Statement by Mr. Guerra and Ms. Lankester Campos on Costa Rica
November 14, 2022

Our authorities want to convey their appreciation to management and staff for their close and dynamic engagement in order to conclude successfully the third review under the Extended Fund Facility (EFF) arrangement and the guidance on their request of a follow-up financial assistance in the form of the RSF. They would like to extend their gratitude to Ms. Manuela Goretti, the Mission Chief, and her team, for their outstanding work, commitment and fruitful discussions with the government and civil society. Also, they value and welcome the work and collaboration from both the World Bank and the Interamerican Development Bank's staff with the country team and authorities.

Amid the ongoing global challenges, the tightening financial conditions and the risks posed by the COVID-19 pandemic, the economic program laid out by the Costa Rican authorities, and supported by the EFF, has been critical to safeguard macroeconomic stability and anchor the fiscal consolidation efforts. The program has also been instrumental to catalyze additional financial support from other multilateral institutions and to improve the negotiation at the international capital markets. Furthermore, at this time, it provides the authorities with the opportunity to request the Resilience and Sustainability Facility (RSF) Arrangement that builds up over the country's already advanced efforts to promote a greener, more inclusive, and sustainable growth over the medium term.

For the third review, the Costa Rican authorities report a strong fiscal quantitative performance, the implementation of macroeconomic policies to achieve the main program objectives and significant progress on the structural reforms. All fiscal outcomes were met with a comfortable margin, along with three out of four structural benchmarks. The fourth was approved with a delay.

Since the program was first designed by the past administration, the authorities have shown strong ownership and commitment to the EFF. The government of Mr. Chaves has shown its renewed commitment to the program's key objectives and has ambitiously further strengthened its reform agenda.

On top of a very strong program, the administration has also committed to a bold RSF reform agenda to strengthen the policy framework and available resources to tackle the climate change challenge. The Costa Rican authorities take pride on being pioneers on their strategies to combat climate change and, accordingly, they welcome the opportunity to be the first country to come to the Board of the IMF with a request for this new pivotal facility, underpinned by very strong and far-reaching package of measures. The authorities acknowledge the responsibility that this entails, and they are committed to a strong delivery of the program objectives.

Economic Outlook

Against a challenging international context, the Costa Rican economy has been recovering and showing resilience. After a strong growth rebound in 2021 of 7.8 percent (4.1 percent contraction in 2020), economic activity has moderated during 2022.

The Central Bank (BCCR) projects a GDP real growth of 4.3 percent for 2022 and a slowdown in 2023. The outlook is anchored on a continued strong external demand and moderate domestic demand and private investment, given the deteriorating terms of trade. In August 2022, the monthly index of economic activity expanded 3.7 percent, y-o-y, while the 12-month rolling average was 7.2 percent.

The labor market has also been recovering, but more slowly than activity, with the unemployment rate coming down from a peak of 24.4 percent to 12 percent in September 2022, slightly below pre-pandemic levels (12.2) but still above past average levels (9.9 percent from 2010 until 2019).

External pressures, particularly higher prices of food and energy, boosted inflation during the last quarter of 2021, which ended the year at 3.3 percent. In June 2022, the Costa Rican inflation, 10.1 percent, was one of the highest among the Latin-American countries with an inflation targeting regime after Brazil and Chile. Still, the BCCR has taken strong measures by increasing the monetary policy rate by 825 b.p. since December 2021. Annual inflation peaked at 12.13 percent in August, diminish to 10.37 percent in September and reached 8.99 percent in October.

Going forward, in a nutshell, geopolitical tensions channeled via higher commodity prices and lower global growth will define the uncertainty levels for the short and medium term. The risks associated with climate change will outline medium and long run risks.

Fiscal policy

The EFF program's first pillar involves the implementation of equitable fiscal reforms to ensure debt sustainability while protecting the most vulnerable. Its design resulted from fiscal urgent needs at the end of 2018. At that time, public spending had outpaced revenues for over two decades. If structural changes were not implemented the result was going to be an unsustainable path of government debt ratio, measured as a percentage of GDP.

Therefore, Costa Rica approved an ambitious fiscal reform by the end of 2018, which comprised income and expenditure measures along with a fiscal rule. The latter limits the expenditure growth at a rate in accordance with the debt level. Since then, there has been strong expenditure demands given the COVID-19 pandemic and the terms of trade price shock resulting from the invasion of Russia to Ukraine. Nevertheless, the authorities have maintained their commitment to the fiscal rule and to fiscal discipline more broadly.

