COSTA RICA — "Solid Revenues & Expenditure Restraint"

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SYNOPSIS

Costa Rica is a Central American country with a relatively high standard of living. There is a high level of political stability with smooth transfer of political power after elections. The country has long-standing democratic traditions characterized by checks and balances on political power and a history of arresting corrupt political leaders. Costa Rica also has a well-developed social benefits system which sets it apart from its immediate neighbors Nicaragua, Honduras and Guatemala. Within Central America, only Panama has similar social and economic indicators. The sovereign consistently spends approximately 20% of its GDP annually towards key development goals such as universal access to education, healthcare, access to potable water, reduced poverty and access to electricity.

Table 1

Costa Rica Commodities Trade	
Major Exports	*medical instruments, bananas, pineapples, orthopedic appliances, food preparations (2021 est.)*
Major Export Partners	*United States 38%, Netherlands 6%, Belgium 5%, Guatemala 5%, Panama 5% (2019 est.)*
Major Imports	*refined petroleum, broadcasting equipment, cars, medical instruments, packaged medicines (2019 est.)*
Major Import Partnets	*United States 41%, China 13%, Mexico 7% (2019 est.)*

Source: www.cia.gov/the-world-factbook

On the economic side, **Costa Rica is a trade-based upper-middle income country with per capita GDP of approximately US$21,200** and total GDP output valued at US$109.26 billion (2021 est.). Costa Rica is a part of the DR-CAFTA or Dominican Republic & Central America Free Trade Area. The DR-CAFTA is a free trade agreement between the United States, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Dominican Republic. The nation has a strong tourism base with approximately 3 million visitors per year. The tourism product offers beaches, volcanoes, bio-diversity, protected wildlife and pre-Colombian gold museums.

In terms of GDP composition by end use, household consumption (64.2%), exports of goods

and services (33%), government consumption (17%) and investment in fixed capital (17.1%), are the major drivers of economic activity.

On the trade side (***Table 1***), **Costa Rica's major trading partner is the United States**; other notable trading partners include China, Mexico and its other Central American neighbors (Panama, Guatemala). Its major industries include medical equipment, food processing, textiles and clothing, construction materials, fertilizer and plastic products.

Costa Rica is also widely recognized as a **"green economy"** which means that it focusses on improved human well-being and social equity while simultaneously reducing environmental risks and ecological scarcities. As a major contributor to its green economy status, **the sovereign generates almost 100% of its energy from renewable sources**; wind (12.5%), hydroelectricity (71.1%), geothermal (14.5%) and biomass & waste (1.2%) are the major sources of energy. This provides an enviable hedge against oil price shocks and increases demand for Costa Rican global bonds as a diversity play despite its relatively low sovereign credit rating.

RECENT CHALLENGES

In recent times (2016 -2020), the inability to pass and implement legislation to increase revenue generation has led to liquidity issues for the government. Grid-lock in Congress, combined with the need for consensus among multiple parties to enact revenue enhancing legislation, has led to widened deficits. Widened deficits were financed by increased domestic borrowing (external debt issuance needs legislative approval) as local investors took advantage of the political grid-lock to demand increased domestic interest rates. Covid-19, the Russia / Ukraine conflict, increased global inflation and increased global interest rates also combined to further exacerbate the problem. The aforementioned factors combined to lead to increased debt/GDP levels, no access to international capital markets and downgrades by the international rating agencies (***Table 2***).

Costa Rica - Historical Sovereign Credit Ratings- S&P

Table 2	Foreign currency rating (LT/outlook/ST)
Feb. 23, 2023	**B+/Stable/B**
Mar. 17, 2022	B/Stable/B
Jun. 09, 2020	B/Negative/B
Dec. 21, 2018	B+/Negative/B
Feb. 25, 2016	BB-/Negative/B
Feb. 13, 2012	BB/Stable/B
Oct. 10, 2008	BB/Stable/B

Source: Capitaliq.com

Things turned for the better in 2021 as the implementation of the 2018 fiscal spending reforms began to take effect. The President and the fragmented Legislative Assembly finally achieved consensus, as the threat of default and its consequent economic challenges were accepted by the political class. Economic growth of 7.8% in 2021, due to recovery from covid-19, combined with a solid 4.3% economic expansion in 2022 and **fiscal restraint** combined to halt the fiscal slippage. **One-off contributions to revenue** also drove Costa Rica to generate its first primary surplus in 2022 after almost a decade.

