assumptions						10-Year Historical Average	10-Year Standard Deviation						Projected Average
Real GDP growth (in percent)	8.2	1.8	1.0	2.9	5.6	4.3	2.7	3.8	3.5	3.0	3.0	3.0	3.7
GDP deflator in U.S. dollars (change in percent)	3.6	-0.8	1.6	-0.2	-1.2	1.9	2.6	-0.2	1.6	2.1	2.2	2.2	1.1
Nominal external interest rate (in percent)	6.7	7.2	7.6	6.0	5.6	6.2	0.8	5.2	5.4	5.9	6.2	6.4	5.8
Growth of exports (U.S. dollar terms, in percent)	19.5	-5.8	-12.0	4.5	14.6	9.7	12.5	2.2	6.2	5.9	6.4	6.8	7.0
Growth of imports (U.S. dollar terms, in percent)	1.9	1.6	-5.3	11.7	9.7	7.8	7.7	2.9	4.2	5.3	5.9	6.1	5.7
Current account balance, excluding interest payments	-2.6	-2.4	-2.4	-4.0	-3.6	-2.7	0.8	-3.6	-3.3	-2.9	-2.8	-2.5	-3.1
Net non-debt creating capital inflows	3.9	2.5	2.7	3.8	3.3	3.3	0.6	3.1	2.8	3.0	3.1	3.2	3.1
								II. Stress Tests for External Debt Ratio					**Debt-stabilizing non-interest current account 6/**
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2004-08 6/								32.2	30.0	29.6	29.1	28.6	-3.8
B. Bound Tests													
B1. Nominal interest rate is at historical average plus two standard deviations in 2004-05								34.7	34.4	34.7	34.7	34.6	-3.3
B2. Real GDP growth is at historical average minus two standard deviations in 2004-05								35.4	35.5	35.7	35.4	35.0	-3.6
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2004-05								34.4	34.2	34.4	34.3	34.0	-3.4
B4. Non-interest current account is at historical average minus two standard deviations in 2004-05								35.4	36.2	36.5	36.5	36.3	-3.3
B5. Combination of 1-4 using one standard deviation shocks								35.5	36.6	37.0	37.0	36.8	-3.4
B6. One time 30 percent nominal depreciation in 2004								41.3	38.8	38.5	37.7	36.8	-4.2

1/ Assumes that key variables remain at the same level as in 2008.

2/ 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 depreciation (decline in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ 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. Declines with a depreciating domestic currency (e > 0) and declining inflation (based on GDP deflator).

4/ For projection purposes, includes effect of price and exchange rate changes.

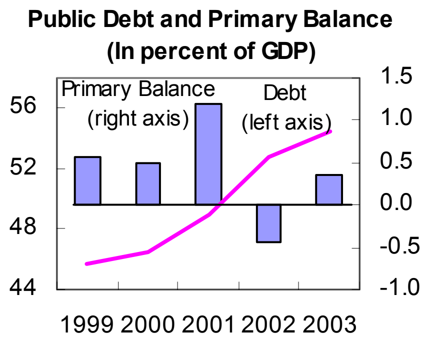
5/ External current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

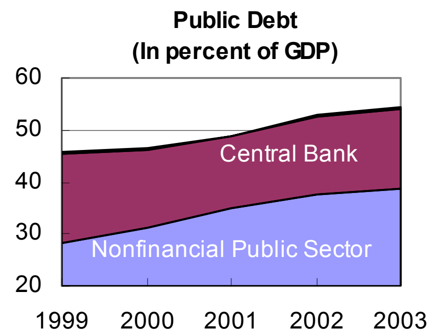
6/ Key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows.

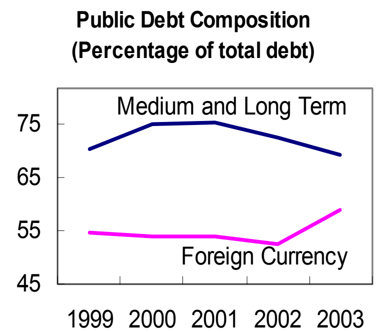
COSTA RICA—PUBLIC DEBT SUSTAINABILITY

I. BACKGROUND

Costa Rica's public sector debt has increased significantly over the past five years.[1] By end-2003, public debt reached 55 percent of GDP, from 46 percent in 1999. The maturity debt structure and its currency composition deteriorated, as efforts were made to limit the financing cost. Reliance on short-term debt and the use of foreign-currency debt in the domestic market intensified.







In a context of sluggish growth, the primary surpluses were insufficient to compensate for a high interest burden, resulting in a rising debt ratio. Despite the decline in real interest rates, the average interest payment amounted to nearly 3½ percent of GDP per year during this period. The heavy burden of real interest payments more than offset the public sector primary surplus (almost ½ percent of GDP per year) and the effect of sluggish growth.

