Costa Rica

1. General trends

After three years of low growth, the Costa Rican economy showed an upturn in 2003. The macroeconomic context was stable, despite persistent domestic and external vulnerability that was mainly due to the chronic fiscal imbalance. Real gross domestic product (GDP) rose by 6.5% (5.7% excluding the high-technology sector), mainly on the strength of the considerable expansion in goods and services exports (12.5%) following their modest recovery in 2002. Growth in domestic demand (1.3%), on the other hand, slowed down for the second year in a row. Per capita national disposable income grew by only 2.4%, owing to the sharp increase (79.2%) in the repatriation of profits and dividends associated with foreign direct investment.

As a result of the Fiscal Contingency Act, adopted in December 2002, the narrowly defined non-financial public sector ran a deficit (3% of GDP) that was smaller than the one posted the previous year (4%). However, progress was limited to short-term adjustments, as the legislature deferred action on the Fiscal Covenant and Structural Fiscal Reform Act, which was to have been adopted in December. Higher capital inflows made it possible to finance the voluminous balance-of-payments current account deficit (5.5% of GDP) and to accumulate international monetary reserves. Real interest rates trended downward and the pace of devaluation (10.5%) was in keeping with the rate of inflation (9.9%), which has stayed practically constant in recent years.

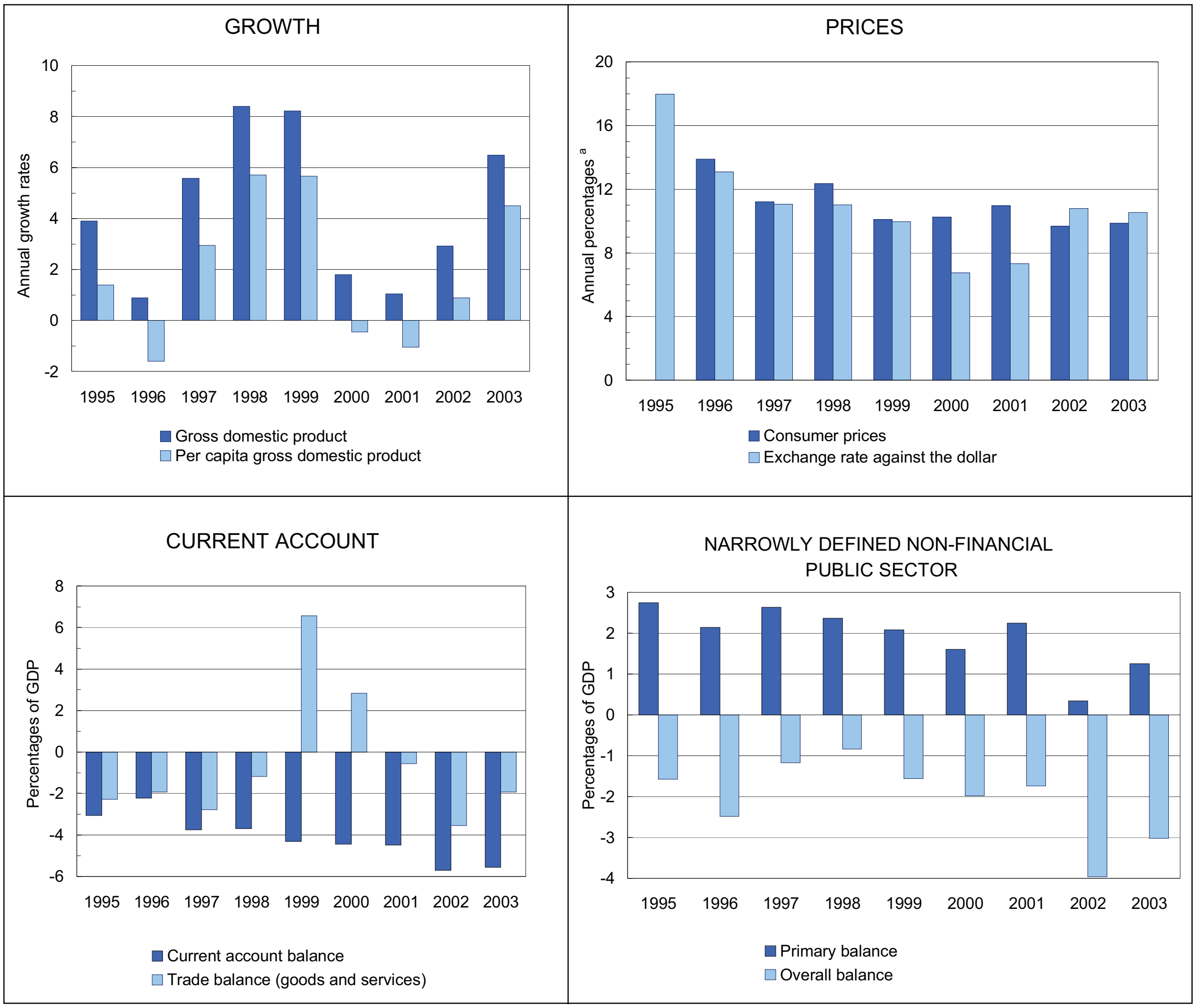
The revised monetary programme for 2004 estimates GDP growth of 3.9% and inflation of 11%. The public sector's consolidated deficit is expected to be similar to the one recorded in 2003, while the balance-of-payments current account deficit (as a percentage of GDP) should reach 5%.

