Sovereign Bond Analysis: Government of Costa Rica

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- **Bond Recommendation:**

Appetite for Low Risk: MARKETWEIGHT
Appetite for Moderate Risk: OVERWEIGHT
Appetite for High Risk: MARKETWEIGHT

ABOUT

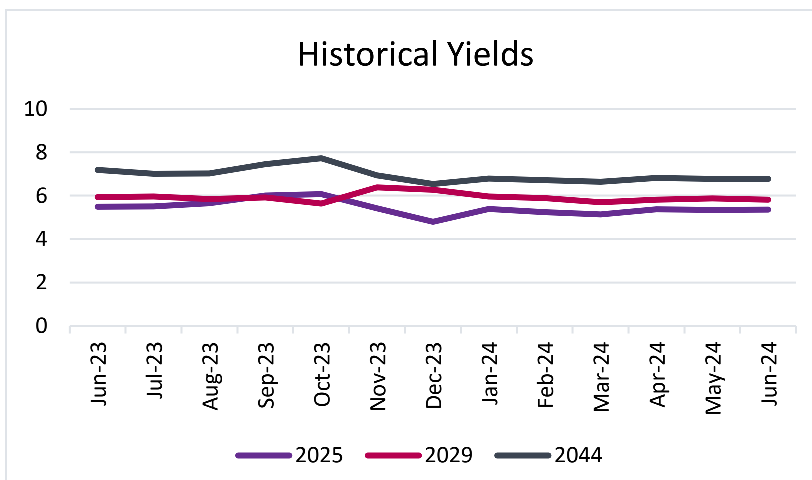
According to the World Bank, Costa Rica is regarded as a small, open economy located in Central America. Due to its open approach to foreign investment, liberalized trade agreements and political stability, the country has benefited from sustained economic growth over the past 25 years. In fact, it is regarded as a success story in the region in terms of development and it is often considered to be an upper middle-income nation.

Notwithstanding, the COVID-19 pandemic posed fiscal and social challenges for the country, causing a rise in unemployment and poverty rates. Efforts to fiscally consolidate the financial accounts were interrupted as government revenues declined and expenditures increased to mitigate the pandemic's impact.

Recently, the Costa Rican government has undertaken several initiatives to bolster economic resilience and promote sustainable growth. Notable actions include the implementation of the Fiscal Management Improvement Project, also known as "Hacienda Digital," aimed at enhancing tax compliance and expenditure management. Moreover, Costa Rica has introduced measures to address climate change and disaster resilience.

Government of Costa Rica: Bond Term Summary

Issuer	Government of Costa Rica		
Currency	USD		
Credit Rating/Outlook	**Standard & Poor's (S&P):** BB-/Stable **Moody's:** B1/Positive **Fitch Ratings:** BB/Stable		
Day Count Basis	30/365		
Use of proceeds	Refinance; General Corporate Purposes		
Maturity	**04/30/2025**	**02/21/2029**	**04/04/2044**
Coupon Rate	4.375%	9.200%	7.000%
Issue Date	04/30/2013	02/21/2019	04/04/2014
Tenor	12 Yrs.	10 Yrs.	30 Yrs.
Maturity Type	Bullet	Bullet	Bullet
Amount Outstanding	500,000 (M)	600,000 (M)	1,000,000 (M)



Recommendation: On a forward-looking basis, the overall outlook on Costa Rica is positive. Recent credit rating upgrades from Fitch and S&P affirm the country's economic viability and robustness. The narrowing of the current account deficit and the decline in the Debt-GDP ratio are promising indicators of a stable and improving economy. Costa Rica's strong exports, larger liquidity buffer, and fiscal discipline, reflected in a primary surplus for two consecutive years, underpin this optimistic trajectory. Political stability and ongoing fiscal reforms further enhance the country's attractiveness to investors. President Rodrigo Chaves' administration has demonstrated a commitment to fiscal management and debt profile improvement. Additionally, support from the IMF through the Extended Fund Facility (EFF) and the Resilience and Sustainability Facility (RSF) underscores international confidence in Costa Rica's economic policies.

