COSTA RICA

Growth is projected to remain solid, supported by strong exports and inflows of foreign direct investment. Domestic investment is set to rebound, driven by public infrastructure projects. Despite robust output growth, unemployment will remain high, reflecting persistent skill mismatches. Inflation will increase, but is projected to stay below 3%.

Restoring sustainable public finances has become more urgent. The continuation of the current piecemeal fiscal consolidation measures will result in a modest improvement in the primary balance but will fail to halt the deteriorating public debt trajectory. This will put upward pressure on interest rates and hurt private investment and growth prospects. As public debt grows, so does the risk that the government becomes unable to meet its financing needs through debt issuances, which would force damaging cuts to the welfare system and threaten macroeconomic stability. Structural reforms to reduce informality, improve education, address infrastructure gaps and strengthen competition would boost productivity and inclusive growth.

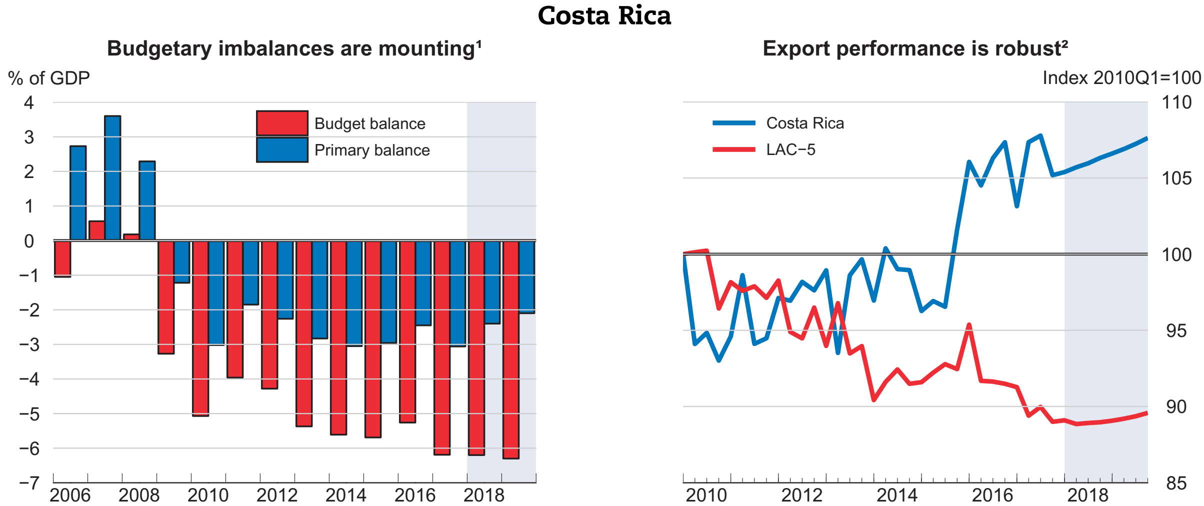
Broad-based growth continues

While output growth remains above 3%, it was lower than expected in the second half of 2017 as adverse weather conditions, including tropical storm Nate, disrupted agricultural production and ongoing construction projects. This disruption, along with rising interest rates, resulted in contracting private investment. Robust output growth has not translated into a strong labour market, with the unemployment rate remaining above 9% and more than 40% of workers holding informal jobs.

The fiscal outlook has deteriorated

After a period of deceleration, core and headline inflation have picked up to within the 2-4% target range. The central bank has started to withdraw its accommodative stance and

Costa Rica



1. Refers to the central government.
2. Ratio between export volume and export market of total goods and services. LAC-5 is a simple average of Argentina, Brazil, Chile, Colombia and Mexico.

Source: Ministry of Finance; and OECD Economic Outlook 103 database.

StatLink http://dx.doi.org/10.1787/888933729838

Costa Rica: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices CRC trillion	Percentage changes, volume (2012 prices)				
GDP at market prices	27.2	3.6	4.2	3.2	3.7	3.7
Private consumption	18.0	4.6	3.5	2.6	3.3	3.9
Government consumption	4.8	2.3	2.4	2.9	2.4	2.3
Gross fixed capital formation	5.3	3.1	3.8	-2.8	2.7	4.3
Final domestic demand	28.1	3.8	3.3	1.7	3.1	3.6
Stockbuilding[1]	- 0.2	0.3	0.0	0.8	0.2	0.0
Total domestic demand	27.9	4.2	3.5	2.5	3.4	3.7
Exports of goods and services	8.8	2.8	11.4	5.0	4.9	6.0
Imports of goods and services	9.5	4.4	8.7	3.1	4.2	5.7
Net exports[1]	- 0.7	-0.7	0.5	0.6	0.2	0.0
Memorandum items						
GDP deflator	_	3.7	1.8	2.0	2.1	3.0
Consumer price index	_	0.8	0.0	1.6	2.9	3.0
Core inflation index[2]	_	1.8	0.1	1.2	2.5	3.0
Unemployment rate (% of labour force)	_	9.6	9.5	9.1	9.6	9.3
Current account balance (% of GDP)	_	-3.8	-2.6	-3.0	-3.0	-3.2

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 103 database.

StatLink http://dx.doi.org/10.1787/888933730902

increased the policy rate in several steps between April 2017 and February 2018. Fiscal performance continues to deteriorate. The central government budget deficit was 6.2% of GDP in 2017, the worst performance in almost two decades, and the primary deficit rose to 3.1% of GDP, from 2.4% in 2016. Central government debt soared from 24% of GDP in 2008 to 49% in 2017, and as a result interest payments now account for almost half of the deficit.

Political gridlock has prevented the enactment of legislation to address the fiscal situation, and the current piecemeal consolidation will fail to halt further increases in the deficit. While a bill to strengthen public finances is currently going through a fast-tracked approval process in Congress, there is uncertainty about whether it will pass into law. Moreover, even if this reform is implemented, further fiscal consolidation will be necessary to reduce public debt to prudent levels. Given that the fiscal multiplier appears low, fiscal consolidation efforts are likely to have only a limited effect on growth in the near term, but could improve investor and consumer confidence.

Unemployment is projected to remain high, reflecting structural mismatches between the supply of and demand for skills as the economy has moved towards more knowledge-intensive activities. This highlights the need for educational reforms to improve outcomes and strengthen linkages with the labour market. While inflation expectations remain well anchored, they are in the upper end of the target range, which together with the closing output gap and growing pressures exerted by the fiscal situation, will necessitate further increases in the policy rate.

The fiscal situation represents a downside risk to the outlook

Growth is projected to pick up due to stronger external demand supporting exports, including tourism and skill-intensive professional services, which will also help improve the current account. Investment is also projected to strengthen, owing to stronger public infrastructure spending and reconstruction related to hurricane Otto and tropical storm Nate. The major domestic risk to the outlook is the persistently high fiscal deficit and rapidly growing public debt, which, if left unaddressed, will threaten macroeconomic stability and Costa Rica's successful development model. In international markets, disorderly corrections in asset prices that create financial turbulence, and faster-than-expected monetary policy normalisation in advanced economies, could trigger capital outflows that would lead to unanticipated currency depreciation. This would in turn weaken Costa Rica's fiscal position even more and threaten financial stability, as the Costa Rican banking sector is still heavily dollarised and a high share of dollar-denominated loans are extended to unhedged borrowers.