



COSTA RICA

October 28, 2022

THIRD REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY, REQUEST FOR AN ARRANGEMENT UNDER THE RESILIENCE AND SUSTAINABILITY FACILITY, REQUEST FOR WAIVER OF NONOBSERVANCE OF PERFORMANCE CRITERION, AND MONETARY POLICY CONSULTATION—WORLD BANK ASSESSMENT LETTER FOR THE RESILIENCE AND SUSTAINABILITY FACILITY

WORLD BANK ASSESSMENT LETTER FOR THE RESILIENCE AND SUSTAINABILITY FACILITY

A. Climate Change Implications for Costa Rica

1. Costa Rica's economic progress over the last two decades allowed it to become more resilient to exogenous shocks, including climate events. Costa Rica doubled its income per capita during this period, relying on relatively solid institutions, an outward-oriented growth model and investments in human capital. The country upgraded and diversified its exports, increasing resilience to external shocks, and invested in preparedness against domestic shocks, including related to natural disasters. Improvements in institutional capacity with respect to multi-sectoral coordination and implementation of sector-specific policies have been critical for preparedness. However, fiscal vulnerabilities built up during this period, as spending increased while revenues stayed flat. Fiscal space is currently limited, reducing the potential for increasing public investment in the short run. In this context, it is critical to continue pursuing a fiscal consolidation and rebuilding fiscal buffers for implementing decarbonization related investments as well as navigating climate related shocks.

2. Climate change affects Costa Rica through intensification of extreme climate events and natural hazards and through key economic sectors. Despite

recent achievements, Costa Rica still ranks 61 out of 182 countries in the 2022 ND-GAIN Index.¹ Approximately 6.8 percent of its total area is exposed to three or more adverse natural events. Around 80 percent of Costa Rica's population reside in areas at high risk of multiple hazards. In 1998-2018, infrastructure damage from rains and droughts averaged 0.7 percent of GDP.² Studies suggest that climate change could increase the frequency of occurrence of weather-related events and the intensity of these phenomena. In a high-risk scenario, damage could rise to 1.6 to 2.5 percent per year over the medium term. Natural disasters have complex, interrelated effects on Costa Rica's people through death, disease, displacement, loss of physical assets, and disruptions in income and key services such as health and education. This could lead to long lasting impacts on growth, fiscal, poverty and vulnerability. Natural disasters disrupt the country's buoyant tourism sector, for example through coastal flooding from rising seas and storms. Agriculture is vulnerable to extreme events, including floods and droughts, as well as rising temperatures and desertification driven by poor land use practices. Key crops such as coffee beans and bananas will be negatively affected. Changing rainfall patterns can also affect hydroelectric powerplants which account for most of the energy produced in Costa Rica. These could have significant fiscal and financial implications and affect long-term growth.

3. Costa Rica's efforts to fight climate change and restore ecosystems have resulted in a significant reduction of greenhouse gas (GHG) emissions per capita over the last decade, but this trend could reverse. Placing the sustainable use of natural resources at the core of its development strategy, Costa Rica has become the only tropical country in the world that has reversed deforestation, more than doubling its area covered by forests from 26 percent of its territory in 1983 to 59 percent today. National parks and protected areas comprise 26 percent of land area and contribute to a successful eco-tourism industry. The share of renewables in the energy sector is among the largest in the world. Wind technologies contributed significantly to electricity generation, allowing a drastic reduction in the use of oil during the last decade. Finally, Costa Rica has attracted multinational corporations with sustainable investments. Emissions amounted to a low 11.5 megatons in 2020 - below most upper middle-income countries. Emissions come mainly from transport (43 percent), agriculture (21 percent), industrial processes and production (9.6 percent). In the past, improvements in land and energy use have more than compensated for a sharp increase in emission from these sectors. However, going forward, GHG emissions are estimated to increase 69 percent between 2015-2050 in the absence of additional emissions-reducing reforms, largely driven by transport, the largest and fastest-growing source of GHG emissions.

B. Costa Rica's Policies and Strategies

4. Costa Rica has continuously strengthened disaster risk management and advanced policies in support of climate change adaptation. It has managed to limit vulnerabilities from climate change by i) building an efficient disaster response system, ii) enforcing building codes, environmental standards, and land use planning;³ iii) strengthening its institutional and legal framework, and iv) mainstreaming disaster risk management in its national development program. Costa Rica's National Adaptation Plan was

¹ The Notre Dame Global Adaptation Initiative (ND-GAIN) Index ranks 182 countries using a score which calculates a country's vulnerability to climate change and other global challenges as well as their readiness to improve resilience.

² *Controlaría General de la República*, cited by Ministerio de Ambiente y Energía (ibid.).

³ Costa Rica Climate Risk Profile, World Bank 2022.

launched in April, with key milestones for 2022–2026 across different sectors of the economy. The plan is aligned with the National Risk Management policy (2016–2030) and seeks to improve resilience in infrastructure, tourism, and water resources management, including by incorporating climate consideration into public investment decisions. An insurance scheme for agriculture enhances financial resilience by allowing agricultural producers to insure their harvest against climate change risks. The authorities are also increasing forest biomass against impacts from tropical storms, such as landslides. Costa Rica also recently launched a disaster financing strategy.⁴ Finally, the country's ongoing effort to rebuild fiscal buffers will be critical for dealing efficiently with climate events in the future.