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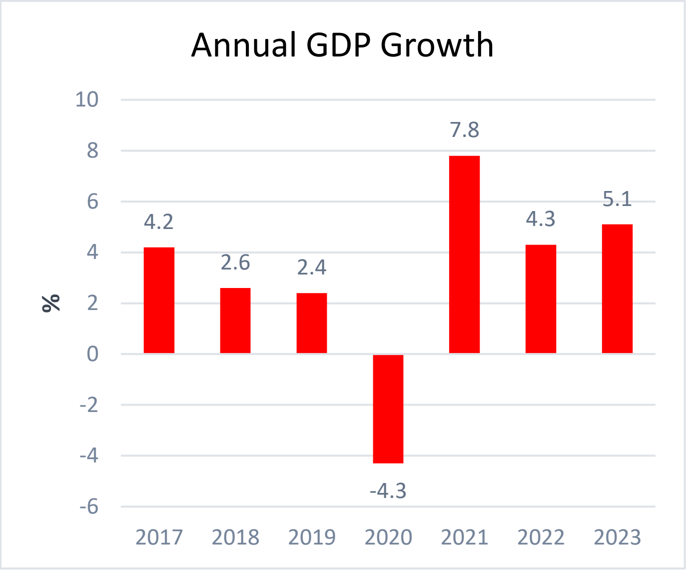
COUNTRY OUTLOOK

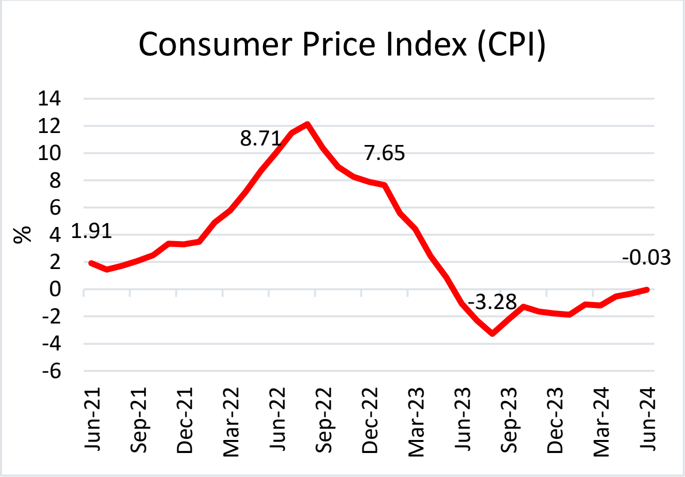
Economic activity ticks higher on greater private consumption, Investments & Economic activity outside the free trade zones.

As per the report by the International Monetary Fund (IMF), Costa Rica's GDP grew by roughly 5.10% in 2023 and 4.30% in 2022. and it projects strong GDP growth of 4% in 2024. The primary factors contributing to the robust GDP growth observed in 2023 were identified as private consumption, investment, and economic activity outside free trade zones. The IMF continued by explaining that growth is expected to reach 4% in 2024, which is higher than the long-term prospective growth rate of roughly 3.25%. The risks to growth and the balance of payments are essentially balanced; the possibility of stronger-than-expected inflows of foreign direct investment offsets the risk of supply chain disruptions or a protracted tightening of global financial conditions. However, tensions in neighbouring countries could lead to a significant increase in in-transit migration, potentially adding fiscal pressures and social tensions.



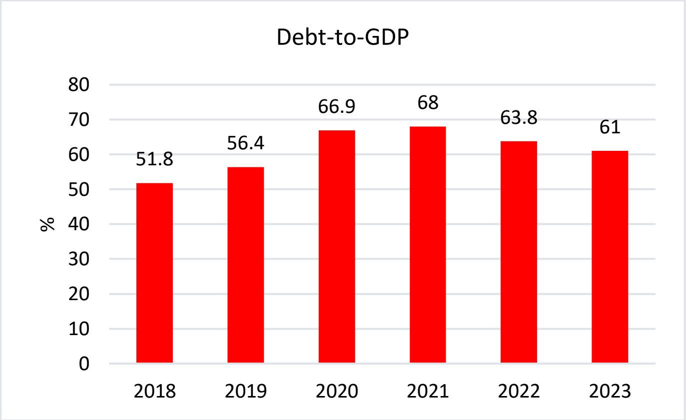
Inflationary remains below the lower limit of the band

Inflation at -0.03% (Year-over-Year) Y/Y in June 2024 was significantly below the BCCR's 2%-4% target band. This was influenced by base effects, lower commodity prices, past monetary policy tightening, and currency appreciation. Core inflation was also low at 0.05% Y/Y in April, with inflation expectations falling to the lower limit of the BCCR's tolerance band. According to the IMF, faced with large external shocks, the central bank has maintained a data-dependent, forward-looking approach. Once confirming that inflation was on a steady downward trend, the BCCR was one of the first central banks in the region to start easing in March 2023 and has since lowered the policy rate from the peak of 9.00% to 4.75% as of end-April 2024. IMF Staff forecasts annual inflation to hit the lower limit of the band by year-end. The main upward risks to inflation are higher commodity prices, potentially driven by global geopolitical events.