2. Economic policy

Despite the positive results obtained in 2003, some indicators still reflect the fragility of the country's achievements in terms of macroeconomic stability.

The chronic imbalance in public finances is one of the factors behind Costa Rica's high interest rates (compared to international rates), which encourage inflows of speculative capital and raise the cost of open-market operations, thereby reducing the effectiveness of monetary policy. Total borrowing by the public sector (including the central bank), which exceeds 60% of GDP, constitutes a considerable burden on public finances and an obstacle to the authorities' efforts to

Figure 1
COSTA RICA: MAIN ECONOMIC INDICATORS



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] December-December variation.

improve the country-risk rating and reduce the cost of issuing bonds on international markets.

One of the main sources of monetary imbalance is the debt of the central bank. To contain the growth of liquidity, the central bank has been paying the interest on its stabilization bonds by issuing new debt, and this process generates a snowball effect. The only long-term solution, which would also curb inflation, is government capitalization of the issuing authority. Moreover, the effectiveness of monetary policy continues to be eroded by the economy's growing dollarization. This is because the central bank's influence extends only to local-currency liquidity, which represents just over half of the means of payment. The dollarization of loan portfolios (57%) and the increase in dollar loans to customers with no foreign-exchange income are also matters of concern.

As in 2003, economic policy in 2004 has continued to give priority to controlling inflation and to reducing the fiscal imbalance and the balance-of-payments current account deficit.

(a) Fiscal policy

The fiscal outcome for 2004 will depend on whether the Legislative Assembly adopts the structural reform measures currently under discussion. The government has announced that, failing the reform's adoption, it will cut spending in order to keep the fiscal gap at a level similar to the one observed in 2003. If the reform is adopted, the government deficit will probably amount to about 2% of GDP and the consolidated deficit, to 2.8%. The proposed law includes reforms whereby individuals would be taxed on their total worldwide income, all enterprises (both within and outside free-trade zones) would be taxed at a standard rate and the general sales tax would be turned into a value added tax.

In 2003 the tax measures adopted and the containment of public spending enabled the authorities to narrow the fiscal gap, particularly the central government deficit.

The narrowly defined non-financial public sector saw its deficit fall from 4% to 3% of GDP. The central government deficit (2.9% of GDP) was smaller than the figure initially predicted (3.1%) thanks to the positive effects of the fiscal contingency plan and a reduction in spending. The performance of revenue and expenditure also led to an increase in the primary surplus, which reached 1.4% of GDP. This substantially reduced the need for the Ministry of Finance to seek resources from the domestic financial system, especially through auctions. On the other hand, the surplus posted by the rest of the non-financial public sector (0.3% of GDP) fell short of the expected level (1.2%). This is mainly because the Costa Rican Electricity Institute ran a deficit and the Costa Rican Social Security Fund ran a smaller surplus, in both cases because of higher investment outlays.