Public Sector Debt

(In percent of GDP, unless otherwise noted)

	1999	2000	2001	2002	2003	Contribution
Public sector debt	**45.7**	**46.5**	**49.0**	**52.8**	**54.5**	**8.7**
Of which: foreign-currency	25.1	25.0	26.4	27.8	32.1	7.1
Identified debt-creating flows	. . .	2.3	1.5	2.9	0.2	6.9
Primary deficit (+)	. . .	-0.5	-1.2	0.5	-0.4	-1.6
Automatic debt dynamics	. . .	2.8	2.7	2.4	0.5	8.5
Real interest rate	. . .	3.5	3.2	3.7	3.1	13.5
Real GDP growth	. . .	-0.8	-0.4	-1.3	-2.5	-5.0
Other	. . .	-1.5	0.9	0.9	1.5	1.8
Memorandum items:						
Public sector debt-to-revenue ratio	231	224	220	241	250	
Gross financing needs	18.6	17.1	16.0	18.9	19.8	
In billions of U.S. dollars	2.9	2.7	2.6	3.2	3.5	
Of which: short-term debt rollover	13.4	11.5	11.9	14.4	16.7	
Real GDP growth (in percent)	8.2	1.8	1.0	2.9	5.6	
Average real interest rate (in percent)	-3.6	4.7	3.2	2.7	1.9	

[1] Public sector debt consolidates the debt of the central government, agencies, public sector enterprises, and the central bank. It excludes operational leases with private telecommunications companies arranged by the state-owned electricity and telecommunications company (ICE) for about 2 percent of GDP. These contingent government liabilities are unlikely to be realized considering Costa Rica's strong institutional framework and the expected high rate of return of the investment projects.

II. BASELINE SCENARIO

The staff baseline scenario projects public debt to decline only slightly to about 50 percent of GDP by 2008. This scenario is based on:

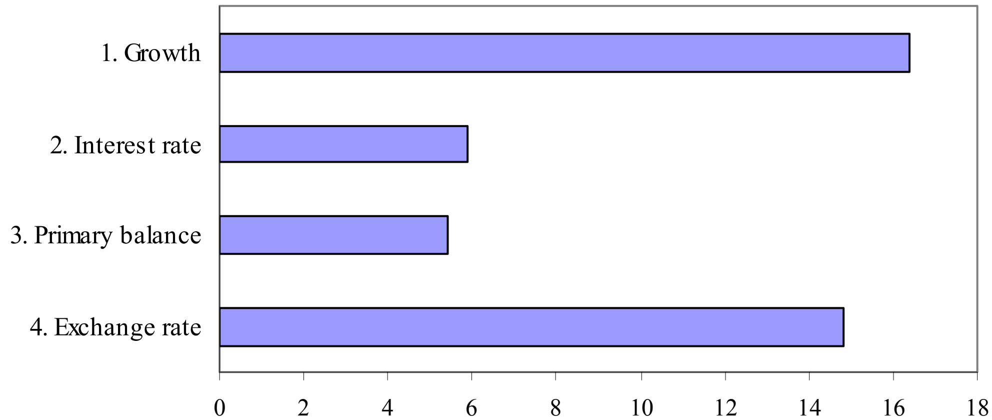
- Primary surplus rising to 2 percent by 2006, reflecting the approval of tax reform (with an annual yield of 2 percent of GDP) and substantial strengthening of tax administration.
- Growth of 3 percent per year, based on CAFTA and tax reform approval, but with no other structural reforms put in place.
- An average real interest rate of about 1½–2 percent, compared to minus 1½ percent during most of the 1990s.
- A constant real exchange rate *vis-à-vis* the U.S. dollar, which has a dampening effect on the debt ratio proportional to the rate of U.S. inflation.
- An NIR coverage of two months of imports (40 percent of gross financing needs of the public sector).

	2004	2005	2006	2007	2008
(In percent of GDP, unless otherwise indicated)					
Public sector debt	**54.0**	**53.5**	**53.0**	**51.6**	**50.2**
Of which: foreign-currency	26.9	27.7	27.8	28.0	28.4
Gross financing needs	21.5	20.2	18.8	18.0	17.1
In billions of U.S. dollars	3.9	3.9	3.7	3.8	3.8
Of which: short-term debt rollover	16.1	15.9	15.2	14.5	13.8

Public finances would remain highly vulnerable to shocks. The debt ratio would still remain high, with gross financing needs of the public sector ranging between 18–20 percent of GDP (US$3.5–4 billion) per year during the projection period. The assumed persistently large share of foreign-currency debt and short-term maturities would leave the public finances vulnerable to changes in the exchange rate, interest rates, and availability of financing to the public sector.

Standard sensitivity tests highlight the vulnerability associated with the public debt. Stress tests show that the debt dynamics are highly sensitive to output growth volatility. Using 2003 as a starting point and two-standard deviation shocks for 2004–05, lower GDP growth would increase the debt ratio by 16 percentage points of GDP by 2008, compared to the baseline. Similarly, higher interest rates or a lower primary surplus would each add some 6 percentage points of GDP to the debt ratio by 2008. Moreover, a 30 percent real depreciation would increase the debt ratio by 15 percentage points of GDP by 2008 relative to the baseline projection.

Sensitivity Tests on Public Debt
(Percentage points of GDP)



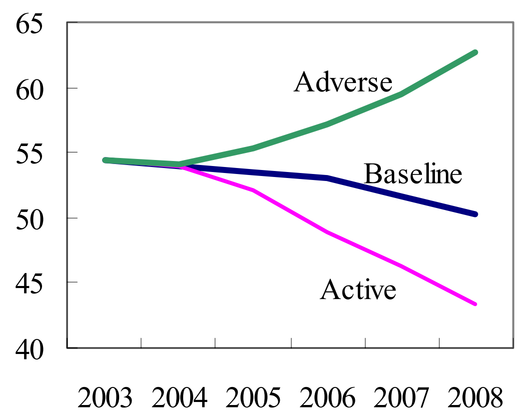
Shocks to baseline:
(Two-standard deviations from historical levels in 2004-05 for output growth, interest rate, and primary balance)

1. Real GDP contracts by 1.2 percent versus 3.6 percent increase in baseline.
2. Real interest rate increases to 7.4 percent from 2.1 percent in baseline.
3. The primary balance declines to a 2 percent of GDP deficit versus 0.5 percent surplus in baseline.
4. One-time real exchange rate depreciation of 30 percent in 2004.