Costa Rica's access to multilateral financing under the IMF's **Extended Fund Facility (EFF)** and the **IMF's recently created Resiliency and Sustainability Fund (RSF)**, would have come with strict technical criteria and guidelines. This undoubtedly renewed market confidence in the sovereign's fiscal program and would have been timely given the uncertain global economic climate. The RSF was designed to provide affordable long-term financing to countries undertaking reforms to reduce risks to prospective balance of payments stability, including those related to climate change and pandemic preparedness. Since its inception, Costa Rica was the first country to access the RSF and have been followed by Jamaica, Bangladesh, Barbados, and Rwanda. **Costa Rica's RSF loan is worth US$725 million**. Its EFF facility facilitates semi-annual disbursements and ends on March 25, 2025.

The positive fiscal numbers (***Table 3***), multilateral access and economic growth led to a **rating upgrade to B+/Stable** from B/Stable on Feb-23-2023. This paved the way for a successful reentry into the global capital markets on March 27, 2023 as "**Costar**" tapped the debt markets for US$1.5 billion which came after the government last raised international debt in 2019.

Table 3	2016	2017	2018	2019	2020	2021	2022	2023f	2024f	2025f
Fiscal indicators (general government; %)										
Balance/GDP	-4.6	-5.3	-4.9	-5.5	-8	-4.6	-2	-3.4	-3.4	-3.5
Primary balance/GDP	-1.9	-2.3	-1.5	-1.5	-3.4	0.1	2.6	1.3	1.2	0.9
Revenue/GDP	25.6	25	25.4	26.3	24.9	25.3	26.2	25.7	25.7	25.6
Expenditures/GDP	30.3	30.3	30.3	31.9	32.9	29.9	28.2	29.1	29.1	29.1
Interest/revenues	10.6	11.9	13.4	15.2	18.5	18.7	17.6	18.4	17.8	17.1
Debt/GDP	45.7	47.1	52.3	57.3	65.3	66.4	63	61.4	60.9	60.9

Source: Capitaliq.com / ratingsdirect.com

POSITIVE STEPS GOING FORWARD

Going forward, it is important that Costar maintains its fiscal containment and debt reduction strategy. The government and the legislative assembly would have seen the benefits of the consensus which led to the 2018 reform measures. **A test of said consensus is the upcoming public employment reform due to come into effect in 2023**. The employment reform is aimed at improving the equity and efficiency of employment in both the public and private sectors. The employment/labour reform focusses on areas such as discrimination, special protection for women, minors & union leaders and the right to strike among other reforms.

That said, as at April 28, 2023, the IMF and the Costa Rican authorities reached a Staff Level Agreement on the 4th review of the EFF and the 1st assessment of the RSF. According to the IMF, Costa Rica continues to move forward with its economic reform program. The Fund also notes that **performance "under the program has been strong, and all quantitative targets have been met**."[1] The overall policy stance involves bringing inflation durably back within target and