5. Costa Rica's National Decarbonization Plan (NDP) outlines paths and actions to reach net-zero emissions by 2050.⁵ The plan includes short, medium, and long-term goals related to emissions reductions in strategic sectors, such as transport, energy, and agriculture, among others. For the transport sector, the NDP focuses on enabling conditions and measures to promote the use of both public and private electric transportation, including through rebates and tariff schemes. For the agriculture sector, the NDP promotes technical and financial programs to help rural communities and small enterprises better manage land resources and access financing. For the energy system, the NDP fosters system capacity for the electrification of the economy. The plan aims at increasing the flexibility and "intelligence" of energy infrastructure, allowing for the integration of distributed generation and demand management strategies, along with new technologies. These approaches also enable Costa Rica to maintain its high share of renewable energy as it meets increasing energy demand. Initial estimates suggest that the plan could generate a net economic benefit somewhere in the range of US\$50 billion derived from energy savings, reduced congestion, reduced accidents, improved air and water quality, increased productivity, and the benefits of ecosystem services for tourism, water, and soil health.

6. Going forward, continued progress towards decarbonization goals will require large investments and come with fiscal, economic, and social implications as well as opportunities. The cumulative investment (both private and public) needed to reach the set objective is estimated somewhere in the range of US\$30 billion until 2050.⁶ Yet, fiscal space to scale up public investment is currently limited. Decarbonization would also lead to economy-wide adjustments. Those could be triggered by shifts in relative prices of inputs, or policies to encourage the faster adoption of new (cleaner) technologies, shifting economic activity and jobs across sectors and regions. While the decarbonization process should be consistent with long-term growth objectives, the transition can produce winners and losers and require mitigation measures, such as investments in human capital and skills needed in emerging segments to facilitate the transition or tailored social protection responses. At the same time, Costa Rica's global leadership in decarbonization also creates important opportunities, for example, allowing the country to position itself as a low-carbon exporter and a destination for sustainable investment, including by improving the readiness of its financial sector, for which Costa Rica is implementing the Greening the Financial System (NGFS) initiative. Costa Rica has succeeded in attracting sustainable FDI.

⁴ Enacted by Executive Decree No. 43663-H, *La Gaceta* No 182, San Jose, Monday, September 26th, 2022.

⁵ Executive Decree no. 41581, February 2019.

⁶ World Bank TA associated with Fiscal Management and Decarbonization DPL (2021).

C. World Bank Engagement

7. The World Bank has been actively supporting a broad range of policies and initiatives implementing Costa Rica's decarbonization and climate adaptation strategy through a combination of lending, technical assistance, and knowledge instruments and expect to continue this strategic engagement in the medium term. Activities include:

- **Climate adaptation:** Costa Rica was the first country to ever receive a Catastrophe Deferred Draw Down Option loan⁷ (CAT DDO) from the World Bank in 2008. This loan marked the beginning of long-standing technical engagement with Costa Rica on DRM and climate adaptation activities,⁸ including support to National Adaptation Plans, disaster financing strategy, assessment of contingent liabilities associated with natural disasters, among others. This program of knowledge and technical assistance has built the foundations for the ongoing preparation two lending operations: the Climate Change Resilience Recovery and Territorial Development (P178049), supports resilient infrastructure across the territory, and the Second Costa Rica CAT DDO (P179861), which recognize recent improvements in disaster risk management and complements Costa Rica disaster financing strategy.
- **Decarbonization Strategy:** The Fiscal and Decarbonization Management Development Financing series (2020-2023 – [P171912](#), [P174786](#), [P177029](#)) provided an umbrella for policy dialogue and technical assistance on decarbonization. The operation was informed by a knowledge program for Costa Rica and Central America more broadly.⁹ The third pillar of the operation supports the implementation of reforms that assist a greener and more low-carbon post-COVID recovery. In particular, it supports the information infrastructure for monitoring, reporting, verifying, and registering GHG emissions to inform policy and investment decisions and enable carbon-market mechanisms. The operation also supports initiatives to motivate greater investments in, and faster deployment of, green and low-carbon technologies and practices, including inclusion of climate considerations in the assessment of financial sector risks, policies to facilitate electric mobility and climate friendly practices in agriculture. Finally, it helps advance a dialogue on strengthening the governance and transparency of institutions in the energy sector to enhance efficiency and help level the playing field for investments in renewable energy. The lending series has also provided a platform for integrating climate consideration in public finances. The World Bank participated in a joint climate-Public Expenditure and Financial Accountability (PEFA) and supported the inclusion of climate considerations in public investment management, integrating climate into appraisal methodologies. Costa Rica's decarbonization

⁷ Costa Rica CAT DDO (P111926, approved in August 2008).

⁸ Central America Disaster Risk Financing Technical Assistance (P172169), Sustainable urban & regional development: unlocking post-COVID transformational opportunities in Costa Rica (P175084).

⁹ Options for a Blue, Green, and Climate Smart recovery in Costa Rica (P177951), Green Resilient and Inclusive Landscapes in Central America (P176670), Partnership for Market Readiness (P158795), Supporting a sound energy transition for an efficient Central America (P169052).

efforts enable the country to be the first Latin America country to meet the conditions to access the first tranche (US\$16 million) of the World Bank's Forest Carbon Partnership Facility (FCPF).¹⁰

¹⁰ The country's Emission Reductions Payment Agreement (ERPA -P160368) with the FCPF unlocks up to US\$60 million across three scheduled payments, for reducing a total of 12 million tons of carbon emissions through to 2025, in line with the country's NDC commitment.