Euler Hermes Economic Research

Country Risk Analysis

Costa Rica

A tale of two deficits?

General Information

GDP	USD40.9bn (World ranking 83, World Bank 2011)
Population	4.73 millions (World ranking 118, World Bank 2011)
Form of state	Democratic Republic
Head of government	Laura CHINCHILLA Miranda
Next elections	2014, presidential and legislative

Strengths

- Attractive for large foreign (mainly US) corporates, particularly in electronics sector
- Strong medium-term growth
- Po-business, generally sound policy framework, likely to win support of IFIs should it be necesary
- Sound external balance, despite large current account deficit
- Moderate debt ratios
- Stable, enduring democratic framework.
- Above average business environment

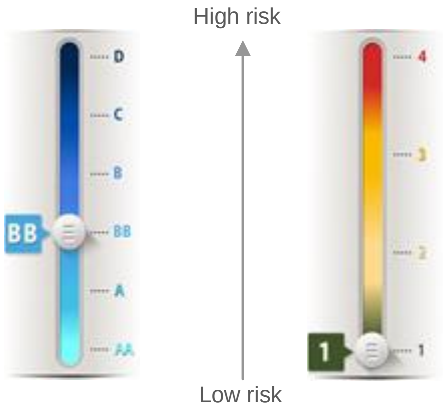
Weaknesses

- High dependency on US (foreign investment in a few large companies, export demand and tourism)
- Need for consensus building in congress can slow policy reforms
- Large fiscal deficit and the need for tax reform to raise structural revenue base

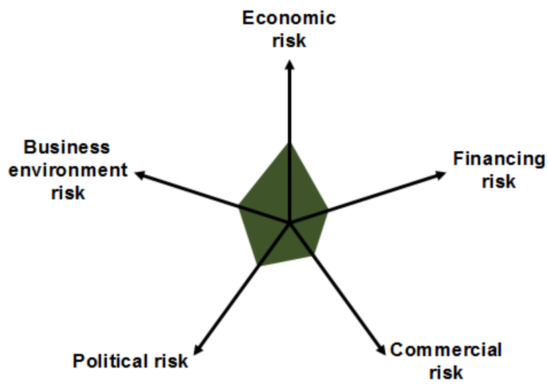
Country Rating

BB1

Country Grade **Country Risk Level**

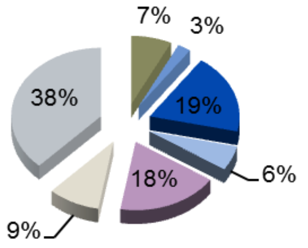


Risk Dimensions



Economic Structure

GDP breakdown (% of total, 2010)



Sources: Chelem, UnctadStat, IHS Global Insight, Euler Hermes

Trade structure (% of total, 2010)

By destination/origin

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

Exports		Rank		Imports
Electrical machinery, apparatus and appliances, n.e.s.	51%	1	17%	Electrical machinery, apparatus and appliances, n.e.s.
Vegetables and fruits	18%	2	12%	Petroleum, petroleum products and related materials
Professional and scientific instruments, n.e.s.	4%	3	7%	Road vehicles
Office machines and automatic data processing machines	3%	4	4%	Miscellaneous manufactured articles, n.e.s.

Economic Forecast

	Average 2000-08	2009	2010	2011	2012	2013f	2014f
GDP growth (% change)	4.6	-1.0	5.0	4.4	5.1	3.6	4.0
Inflation (%, end-year)	11.3	4.0	5.8	4.7	4.5	5.6	5.2
Fiscal balance (% of GDP)	-2.5	-3.6	-5.4	-4.3	-4.6	-4.5	-4.3
Public debt (% of GDP)	35.6	27.2	29.2	30.9	34.8	36.0	37.0
Current account (% of GDP)	-5.3	-2.0	-3.5	-5.3	-5.1	-4.7	-4.4
External debt (% of GDP)	31.2	27.8	23.5	24.8	21.7	30.0	28.0

