Euler Hermes Economic Research

Country Report

Costa Rica

Public finances need to be addressed

General Information

GDP	USD45.127bn (World ranking 80, World Bank 2012)
Population	4.81 million (World ranking 118, World Bank 2012)
Form of state	Democratic Republic
Head of government	Luis Guillermo SOLIS Rivera
Next elections	2018, presidential and legislative

Strengths

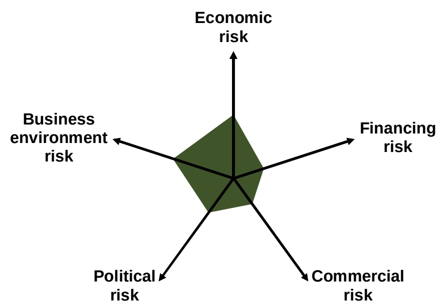
- Stable, enduring democratic framework
- A dynamic tourism sector
- Moderate public and external debt
- Large FDI inflows
- Large foreign reserves, covering more than 6 months of imports

Weaknesses

- High dependency on the U.S. (foreign investment in a few large companies, export demand and tourism)
- Large fiscal deficit and a need for tax reform to raise the low structural revenue base
- Low export growth

Country Rating

BB1



Source: Euler Hermes

Trade Structure

By destination / origin (% of total)

Exports		Rank		Imports
United States	32%	1	42%	United States
China	11%	2	7%	Mexico
Netherlands	10%	3	6%	China
Mexico	8%	4	6%	Japan
United Kingdom	7%	5	4%	Panama

By product (% of total)

Exports		Rank		Imports
Electrical machinery	51%	1	17%	Electrical machinery
Vegetables and fruits	18%	2	12%	Petroleum, products
Scientific instruments	4%	3	7%	Road vehicles
Office machines	3%	4	4%	Miscellaneous manufactures
Miscellaneous manufactures	3%	5	4%	Telecom. apparatus

Source: UNCTAD (2012)

Economic Overview

Slower growth in 2014 and 2015

Growth slowed from +5.1% in 2012 to +3.5% in 2013. In Q1 2014, GDP increased by +4.3% y/y, mainly driven by private consumption while external demand contributed negatively to growth (-0.6% y/y for exports in Q1 2014). Government consumption and investment slowed as spending was curbed. In 2014, GDP growth should reach +3.4% followed by +3.2% in 2015. Domestic demand will continue to be a driving force in 2014.

Inflationary pressures to be temporary

The monetary policy framework is based on inflation targeting, currently set at 4% +/-1pp. Inflation eased to +3.7% y/y at end-2013 but strengthened sharply in H1, reaching +5.5% y/y at the end of August 2014, above the Central Bank target. Concerned with growing inflationary pressures, the Central Bank increased its key policy rate twice: once from 3.75% to 4.75% in March 2014 and a second time to 5.25% in May 2014. Another rate increase is expected as inflation is expected to continue rising and to reach +6% y/y by the end of the year. Consumer prices should decelerate gradually thereafter, returning to the Central Bank's target range by the end of 2015 (+4.1% y/y).

Deteriorating twin deficits

The fiscal deficit widened during the downturn of 2008-2009 as expenditures increased while revenues (only accounting for about 14% of GDP) stagnated. There was some improvement in 2012 as the deficit narrowed to -4.6% of GDP from -5.4% in 2011 according to IMF data. However, it widened again in 2013 to -5.4% and is expected to reach -6.2% in 2014 and -6.9% in 2015, following the August decision to delay implementation of a necessary tax reform until 2017. This decision came after Intel and Bank of America decided to cease some of their manufacturing operations and back office services in the country and relocate to the United States.

The current account deficit remains large, narrowing slightly to -4.9 % of GDP in 2013 (from -5.2% in 2012). It is likely to expand to -5.2% of GDP in 2014 and -5.3% in 2015, on the back of stagnating exports while imports may slightly pick up with the strengthening of domestic demand. The positive service balance (+12.7% of GDP), mainly due to significant receipts from the tourism sector, would compensate the strong deficit in goods, which should remain larger than -15% of GDP over next years.

Exports within free trade zones (mainly electronics) account for approximately 50% of total exports while the share of traditional agricultural commodities, albeit declining, still accounts for 18% of total exports. The United States weighs heavily on the economic performance, absorbing 33% of exports and providing 61% of total FDI. Moreover, the economy is highly dependent on tourism receipts and the electronic sector, the latter being dominated by a few large companies. Costa Rica is thus highly vulnerable to external shocks, recently illustrated by Intel's (microchips producer) withdrawal from the country. Intel accounted for 20% of goods exports

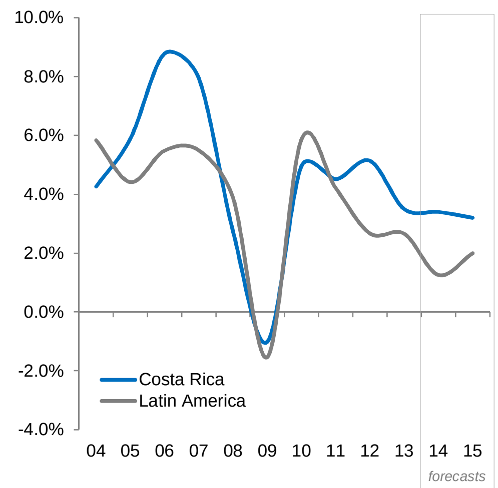
Key economic forecasts

	2012	2013	2014f	2015f
GDP growth (% change)	5.1	3.5	3.4	3.2
Inflation (%, yearly average)	4.5	5.2	4.6	4.3
Fiscal balance* (% of GDP)	-4.6	-5.6	-6.2	-6.9
Public debt* (% of GDP)	35.1	37.0	39.0	42.0
Current account (% of GDP)	-5.2	-4.9	-5.2	-5.3
External debt (% of GDP)	31.6	29.0	28.8	27.6