Alternative scenarios suggest that with the right policies, the fiscal vulnerabilities could be reduced sharply.

- **Active Scenario.** A stronger fiscal adjustment effort and the full implementation of the measures in Table 14 would drastically improve the growth outlook and the debt dynamics. A quick rebound in growth to historical levels (5 percent) and lower inflation would follow. The primary surplus would rise to 3½ percent of GDP over the medium term, mainly as a consequence of pension reform, leading to a steady decline of the debt/GDP ratio to about 43 percent by 2008.

Debt/GDP Scenarios



- **Adverse Scenario.** In contrast, an adverse (no reforms) scenario would produce a sharp deterioration in debt indicators as it would signal political incapacity to reverse the ongoing fiscal deterioration. Investment and productivity would slow causing real GDP growth to decelerate to 1½ percent by 2008. Sagging fiscal revenues as a consequence of poor growth and limited political room for cutting expenditures would result in a zero primary balance. The public debt ratio would therefore increase steadily to over 62 percent of GDP by 2008.

Public Sector Debt Dynamics under Alternative Scenarios

(In percent of GDP, unless otherwise indicated)

	2004	2005	2006	2007	2008
I. Baseline Scenario					
Public sector debt	**54.0**	**53.5**	**53.0**	**51.6**	**50.2**
Foreign-currency	26.9	27.7	27.8	28.0	28.4
Domestic currency	27.0	25.8	25.2	23.5	21.8
Primary balance	0.3	0.7	2.0	2.0	2.0
Interest	5.5	5.6	5.3	5.3	5.1
Stress Tests					
1. Real interest rate shock 1/	56.2	59.0	58.7	57.3	56.1
2. Real GDP growth shock 2/	57.9	62.5	64.5	65.5	66.6
3. Primary balance shock 3/	56.2	58.5	58.2	56.9	55.7
4. Exchange rate shock 4/	67.6	67.3	67.3	66.1	65.0
Memorandum items:					
Gross financing needs 5/	21.5	20.2	18.8	18.0	17.1
In billions of U.S. dollars	3.9	3.9	3.7	3.8	3.8
Of which: short-term debt rollover	16.1	15.9	15.2	14.5	13.8
Real GDP growth (in percent)	3.8	3.5	3.0	3.0	3.0
Average real interest rate (in percent) 6/	2.9	1.3	2.0	1.2	1.3
Public sector debt-to-revenue ratio 7/	238	230	221	215	208
II. Active Scenario					
Public sector debt	**54.0**	**52.1**	**49.6**	**46.7**	**43.3**
Primary balance	0.3	2.0	3.0	3.5	3.5
Interest	5.6	4.5	4.0	3.5	3.2
Memorandum items:					
Gross financing need 5/	21.5	18.0	15.6	13.3	11.2
Real GDP growth (in percent)	3.8	5.0	5.0	5.0	5.0
Average real interest rate (in percent) 6/ 8/	2.9	1.7	2.0	3.0	2.7
Public sector debt-to-revenue ratio 7/	238	212	201	189	176
III. Adverse Scenario					
Public sector debt	**54.0**	**55.3**	**57.1**	**59.4**	**62.7**
Primary balance	0.2	0.0	0.2	0.1	0.1
Interest	5.7	5.9	6.3	7.4	8.4
Memorandum items:					
Gross financing needs 5/	21.6	21.9	22.6	24.7	26.7
Real GDP growth (in percent)	3.8	3.0	2.5	2.0	1.5
Average real interest rate (in percent) 6/ 8/	3.1	1.9	1.7	3.1	3.6
Public sector debt-to-revenue ratio 7/	241	254	266	280	295

Source: IMF staff estimates.

1/ Real interest rate increases to 7.4 percent from 2.1 percent in baseline in 2004-05.
2/ Real GDP contracts by 1.2 percent annually in contrast to a 3.6 percent increase in baseline in 2004-05
3/ The primary balance declines to a 2 percent of GDP deficit against 0.5 percent surplus in baseline in 2004-05.
4/ One-time real exchange rate depreciation of 30 percent in 2004.
5/ Defined as public sector deficit plus amortization of public sector debt.
6/ Nominal rate deflated by the change in GDP deflator. It averaged minus 1.5 percent per year during 1993-2002.
7/ Revenue of the nonfinancial public sector.
8/ Because a large fraction of the public debt was contracted at fixed nominal interest rates, the real interest rate initially rises (falls) as inflation declines (increases) in the active (adverse) scenario compared to the baseline.

COSTA RICA: FUND RELATIONS
(As of May 24, 2004)

I. Membership Status: Joined: January 08, 1946; Article VIII

II. General Resources Account:

	SDR Million	Percent of Quota
Quota	164.10	100.00
Fund holdings of currency	144.11	87.82
Reserve Position	20.00	12.19

III. SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	23.73	100.00
Holdings	0.06	0.24

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	11/29/95	02/28/97	52.00	0.00
Stand-By	04/19/93	02/18/94	21.04	0.00
Stand-By	04/08/91	09/30/92	33.64	25.64

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

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.38	0.37	0.37	0.37	0.37
Total	**0.38**	**0.37**	**0.37**	**0.37**	**0.37**

VII. Exchange Rate Arrangements: Costa Rica's current exchange arrangement is a crawling peg. The central bank adjusts the exchange rate daily on the basis of the differential between (past) inflation in Costa Rica and its main trading partners. The central bank has also used foreign exchange intervention to help maintain the crawling peg. Costa Rica has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. Buying and selling exchange rates were 432.60 colones per U.S. dollar and 433.89 colones per U.S. dollar, respectively, as of May 24, 2004.