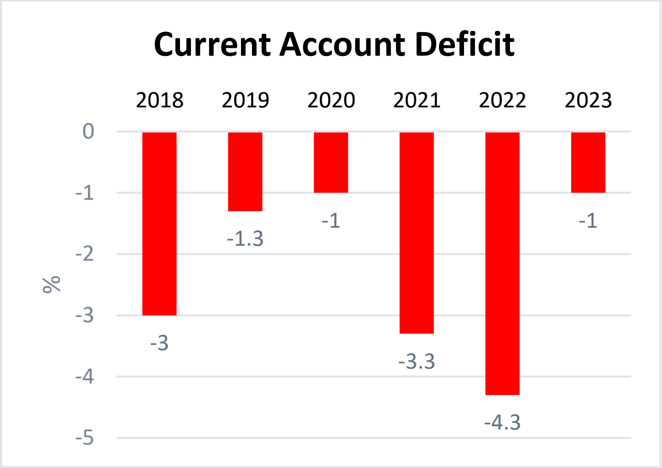
Debt/GDP has seen further decline

According to the IMF, debt decreased to 61.00% of GDP by the end of 2023, despite a 0.60% of GDP increase in cash balances. Since 2021, the primary balance has played a significant role in reversing the debt trajectory, alongside contributions from strong GDP growth, inflation, and currency appreciation. Debt is projected to continue decreasing by approximately 1.00% of GDP annually over the medium term. Gross financing needs are expected to remain around 8.00% of GDP in 2024-2025, partly due to a high interest burden. The risk of sovereign debt distress is low, with a major concern being contingent liabilities, including an increasing disputed claim from the social security fund.



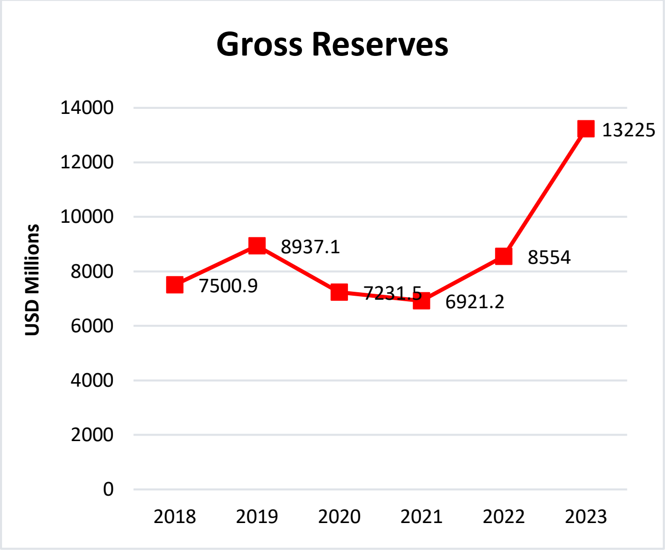
Current account deficit to narrow to 1.0%.

The IMF estimated that the current account deficit decreased from 3.20% of GDP in 2022 to 1.00% of GDP in 2023, driven mainly by stronger exports and more favourable terms of trade. However, higher imports and larger net primary income outflows (due to increased returns on foreign investment and public debt service payments) are expected to widen the current account deficit in 2024. Net International Reserves (NIR) exceeded the program target by nearly US$5 billion at the end of December 2023, and gross reserves were 135% of the IMF's Assessing Reserve Adequacy metric at the end of April 2024, after repaying the remaining $1.10 billion loan from the Latin America Reserve Fund (FLAR). Although the currency has continued to appreciate, its pace has slowed since March 2023. The narrowing of the current account deficit is a positive sign for Costa Rica as it signals a stronger position on the international scene which leads to a more demanded and stronger currency.



Strong reserves exceeding the NIR target in December 2023 and March 2024.

The IMF reported that Costa Rica follows a flexible exchange rate system, intervening only to prevent disorderly market conditions and to maintain adequate reserve levels. In the first half of 2022, the BCCR faced significantly higher foreign exchange demands from energy imports by the NFPS and from pension funds. This was only partially balanced by the BCCR's foreign exchange purchases from the market, resulting in the end-June 2022 and end-September 2022 NIR targets being missed by US$612.20 million and US$48.60 million, respectively. As external pressures decreased in the latter half of 2022 and throughout 2023, the BCCR actively purchased foreign currency from the market and exceeded all NIR targets from end-December 2022 to end-March 2024. The end-December 2023 and end-March 2024 NIR targets were surpassed by US$4982 million and US$4832 million to close at $13,325 and $13,391.50 respectively. The Internal Audit Office of the BCCR has been regularly reviewing the NIR and the underlying data in accordance with the TMU definition, reconciling them with the audited financial statements as necessary at the end of each fiscal year.