In 2021, the primary fiscal deficit was 0.3 percent of GDP (3.4 percent in 2020), below the EFF target of 1.7 percent, and the overall deficit was 5 percent (8 percent in 2020). In 2022, fiscal performance continues to be strong. The fiscal targets were met in spite of the cyberattack disruption between March and June 2022. During the first semester of 2022, the primary fiscal balance was 1.3 percent of

GDP, while the financial deficit was 1.0 percent of GDP, the lowest of the last twelve years. Preliminarily, in September, the primary balance was 2.2 percent of GDP, while the financial deficit was 1.7 percent of GDP. Total income represented 12.2 percent of GDP, 0.9 percent more than the same period last year, while tax revenue was the highest of the last seventeen years, 10.3 percent of GDP. The fiscal balance overperformance has benefited from the robust economic recovery, and by a reduction in primary expenditure as a share of GDP under the fiscal rule. For the third quarter of 2022, the debt to GDP ratio was 63.1 percent.

The accomplishment of the fiscal targets, defined in the program with the IMF, and the overperformance on the fiscal balance, have allowed the government to face a lower country risk premium when comparing the sovereign spread with the GLOBAL and the LATAM EMBI.

Going forward, the authorities have reaffirmed their commitment to the required fiscal consolidation, as evidenced in the 2023 budget, which aims to achieve a primary balance of 1.3 percent of GDP. Also, in line with OECD recommendations, the authorities are planning to remove regulatory differences between private and public banks and submit for Parliament discussion the sale of the state bank Banco de Costa Rica.

Monetary policy

The second pillar of the EFF program aims to maintain monetary and financial stability while continuing to strengthen the central bank´s autonomy and governance and addressing structural financial vulnerabilities. On this matter, the BCCR has proactively responded to the shocks faced by the economy demonstrating its independence and vigilant behavior towards financial stability.

From June 2020 until mid-December 2021, the BCCR maintained its monetary policy rate on its lowest level ever of 0.75 percent in order to mitigate the harsh impact of the pandemic, but without risking un-anchoring inflationary expectations. Overall, inflation remained contained by international standards in 2021, despite external price pressures.

The BCCR’s monetary policy decisions, as an inflation targeter, are data-dependent and forward-looking, therefore, by the end of 2021 it started normalizing its rate in order to maintain inflation expectations in check. In December and January, the monetary policy interest rate increased, consecutively, 50 basis points. Since February, inflation has been above the BCCR target and with a growing trend. In March, the rate was raised by 75 b.p. followed by two consecutive increments of 150 b.p. each in April and June, and since last May, inflation has been above the upper outer band limit established in the Monetary Policy Consultation Clause. In July the rate was raised by 200 b.p., and by 100 b.p. more in September.

The last monetary policy meeting took place on Oct 26th and the decision was to increase the policy rate by 50 b.p. In the aggregate, there has been eight adjustments, one at each monetary policy meeting since December 2021, which sum up 825 b.p. resulting in a monetary policy interest rate of 9 percent.

In its last communique, the BCCR reiterated its commitment to achieve the inflation target, and it explained its outlook for inflation, risks around the outlook, and the implications for monetary policy. They are vigilant about the tightening of global financial conditions and the risks posed by sustained global price pressures, worsened by the war in Ukraine. Furthermore, the central bank announced that the adjustments made until now have moved the real monetary policy rate towards a restrictive stance given the inflation expectations. Still, it will continue to decide on its policy rate changes considering the macroeconomic circumstances and inflation projections which are conditional on a series of risk factors.

Among the upward risks, the inertia in inflation expectations stands out, although recently, they have registered a downward correction. The 12-month inflation expectation, on average, was 9.9 percent (9.5 percent was the median) in August, while for October it was 7.5 percent (7.5 percent the median). Inflation expectations measured by the 24-month average was 8.5 (7 percent median) and 6.1 (5.4 percent median) respectively.

During 2022, the FX market has reflected the pressures from higher commodity prices, transport costs, and other imports costs, along with internal factors such as a higher demand from portfolio diversification by pension funds. Therefore, by end-June, reserves decreased below the NIR floor in the program, despite continued exchange rate flexibility. Nonetheless, the BCCR has actively rebuilt reserves through systematic FX purchases from the market and has reduced the breach of the end-September indicative target to US$48.6 million, although this was driven by valuation effects. Also, in order to strengthen its reserves-buffer, the BCCR asked for a US$1.1 billion credit line from the Latin American Reserves Fund in August.