VIII. Last Article IV Consultation: Concluded on March 3, 2003 (Country Report No. 03/82). Costa Rica is on the standard 12-month cycle.

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

X. Technical Assistance:

Department	**Dates**	**Purpose**
STA	February 2004	Migration to Government Finance Statistics Manual 2001 methodology
	July 2003	Monetary and financial statistics
	April 2002	Establishment of an integrated data base
	February 2001	SDDS metadata and compilation of the monetary data
	November 2000	Follow-up on balance of payments statistics
	July/December 1999	Balance of payments and banking statistics
MFD	March 2004	Financial Integrity offshore banking regulations
	February 2004	Monetary policy and prudential response to growing dollarization
	March 2000	Condition of the banking system and the regulatory and prudential framework
	February 1999	Financial management and procurement systems
	September 1998	Monetary programming and liquidity forecasting, the use of monetary instruments, and the development of a secondary market for government securities
	March 1998	Payments system
FAD	March 2004	Readiness of tax administration for planned tax reform
	October 2003	Tax policy, including establishment of VAT
	July 2002	Tax policy and administration
	December 1999	Fiscal database and plan to improve statistics
	November 1999	Tax policy
INS	November 2001	Regional course on financial programming and policies

COSTA RICA: RELATIONS WITH THE WORLD BANK

I. FINANCIAL RELATIONS

(In millions of U.S. dollars as of May 20, 2004)

IBRD/IDA Operations by Sector	Committed [1/]	Disbursed	Debt Outstanding
Agriculture	56.8	56.8	0.0
Education	28.6	28.6	7.7
Electric power and other energy	117.4	117.4	0.0
Environment	32.6	18.9	18.9
Finance	15.0	15.0	0.0
Health, population, and nutrition	38.6	22.7	14.8
Industry	4.9	4.9	0.0
Oil and gas	3.0	3.0	0.0
Public sector management	3.5	3.5	0.0
Telecommunications	57.9	57.9	0.0
Transportation[2/]	166.3	166.3	14.1
Water supply and sanitation	42.0	41.2	9.0
Multisector	205.3	205.3	12.9
Total	**771.9**	**741.5**	**77.4**

IBRD loan disbursements (In millions of U.S.dollars, as of January 31, 2004)	1999	2000	2001	2002	2003	2004
Total net disbursement	**-22.7**	**-27.4**	**-18.8**	**-11.3**	**-11.7**	**-3.4**
Gross disbursement	11.6	5.8	8.4	11.6	6.6	3.1
Amortizations	34.4	33.3	27.2	22.9	18.3	6.5

1/ Net of cancellations. Includes fully disbursed operations.

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

II. Recent World Bank Activities

Current Portfolio: the Bank's portfolio in Costa Rica consists of two active IBRD projects (for a total of US$49.6 million) and two Global Environmental Facility (GEF) grants (for a total of US$15 million). Combined, all four projects have US$48 million undisbursed. The Ecomarkets Project and the Health Sector Strengthening and Modernization Project will be active until 2006. In addition, the Biodiversity Grant will be active until 2005 and the Ecomarkets Grant until 2006.

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

Bank's Future Assistance: Costa Rican authorities have expressed concern about the country's economic prospects and have requested additional Bank involvement. In recent years, Costa Rica did not borrow from the Bank and the program of economic and sector work was drastically reduced. The Bank has a strong opportunity for reactivating its relationship with Costa Rica, returning to more normal assistance levels. To that purpose, the Bank finalized the Country Assistance Strategy (CAS) for the 2004–07 period, which was approved by the Board on May 18, 2004.

The Bank's CAS intends to play a supporting role of the government's own development program as requested by the government. The Bank considers that Costa Rica is one of the best performers in areas which are very dear to the Bank's mission, such as poverty reduction, governance, and environmental sustainability. Taking into account the government's request, the bank's lending strategy will be to give assistance in the areas of infrastructure, education, agriculture, and technology and innovation

COSTA RICA: RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

III. FINANCIAL RELATIONS

(In millions of U.S. dollars)

A. Operations (as of May 17, 2004)

	Approved	Disbursed	Available*
Loans in execution	**591.8**	**344.9**	**192.7**
Energy	350.0	224.7	85.7
Education	28.0	15.6	9.6
Health and sanitation	99.4	91.9	7.4
Land title register reform	65.0	0.7	53.9
Reform and public sector modernization	35.1	11.9	21.8
Agriculture	14.4	0.0	14.4
Non-reimbursable technical cooperation	8.9	4.9	4.0
Total	**600.7**	**349.8**	**196.7**

B. Loan Disbursements

	1998	1999	2000	2001	2002	2003
Disbursements	**54.5**	**52.4**	**80.3**	**31.5**	**45.1**	**88.6**
Amortization	55.9	85.1	77.9	80.4	81.3	94.9
Interest and charges	57.8	57.7	57.8	54	47.6	47.1
Net cash flow	**-59.2**	**-90.4**	**-55.4**	**-102.9**	**-83.8**	**-53.4**