Sources: IHS Global Insight, National sources, Euler Hermes

Economic Growth

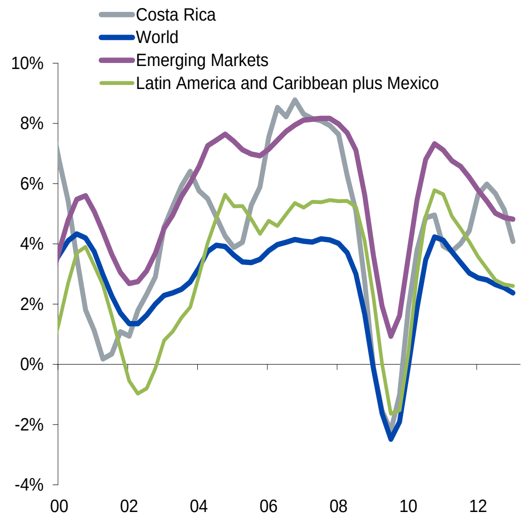
Electronics led, solid growth

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 just over 50% of exports while the share of traditional commodities such as bananas and coffee has declined to only 7% and 4% respectively. However, with tourism also important and the electronics sector dominated by a few large foreign corporates, the economy is vulnerable to external shocks, particularly from the US. Real per capita GDP has increased at a solid, if unspectacular, annual average of 2.9% over the past ten years.

Slower growth in 2013-14

Growth slowed through 2012, though H1 was very strong, with full year growth at +5.1% (+4.2% 2011). Consumption was supported by increases in real wages and credit growth, while investment also grew strongly with plant and equipment investment boosting import demand. Government consumption and investment slowed as spending was curbed. In Q4 2012 growth had eased to 3.4% y/y, but the monthly indicator of activity in the first two months of 2013 pointed to stabilisation and growth in full year 2013 should reach 3.6% followed by 4% in 2014. Domestic demand will lead the way in 2013, though government spending growth will be lower, as the net export contribution will be broadly neutral.

GDP growth (y/y, 4 qtrs cumulated %)



Sources: IHS Global Insight, Euler Hermes

Economic Policies

Policies have been generally conservative, prudent and pro-business. The economy was resilient in the 2008-9 global financial crisis as policies were modified, including a more flexible exchange rate, in association with a precautionary IMF stand-by programme. While inflation remains under control and lower than in the past, the fiscal deficit has remained stubbornly large and efforts to implement durable tax reforms have foundered as the government has lacked effective control of congress and elections are due in February 2014.

Inflation and monetary policy

Monetary policy is framed against inflation targeting, currently 4-6%. Inflation eased to 4.6% y/y at end-2012 and though it has picked up in the early months of 2013 should end the year at 5% or less, within target. The policy interest rate has been unchanged since mid-2011. Credit growth was on the strong side in 2012 and faster than the monetary programme envisaged, though real growth has begun to ease.

The exchange rate has been made more flexible since 2008 and is allowed to float within a band that allows a crawl on the depreciation side and a "floor" on the appreciation side. However, strong capital inflows have generally kept the rate at or close to the floor (i.e. strong) since mid-2010. One downside of this is an overly strong real effective exchange rate.

The financial system capital-assets ratio is above that of most in the region and non-performing loans are low. According to the latest IMF Article IV review (March 2013) reliance on foreign funding is small and exposure to foreign assets modest. A vulnerability, however, is the relatively high level of dollarization in the system.

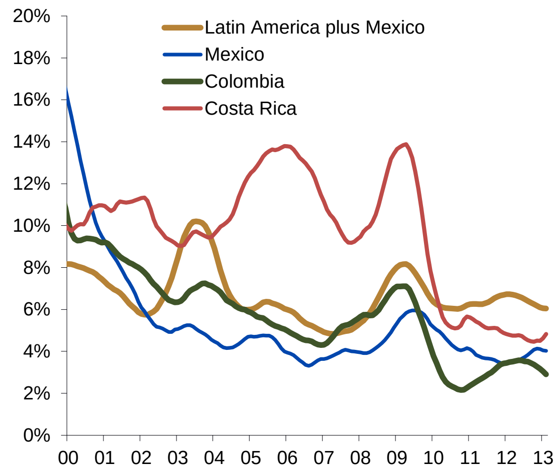
Large fiscal deficit, but moderate debt

The fiscal deficit widened during the downturn of 2008-9 as expenditures increased, but has remained high even though economic growth has recovered. There was some improvement in 2012, however, as the deficit narrowed to -4.6% of GDP from -5.4% in 2011 and -6% in 2010. This resulted from a curb on spending since 2011, largely through piece-meal measures. Revenues as a proportion of GDP have remained flat. The deficit is likely to remain contained in 2013.

A key problem is a Supreme Court decision to nullify a revenue-raising tax reform on procedural iregularities in the legislative approval process, for which the government had gained approval in March 2012. The government has not yet re-presented the proposals and instead has relied on piece-meal measures, though it is seeking to build a consensus for the reforms ahead of the elections.

