

COUNTRY REVIEW

Costa Rica



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EULER HERMES COUNTRY RISK GRADE: B

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Long-standing democracy with smooth hand-over of power from one civilian government to another. (There is no army.) Political institutions are widely accepted.
- Generally pro-business, market-oriented economic policies.
- Attractive to FDI (led by Intel microprocessor plant).
- Moderate levels of external debt.
- Structural business environment better than average.

Weaknesses

- Presidential and legislative elections due in February 2009.
- Closely linked to US business cycle.
- Historically high inflation.
- Wide external financing gap, relatively low FX reserves.
- Crawling band exchange rate mechanism, but exit mechanism in place.
- Highly dollarised banking system.

Key Risks

- **Recession**
- **Exchange rate**

Country Risk Assessment

Ratings	Costa Rica		Median Grade B	Colombia	Peers	
	Latest	Previous			Peru	Poland
Systemic Political Risk:	P2+	P2+	P2-	P3+	P3+	P2+
Systemic Economic Risk:	E4	E4	E4	E4	E4	E4
ME rating:	ME4	ME4	ME4	ME4	ME4	ME4
<i>Structure</i>	2.3	2.3	5.0	5.0	5.0	2.3
<i>Policy</i>	5.8	4.8	4.0	4.0	3.8	4.3
<i>Solvency</i>	1.3	1.3	2.5	3.8	2.8	3.2
<i>External Liquidity</i>	5.5	6.0	3.7	4.2	2.8	6.0
SBE rating:	SBE3	SBE3	SBE3	SBE3	SBE3	SBE2
COUNTRY GRADE:	B	B	B	B	B	B

Nomenclature:
 Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
 Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
 ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
 The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
 SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
 Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	San Jose
Population:	4.52 mn (2008)
GDP:	USD 29670 mn (2008)
Currency:	Colon (CRC)
Form of state:	Republic
Head of government:	President Oscar Arias
Next elections:	2010 (presidential & legislative)

Major Industries (% of GDP at market prices, 2008)

Agriculture, forestry & fishing	10.3%
Mining & manufacturing	24.1%
Construction	5.3%
Utilities	3.0%
Services	17.9%

Global Assumptions

	2009	2010
Real GDP grth (% yr/yr) *	-3.9	0.9
Inflation (% , av) *	-0.1	1.3
Dated Brent (USD/b)	61	72
* Major economies		

Main Exports (% of total, 2008)

Free Zone	51.2%
Manufactures	22.8%
Fishing & seafood	11.0%
Bananas	7.3%
Coffee	3.2%

Main Imports (% of total, 2008)

Consumer goods	18.0%
Raw materials & intermediate goods	52.2%
Fuel & lubricants	10.8%
Capital goods	15.4%
Other	3.4%

Lead Export Markets (% of total exports, 2007)

US	25.7%
China	14.1%
Netherlands	10.9%
Mexico	5.0%

Lead Import Markets (% of total imports, 2007)

US	41.0%
Mexico	6.1%
Venezuela	5.7%
Japan	5.4%

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	22,527	26,267	29,670	27,364	27,567
Population (mn)	4.40	4.46	4.52	4.58	4.64
GDP per capita (USD)	5,120	5,889	6,564	5,975	5,941
Real GDP growth (% yr/yr)	8.8	7.8	2.6	-3.6	2.8
Inflation (% , eop)	9.4	10.8	13.9	4.9	6.0
Fiscal balance (% of GDP)	-0.4	0.8	-0.4	-4.5	-4.0
Current account balance (% of GDP)	-4.8	-6.0	-8.8	-2.8	-3.4
External debt/GDP (%)	31	32	31	32	31
External debt/Exports of goods & services (%)	62	63	65	69	62
Interest payments/Exports of goods & services (%)	2	2	2	2	2
Foreign exchange reserves (USD mn)	3,115	4,114	3,799	4,000	4,100
Import cover (months)	3.0	3.5	2.8	3.6	3.4
Exchange rate assumption, CRC:USD (av)	511.30	516.62	526.24	578.00	624.00
f: CRU central forecast					

Sources: National, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Costa Rica has a good record of systemic political stability. There has been uninterrupted democracy since a civil war in 1948 with orderly transfers of power from one civilian government to another. Indeed, the army was abolished following the end of the civil war. Political institutions and representation are deep-rooted and generally respected. Social indicators are among the best in the region. Governments generally support market-oriented, pro-business policies, but government effectiveness is constrained as the ruling party lacks a simple majority in a fragmented congress.