C. Lending Program for 2004 (tentative)

Hybrid programs:	
PBL Fiscal Reform	100
International Trade	84
Science and Technology for Competitiveness	35
Participative Rehab for Rural Roads	40
Strengthening Digital Management	35
Secondary Ed. And Labor Force	20
Monitoring and Evaluation Unit	10
Other projects	
Cuenca Binacional del Río Sixaola	9
Ecotourism in Protected Areas	20
Sustainable Development in Huetar	16
Total	**369**

IV. Recent Activities

The Strategy Paper, or EBP (IDB Country Strategy), of the Inter-American Development Bank with Costa Rica was approved June 25, 2003. The strategy of the bank is to support the government's development plan whose long-term goal is poverty reduction. The short- and medium-term objective of the EBP is to accelerate economic growth via private sector participation as a necessary condition to reduce poverty. A market-friendly environment that promotes private initiative and competitiveness should make such goals possible. The pillars of the desired market-friendly environment are: (i) macroeconomic consolidation through reduction of fiscal deficit and rationalization of public sector expenditures, and (ii) the integration of the economy to the region and the world. There are synergies between both areas which should benefit economic growth and macroeconomic stability, allowing the country to develop and reducing the incidence of poverty. The Hybrid Program is under preparation expecting to be approved by the Inter-American Development Bank Board by August, 2004.

V. Future Plans

Besides the expected approval of the Hybrid Program, there are three projects in the 2004 pipeline. One is the Cuenca Binacional del Rio Sixaola for US$9 million, the second one is an Ecotourism in Protected Areas for US$20 million, and the third is Sustainable Development in the Region Huetar-Vertiente Atlántica for US$16 million.

Costa Rica: Core Statistical Indicators

(As of June 2, 2004)

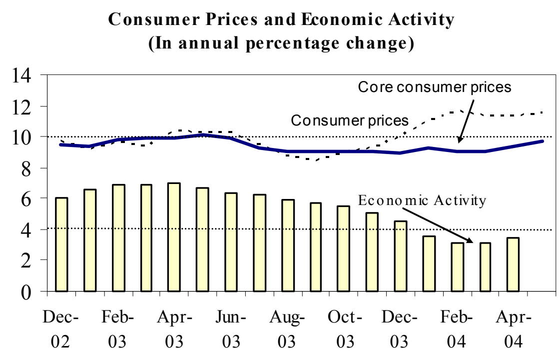
	Exchange Rates	Interna-tional Reserves	Central Bank Balance Sheet 1/	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	5/25/04	5/14/04	4/30/04	4/30/04	5/07/04	5/25/04	4/30/04	4/30/04	12/31/03	3/31/04	12/31/03	12/1/03
Date Received	5/25/04	5/25/04	5/25/04	5/25/04	5/25/04	5/25/04	5/10/04	5/25/04	2/9/04	5/10/04	5/10/04	3/10/04
Frequency of Data 2/	D	W	M	D	M	D	M	M	Q	M	Q	Q
Frequency of Reporting 3/	D	D	M	M	M	W	M	M	Q	M	Q	Q
Source of Update 4/	A	A	A	A	A	A	A	A	A	A	A	A
Mode of Reporting 5/	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C
Confidentiality 6/	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of Publication 3/	D	W	M	M	M	W	M	M	Q	M	Q	Q

1/ Summary version.
2/ D-daily, W-weekly, M-monthly, Q-quarterly, or A-annual.
3/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annually, or V-irregularly in conjunction with staff visits.
4/ A-direct reporting by central bank, ministry of finance, or other official agency, N-official publication or press release, P-commercial publication, or C-commercial electronic data provider, E-EIS.
5/ E-electronic data transfer, C-Cable or facsimile, T-Telephone, M-mail, or V-staff visits.
6/ A-for use by the staff only, B-for use by the staff and the Executive Board, C-for unrestricted use, D-embargoed for a specified period and thereafter for unrestricted use, or E-subject to other use restrictions.

Statement by the IMF Staff Representative
July 2, 2004

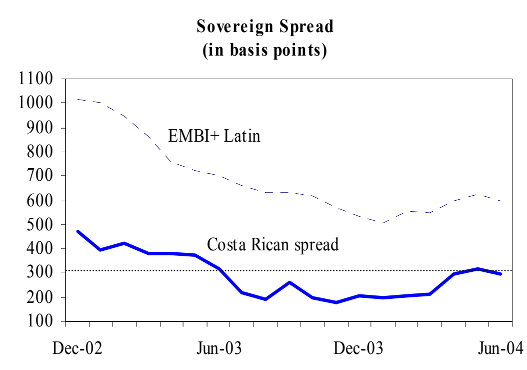
1. The information on recent developments presented below has become available since the staff report was issued. It does not affect the thrust of the staff appraisal.

2. **Output growth has slowed somewhat and inflation edged up broadly in line with projections in the staff report.** Economic activity grew by 3½ percent in April (y/y; down from over 7 percent a year earlier). The slowdown reflects mainly weaker growth of computer parts exports following the switch to a new production line by a large company and international inventory stockpiling. The 12-month inflation rate rose to 11½ percent in May due to higher oil prices; core inflation has remained under 10 percent. At end-May, the central bank raised its policy interest rate by 57 basis points, to 12.25 percent.



3. **The tax reform bill continues to make progress in the National Assembly and is now anticipated to be approved by end-August.** The fiscal commission in congress is expected to conclude its discussions of the reform in the coming two weeks. So far, no changes have been introduced and the reform is still expected to yield 2 percent of GDP on an annual basis. To offset any potential delay of the reform beyond August, the authorities have announced contingent expenditure cuts of up to 1 percent of GDP.