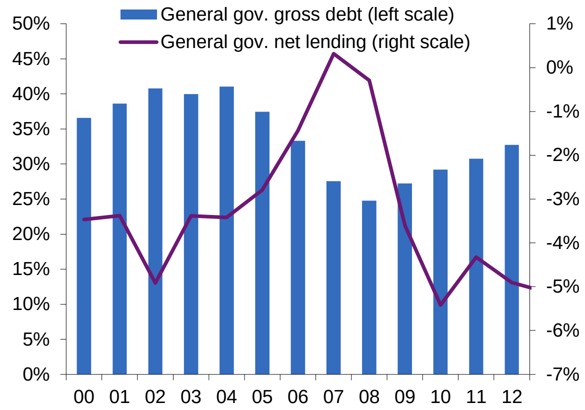
Without structural reform the deficit is likely to remain uncomfortably large and the public debt-GDP ratio will probably increase, albeit steadily and from currently moderate levels. Revenues are currently less than 14% of GDP. The public-debt GDP ratio measured by debt issued by the public sector was 51% in 2012, but if intra-public sector debt holdings, including those by the social security system, are netted out the ratio was 38%. The IMF puts general government debt slightly lower at 35%. The debt-GDP ratio increased in 2012, though this was partly pre-funding of the 2013 financing requirement.

Inflation rate (%)



Sources: IHS Global Insight, Euler Hermes

Fiscal balance and debt (% of GDP)



Sources: IHS Global Insight, Euler Hermes

External Sector

Large current account deficit but strong FDI flows

The current account deficit is large but in 2012 narrowed to -5.1% of GDP from -5.4% in 2011, as import growth moderated while export growth picked up slightly. Net service receipts also continued to strengthen.

The deficit is likely to narrow to -4.7% of GDP in 2013 and -4.4% in 2014, as export growth is likely to continue to outstrip that of imports as the US economy maintains momentum and net services continue to benefit from robust growth of tourism revenues.

Moreover, the current account deficit is 85% covered by strong FDI flows (equivalent to 5% of GDP annually on average since 2009) limiting the need to build up external debt rapidly.

Moderate external debt

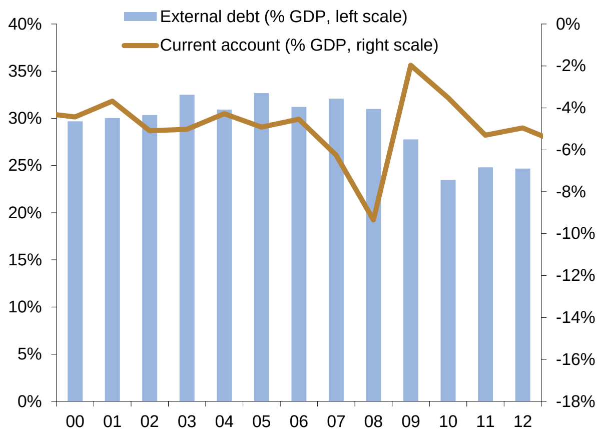
External debt is moderate. External debt is 32% of GDP, 84% of exports of goods and services and interest payments are 2.5% of exports of goods and services. Only 30% of total external debt is with the public sector. This proportion increased in 2012 with the issuance of US1bn eurobonds towards the end of the year and the government plans to issue more.

Foreign exchange reserves increase

Foreign exchange reserves have increased and cover a comfortable 4 months imports of goods and services and 175% of external debt falling due (including ST) in 2013. M2 as a proportion of FX reserves is also moderate.

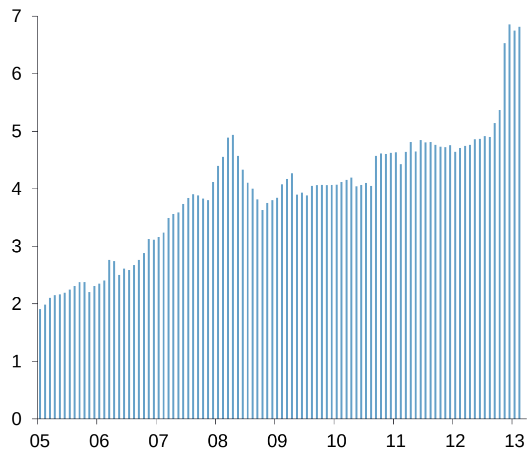
Overall, the external balance is relatively sound.

External debt (% of GDP)



Sources: IHS Global Insight, Euler Hermes

FX reserves (USDbn)



Sources: IHS Global Insight, Euler Hermes

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