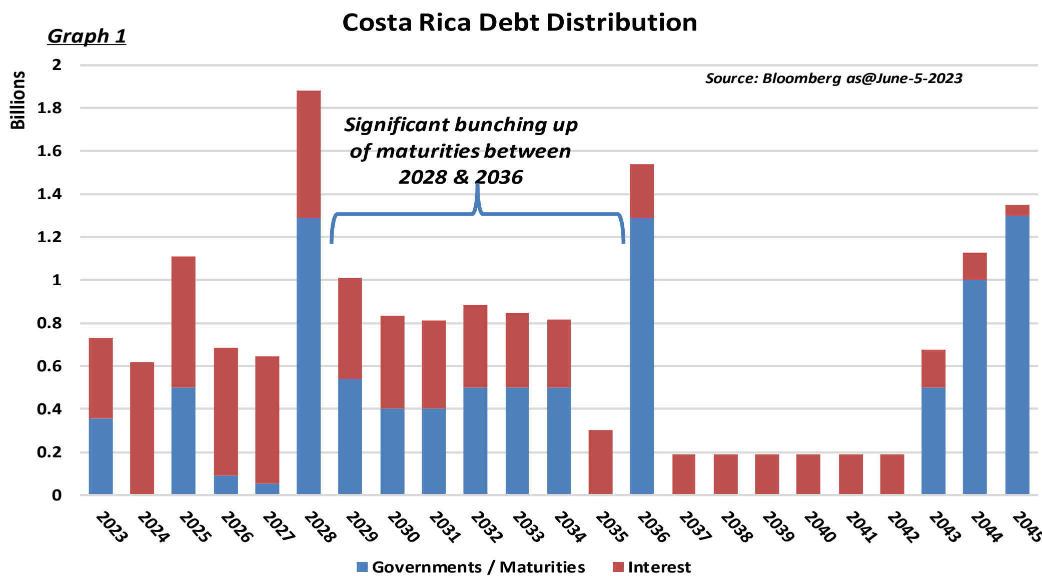
[1] https://www.imf.org/en/News/Articles/2023/04/28/pr23130-costa-rica-imf-reaches-staff-level-agreement-with-costa-rica-on-eff

keeping public debt on a sustainable downward path. Maintenance of the fiscal reforms will underpin both local and international investor confidence which should further guarantee Costar access to capital markets.

FISCAL CHALLENGES, THE MAJOR RISK

Costa Rica's fiscal challenges began in 2016 and peaked in 2021 as debt/GDP climbed from 45.7% to 66.4% over the period. Increased spending was the main factor leading to the challenge, as expenditure was not matched by revenue inflow. The expenditure / revenue mismatch led to consistent and widening fiscal deficits, this ranged from a low of 4.6% in 2016, to a high of 8% in 2020. The interest burden (interest/ revenue) also climbed, moving from a manageable 10.6% in 2016, to a peak of 18.7% in 2021.

The nation's poor fiscal performance, combined with the Legislative Assembly's refusal to sanction the issuance of external debt, led to debt issuance being confined to the domestic market. This increased domestic interest rates, as local investors, while providing a needed captive local market, priced in fully, the effect of the fiscal rigidities. Going forward, JMMB Research is optimistic that Legislative approval granted to issue debt in the global capital markets, for 2023 and for several years to come, subject to certain conditions, will allow the government to improve its debt maturity profile. **Costa Rica has a significant bunching-up of debt maturities between 2028 and 2036 (*Graph1*).** In this situation, debt needs to be pre-funded and where possible, bonds need to be called where call features exist, and debt re-issued at longer maturities.



Costa Rica suffers somewhat from the asset / liability mismatch on the fiscal side, where debt is issued in USD but revenues are raised primarily in Colons (domestic currency). **Approximately 40% of government debt is denominated in foreign currency, however, this is mitigated by the fact that 75% of all debt is issued in the local market.** Going forward, the interest burden is projected at 18.4% in 2023 before moderating slightly to 17.1% in subsequent years. Concerns regarding ongoing local investor preference for hard currency, and dollarization could lead to a deterioration of the forecasted 17.1% interest

burden. Dollarization, while not as large a concern currently, as in previous years, remains a risk and inhibits the central bank's ability to conduct monetary policy.

