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INVESTOR UPDATE

MARCH, 2019

COSTA RICA—"SOVEREIGN DOWNGRADED DUE TO HIGH DEBT BURDEN, POOR DEBT MANAGEMENT & HIGH LEVEL OF DOLLARIZATION"

OVERVIEW

On December 21, 2018, Standard & Poor's downgraded Costa Rica from "BB-" to "B+" on concerns of a persistently high fiscal deficit, poor debt management, an increasing share of debt denominated in hard currency and a consistently high level of dollarization in the financial sector. The rating agency's ongoing concern is further underlined by the maintenance of its negative outlook which indicates a 33% chance of another downgrade in the next 6 to 24 months.

Costa Rica has long been warned by the rating agencies of their concern regarding long term fiscal stability (see our write-up on April-17-2017…. "Congress' Inability To Reach Consensus Continues To Hurt Credit Quality"). Between 2013 and 2017 the sovereign's fiscal deficit averaged in excess of 5% of GDP with estimates for 2018 suggesting that the deficit could climb to a 10-year high of 6.7% of GDP. The near term forecast is also a concern with the deficit projected to hover between 5.4 and 5.9 percent over the next two years despite recent tax reform being passed in Congress.

Luckily, **Costa Rica has a dynamic and diversified economy** which has registered growth, on average, of approximately 3.8% between 2011 and 2017. This relatively strong growth has helped to somewhat contain the debt to GDP ratio. Growth, however, is estimated to have cooled to a modest 2.6% in 2018 though the near term forecast (3-years) suggests a recovery of between 3.0 and 3.5 per cent.

Despite the strong growth however, the debt ratios have deteriorated with debt/GDP climbing from 31.6% in 2011 to 49.3% in 2017. Estimates for 2018 suggest that the debt/GDP ratio will climb to 53.6% with forecasts suggesting that by 2021 the debt/GDP ratio could double (60.7%) compared to 2011 numbers. Rising debt has brought with it a rising debt burden; interest payments to government revenues (immediate cash flow needs) have climbed from 8.5% in 2011 to an estimated 14.1% in 2018. The forecast however, suggests that by 2021 the interest burden will decline to 13.1%.

CONCLUSION

In recent times Costa Rica has passed long overdue tax reform. However, there is implementation risk and anticipated difficulties if additional reform is needed to contain the deficit. This has potential negative implications for the rising debt and the burgeoning interest burden. The domestic private sector has also weighed in, preferring to hold hard currency in their individual portfolios (dollarization) and increasing the government's risk/vulnerability to shocks by demanding more sovereign debt denominated in USD.

THE MEDIUM TERM OUTLOOK

Recent Rating History- S&P rates Costa Rica at "B+/Negative", FITCH has them at BB/Stable while Moody's has them at B1/Negative for a Composite rating of B+. Both S&P and Moody's downgraded Costa Rica in December-2018 while FITCH acted in early 2017. The negative outlook from the top two rating agencies is a concern and suggests that further downward revisions may be on the horizon despite the recent tax reform. The view is that while the tax reform is welcome, it has been strongly recommended for at least the last three years. The time taken to pass the legislation is a concern further compounded by the fact that more tax reform may be needed.

Stable Political System- despite a poor track record of implementing reforms to public finances, Costa Rica has a stable political system and higher social indicators than its rating peers. Policy continuity, the smooth transition of power by peaceful means and a low crime rate compared to its Central American peers are enviable factors.

President Alvaro from the PAC party is expected to maintain policy continuity, however the PAC only has a total of 10 seats out of the 57 in Congress. This limits their ability to push through vital legislation. As noted earlier, fiscal reform has recently been passed, but the two previous administrations were unsuccessful in passing similar legislation. The fragmented decision-making process which allows even small minorities in Congress to stall legislation contributes heavily to the slow pace of vital reforms. Congress has not voted to approve the issuance of external debt since 2016, forcing the issuance of debt in the domestic market which at times limits debt management flexibility.

The recent fiscal reform is welcomed but it is considered insufficient to stabilize the ballooning debt. Consequently more reforms are needed to contain the fiscal deficit via control of the public sector wage bill. The passage of any bill to control wages however, is likely to be difficult given Congress' track record.

If the owners of capital are aware of the difficulties in passing legislation, especially as it relates to the issuance of external debt, they can hold out/demand higher interest rates/compensation for their capital. Rising interest rates increases the cost of capital to entrepreneurs, has the effect of slowing domestic demand and consequently economic growth. Growth is estimated to have decelerated to 2.6% in 2018 from 4.2% in 2016 due to the prevailing economic environment.

Over the medium term (3-years) growth is projected to average a relatively modest 3%. Higher domestic interest rates, slow credit growth, sluggish private consumption and investment combined with a large budget deficit will limit both private and government investments. Costa Rica's physical infrastructure also needs investment which is restraining the sovereign's overall economic expansion.

Despite the anticipated challenges, FDI inflows, strong commodity exports (banana, coffee, beef & sugar), eco-tourism, digital technology and value added exports such as medical devices all contribute to diversified growth. Costa Rica has a highly educated population, political stability as well as attractive incentives offered in free trade zones. The US-Central America and Dominican Republic Free trade zone (DR-CAFTA), which begun in 2009, helped to drive FDI inflows into key sectors like insurance and telecommunications.