At the same time, the central bank's deficit widened slightly (to 1.6% of GDP) owing to the increased need for monetary absorption in the wake of the unexpected rise in international reserves and the need to sterilize the monetization of the US$ 450 million in bonds that the government had issued on external markets early in the year. Of this amount, US$ 200 million was used to pay off a previous bond issue.

Total public debt increased from 59.7% of GDP in 2002 to 60.7% in 2003, with domestic debt again accounting for the larger share (64.7% of total debt). In 2003 the government and the central bank took steps to replace some financial instruments with fixed-interest-rate bonds as part of a strategy for reducing the cost of debt refinancing.

Although revenues were up by 17.7% in the period January-April 2004, the central government's fiscal deficit was 31.4% higher than it had been in the same period of 2003. This was a result of a sharp upturn in spending (20%) due mainly to higher interest payments on the public debt (34.7%). Interest on the domestic debt swelled by 36.6% and interest on the external debt, by 27%. It is worth mentioning, however, that the primary surplus grew by 39.2%.

(b) Monetary policy

In 2004 monetary policy has sought to create conditions that are consistent with annual inflation of 11% and a smaller deficit on the current account of the balance of payments (5% of GDP). The central bank's chief instrument for achieving domestic stability has been open market operations, specifically monetary stabilization bonds and short-term investments, since the legal minimum reserve requirement has remained largely unchanged. Efforts to achieve external stability have consisted primarily of setting a nominal exchange rate compatible with the real equilibrium exchange rate.

Starting in mid-March investors became increasingly skittish as Costa Rican sovereign bond prices fell in response to growing expectations of higher interest rates in the United States. The consequent decline in returns on investment and pension funds prompted many investors to transfer their resources to current and savings accounts and to time deposits and certificates of deposit. The funds' bond prices and assets then plummeted and interest rates rose. For the first time ever, the central bank bought back its own bonds in May with a view to pumping more liquidity into the financial market, thus stemming the outflow of resources from investment funds and stabilizing interest rates. While this move had the desired result, the bond repurchase could lead to a short-term spurt in inflation.

In the first half of 2004 monetary and exchange-rate policy were implemented as originally programmed. However, given the worsening domestic and external imbalances (increases in inflation and in the balance-of-payments current account deficit) and the scant room for manoeuvre available to fiscal policy, the central bank tightened monetary policy at the end of July. Most importantly, it decided to raise the short-term interest rate (from 12.65% to 13.15%), increase the legal minimum reserve requirement by two percentage points (one point in September and one point in October), speed up the devaluation rate (from 15 to 17 céntimos per day) and engage more actively in open market operations.

In 2003 monetary policy was aimed primarily at preserving the gains made in previous years in terms of macroeconomic stability. In the first quarter the central bank gradually raised the legal minimum reserve requirement from 5% to 10%, thereby decreasing the amount of resources that banks could use for loans and helping to reduce their losses as a result of interest payments on monetary stabilization bonds. The central bank also decided to lower the benchmark interest rates it offers on its bonds. Accordingly, the basic deposit rate (which is the market reference rate) dropped from 17.5% to 13.75%.

