International Monetary Fund

Costa Rica and the IMF

Press Release:
IMF Executive Board Approves US$ 735 Million Precautionary Stand-By Arrangement for Costa Rica
April 13, 2009

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Costa Rica: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

March 26, 2009

San José, March 26, 2009

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C.

Dear Mr. Strauss-Kahn:

1. Costa Rica's strong policy record has greatly increased the economy's resilience to external shocks. Prudent fiscal policies and high real GDP growth rates have allowed us to lower substantially the public debt burden. We have also made progress in strengthening the monetary and exchange rate policy frameworks, improving financial sector regulation and supervision, and extending the social safety net.

2. Notwithstanding these achievements, and reflecting its integration into the global economy, Costa Rica has not been immune to the present global financial turmoil and economic slowdown. Real GDP growth has slowed markedly in recent months, financial conditions have tightened, and the exchange rate has moved to the upper end of the currency band. Looking ahead, global economic forces pose downside risks to the real economy and balance of payments. Against this backdrop, the government of Costa Rica is determined to continue implementing macroeconomic policies that will mitigate the adverse effects of the downturn on growth and employment, and safeguard domestic financial stability.

3. The attached Memorandum of Economic and Financial Policies (MEFP) describes the plans and policies of the government of Costa Rica for 2009. Prudent monetary policy and increased exchange rate flexibility will support the needed external adjustment and target a gradual decline in inflation. Fiscal policy will be geared toward cushioning the effects of a rapidly slowing economy, including by providing protection to the most vulnerable groups. Financial sector policies seek to further increase the resilience of the system while enhancing monitoring and allowing for contingency planning. The plans and policies of the government for 2010 will be defined at the time of the second program review

4. In support of Costa Rica's economic program, we request a Stand-By Arrangement (SBA) from the International Monetary Fund totaling SDR 492.3 million (300 percent of quota), covering the period to July 10, 2010. Our intention is to treat the arrangement as precautionary. Together with contingency funds from other international financial institutions, the SBA will provide an important signal and a critical liquidity cushion against worse-than-expected balance of payments outcomes, thereby bolstering investor and depositor confidence, and supporting a smooth transition to a more flexible exchange rate regime.

5. Program implementation will be monitored through quarterly reviews, quantitative performance criteria and indicative targets, and structural benchmarks, as described in the attached MEFP and Technical Memorandum of Understanding (TMU). We expect the first purchase in the amount of SDR 328.2 million (200 percent of quota) to become available upon approval of the program by the IMF Executive Board. The schedule for the availability of subsequent purchases is set out in Table 1 of the MEFP. The first review will be completed on or after September 16, 2009, and the second review on or after December 11, 2009.

6. We believe that the policies described in the attached MEFP are adequate to meet the objectives of our program. However, if needed, the government stands ready to take additional measures. In accordance with the Fund's policies, we will be in continuous communication with the Fund with regard to policy actions related to this program.

Sincerely yours,

/s/	/s/
Guillermo Zúñiga Minister of Finance	Francisco de Paula Gutiérrez President, Central Bank of Costa Rica

Attachments

Costa Rica—Memorandum of Economic and Financial Policies

March 26, 2009

I. Introduction

1. In the wake of the global downturn and financial crisis, Costa Rica is confronting increasingly challenging external and domestic economic conditions. After several years of strong growth, activity cooled off in 2008. Despite this slowdown, inflation exceeded the central bank's target, reflecting high commodity prices and domestic demand pressures, and the external current account deficit rose to almost 9 percent of GDP. These developments put pressure on the exchange rate, which depreciated by almost 12 percent in 2008 and remains close to the ceiling of the currency band. With foreign direct investment (FDI) and exports of goods and services expected to decline in 2009, the adverse external environment poses downside risks to Costa Rica's balance of payments and the real economy.

2. In view of the deteriorating external environment and growing risks, the government of Costa Rica is implementing a broad strategy to strengthen the economic policy framework and bolster confidence. Our objective is to increase the economy's resilience to the adverse external environment, mitigating its negative effects on growth, employment, and vulnerable segments of the population, and maintaining macroeconomic stability with policies that facilitate an orderly reduction of the current account deficit and a lasting decline in inflation. A tighter monetary stance and greater exchange rate flexibility will be key instruments to attaining these goals. Fiscal policy is starting from a position of relative strength and can therefore provide some countercyclical support, including by strengthening the social safety net. In addition, we are taking measures to increase the resilience of the financial system. While our policy response focuses primarily on addressing the immediate challenges faced by the Costa Rican economy, it remains consistent with the government's broader strategy to foster high and sustainable medium-term growth.