CREDIT RATINGS ANALYSIS

S&P Global Ratings had upgraded Costa Rica's long-term sovereign credit ratings to 'BB-' from 'B+', in its October 2023 report, citing stronger financial performance and solid economic growth. The upgrade reflects improvements in Costa Rica's external profile, robust exports, and a larger liquidity buffer due to a primary fiscal surplus for the second consecutive year. The stable outlook indicates expectations of continued fiscal improvements and liquidity management, despite global economic challenges. The government's commitment to fiscal reforms, such as modifying the fiscal spending rule and implementing a public employment regime, is expected to support its borrowing plans in global markets.

S&P went on to emphasize that Costa Rica's economy benefits from a strong democratic tradition and a positive business climate, supporting steady foreign direct investment (FDI) and dynamic export sectors. The country's efforts in decarbonization and attractive investment environment have bolstered economic resilience and growth prospects. Despite a high debt burden and interest payments, the government's solid fiscal performance and access to global capital markets are key to managing its financial flexibility. Continued reforms and strong fiscal execution are crucial to maintaining the country's credit rating and supporting economic stability.

Fitch Ratings has upgraded Costa Rica's Long-Term Foreign-Currency Issuer Default Rating (IDR) to 'BB' from 'BB-', reflecting improvements in the country's fiscal position, robust economic growth, and better external liquidity. Key factors include the government's adherence to a fiscal rule, structural strengths like strong governance indicators, and high per-capita income. Despite these improvements, challenges remain, such as high interest payments and political gridlock. Fitch highlights the successful issuance of US$3 billion in international bonds, which has reduced domestic market pressures and improved financing flexibility.

Economic growth exceeded expectations in 2023, driven by external demand, investment recovery, and strong household consumption. Fitch forecasts growth of 3.70% in 2024 and 3.50% in 2025, with Costa Rica benefiting from the global near-shoring trend. The current account deficit improved significantly, accompanied by strong foreign direct investment and reserve accumulation, which has led to currency appreciation and historic high reserve adequacy. Inflation fell dramatically, prompting the central bank to reduce its policy rate. Costa Rica's high governance scores reflect its stable political environment, strong institutional capacity, and low corruption levels.

Investment Positives:

- The Costa Rican economy remains diverse, operating in various sectors such as manufacturing, tourism and other services.
- Credit rating upgrades from S&P and Fitch underscoring the improvement of the economic fundamentals of the country.
- Costa Rica benefits from a stable, democratic, political institution. This is integral in the current tensed geopolitical environment, and it may result in an increase in foreign investments.

Investment Negatives:

- Costa Rica's economy is susceptible to external shocks, such as fluctuations in global commodity prices and changes in U.S. monetary policy. These external factors can adversely affect the country's economic performance and its ability to service debt.
- The implementation of economic reforms, particularly those related to public employment and tax systems, has been slower than anticipated. Delays in these reforms can hinder economic stability and growth prospects, adding to investor uncertainty.
- Costa Rica's external debt is significantly exposed to foreign exchange risk. A substantial portion of the country's debt is denominated in foreign currency, which increases vulnerability to currency fluctuations and can lead to higher debt servicing costs if the local currency depreciates

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Conclusion

On a forward-looking basis, the overall outlook on Costa Rica is positive. Recent credit rating upgrades from Fitch and S&P affirm the country's economic viability and robustness. The narrowing of the current account deficit and the decline in the Debt-GDP ratio are promising indicators of a stable and improving economy. Costa Rica's strong exports, larger liquidity buffer, and fiscal discipline, reflected in a primary surplus for two consecutive years, underpin this optimistic trajectory. Additionally, the yields on the fixed income instruments are higher than the benchmark US treasury notes. Taking that into consideration with the improved credit ratings from both Fitch and S&P should be attractive for moderate risk investors.

SOURCES

Bloomberg, IMF, S&P, Fitch Ratings, Central Bank of Costa Rica, INEC Costa Rica (Instituto Nacional de Estadistica y Censos), World Bank.

DEFINITIONS

- **OVERWEIGHT** - Security is deemed to be undervalued and is expected to outperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **MARKETWEIGHT** – Security is expected to provide similar returns compared to the market in general or at the same pace as comparable companies; neither strongly positive nor negative.
- **UNDERWEIGHT** – Security is deemed to be overvalued and is expected to underperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **ZEROWEIGHT** – This security is substantially distressed or at risk of a shock which may significantly impair its value.