Table 1
COSTA RICA: MAIN ECONOMIC INDICATORS

	1995	1996	1997	1998	1999	2000	2001	2002	2003[a]
				Annual growth rates [b]					
Gross domestic product	3.9	0.9	5.6	8.4	8.2	1.8	1.0	2.9	6.5
Per capita gross domestic product	1.4	-1.6	2.9	5.7	5.7	-0.5	-1.0	0.9	4.5
Gross domestic product, by sector									
Agriculture, livestock, hunting, forestry and fishing	7.3	1.8	1.5	8.2	4.5	0.7	1.4	-2.5	7.4
Mining	-3.8	-4.7	13.0	9.2	-6.1	6.3	6.3	-1.8	5.5
Manufacturing	4.1	0.5	7.7	11.4	24.7	-2.9	-9.1	3.4	8.7
Electricity, gas and water	3.1	2.6	5.6	8.7	6.2	6.4	4.1	5.3	5.8
Construction	7.6	-17.9	6.1	17.4	-1.6	4.4	14.4	-1.5	6.2
Wholesale and retail commerce, restaurants and hotels	3.5	-0.6	6.1	8.5	2.4	1.5	1.9	1.3	3.6
Transport, storage and communications	7.3	4.8	9.9	8.1	6.9	10.2	8.9	11.8	11.7
Financial institutions, insurance, real estate and business services	2.4	2.1	4.8	4.7	7.6	8.1	6.7	4.6	6.8
Community, social and personal services	2.1	1.4	2.6	4.6	3.0	2.6	2.0	3.4	3.3
Gross domestic product, by type of expenditure									
Consumption	2.8	2.0	5.1	5.0	2.1	1.1	1.4	3.1	2.5
General government	-0.3	-0.6	4.6	2.2	1.8	1.4	3.6	2.1	-0.2
Private	3.3	2.4	5.1	5.4	2.2	1.0	1.1	3.2	2.9
Gross domestic investment	-5.4	-10.4	24.9	26.3	-15.6	-1.5	31.4	7.2	-2.6
Exports (goods and services)	11.1	6.2	8.6	26.7	21.3	-0.3	-9.8	4.2	12.5
Imports (goods and services)	2.9	2.7	14.7	25.2	0.4	-2.6	1.1	6.3	1.7
				Percentages of GDP					
Investment and saving [c]									
Gross domestic investment	18.2	16.0	18.1	20.5	17.1	17.0	20.4	22.2	20.2
National saving	14.6	12.4	13.3	15.3	12.0	12.5	13.3	14.0	15.0
External saving	3.6	3.5	4.8	5.3	5.2	4.5	7.1	8.3	5.3
				Millions of dollars					
Balance of payments									
Current account balance	-358	-264	-481	-521	-680	-707	-737	-960	-970
Merchandise trade balance	-323	-249	-498	-399	581	-211	-820	-1 275	-1 114
Exports, f.o.b.	3 482	3 774	4 221	5 538	6 577	5 813	4 923	5 259	6 132
Imports, f.o.b.	3 804	4 023	4 718	5 937	5 996	6 025	5 743	6 535	7 245
Services trade balance	56	20	140	234	459	665	728	679	777
Income balance	-226	-184	-249	-469	-1 822	-1 252	-793	-532	-830
Net current transfers	134	149	126	113	102	92	148	169	197
Capital and financial balance [d]	574	194	288	16	781	83	750	1 123	1 311
Net foreign direct investment	331	421	404	608	615	400	445	628	540
Financial capital [e]	243	-227	-116	-592	167	-317	305	494	771
Overall balance	216	-69	-193	-504	101	-623	13	163	341
Variation in reserve assets [f]	-179	77	-216	150	-481	152	-13	-163	-341
Other financing [g]	-37	-8	409	355	380	471	0	0	0
Other external-sector indicators									
Real effective exchange rate (index: 2000=100) [h]	99.7	100.3	100.7	99.3	101.4	100.0	97.7	99.3	105.1
Terms of trade for goods (index: 1997=100)	99.4	94.3	100.0	103.2	102.2	95.2	93.9	92.5	91.1
Net resource transfer (% of GDP)	2.7	0.0	3.5	-0.7	-4.2	-4.4	-0.3	3.5	2.7
Total gross external debt (millions of dollars)	3 259	2 859	2 640	2 872	3 057	3 151	3 243	3 338	3 753
Total gross external debt (% of GDP)	27.8	24.1	20.6	20.4	19.3	19.8	19.8	19.8	21.5
Net profits and interest (% of exports) [i]	-5.1	-3.9	-4.8	-6.7	-21.9	-15.9	-11.3	-7.2	-10.0

Table 1 (concluded)