II. Economic Program for 2009

A. Program Objectives and Risks

3. External conditions are expected to weaken further during 2009. We anticipate a decline in exports and tourism receipts owing to the sharp deceleration in global demand. External financing will also be constrained, as FDI is expected to drop significantly and private sector access to external credit lines will be more limited. Although improving terms of trade should partially offset the effect of these shocks on the balance of payments, a moderation of non-oil import demand will also be necessary to reduce the current account deficit and avoid reserve losses.

4. Under these circumstances, our policy strategy aims to mitigate the adverse effects of the external environment on growth and employment. Our policy objectives include: (i) protecting vulnerable groups of the population from the negative effects of the economic slowdown; (ii) facilitating an orderly reduction in the external current account that minimizes adverse effects on activity; (iii) reducing inflation, while gradually allowing greater exchange rate flexibility; (iv) reducing the reliance on the exchange rate as a nominal anchor for monetary policy, and making progress toward the adoption of an inflation targeting regime; and (v) increasing the resilience of the financial system.

5. The uncertainty surrounding the severity and duration of the global slowdown and financial turmoil and their impact on Costa Rica's balance of payments pose the greatest downside risks to the economic outlook. While we believe that the resilience of our economy and the existing liquidity buffers are sufficient to withstand a substantial deterioration in the external environment, we recognize that more extreme shocks to global growth and financial markets are possible. Against this background, we view a precautionary arrangement with the IMF as key to bolstering investor confidence and helping insure against downside risks. Access to financial support from the IMF, together with complementary financing from other international financial institutions, will provide a substantial liquidity cushion to help absorb unanticipated shortfalls in external inflows and enhance the credibility of our policy framework, including the transition to a more flexible exchange rate regime. As the external environment improves, growth would be expected to return gradually to potential, supported by factors such as the implementation of the CAFTA-DR; the liberalization of the telecommunications and insurance markets; the conclusion of other trade agreements; and higher infrastructure investment, particularly in the road network and ports.

B. Monetary and Exchange Rate Policy

6. Monetary and exchange rate policy will focus on reducing inflation and the current account deficit, and on supporting the normal operation of the domestic financial system. We remain committed to moving gradually to greater exchange rate flexibility. In line with this commitment, we have recently increased the rate of crawl of the ceiling of our exchange rate band to an annual rate of about 9 percent, from 3 percent previously. With the faster rate of crawl the width of the currency band is projected to widen to about 22 percent by the end of 2009 and about 30 percent by the end of 2010. In addition, we are undertaking steps to improve operations in the foreign exchange market, broadening access to the wholesale foreign exchange market to foster competition and reduce intermediation spreads.

7. We will keep interest rates consistent with the goals of attaining the inflation target and maintaining the exchange rate within the currency band. For 2009, we aim to reduce inflation to 9 percent (plus/minus one percent) by year-end, while our medium term goal remains to achieve inflation rates comparable to those observed in our trading partners. We expect inflationary pressures to subside in the coming months as the recent decline in

commodity prices continues to feed through. At the same time, higher interest rates and lower money supply growth should ensure that private credit and domestic demand growth converge to levels that are consistent with the inflation target, and help reduce pressures on foreign exchange reserves. In this context, we increased in mid-January short term interest rates of the Central Bank's deposit window by 70-150bps, and we expect central bank and market interest rates for deposits with maturities above 6 months to become positive in real terms as inflation declines. We will monitor closely liquidity conditions and the appropriateness of our interest rate levels throughout the program period, and are fully committed to adjusting them as necessary to achieve our inflation target, keep the exchange rate within the currency band, and maintain orderly conditions in the foreign exchange market.

8. To prepare for the adoption of an inflation targeting regime, which we hope to complete by late 2010, we will continue our efforts to strengthen the transmission mechanism of interest rates. To this end, we will implement a daily liquidity forecasting exercise to estimate the required interventions of the Central Bank in the money market, and will proceed to integrate the currently segmented money market through a new integrated platform (both benchmarks for end-June 2009). We will also work toward obtaining legislative approval of the draft law to recapitalize the Central Bank, which is key for the independent conduct of monetary policy.