Two parties dominated politics from 1949 until 2002—the Partido Unidad Social Cristiano (PUSC) and the Partido Liberacion Nacional (PLN)—and generally alternated in government. The PUSC, however, has since been displaced by the Partido Accion Ciudadana (PAC). Presidential, legislative and municipal elections were held in February 2006, which President Oscar Arias (PLN), a centrist former president and Nobel peace prize winner, won narrowly (retaining the presidency for the PLN). A key reason for the narrow result was public opposition to DR-CAFTA (the DR-Central American Free Trade Agreement with the US), which Arias strongly supported. In October 2007 the president strengthened his position by winning a victory in a national referendum on ratification of the treaty, though it was not until 2009 that the agreement finally became effective.

Presidential and legislative elections are due in February 2010. The PLN candidate is former vice-president and minister of justice, Laura Chinchilla, who is essentially a continuity candidate. The opposition is fragmented with the PAC fielding Otton Solis, the defeated candidate in the 2006 elections, and a new centre-left coalition, the Alianza Patriótica (AP), Rolando Araya, a former minister and deputy of the PLN who left the party. The AP is a coalition of parties opposed to the DR-CAFTA, while the PAC, though opposed to DR-CAFTA has compromised to allow it to be implemented but is less free-market oriented than the PLN. It is too early to have a strong indication of who will win the presidency, but whoever does win is unlikely to have a simple majority in congress, so legislation and fiscal reform—a priority of the Arias government, as with his predecessor, though neither made much progress—probably will again prove difficult to achieve.

As the global financial crisis intensified Costa Rica entered into a precautionary (i.e. undrawn) stand-by agreement with the IMF. The mission for the first review concluded with a positive statement regarding performance against the programme.

International relations are generally good. DR-CAFTA will provide an important anchor for trade in the new administration.

Economic Stability

Costa Rica is an upper middle income country (World Bank classifications) with an estimated per capita GDP of USD6,564 in 2008. Liberalisation of foreign investment followed by the development of hi-tech industries based in free zones—particularly the decision by Intel to establish a major microprocessor plant in the country—transformed the economy in the 1990s. Free zone exports (mainly electronics) account for more than 50% of exports while the share of traditional commodities such as bananas and coffee has declined to only 7% and 3% respectively. Real per capita GDP has increased at a solid, if unspectacular, annual average of 2.7% over the past ten years.

The increase in real GDP was a strong annual average 6.5% in 2003-07. In 2008, however, growth slowed sharply and GDP contracted 1.8% yr/yr in Q4, followed by -4.8% in Q1 2009. Nonetheless, the monthly activity indicator points to the worst being over and a modest upturn is likely in 2009 continuing through 2010. We expect real GDP to contract by 3.5% in 2009 overall and increase by 2.5% in 2010. The downturn is closely linked to the US business cycle via exports, tourism and remittances which has spilled over to business and consumer confidence.