	1995	1996	1997	1998	1999	2000	2001	2002	2003[a]
					Percentages				
Employment									
Labour force participation rate [j]	53.9	52.2	53.8	55.3	54.8	53.6	55.8	55.4	55.5
Open unemployment rate [k]	5.2	6.2	5.7	5.6	6.0	5.2	6.1	6.4	6.7
Visible underemployment rate [k]	10.0	12.0	11.0	11.7	12.0	9.7	9.5	11.2	13.2
					Annual percentages				
Prices									
Variation in consumer prices (December-December)	…	13.9	11.2	12.4	10.1	10.2	11.0	9.7	9.9
Variation in nominal exchange rate (December-December)	18.0	13.1	11.1	11.0	10.0	6.8	7.3	10.8	10.5
Variation in average real wage	-1.9	-2.1	0.8	5.6	4.7	0.8	1.0	4.0	0.4
Nominal deposit rate [l]	…	…	12.7	13.9	14.6	12.9	11.3	11.6	10.9
Nominal lending rate [m]	…	…	22.7	24.5	26.0	24.0	22.2	24.2	23.4
					Percentages of GDP				
Narrowly defined non-financial public sector									
Current income	22.0	22.2	22.5	22.3	19.7	21.5	23.0	22.9	22.6
Current expenditure	20.0	20.8	19.5	19.0	17.5	19.5	21.0	22.3	21.6
Current balance	2.1	1.4	3.1	3.3	2.2	2.0	2.0	0.6	1.1
Net capital expenditure	3.6	3.9	4.2	4.2	3.7	3.9	3.7	4.5	4.0
Primary balance	2.7	2.1	2.6	2.4	2.1	1.6	2.2	0.3	1.2
Overall balance	-1.6	-2.5	-1.2	-0.8	-1.6	-2.0	-1.7	-4.0	-3.0
Public debt of the central government	26.4	31.3	28.6	37.4	33.7	35.4	37.2	38.8	38.1
Domestic	15.8	22.7	21.2	29.8	25.5	25.6	26.7	27.2	25.7
External	10.6	8.7	7.5	7.7	8.2	9.8	10.5	11.6	12.5
Interest payments (% of current income)	19.6	20.9	16.9	14.3	18.5	16.6	17.3	18.8	18.9
Money and credit [n]									
Domestic credit [o]	10.4	14.9	15.5	18.1	19.0	24.3	28.0	32.1	34.3
To the public sector	0.7	3.1	3.1	3.1	2.4	3.4	4.3	5.0	6.0
To the private sector	9.8	11.8	12.4	15.0	16.6	20.9	23.7	27.1	28.3
Liquidity (M3)	27.9	30.5	29.7	30.9	30.1	33.3	33.4	35.5	36.9
Money stock and local-currency deposits (M2)	18.4	20.4	19.0	18.5	17.8	19.7	18.5	19.2	19.9
Foreign-currency deposits	9.5	10.1	10.6	12.4	12.3	13.6	14.9	16.3	17.0

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] Preliminary figures. [b] Based on figures in local currency at constant 1991 prices. [c] Based on figures in local currency at current prices. [d] Includes errors and omissions. [e] Refers to the capital and financial balance (including errors and omissions), minus net foreign direct investment. [f] A minus sign (-) denotes an increase in reserves. [g] Includes the use of IMF credit and loans and exceptional financing. [h] Annual average, weighted by the value of merchandise exports and imports. [i] Refers to net investment income as a percentage of exports of goods and services as shown on the balance of payments. [j] Economically active population as a percentage of the working-age population, nationwide total. [k] Percentages of the economically active population, nationwide total. [l] 90-day deposits at the four State-owned commercial banks. [m] Rate on loans to the agricultural sector from the four State-owned commercial banks. [n] The monetary figures are annual averages. [o] Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions.

To reduce the risk associated with short-term refinancing, the central bank issued fixed-rate medium-term (two-, three- and five-year) bonds as its primary instrument for mopping up excess liquidity. By the end of the year these bonds accounted for 30% of all monetary stabilization bonds. In the interest of better liability management, the central bank took out a loan from the Latin American Reserve Fund to make prepayments on its series A Brady bonds; this operation was carried out in the third quarter. At the end of 2003 the central bank issued fixed-term certificates of deposit in dollars so that it could make prepayments on all of its series B Brady bonds (which it proceeded to do in early 2004). These operations resulted in better financing conditions for the country's foreign-currency debt.