C. Financial System Policy

9. Costa Rica's financial system is fundamentally sound, and important progress has been made in recent years to strengthen bank regulation and supervision. We will continue to improve the regulatory framework and bolster the safety net for the financial sector. In this context, we are committed to working closely with our Legislative Assembly to obtain swift passage of the draft bill to establish consolidated supervision of financial conglomerates and to strengthen the sanctions regime. In addition, we intend to address the remaining gaps of the financial sector safety net. This will involve submission to Congress of draft laws to establish a bank resolution framework in line with international best practice (benchmark for end-September 2009) and create a deposit insurance scheme (benchmark for end-December 2009).

10. In view of the continued dislocations and volatility in global financial markets, the Superintendency of Financial Entities (SUGEF) is in the process of setting up, as a preventive measure, a system to detect early symptoms of liquidity pressure in the banking system. To this effect, SUGEF will produce a monthly report to monitor, on a bank-by-bank basis, the liquidity position, including compliance of legal reserve requirements, levels of cash in vault and securities, outstanding balances of sight and term deposits, and the availability and effective usage of foreign credit lines, among others (benchmark for end-June 2009). With respect to liquidity provision for the financial sector, we are committed to keep in place for as long as necessary the recently established mechanisms to provide

exceptional liquidity assistance in *colones*. In addition, we have signed an agreement with the Interamerican Development Bank (IDB) for a $500 million credit line, which has already been submitted to our Legislative Assembly for approval. The credit line will be made available to the banking sector, and could be used—among other things—in case funding sources from abroad are cut off.

D. Fiscal Policy

11. Fiscal policy will be aimed at mitigating the effects of the economic slowdown and maintaining the nation's efforts to foster human development and strengthen systemic competitiveness over the medium term. This includes a strong focus on investing in education, health, infrastructure, and science and technology, among others. Fiscal policy in recent years has been very prudent, with the central government posting a surplus in both 2007 and 2008 (excluding the capitalized inflation component of inflation-indexed bonds (TUDES)). Our moderate combined public sector debt level of under 36 percent of GDP leaves us room to use countercyclical fiscal policy to try to offset the downturn. In particular, we intend to increase spending on education, to raise coverage levels; on labor-intensive infrastructure projects, to improve our network of roads, ports, and airports; and on broadening the social safety net, including by expanding the coverage of our conditional cash transfer program *AVANCEMOS* and noncontributory pensions. With the expected cyclical decline in revenues, this higher spending will raise the deficits of the Central Government and the combined public sector to 3.2 percent and 4.1 percent of GDP, respectively, during 2009.

12. The borrowing needs of the public sector will be mostly financed from domestic sources, and the remainder from external sources that have already been secured. This will result in a moderate, transitory increase in the public debt-to-GDP ratio. However, over the medium term, as the output gap closes, the borrowing needs of the Central Government and the overall public sector are expected to decline and reverse the increase in public indebtedness.

13. In light of the challenging balance of payments outlook and the uncertainties surrounding the government revenue projections we are committed to a prudent execution of the budget. In this context, further fiscal measures would be taken if inflation and/or the current account deficit do not decline at the expected pace. In addition, we are in the process of securing a $500 million contingent budget support loan from the World Bank, which we could use to finance the budget in case revenues and the planned domestic financing cannot be mobilized as envisaged.

III. Safeguards Assessment

14. We recognize the importance of completing a safeguards assessment of the central bank of Costa Rica (BCCR) before the first review of the Stand-By Arrangement. To facilitate this, the central bank auditors will hold discussions directly with IMF staff. An IMF mission to conduct the safeguards assessment is scheduled for late March 2009, and we will provide Fund staff promptly with all necessary information, including information related to correspondent banks and foreign reserve placements.

IV. Program Monitoring

15. The program will be monitored on a quarterly basis, by quantitative performance criteria and indicative targets, and structural benchmarks. The phasing of access under the arrangement and the review schedule are set out in Table 1 of this memorandum; the quantitative performance criteria and indicative targets for end-June 2009 and end-September 2009, and indicative targets for end-December 2009, are set out in Table 2 (targets for March 2010 will be identified at the time of the second program review). Structural benchmarks are set out in Table 3. Program conditionality is further specified in the accompanying TMU.