POLITICS

Costa Rica's political system is fragmented and, as noted before, is a key source of frustration regarding timely legislative action. **The decision making process gives even small parties with limited representatives, the ability to stall legislation**. Costa Rica's failure to achieve consensus, among its many political parties between 2019 and 2021, meant that debt management was not timely when compared to higher rated sovereigns. This led to an almost 50% increase in the debt/GDP ratio, pre-covid-19. **According to Costa Rican law, the Legislative Assembly must approve financing and loans, including debt raised in global capital markets and multilateral debt (IDB, World Bank & IMF).** Where the legislature refuses to give its authority, it forces the government to rely on the relatively small domestic market to finance its budgetary needs.

Where such political systems exist, coalition building is key to any type of consistent policy making. New President, Rodrigo Chavez, may be the man to build said consensus. His win in the 2022 elections continues the trend of a move away from the long standing two-political party preference. The decade-long trend of anti-establishment voting and the move away from political fragmentation, is also embodied in his preference by the Costa Rican electorate. The new President's above 70% approval rating should help him to appeal across party lines during negotiations with the legislature.

That said, we are still cautious regarding policy making as the SDP (Social Democratic Party), to which the President belongs, only has 9 out of the 57 seats in the Legislative Assembly. Further, the President's party is only 1 of 5 political parties represented in Congress. Of note also is the fact that much of the solid fiscal results achieved by Costa Rica were partly due to the efforts of the previous administration. This means that President Chavez must generate solid results, especially given that potential policy adjustments to the 2018-fiscal reforms are on the horizon.

It is believed that any adjustment to the 2018-fiscal rules will maintain the core of the reform that has generated the positive results highlighted in ***Table 3*** above. Some of the reforms proposed should make doing business easier, should improve equity in the society and should facilitate international participation in the debt issued by government. **Giving non-locals access to locally issued Costar debt improves funding diversity and reduces the crowding out effect.** Local state owned banks, institutional investors and other state owned enterprises are key creditors to the government; consequently, a Costa Rica default would have significant contagion effect throughout the local financial system (***Table 4***).

Table 4

Costa Rica - Proposed Amendments to the 2018-Fiscal Rules
1. Making the Tax Code More Progressive
2. Facilitating non-residents holding locally issued debt
3. Strengtheining the Statutes of the Central Bank
4. Increasing the depth of the Foreign Exchange Market

Source: Capitaliq.com

The Costa Rican Legislature approved a US$5 billion global bond borrowing facility for the period 2023 to 2025, subject to certain condition, at the end of 2022. The full realization of this legislative approval is key to improving fiscal flexibility and reducing sovereign risk.

ECONOMIC GROWTH

Costa Rica's economic performance continues to be relatively strong (***Table 5***). **Pre-covid (2016-2019), GDP growth averaged 3.4% despite the fiscal challenges, while post-covid (2021-2022), growth has averaged a robust 6.1%.** Private investment, manufacturing exports from free trade zones via DR-CAFTA and recovery in tourism would have driven the post-covid performance. Creating linkages between the high growth export zones and the lower growth domestic economy continues to be a challenge for Costa Rica. Despite these constraints, GDP growth is forecasted to average about 3.2 to 3.3 percent between 2024 and 2026.

Table 5

	COSTA RICA-SELECTED ECONOMIC INDICATORS (%)								
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023f**	**2024f**
GDP per capita ($000s)	12	12.2	11.9	13.1	11.7	12.1	14.3	14.8	14.9
Real GDP growth	**4.2**	4.2	2.6	2.4	**-4.3**	**7.8**	4.3	2.6	**3.2**
Real investment growth	**6**	0.1	1.6	**-8.2**	**-3.4**	11	0.8	3.1	**4.2**
Investment/GDP	18.9	18.1	18.4	**16.1**	16.2	**19.6**	18.6	**19.7**	19.2
Savings/GDP	16.8	14.4	15.3	14.8	15.1	17	14.8	16.3	16.1
Exports/GDP	**31.3**	32.8	33.7	34.3	31.9	36.8	**41.2**	36.8	**37.7**
Net FDI/GDP	**3.6**	**4.4**	**4.1**	**4**	**2.7**	**5**	**3.9**	**3.8**	**3.8**
Unemployment rate	**9.5**	9.3	12	12.4	**20**	13.7	**11.7**	12.7	12.3