4. **Costa Rican sovereign bond prices have rebounded slightly after a sizable drop in April–May.** The rebound reflects the overall narrowing emerging market spreads and reduced sales of Costa Rican bonds by local investment funds.



5. **Outflows from local investment funds have slowed markedly in recent weeks.** As a result, the value of these

funds has now stabilized at around US$1.5 billion, from about US$3 billion in early 2004. The decline in the funds' value reflects both a price effect (investments are marked-to-market) and the redemption from the funds. While outflows have halted, there are continuing risks associated with further increases in U.S. interest rates.

6. **It appears that most of the outflows from the funds were deposited at domestic commercial banks** (deposits increased by over US$700 million in March–May). As noted in the staff report, banks used the resources partly to buy government bonds (banks' bond holdings increased by around 30 percent since end-2003), and partly to on-lend to the investment funds, taking advantage of a temporary increase in the leverage ceilings for such funds. The funds' borrowing increased by US$85 million in March–April, but most of this has been already repaid.

7. **Monetary stability has been maintained through this episode.** The recycling of liquidity minimized the need for central bank intervention to stem a wider collapse of funds (which are managed mainly by banks) and/or a sharp fall in bond prices. Action by the central bank has been limited to small repurchases of bonds (about US$50 million) to help stabilize their prices. Net international reserves have remained stable at US$1.5 billion.

8. **The authorities are taking measures to ensure appropriate prudential safeguards against the risks associated with investment funds.** Preliminary estimates put the losses arising from lower bond prices at about 1 percent of risk-weighted assets (2 percent for public banks).While the weakening of profitability might complicate some banks' recapitalization plans, the authorities have instructed them to keep those plans on track; the largest public bank has already announced asset liquidations and expenditure cuts to meet its recapitalization goals. The authorities have also issued guidelines to keep investors appropriately informed about the nature of risks associated with investment funds.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 04/94
FOR IMMEDIATE RELEASE
August 19, 2004

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

IMF Concludes 2004 Article IV Consultation with Costa Rica

On July 2, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Costa Rica.[1]

Background

Economic performance improved in 2003. Following several years of slow growth, real GDP rose by 5½ percent, boosted by a recovery of exports and strong private investment. Inflation declined below 10 percent, while unemployment fell to 6 percent. The external current account deficit narrowed to 5.3 percent of GDP in 2003 from 5.7 percent of GDP in 2002. Strong export growth, particularly electronics, largely offset higher imports of oil and capital goods. Gross reserves rose to 2½ months of imports, owing to pre-financing of 2004 fiscal needs and short-term capital inflows.

The public sector deficit was reduced to 5.2 percent of GDP in 2003 from 5.7 percent in 2002, owing to temporary tax measures and expenditure restraint. The primary balance shifted to a surplus of 0.3 percent of GDP, from a deficit of ½ percent of GDP in 2002. However, the public debt continued to rise, reaching 55 percent of GDP by the end of the year.

Monetary policy continued to be heavily constrained by the large quasi-fiscal deficit of the central bank. Broad money rose by 13.6 percent in 2003, reflecting large inflows of private capital, and credit to the private sector increased by about 20 percent in nominal terms. Financial dollarization continued to deepen and, by end-2003, about 60 percent of private

[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 the Executive Directors, and this summary is transmitted to the country's authorities and this PIN summarizes the views of the Executive Board.

sector credit was denominated in foreign currency. Some progress was made in implementing the banking reform recommendations of the 2001 Financial Sector Assessment Program (FSAP), but many reforms remain pending, including to level the playing field between onshore and offshore, as well as public and private banks.

Real GDP is expected to expand by 4 percent in 2004, and while inflation has risen to 11 percent recently owing to higher oil prices, core inflation remains stable at around 10 percent, broadly in line with the rate of crawl. The fiscal deficit is projected to remain at about 5.3 percent of GDP in 2004, as a comprehensive tax reform currently before Congress is expected to compensate for the temporary revenue measures that expired at end-2003. The successful conclusion in early 2004 of negotiations for a trade agreement with the United States (CAFTA) will make permanent the preferential access to the U.S. market hitherto granted under the Caribbean Basin Initiative.

Executive Board Assessment

Executive Directors welcomed the improvement in Costa Rica's economic situation since the last Article IV consultation, and commended the country's long-standing democratic tradition, solid institutions, and strong record of social development. They noted the favorable medium-term outlook, which should provide a good environment to make rapid progress on structural reforms. At the same time, Directors observed that significant vulnerabilities remain. Fiscal and external current account deficits continue to be large, the public debt has risen to 55 percent of GDP, the banking system suffers from growing dollarization and other weaknesses, and international reserves should be strengthened given the currency peg and the banking system's dollar liabilities.

Against this background, Directors endorsed several important reforms launched by the authorities, including a tax reform and trade agreements with the United States and CARICOM, and they were encouraged by the broad-based political support that these reforms are receiving. However, Directors called for a more comprehensive agenda of well-sequenced reforms to address remaining vulnerabilities, with special focus on tax administration, government spending, state enterprises, monetary management, and the prudential regulation and supervision of the financial sector. In light of the consensus-based character of the political system in Costa Rica, Directors emphasized that greater attention should be directed toward building the necessary political support for the reform agenda.

Directors stressed that strengthening the fiscal position is crucial for medium-term fiscal sustainability. They supported the authorities' efforts to obtain prompt legislative approval of the proposed tax reform, and stressed the need to underpin this reform with measures to strengthen tax administration. Directors also urged expenditure reform as a key priority, in particular by rolling back tax revenue earmarking, strengthening the finances of the pension system, keeping the wage bill under control, and improving the performance of the public enterprises.