Owing to the prudent management of fiscal and monetary policy, credit and liquidity grew moderately, interest rates tended to decline, inflation rose in line with forecasts and the local currency depreciated slightly in real terms.

Table 2
COSTA RICA: MAIN QUARTERLY INDICATORS

	2002				2003[a]				2004[a]	
	I	II	III	IV	I	II	III	IV	I	II
Gross domestic product (variation from same quarter of preceding year) [b]	0.8	3.1	3.8	4.0	7.0	5.8	6.7	6.4	3.0	...
Merchandise exports, f.o.b. (millions of dollars)	1 219	1 365	1 343	1 325	1 530	1 648	1 500	1 425	1 580	...
Merchandise imports, c.i.f. (millions of dollars)	1 701	1 920	1 777	1 791	1 939	1 887	1 908	1 908	2 015	...
International reserves (millions of dollars)	1 490	1 452	1 402	1 497	1 790	1 688	1 596	1 836	1 746	1 634
Real effective exchange rate (index: 2000=100) [c]	97.1	99.6	100.0	100.7	102.8	104.8	105.9	107.1	107.5	107.7
Consumer prices (12-month percentage variation)	8.9	8.1	9.2	9.7	9.4	10.2	8.4	9.9	11.3	11.9
Average nominal exchange rate (colones per dollar)	346	355	364	374	383	393	403	413	424	433
Nominal interest rates (annualized percentages)										
Deposit rate [d]	16.4	17.2	17.5	17.5	17.3	16.4	15.1	14.0	13.6	13.5
Lending rate [e]	21.9	24.9	25.0	25.2	24.0	25.7	22.7	21.4	21.0	20.9
Interbank interest rate [f]	11.4	11.8	11.7	11.6	11.5	11.1	10.6	10.2	10.1	10.0
Domestic credit (variation from same quarter of preceding year) [g]	26.8	27.2	33.9	26.5	21.9	23.7	20.0	20.5	19.9	30.3[h]
Non-performing loans as a percentage of total loans [i]	2.5	2.6	2.7	3.0	2.2	2.0	2.0	1.7	1.6	1.7

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] Preliminary figures. [b] Based on figures in local currency at constant 1991 prices. [c] Quarterly average, weighted by the value of merchandise exports and imports. [d] 30-day deposits at the four State-owned commercial banks. [e] Average rate for State and private bank lending. [f] Benchmark rate for 6-month open-market operations. [g] Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions. [h] Data up to May. [i] Refers to total credit extended by the banking system.

(c) Exchange-rate policy

The rate of adjustment of the colón's nominal exchange rate against the dollar was maintained at 15 céntimos per day in 2003, which reduced the annual rate of nominal devaluation from 10.8% to 10.5% and resulted in another real depreciation (3.5%). In 2004 the authorities continued to implement the policy of daily mini-devaluations based on the expected difference between domestic inflation and inflation in Costa Rica's main trading partners. However, the moderate slackening of the colón's year-on-year nominal depreciation against the dollar, observed since April 2003, and the increase in prices began to affect the real exchange rate, which appreciated by 1.7% in the first four months of 2004. This contributed to the increase in the trade deficit over that period (14.3%).

(d) Other policies

In January 2004 Costa Rica concluded its negotiations with the United States to join the other Central American countries as a party to the United States-Central American Free Trade Agreement (CAFTA). This agreement is expected to confer considerable benefits, particularly in the form of stronger legal guarantees of access to the United States market for Costa Rican products and increased direct investment (from the United States and elsewhere) in domestic activity and in the export assembly industry. The treaty includes exemptions and safeguards for certain sensitive products and services and provides generous time frames for trade liberalization and tariff rollbacks to allow Costa Rican producers, particularly small and medium-sized enterprises, to upgrade their competitiveness before the agreement's provisions enter into force. In March 2004 Costa Rica signed a free trade agreement with the countries members of the Caribbean Community (CARICOM).