Source: Capitaliq.com / ratingsdirect.com

Costa Rica's energy mix, which is 98% clean energy, is an attraction for most businesses. The energy mix acts as a hedge against hydrocarbon (oil, natural gas, coal) price volatility; this helps to contain production costs. The strong foreign direct investment (net FDI / GDP) inflow, highlighted above, both pre and post-covid, is testament to the sovereign's attractiveness to international businesses. **Global nearshoring or friend shoring is also a spill-off benefit of the DR-CAFTA free trade zone. Nearshoring occurs where companies transfer parts of their production to countries close to their markets and with similar time zones, in order to minimize the effects of disruptions in supply chains**. Costa Rica has special trade zones that produce medical equipment, is involved in life sciences and digital technology.

Intel, one of the world’s largest producers of semiconductor chips for computers, has been in Costa Rica since 1997. Intel supplies microprocessors for computer system manufacturers such as Acer, Lenovo, HP, and Dell; hence it represents a massive operation. The company has, since 1997, diversified its operations from manufacturing to research and development, taking advantage of Costa Rica’s highly educated labour force, and simultaneously taking advantage of Asia’s cheaper labour force. However, in 2020, the company reestablished its manufacturing facility, representing an investment of approximately US$1 billion as at 2022. The company **has opened, in Costa Rica, its only semiconductor assembly and test unit, in the entire Western Hemisphere**.

CONCLUSION

Costa Rica’s fortunes have improved since the implementation of the 2018-fiscal reforms in 2021. Expenditure restraint plus one-off improvements in revenue have served to narrow the fiscal deficit, generate a primary surplus, put the interest burden back on a downward path and contain the growth rate of the debt/GDP ratio. The approval of an IMF program and the disbursement of funds under the EFF and the RSF have given the government access to cheaper multilateral funding. These factors, when combined with the approval given by the Legislature for the issuance of external debt, have led to a recent upgrade by international rating agency, Standard & Poor’s.

That said, the problem of a fragmented, multi-party political system, that requires the pre-approval of the legislature to raise both multilateral and international debt, remains. The legislature has given its approval, with conditions, for the raising of approximately US$5 billion in debt over the medium term. We also note that the popularity of new President Chavez, could aid the consensus building process, however the risk of frustration in debt issuance remains. We also note the bunching up of maturities that Costa Rica faces from 2028 to 2036.

Based on the above, we assign a **MARKETWEIGHT** rating to Costa Rica at this time.

BOND VALUATION & ANALYSIS

Our analysis of Costa Rica’s debt will include Cosice / ICE and Banco Nacional as a part of the sovereign debt profile. We include both quasi-sovereign entities, given the high probability we place on the likelihood of government intervention to support both entities, in the event of a default or credit event. **We also attach a snapshot view of Cosice & Banco Nacional** and ask that they be read with the sovereign analysis.

A cursory look at Costa Rica’s bonds shows its sovereign debt issuances from the 2025’s to the 2045’s (***Table 6***). **The 2034 is Costa Rica’s most liquid bond**, with an issue size of US$1.5