Costa Rica, unlike most of Central America, is not highly dependent on remittances which generally represents only about 1% of GDP; the sovereign is however, highly dependent on FDI inflows which accounts for approximately 5% of GDP.

Costa Rica's poor debt management and high fiscal deficits translated into liquidity pressure over the last quarter of 2018. The government was forced to borrow a short-term loan of US$859 million from the central bank in September-2018. This raised concerns regarding access to liquidity.

The recent VAT (Value-added tax) plus other taxes and expenditure controls are projected to reduce the general government deficit by 2% of GDP in total over the next three years. This however is not enough to stabilize the debt burden with the fiscal deficit projected to decline towards 4.6% of GDP in 2021. This would push the debt/GDP ratio to 60.7% and the debt burden (interest/revenue) to 13.1% of government revenues.

From an External Account perspective, Costa Rica has historically run a current account (C/A) deficit between three and five percent of GDP over the last decade. The gap on the current account is closed by a surplus on the capital and financial account due primarily to strong FDI inflows. Going forward the medium term forecast is for the C/A deficit to widen from 2.2% in 2016 to in excess of 4.4% between 2018 and 2021. Higher interest rates on external debt is projected as higher US FED rates combined with domestic economic volatility due to debt, fiscal, and a consequent rating downgrade impacts the income account of the BOP (Balance of Payments).

The external vulnerability indicator, which is a measure of gross external financing needs to current account receipts (CAR) plus usable reserves, is projected to widen from 98.7% in 2016 to 117.3% by 2021. As noted before, higher external interest rates driven by fiscal volatility is projected to negatively impact the numbers.

Costa Rica's external vulnerability is further negatively impacted by the rising share of government debt denominated in foreign currency and the high level of domestic dollarization. Estimates suggest that 40% of government debt is denominated in USD which means that as exchange rate pressures increase the nominal amount of Colon (official currency of Costa Rica) required increases. This, in turn, increases the cash payments and consequently the interest and debt burden. **The average depreciation between 2012 and 2017 was 1.8%, however the forecast suggests depreciation per year of 5.7% between 2018 and 2021**.

High dollarization by the private sector further increases the interest burden and constrains monetary policy by limiting the central bank's capacity to act as lender of last resort. Dollar denominated loans are about 40% of total as at October-2018. Further, because the central bank has a managed float system, each time that the dollar devalues the bank pulls down on its net international reserves and increases interest rates. This policy move in turn deteriorates the debt and raises the interest burden as a second round effect. *Costa Rica's usable reserves have declined from a high of US$7.83 billion in 2016 to an estimated US$7.0 billion in 2018*. The forecast however is for usable reserves to decline to US$5.0 billion by 2021.

Given the economic slowdown being experienced by the sovereign it is no surprise that the non-performing loan rate has climbed. Higher interest rates, the depreciation of the Colon in a highly dollarized environment still characterized by a persistently high unemployment (9.5%) has resulted in an increase in non-performing loans (NPL) to 2.7% as at September-2018 from 1.9% in December-2017. The forecast is for NPL's to rise to as high as 3.5% in 2019.

USD denominated loans are about 40% of total loans to the private sector with some borrowers having an asset liability mismatch which leaves them without a hedge. This acts as a risk factor especially when taken within the context of a depreciating dollar. The *asset quality of the banking system* could consequently experience moderate erosion as a result of the prevailing economic conditions.

IN SUMMARY

The current economic performance and the outlook for the fundamentals suggest caution. A lot hinges on the ability of the fragmented Congress to reach consensus on key issues, in particular the clear need for increased taxes to stem the tide of rising fiscal deficits and deteriorating debt. The recently introduced VAT is a positive and is projected to reduce the general government deficit by 2% of GDP in total over the next three years. This would however still push the debt/GDP ratio to 60.7% by 2021; this represents an almost doubling of this key ratio compared to a modest 31.6% in 2011.

That said, Costa Rica remains one of the most economically diverse sovereigns in Central America. Impressive growth over the decades has stymied the growth rate of the debt/GDP ratio. Growth is one of the important factors maintaining the rating and in the event that fiscal reform comes in place, economic growth quickly improves the debt ratios.

Costa Rica also has the added benefit of relative insulation from the volatility of oil prices. *Approximately 64% of Costa Rica's installed electricity capacity comes from hydroelectric plants while another 18% comes from other renewable sources*. Remarkably, the sovereign has limited to zero importation of crude oil.

Our recommendation, based on the fundamentals, is UNDERWEIGHT at this time.

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APPENDIX

IMPORTANT DISCLOSURES

ABSTRACT— As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation DEFINITIONS/ RECOMMENDATIONS.

PLEASE NOTE THAT NO INDIVIDUAL ASSET IN YOUR PORTFOLIO SHOULD HAVE A WEIGHTING GREATER THAN 5% UNLESS OTHERWISE RECOMMENDED BY YOUR PORTFOLIO MANAGER OR A SPECIFIC JMMB RESEARCH REPORT. CONSEQUENTLY THE FOLLOWING **DEFINITIONS** ARE PROVIDED FOR CLARITY.

UNDERWEIGHT -
REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 5% FOR THIS PARTICULAR ASSET

SELL -
REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.

HOLD/MARKET WEIGHT -
EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB.

OVERWEIGHT/BUY -
EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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