Table 1. Proposed Schedule of Disbursements

Amount	Date	Conditions for Disbursement
SDR 328,200,000	April 10, 2009	Executive Board approval of the 15-month Stand-By Arrangement
SDR 41,025,000	September 17, 2009	Observance of performance criteria for end-June 2009 and completion of the first review under the Stand-By Arrangement
SDR 41,025,000	December 14, 2009	Observance of performance criteria for end-September 2009 and completion of the second review under Stand-By Arrangement
SDR 41,025,000	March 16, 2010	Observance of performance criteria for end-December 2009 and completion of the third review under the Stand-By Arrangement
SDR 41,025,000	June 17, 2010	Observance of performance criteria for end-March 2010 and completion of the fourth review under the Stand-By Arrangement

Table 2. Quantitative Performance Criteria and Indicative Targets

	2008	2009			
	End-Dec. Prel.	**End-March** Proj.	**End-June** Performance criterion	**End-Sept.** Performance criterion	**End-Dec.** Indicative Target
Quantitative Performance Criteria 1/					
Floor on cash balance of the Central Government (Colones billion, cumulative)	35	-210	-312	-403	-492
Floor on NIR of the Central Bank (US$ millions)	3,799	3,500	3,350	3,350	3,500
Ceiling on NDA of the Central Bank (Colones billion)	-1,038	-915	-786	-814	-784
Ceiling on the debt stock of the Central Government (Colones billion)	3,993	4,303	4,356	4,447	4,535
Continuous Performance Criterion					
Accumulation of external debt arrears (US$ million)	0	0	0	0	0
Indicative targets (ceilings)					
Floor on cash balance of the combined public sector (Colones billion, cumulative)	69	-146	-325	-402	-672
Memorandum					
Base Money (Colones billion)	1,151	1,102	1,144	1,116	1,233

Table 3. Structural Benchmarks

Benchmark	**Test Date**
Establishment of a monthly monitoring report for the banking system	End-June 2009
Unification of the money market under a single platform	End-June 2009
Establishment of a system of daily forecasting of systemic liquidity in the money market	End-June 2009
Submission to the Legislative Assembly of a draft law to strengthen the bank resolution framework.	End-September 2009
Submission to the Legislative Assembly of a draft law to create a limited deposit guarantee scheme.	End-December 2009

Costa Rica—Technical Memorandum of Understanding

This Technical Memorandum of Understanding (TMU) sets out the understandings between the government of Costa Rica and IMF staff regarding the definitions of quantitative and structural performance criteria and reporting requirements under the Precautionary Stand-By Arrangement (SBA).

I. Definitions

A. Program Exchange Rates

For the purposes of the program (and not as a target rate), the average exchange rate is set at 576.3 Costa Rican colones per U.S. dollar. The exchange rates against the SDR and Euro are provided in Table 1. The program rate for the inflation indexed unit (UDES) is set at 683.4 colones.

Table 1. Program Exchange Rates in 2009

U.S. dollar	576.3
SDR	886.1
Euro	792.0
UDES	683.4

B. Central Government

Numbers referring to the central government include the Central Government budget and extra budgetary funds. If the government establishes new extra budgetary funds, they will be consolidated within the Central Government system.

C. Combined Public Sector

For program purposes, the combined public sector includes the Central Government, the Central Bank, public enterprises (excluding the Instituto Costarricense de Electricidad (ICE)) and a number of decentralized institutions (Table 2).

Table 2. List of Public Agencies in the Combined Public Sector

Public Enterprises

Consejo Nacional de Produccion
Instituto Costarricense de Acueductos y Alcantarillados
Instituto Costarricense de Puertos del Pacifico
Junta de Proteccion Social
Refinadora Costarricense de Petróleo

Decentralized Agencies

Caja Costarricense de Seguro Social
Consejo Tecnico de Asistencia Medico Social
Fondo de Desarrollo Social y Asignaciones Familiares
Instituto Costarricense de Turismo
Instituto de Desarrollo Agrario
Instituto Nacional de Apredizaje
Oficina de Cooperacion International de la Salud

II. Quantitative Performance Criteria, Indicative Targets, and Continuous Performance Criteria: Definitions and Reporting Standards

A. Floor on the Cash Balance of the Central Government

The cash balance is defined as the difference between total revenues and expenditures. The floor on the cash balance of the Central Government will be monitored from above the line on a cash basis. The interest component of expenditures excludes the capitalized inflation component of inflation-indexed zero coupon bonds (TUDES).

B. Floor on the Cash Balance of the Combined Public Sector

The cash balance is defined as the difference between total revenues and expenditures. The floor on the cash balance of the combined public sector will be monitored from above the line on a cash basis. The balance of the Central Bank will be measured on an accrual basis. The interest component of expenditures excludes the capitalized inflation component of inflation-indexed zero coupon bonds (TUDES) held outside of the combined public sector.

C. Floor on Net International Reserves of the Central Bank of Costa Rica

Net international reserves (NIR) of the Central Bank of Costa Rica (BCCR) are defined as the U.S. dollar value of gross foreign assets minus gross foreign liabilities of the BCCR.

