Economic Alert iQ

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Costa Rica downgraded by S&P to B+ with a negative outlook

- On 21 December 2018, Standard and Poor's Rating Agency lowered its long-term foreign and local currency sovereign rating on Costa Rica from BB- to B+ with a negative outlook.
- According to S&P, the country's general government fiscal deficit will hover around 5%-6% of GDP in the next two years despite the recent approval of fiscal reform, contributing to a steady increase in its debt burden. In addition, external vulnerabilities are exacerbated by a high debt burden, poor debt management, a rising share of government debt denominated in foreign currency, and a persistently high level of dollarization in the financial sector.
- The fragmented nature of Costa Rica's congress makes fiscal reform very difficult. Despite the recent passage of the fiscal reform bills it highlights the slow pace of reform in the country in a system which allows even small numbers of opponents in Congress the ability to stall approval. The recent fiscal reform was an important step toward addressing the country's large fiscal deficit, but it may not be sufficient to stabilize the steady growth of

the sovereign's debt burden. However, further reforms to control the growth of spending, especially the public-sector wage bill, are likely to be difficult to implement.

- GDP growth is forecasted to decelerate to 2.6% in 2018 due to a slowdown in internal demand that was affected by the rise in interest rates and uncertainty about the approval of the fiscal reform. Over the next three years, GDP growth is projected to average marginally above 3% with GDP per capita growth below 2%.
- Costa Rica's central government fiscal deficit is forecasted at 6.7% of GDP in 2018. S&P projects that the fiscal reform, which introduces a value-added tax (VAT) and other taxes along with measures to control expenditures, will lead to a reduction in the general government deficit towards 4.6% of GDP by 2021(compared with the pre-reform scenario), which is not enough to stabilize the debt burden.
- Consistently high fiscal deficits (above 5% of GDP) over the past few years have significantly increased Costa Rica's debt burden and interest payments. In 2018, the net general government debt is forecasted at 52% of GDP, (27% - 2010), while interest payment will reach 14% of the general government revenues, up from 8.3%.
- In the absence of further reform the debt burden is expected to reach near 60% of GDP by 2021.
- Government debt that is denominated in foreign currency has been rising. It now accounts for more than 40% of general government debt and creates another source of vulnerability. Any abrupt change in the exchange rate could boost the sovereign's interest payments and debt burden.
- Costa Rica's high dollarization also constrains monetary policy. An unexpectedly sharp change in the exchange rate could create asset quality problems in the financial system. Dollarization also limits the central bank's ability to act as a lender of last resort.
- Costa Rica is rated BB (Negative) by Fitch and B1 (Negative) by Moody's.

Costa Rica's Key Economic Indicators

	2016	2017	2018	2019	2020
Real GDP (percent change)	*4.2%*	*3.3%*	*2.6%*	*3.0%*	*3.2%*
Central Government deficit	*-4.8%*	*-5.5%*	*-6.7%*	*-5.9%*	*-5.4%*
Debt as a % of GDP	*47.0%*	*49.3%*	*53.6%*	*56.8%*	*59.3%*
Consumer prices	*0.8%*	*2.6%*	*3% ± 1*	*3% ± 1*	*3% ± 1*
Current Account Balance (Percent of GDP)	*-2.2%*	*-2.9%*	*-3.9%*	*-4.7%*	*-4.8%*

Source: S&P, First Citizens Research & Analytics

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