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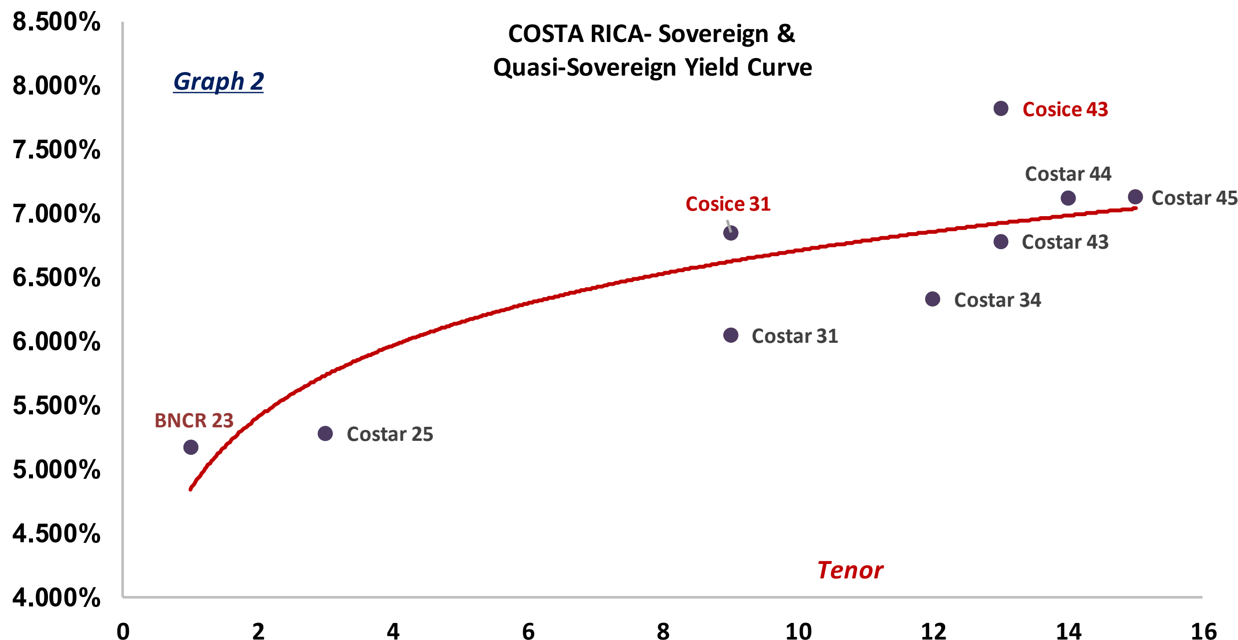
billion, is the most regularly traded and is consequently **the nation's benchmark note**. Next in line, in terms of liquidity and trading activity, are the 2045's with an issue size of US$1.3 billion. Coming in next are the 2031's and 2044's with issue sizes of US$1.2 billion and US$1.0 billion, respectively. **The Cosice bonds are not as liquid as the straight sovereigns**; the Cosice 2043's have an issue size of US$500 million and the Cosice 2031's have an issue size of US$300 million.

Table 6

			Rating Agency						
Country	**Maturity**	**Coupon**	**S&P**	**Moody's**	**Fitch**	**Bid Level**	**Offer Level**	**Bid Yield**	**Offer Yield**
Costa Rica	4/30/2025	4.375%	B+	B2	BB-	97.800	98.400	5.635%	5.287%
	2/19/2031	6.125%	B+	B2	BB-	99.800	100.400	6.160%	6.049%
	4/3/2034	6.550%	B+	B2	BB-	101.050	101.550	6.401%	6.332%
	4/30/2043	5.625%	B+	B2	BB-	86.450	87.450	6.886%	6.784%
	4/4/2044	7.000%	B+	B2	BB-	97.700	98.700	7.214%	7.119%
	3/12/2045	7.158%	B+	B2	BB-	99.300	100.300	7.221%	7.129%
Banco Nacional	11/1/2023	6.25%	NR	B2	BB-	99.875	100.365	6.548%	5.175%
Cosice	10/7/2031	6.75%	NR	B1	BB-	97.850	99.350	7.095%	6.852%
	5/15/2043	6.38%	NR	B1	BB-	84.000	85.500	7.993%	7.823%

Source: Oppenheimer & Co as @ June-16-2023

A look at the Costa Rican yield curve, ***Graph 2***, indicates that the **Cosice bonds** (2031 & **2043**) trade widest to our extrapolated yield curve. This suggests that the Cosice quasi-sovereigns offer the best value on the Costa Rican Curve despite their relatively smaller issue size, compared to the sovereign.