- Gross foreign assets are defined in conformity with the Special Data Dissemination Standard as readily available claims on nonresidents denominated in foreign convertible currencies. They include the BCCR's holdings of monetary gold, SDRs, foreign currency cash, foreign currency securities, deposits abroad, and the country's reserve position at the Fund. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered, claims on residents, claims in foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options), precious metals other than gold, assets in nonconvertible currencies, and illiquid assets.

- Gross foreign liabilities are defined as all short-term foreign exchange liabilities to nonresidents, including commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options) and all credit outstanding from the Fund.

D. Ceiling on Net Domestic Assets of the Central Bank of Costa Rica

Net domestic assets of the BCCR are defined as the difference between base money and the NIR of the BCCR converted at program exchange rates, where base money is defined as the sum of currency issued and domestic currency reserve deposits of deposit-taking financial intermediaries at the Central Bank.

E. Ceiling on the Debt Stock of the Central Government

The ceiling on the stock of Central Government debt shall apply to all debt defined as set forth in point no. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-00/85).[1] Excluded from this performance criterion are normal short-term import credits. All foreign currency denominated debt will be converted into *colones* using the program exchange rates set out in Table 1. All domestic debt denominated in inflation indexed units (TUDES) will be converted into colones using the program rate set out in Table 1.

F. Continuous Performance Criteria on Nonaccumulation of External Arrears

The Central Government will accumulate no external debt arrears during the program period. For the purposes of this performance criterion, an external debt payment arrear will be defined as a payment by the Central Government system which has not been made within seven days after falling due under the contractual agreement, unless specified otherwise. The performance criterion will apply on a continuous basis.

G. Adjustors

The floor on the NIR will be adjusted upward and the ceiling on NDA downward by the amount of external financing contracted by the Central Bank, excluding funding used to provide liquidity support to the financial sector and IMF disbursements.

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[1] The definition of debt set forth in point No. 9 of the IMF's guidelines reads as follows: "(a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the leaser retains the title to the property. For the purpose of the Guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property. (b) Under the definition of debt set out in point 9(a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt."

III. Clarification of Structural Conditions

Benchmark for end-June 2009 on the establishment of a monthly monitoring report for the banking system: Preparation of a monthly report to monitor the liquidity position of the banking system on a bank-by-bank basis.

Benchmark for end-June 2009 on establishing a system of daily forecasting of systemic liquidity in the money market: Establish a daily liquidity forecasting exercise, containing a comprehensive assessment of liquidity supply and demand based on the compilation and consolidation of information on liquidity needs, a forecasting methodology, close communication with market participants and relevant parties, real-time monitoring of money market transactions, and an assessment of the size and scope of BCCR's market intervention and its effectiveness.

Benchmark for end-June 2009 on unification of the money market under a single platform: Establishment of an integrated liquidity market (MIL) that will include the following: (i) the introduction of a short-term lending facility that sets an interest rate ceiling to guide the market rate, (ii) the BCCR's withdrawal from the interbank money market (MIB), and (iii) disallowing access for financial entities to the Central Bank's deposit facility (Central Director) for maturities of 30 days or less, except for deposits with maturities that mirror the maturities offered by the MIL lending facility.

Benchmark for end-September 2009 on submission to the Legislative Assembly of a draft law to strengthen the bank resolution framework: The draft law should provide for a more robust bank resolution framework. This framework should allow for the orderly transfer of assets and liabilities of an insolvent bank to another institution, while imposing first losses on shareholders and subordinated creditors before any of the general creditors, the deposit insurance scheme, or the government incur costs.

Benchmark for end-December 2009 on submission to the Legislative Assembly of a draft law to create a limited deposit insurance scheme: The draft law should establish a deposit insurance scheme, which includes the following elements: contain a clear ex ante funding mechanism, provide for rules to allow for the swift compensation of depositors in the event of a bank failure, and describe the linkages to the bank resolution framework.

IV. Program Reporting Requirements

The following information will be provided to the Western Hemisphere Department of the IMF within the time frame indicated.

- Data on the cash balance of the Central Government will be provided within 6 weeks of the end of the month to which the cash balance is calculated.
- Data on the cash balance of the nonfinancial public sector will be provided within 8 weeks of the end of the month to which the cash balance is calculated.
- NIR will be provided on a daily basis
- NDA will be provided on a daily basis.
- Data on the total stock of debt of the Central Government system will be provided on a quarterly basis within one month of the end of each quarter.