3. The main variables

(a) Economic activity

The robust growth of GDP (6.5%) was based on a surge in goods and services exports (12.5%) that offset the sluggish growth of domestic demand (1.3%). Gross fixed capital formation climbed considerably (9.5%), boosted by public investment in telecommunications and energy and by public and private investment in new construction. Nevertheless, inventory accumulation slumped as stocks were drawn down and the high-technology sector reduced its raw materials imports. Added to this was a decline in general government consumption (-0.2%) and a smaller increase in private consumption (2.9%) caused by employment and wage trends.

The most buoyant sectors were manufacturing (owing to the performance of free-trade-zone firms, including high-technology firms), construction, transport and telecommunications (particularly mobile telephones and Internet service), as well as agriculture and international tourism. Special mention should be made of the recovery of agriculture (7.4%), which bounced back from its 2.5% downturn in 2002 mainly because of increased exports of non-traditional products, particularly pineapples, melons and flowers and foliage. Also contributing to this upturn, albeit to a lesser degree, were increases in milk, fruit and vegetable production and in banana and coffee exports.

Year-on-year measurements of economic activity (monthly index of economic activity calculated on the basis of trend-cycle series) show growth rates of between 5% and 7% throughout 2003. However, growth measured in terms of month-to-month variations slowed down starting in May 2003 and dropped off even more sharply in the first two months of 2004. Even if the electronics industry is excluded, a deceleration can still be observed as a result of a smaller increase in exports, particularly high-technology products. In a significant development, in 2004 Componentes Intel de Costa Rica S.A. opened a manufacturing plant to produce chipsets, sales of which are expected to make up for the decline in exports in the first quarter as a result of a strategic decision to lower product prices. Between March and May 2004 the economic growth rate picked up speed.

(b) Prices, wages and employment

Inflation, measured according to the consumer price index (CPI), stood at 9.9% in 2003, thus meeting the target set in the monetary programme (10%). One contributing factor in this regard was the low price of certain imports, especially capital goods. This partly offset the inflationary pressures generated by increases in the price of hydrocarbons (particularly at the beginning of the year), in public utility rates and in the devaluation rate and by the large fiscal deficit.

Inflation shot up in 2004. The cumulative price increase of 6.3% up to June was far higher than the 4.3% recorded the preceding year. This was mainly due to the sharp rise in international oil prices (which affected fuel and transport prices), the hike in regulated public utility rates and higher prices for certain agricultural products. In view of this pattern, the inflation target for the year was revised upward in June from 9% to 11%.

The generation of employment kept pace with the increase in the working-age population. Nonetheless, a slight increase in the labour-force participation rate pushed up the rate of open unemployment from 6.4% to 6.7%. At the same time, average real income was up by 0.4%, while the real minimum wage was down by 0.4%. The minimum wage increases of 4.72% in the private sector and 3.5% in the public sector, agreed upon in October and December for implementation in the first half of 2004, were cancelled out by the increase in inflation.

(c) The external sector

The balance-of-payments current account deficit (5.5% of GDP) was similar to its level of 2002, since the net outflow of investment income as a result of the large-scale repatriation of profits and dividends linked to foreign direct investment offset a smaller trade deficit and a larger surplus on the services and transfer accounts. The smaller trade deficit bore witness to the buoyancy of merchandise exports (16.6%), as imports increased by 10.9%. Larger inflows of external resources financed the current account deficit and contributed to the US$ 341.3 million increase in international monetary reserves. At US$ 540 million, foreign direct investment inflows were equivalent to 3.1% of GDP and to 55.7% of the current account deficit, although they were down with respect to the preceding year's figure.

Export performance was driven mainly by non-traditional products (87% of total exports) such as microprocessors produced by the Intel plant and sales of medical equipment and pharmaceuticals (33% of the country's exports). These were in addition to agricultural products such as coffee, bananas, pineapples, melons, plants, flowers and foliage. The growth of imports was concentrated in raw materials, fuels and lubricants, construction materials and capital goods, given the decline in purchases of consumer goods.