Directors welcomed the authorities' plans to strengthen debt management, and agreed that fiscal consolidation would make an important contribution in this regard. They supported efforts to lengthen debt maturities and to develop the market for colón instruments in order to reduce the need for foreign-currency instruments.

Directors endorsed the authorities' intention to focus monetary policy on the objective of reducing inflation, and encouraged them to create the conditions for an eventual shift toward inflation targeting. They welcomed the authorities' plans to strengthen monetary management and instruments, make monetary policy more forward looking, and strengthen the analysis of monetary transmission channels. Directors also supported the planned recapitalization of the central bank. They noted that shifting the central bank's quasi-fiscal deficit to the government will improve fiscal transparency, as well as strengthen monetary policy and efforts to reduce inflation, provided that overall public borrowing declines. Some Directors considered that greater exchange rate flexibility could help reduce the economy's vulnerability to external shocks and facilitate adjustment to structural change. Directors noted that a move toward more flexibility should be well sequenced and supported by fiscal and financial reforms, and by the development of exchange market infrastructure.

Directors urged further progress toward strengthening the financial sector. They welcomed the steps taken so far to implement the recommendations of the 2001 Financial Sector Assessment Program (FSAP) report and follow-up technical assistance missions. However, Directors stressed that additional efforts are needed to strengthen the prudential and supervisory system. In particular, they stressed the need to ensure equal treatment of public and private banks and of offshore and onshore banks, implement consolidated supervision, strengthen sanctions and the bank resolution framework, and upgrade liquidity and risk management. They recommended the centralization of credit risk data for banks. The authorities also need to make sure that the investment funds market operates in accordance with relevant norms and transparency standards. Directors noted the authorities' efforts to further improve the already strong framework for combating money laundering and terrorism financing in a regional context.

Directors considered the rising trend of dollarization to be a significant vulnerability. They agreed that, to halt and reverse this trend, a broad strategy centered on reinforcing confidence in the colón and the onshore banking system as well as ensuring that the risks of dollar intermediation are fully internalized would be required.

Directors welcomed the progress made by Costa Rica in opening new markets for its exports. They commended the successful completion of negotiations on the Central American Free Trade Agreement with the United States, and supported the authorities' efforts to secure its early congressional approval. Directors pointed to the positive impact this agreement would have on export growth, foreign direct investment, and economic growth, and urged early approval of the associated structural reforms.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Costa Rica: Selected Economic and Financial Indicators

	2000	2001	2002	Prel. 2003	Proj. 2004
Real economy (change in percent)					
Real GDP	1.8	1.0	2.9	5.6	3.8
Consumer prices (end of period)	10.2	11.0	9.7	9.9	10.2
National savings (in percent of GDP)	12.6	15.6	16.1	15.2	16.0
Gross domestic investment (in percent of GDP)	17.1	20.1	21.9	20.5	21.3
Public finance (in percent of GDP)					
Combined public sector deficit	4.4	3.8	5.7	5.2	5.3
Central government deficit	3.7	3.8	5.0	3.9	4.0
Money and credit (end-year, percent change)					
Net domestic assets	24.8	10.9	15.5	5.9	13.8
Of which					
Credit to nonfinancial public sector	-12.9	-63.5	103.1	-0.1	-1.0
Credit to private sector	31.3	22.9	20.6	19.7	14.7
Liabilities to private sector	17.9	18.7	17.1	17.9	13.2
Interest rates (end of period)					
Deposit rate (tasa básica pasiva)	15.5	16.0	17.5	13.8	...
Lending rate	27.0	25.8	27.9	29.2	...
External sector					
Trade balance	-1.3	-5.0	-7.6	-6.3	-7.0
Current account balance	-4.4	-4.5	-5.7	-5.3	-5.3
Change in net international reserves (in millions of U.S. dollars, increase -)	152	-13	-163	-341	150
Net international reserves 1/	1,086	1,098	1,261	1,602	1,452
Gross international reserves (months of imports of goods and services) 1/	2.3	2.0	2.1	2.6	2.2
External public debt (as percentage of GDP)	19.8	19.8	19.8	21.2	21.1
Real effective exchange rate (end of period; depreciation -)	4.7	3.6	-5.4	-9.4	...

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

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

Statement by Luis Martí, Executive Director for Costa Rica and Roberto Simán, Senior Advisor to Executive Director July 2, 2004

Our Costa Rican authorities would like to convey their appreciation to staff for the constructive discussions, valuable policy advice and support received during the Article IV consultation. The staff report and selected issues papers recognize the significant accomplishments since the last review and, at the same time, identifies the vulnerabilities faced by the Costa Rican economy.

Presently, there is no Fund program for Costa Rica. The last Stand-By arrangements were approved in 1993 and 1995 as precautionary support and were never drawn down.

Recent developments

Costa Rica has been able to advance in many areas during the last year. Its social indicators continue to be at the forefront in the Latin American region and growth in 2003 rebounded to 5.6 percent, led by private investment and exports. The fiscal deficit was narrowed because of the temporary tax measures and the authorities implemented a number of control measures for central government spending. The balance of payments strengthened and the country successfully negotiated a free-trade agreement with the United States and the other Central American countries (CAFTA). In addition to securing a more stable market, CAFTA is expected to be one of the main engines of growth and it should help to continue carrying on several of the pending structural reforms. It should also enhance its investment climate and provide for the gradual opening in telecommunications and of the state monopoly in insurance to private investors.