Furthermore, the central bank has been actively engaged with TA from the Fund in order to reorganize its FX operations and deepen the FX market.

Structural reforms

On the structural front, the third pillar of the program aims for Costa Rica to advance on key reforms to promote an inclusive, green, and sustainable growth. The authorities are committed to continue advancing on this comprehensive roadmap to align public governance and policies with international best practices, and foster transparency, efficiency, and growth while reducing inequality and protecting the most vulnerable.

The public employment law, a SB under the program, and perhaps one of the most ambitious reforms of recent years, was approved in March 2022. Its purpose is to modernize and streamline the public administration while containing the wage bill, count for almost one third of central government spending , as it creates a single pay scale across the public sector, eliminating salary components such as bonuses and annuities. It improves the fairness of public compensation system, and it reduces the high public-private wage premium. This reform will enter into force in March 2023, but preparations for the introduction of the single pay pillar and related reforms have been ongoing since its approval.

The structural fiscal program also envisages gains from reforms to public procurement, modernization of the tax and customs administration, and public financial management reforms. At the end of April, the cabinet approved and published a Medium-Term Fiscal Framework for the entire Non-Financial Public Sector for 2023-2026, along with a Medium-Term Debt Strategy for the same period. Efforts are also underway to operationalize gender budgeting; a pilot project is expected to be completed by the end of December 2022, and the 2024 budget will include a statement identifying gender-related spending for selected entities inside and outside the national budget. Also, a medium-term revenue strategy is being designed to increase progressivity and make the tax system more growth friendly; within it, the authorities are developing a feebate scheme to accelerate the transition towards low-emission vehicles. In these areas, Costa Rica has actively engaged in the use of Fund technical assistance which has been instrumental and, in some cases, critical, for the success of the policy agenda under the program.

Also, the newly available, centralized digital information on recipients of social assistance is being used to assess the existing cash-transfer and in-kind programs in order to eliminate ineffective programs, improve targeting, and create a more accurate picture on how to address critical infrastructure needs and support the most vulnerable.

The BCCR has been working closely with the Fund's legal experts on some amendments to its Organic Law to clarify the Central Bank's objective, improve its governance, provide a clearer allocation of functions among its decision-making bodies, strengthen its institutional, functional, personal, and financial and budgeting autonomy, and enhance its transparency and accountability. The bill will be submitted to the Legislative Assembly by the end of December 2022.

The RSF

Costa Rica has a bold and comprehensive green agenda to protect its rich natural resources. Through the years, the country has been able to accomplish ambitious objectives such as generating almost all of its electricity from renewable sources. It has also taken measures to strengthen its adaptation capacity by assessing the medium-term investment needs to enhance the resilience of the country's physical infrastructure, and to reduce greenhouse gas emissions. Specifically, Costa Rica has pledged for a more ambitious reduction than the one established by the Paris Agreement, and to achieve zero net emissions by 2050 under the National Decarbonization Plan.

Also, to address the impacts and risks related to climate change on its main objectives, the BCCR established the Group for Strategic Analysis of Climate Change (GAECC) which intends to establish comparable data, strengthen the analytical capacity for scenario analysis, promote climate-change risk management in the financial system, and work on the greening international reserves.

The new administration is committed to advance in this agenda to improve the country's resilience to natural shocks, generating new job and growth opportunities. Aligned with these objectives, the new RSF fills a much-needed gap in countries like this one unlocking critical resources to tackle longer-term structural challenges.

As an evidence of Costa Rica's compromise, the proposed reform measures within this facility are ambitious and multi-faceted. These measures are expected to improve the efficiency of budget planning and public investment, create further fiscal space, mitigate financial risks, strengthen public debt dynamics and prospective balance-of-payments stability. Specifically, it comprises four reform priorities: (i) integrating climate risks into fiscal planning, (ii) strengthening public investment and infrastructure resilience, (iii) supporting decarbonization, and (iv) greening reserves and strengthening financial sector resilience.

It is the authorities' aim to keep on building over the RSF's catalyzing effect, including by continued work with the World Bank and other IFIs. Also, the facility will support the issuance of securities focused on sustainability. Broadly, Costa Rica is aiming to be recognized as an ESG-indexed sovereign and considering the issuance of bonds to international investors with key performance indicators related to forestry coverage, ecological integrity, and biodiversity.