YIELD ADJUSTMENTS & FED RATE ACTION

Our last look at the relative value curve in March, indicated that yields had widened across the short-end of the curve, by an average of about 32 basis points (bsp). The increase in yields,

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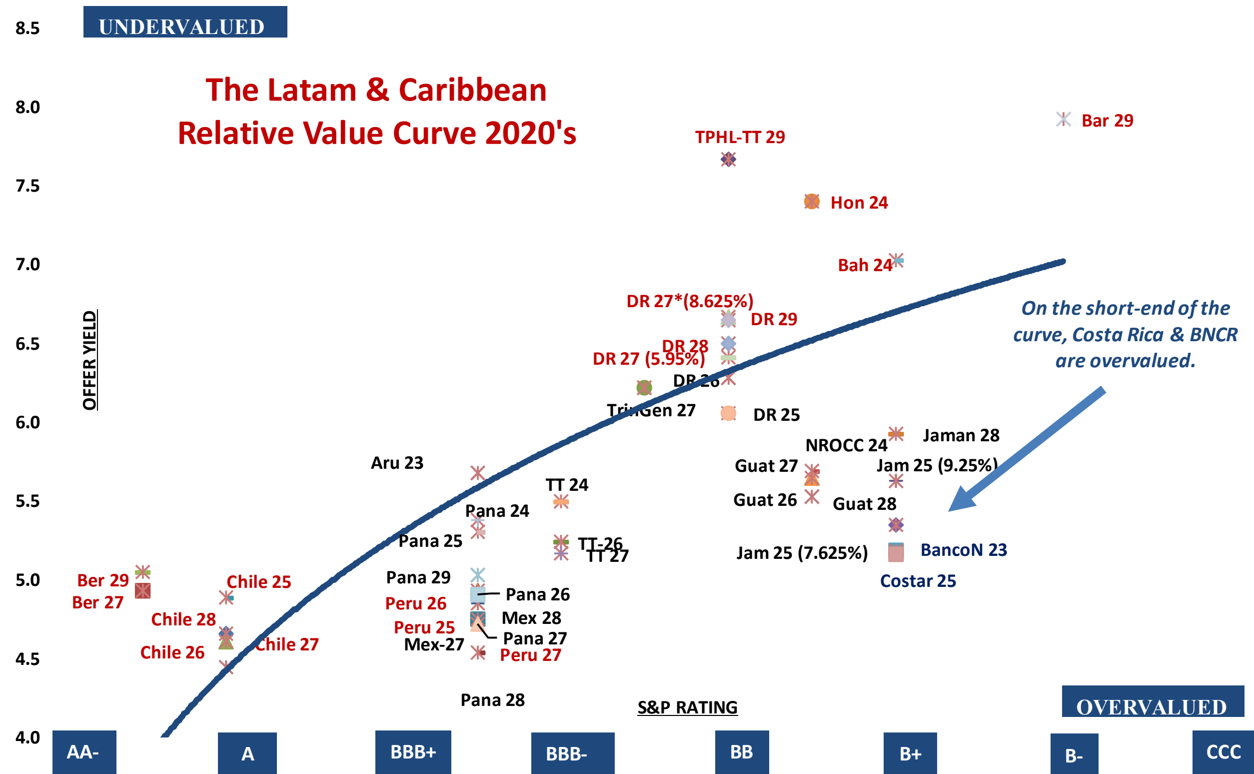
compared to February, came on the back of ongoing strong economic numbers and the Fed's continued increases in interest rates. On March 23, the Fed increased interest rates on its reserve balances to 4.9%.

However, as at June 21, yields across the short end of the curve have contracted by, on average, a modest 6.34 bsp. In our opinion, this is likely due to the Fed's decision, on June-14, to halt rate hikes at 5 to 5.25 percent. The Fed essentially left rates unchanged to assess the impact of previous rate increases on the economy, following ten (10) consecutive increases dating back to 2022. The market has likely priced in a marginal probability of a contraction in interest rates over the medium term. That said, on June-15, the Fed reported that economic activity continued to expand at a modest pace, jobs gains remained robust and that unemployment remained low. **Essentially, inflation remains elevated**, coming in at an annual rate of 4% as at May-2023.