Despite these improvements, Costa Rica's economy still faces a number of challenges. The external current deficit remains large, the fiscal deficit and public debt, even though at manageable levels, are still high, and the banking system experiences growing financial dollarization.

A big effort in the fiscal front

Fiscal consolidation remains a central priority. The Costa Rican authorities are aware that significant improvements in public finances are still needed in order to ensure fiscal and debt sustainability. They have placed enhanced efforts in tax administration, expenditure reforms and especially in the comprehensive fiscal reform package that is expected to be approved by Congress in August 2004.

This tax reform should provide the government with a tax system that will not only increase revenues from a broadening of the tax base by approximate 2.5 percent of the GDP, but will also eliminate the distortions created by multiple taxes. Authorities also believe that tax administration needs to be strengthened and they plan to implement the recommendations of a recent FAD mission to reduce tax evasion, as soon as the tax reform is approved. The proposed administrative measures include a plan to tighten control of large taxpayers, eliminate cross crediting between taxes, limit tax withholdings and strengthen the tax agency.

Monetary issues

Costa Rican authorities are committed to a sound monetary policy and to an enduring reduction of inflation. There are several factors that, combined, have caused a large negative net worth at the Banco Central de Costa Rica (BCCR). For many years, the quasi-fiscal losses have complicated the management of monetary policy. The large losses have inhibited a reduction in inflation to a low single digit and account –to a considerable extent- for the inflationary pressures. The figures involved are substantial and make up about one third of the base money.

Both the BCCR and the Ministry of Finance have taken the initiative to go forward and are in full agreement with the need to recapitalize the BCCR by transferring all of its quasi-fiscal losses to the budget. As a first step, the process to recapitalize U.S. $ 250 million in 2004 is already underway. The authorities intend now to propose to Congress a draft bill for a one–time lump sum recapitalization for the remaining BCCR liabilities, after obtaining approval of the tax reform currently before Congress. The assumption by the government of the BCCR liabilities will definitely enhance the BCCR's capacity to implement monetary policy.

As proven by the recent fluctuations in the funds managed by local banks, the financial system has weathered well the shift of investors towards liquidity following the slump in value of domestic investment funds. We commend the staff for a clear and concise explanation of developments. It is important to underline here that there were no factors of confidence or surveillance involved, but the shift was due to an asset price correction triggered by the rise in long-term rates in the U.S. The authorities have reacted in accordance with observed practice elsewhere, first providing liquidity to the system in order to strengthen the ability of financial institutions to redeem participations, and later watching very closely the level of liquidity in order to keep monetary magnitudes under control and prevent an inflationary fallout.

Crawling peg: an anchor for confidence

Costa Rica has followed a somewhat flexible exchange rate crawl since the early 80s, with periodic adjustments to compensate for inflation differentials between the country and its main trading partners. Over the years, the exchange rate regime has enabled the authorities to avoid deviations in the REER as well as currency crises, and has presided over a remarkable period of opening of the national economy. It enjoys considerable credibility and is not something that the economic agents in Costa Rica see as an immediate problem. This being

said, the authorities are open to considering other exchange rate options especially once the negative net worth of the Central Bank has been addressed and, as a result, inflation has been significantly curbed. As the staff notes, the move towards greater flexibility would need to be gradual, i.e., because of the necessity to develop a solid market infrastructure for price formation.

The challenge of halting financial dollarization

A high degree of financial dollarization in the economy is a source of vulnerability and our authorities are fully aware of the need to reverse the current trend. Dollarization in Costa Rica can probably be related to inflationary expectations, but is also a side effect of the increased participation of the external sector in the Costa Rican economy, where imports and exports of goods and services denominated in U.S. dollars in 2003 represented approximately 94 percent of GDP.

The challenge is to reduce financial dollarization by strengthening the macroeconomic framework through the proposed fiscal consolidation, reduction in inflation and other measures recommended by the recent MFD mission, which will give market players confidence in sustained monetary stability. Authorities are strengthening the prudential framework to ensure full internalization of the dollar-intermediation risks and are also encouraging banks to promote price-index instruments to help promote colón intermediation.

A final word

Costa Rica is in many respects a success story. A stable democracy since 1949, Costa Rica domestic politics have developed a very distinctive feature: it has long placed a high premium on achieving wide socio-political consensus on all major policy issues. The downside to this emphasis on consensus is, of course, that important legislative or executive decisions often take quite long until they effectively materialize. On the other hand, reforms are sustainable when they grow out of the widespread support of society, and the Costa Rican society takes it for granted that the domestic political process is conditioned by the objective of building consensus around all important issues. The authorities are now engaged in one of these exercises in order to secure safe passage of the fiscal reform, and will soon be trying to muster the necessary support for recapitalizing the BCCR.

Costa Rica, which promoted years ago an effective welfare system, has combined reasonable economic progress with large investments in human capital and an explicit concern about environmental constraints. Its social indicators are often close to those prevailing in developed economies, and it is noteworthy that the World Bank underscores the relevance of "knowledge sharing" in its current relationship with Costa Rica, especially in those areas such as poverty alleviation and environmental management, where the country has been particularly successful.

Our authorities highly value the continued policy dialogue with the Fund. They see the Fund and other multilateral institutions as key partners in discussing their priorities and in the implementation of their plans to ensure sustainable growth, capitalize on its remarkable record of social progress and take full advantage of the benefits of its integration to the global economy.