The fiscal balance (NFPS) was in surplus in 2007 (1.6% of GDP) and small deficit (-0.2% of GDP) in 2008. The overall balance, which includes the central bank, was in deficit of -0.4% of GDP in 2008. The central government achieved surpluses in 2007 and 2008. Revenues fell sharply, however, in the latter part of 2008 and first seven months of 2009, partly the result of the downturn but also the loss of import revenues on implementation of DR-CAFTA—central government was down 8%—while spending continued to increase and the central government deficit may be around 4.5% of GDP in the full year, slightly above the latest 4.1% revised target agreed with IMF in the first review. The deficit is likely to be similar, perhaps slightly smaller, as a proportion of GDP in 2010. Deficits of this size should be financeable, however, with continued international support, as the public debt-GDP ratio

has been on a downward trend in recent years, falling to 39% of GDP at end-2008 from 61% of GDP in 2003, though it will rise towards 45% in 2010. Accordingly, tax reform is still required and failing that cuts in recurrent expenditure are likely to be necessary beyond 2010, if not before.

Monetary policy operated within the framework of a crawling peg exchange rate until October 2006 when the peg was replaced by a crawling band to make policy more responsive to the inflation objective and to move to inflation targeting. The objective remains to achieve that by late 2010, notwithstanding the more difficult financial environment. The exchange rate has come under pressure, however, during the global financial crisis. The policy response was to re-set the weak end of the band to an annual rate of 9%, from 3% previously and to widen the band to 22% by end-2009 and 30% by end-2010. The central bank also tightened monetary policy and the combination of the two has eased some of the exchange rate pressure. Inflation has dropped sharply to historical lows of 5.7% yr/yr in August 2009 and could dip below 5% by end-2009, though a return to higher commodity prices combined with the larger depreciation of the exchange rate could outweigh weak output growth in 2010 and inflation is likely to accelerate modestly.

According to the statement of the recent IMF mission (late August) the banking system remains sound. However, rapid past credit growth (which only began to ease in Q1 2009) is likely to lead to increased NPLs and the system remains highly dollarized.

After widening to almost 9% of GDP in 2008, the current account deficit is set to narrow dramatically in 2009 to 2.8%. Exports and imports collapsed in the H1 2009, but the latter by more than the former, helped by lower commodity prices as well as the fall in domestic demand. Tourism and remittances receipts will also fall. In 2010 as the economy begins to recover the deficit may widen to 3-3.5% of GDP. Net FDI inflows are expected to fall sharply in 2009 and remain relatively low in 2010, but even if flows fall back to 2005 levels (a more than 50% drop) this would still cover more or less fully the current account deficit. Other external liquidity indicators are more mixed. FX reserves provide a comfortable 3.6 months import cover, but cover less than 90% of external debt falling due in 2009 and in 2010. M2 is also relatively high against FX reserves. However, external debt ratios, though rising, remain relatively low—32% of GDP and just under 70% of exports of goods and services, while interest payments/exports of goods and services are 2%. The authorities also have the cushion of the precautionary stand-by with the IMF and various financing arranged already with other multilaterals.

In sum, although the economy has contracted, in line with much of the global economy, external sector pressures have eased in recent months, lowering exchange rate risk, though external liquidity indicators remain on the weak side. Nonetheless, external debt ratios remain low and the authorities have entered a precautionary IMF programme. The fiscal deficit has widened, but public finances should remain manageable in 2009-10.

Structural Business Environment

The Structural Business Environment is generally sound, ranking above average in our assessment, but falling short of the strongest ratings overall (93 out of 210 countries assessed).

Based on data and definitions from the World Bank's 2010 Doing Business Survey, Starting a Business, Dealing with Construction Permits, Employing Workers, Enforcing Contracts and Closing a Business were weaker areas, ranking below average, while Protecting Investors and Paying Taxes were particularly weak. The World Bank Institute's Governance Research Indicator puts regulatory quality, control of corruption and the rule of law all above average for the upper middle income group of economies, and well above average for the Latin American Region. Transparency International's Corruption Perception Index, 2008, assigns Costa Rica a score of 5.1—on a scale of 1 (bad) to 10 (good)—and a ranking of 47= out of 180 (the same as Hungary, Jordan and Malaysia). As a broad measure of the pro-business environment The Heritage Foundation 2009 Index of Economic Freedom ranks Costa Rica 46 out of 179.

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Charts