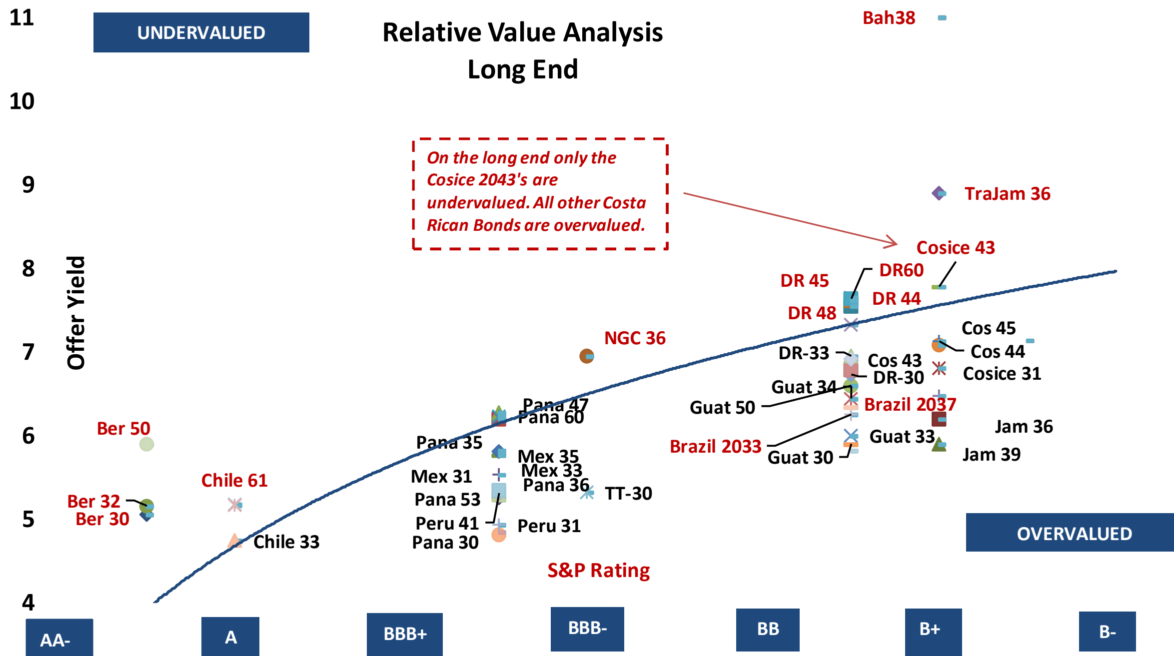
At 4%, US inflation is slowly declining to the Fed's 2% target; combining this with the strong economic numbers suggests that a soft landing may be likely.

RELATIVE VALUE

On the short end of the curve, both the Costa Rican 2025's and the Banco Nacional 2023's are overvalued.



On the long end of the curve, only the Cosice 2043’s are undervalued; all other Costa Rican bonds are overvalued.



CONCLUSION

From a relative value perspective, most of Costa Rica’s bonds are overvalued, both on the long and short end of the curve. **Only the Cosice / ICE 2043’s are undervalued; this coincides with the bond trading relatively wide to our extrapolated yield curve (Graph 2) above**. We therefore note that from a bond trading perspective, exposure to Costa Rica would represent more of a diversity play given the sovereign’s non-dependence on fossil fuels (oil, gas, coal). Costa Rica generates in excess of 90% of its energy from renewable sources.

Source: Standard & Poor’s / www.capitaliq.com; FITCH Solutions / www.businessmonitor.com; www.imf.org; https://www.cia.gov/the-world-factbook/ ; Moody’s Investor Services

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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.

STRONGLY UNDERPERFORM—REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 2.5% FOR THIS PARTICULAR ASSET

UNDERPERFORM—REDUCE EXPOSURE IN YOUR PORTFOLIO TO 2.5% - 4.9% FOR THIS PARTICULAR ASSET

SELL—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.

HOLD/MARKETPERFORM—EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB.

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

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