*Includes Central Government; Nonfinancial Public Corporation; Social Security Funds

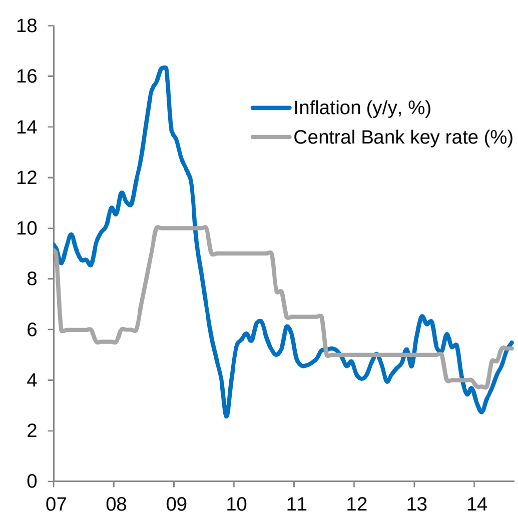
Sources: National sources, Ihs Global Insight, IMF, Euler Hermes

GDP growth (%)



Sources: IHS Global Insight, Euler Hermes

Key policy rate (%) and inflation rate (y/y, %)



Sources: IHS Global Insight, Euler Hermes and will inevitably impact Costa Rica's current account deficit.

Manageable debt ratios

Without structural reforms, the public deficit is likely to remain uncomfortably large and the public debt to GDP ratio will continue to increase. The IMF estimates general government debt at 37% of GDP in 2013 (up from 35% of GDP in 2012). Euler Hermes expects it to rise further in the coming years, reaching 38.9% in 2014 and 42% in 2015. However, 75% of this debt is owned by residents, which lowers the vulnerability to external shocks.

About 85% of the current account deficit is covered by strong FDI inflows (equivalent to 5% of GDP annually on average since 2009) limiting the need to build up external debt. However, since 2012, the government relies increasingly on external bonds: the first USD1.0 bn placement occurred in November 2012, maturing in 2023. The second was issued in 2013, when Costa Rica issued USD500 mn maturing in 2025 and USD500 mn maturing in 2043. In April 2014, another USD1.0 bn was issued.

A sharp depreciation in February 2014

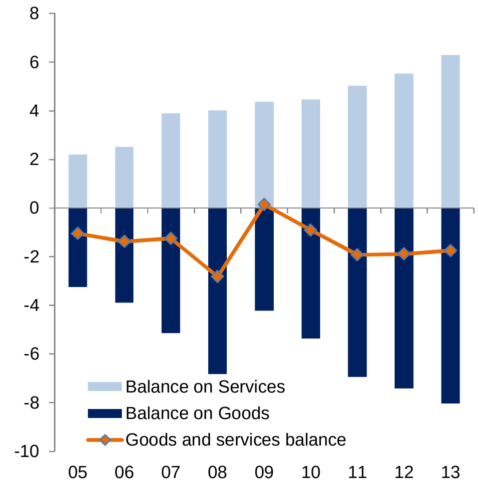
The Costa Rican Colon depreciated strongly during the beginning of year (-7.4% from December 2013 to August 2014), most notably in February 2014 (-6.5% from January 2014). This was due to a combination of internal factors (pre-election period) and external market uncertainties linked to the start of U.S. FED tapering. The Central Bank intervened on the market to maintain the exchange rate within the determined band. The exchange rate is allowed to float within a band that allows a crawl on the depreciation side and a "floor" on the appreciation side. For 2013, the Central Bank committed to maintain the exchange rate above 500 CRC/USD (the floor) and a maximum depreciation of 0.2 CRC/USD per working day.

FX reserves are large and are expected to remain at a comfortable level, allowing the monetary authorities to defend the managed float of the exchange rate against the USD. As of July 2014, the international reserves (minus gold) amounted to USD7.3 bn, which represents about 6.6 months of goods and services imports.

A stable political system

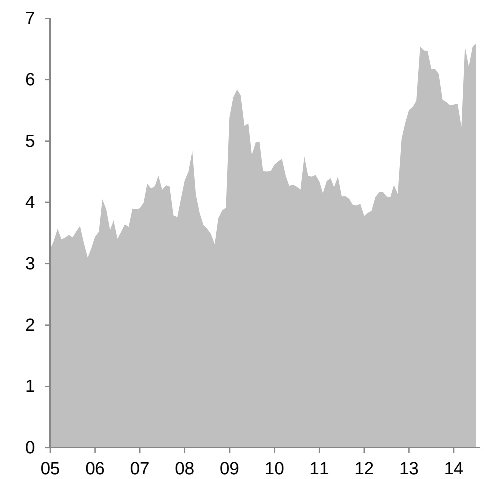
In February 2014 Luis Guillermo Solis, the centre-left candidate, won the presidential election against traditional centre-right and right candidates. He will need to quickly address the lack of infrastructures, the deteriorating fiscal deficit and governmental debt and restore the country's attractiveness (Costa Rica is ranked 120th out of 189 in the World Banks's Doing Business survey).

Balance of goods and services breakdown (USD bn)



Sources: IHS Global Insight, IMF, Euler Hermes

Import cover by foreign exchange reserves (months)



Sources: IHS Global Insight, IMF, Euler Hermes

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Country Risk Analyst:
Daniela Ordóñez
daniela.ordonez@eulerhermes.com