Moody's
INVESTORS SERVICE

Rating Action: Moody's downgrades Costa Rica's rating to B2; changes outlook to stable

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New York, February 10, 2020 -- Moody's Investors Service, ("Moody's") has today downgraded the Government of Costa Rica's long-term issuer and senior unsecured bond ratings to B2 from B1 and changed its rating outlook to stable from negative.

The key drivers for today's downgrade are as follows:

1. High fiscal deficits leading to an upward trend in debt metrics which will remain above rating peers; and,

2. Recurring funding challenges resulting from relatively large borrowing requirements introduce risks to Costa Rica's credit profile

The stable outlook on the B2 rating reflects Moody's view that funding and liquidity pressures will remain contained even as debt metrics continue to rise.

In a related decision, Moody's lowered Costa Rica's long-term country ceilings: the foreign currency bond ceiling to Ba3 from Ba2; the foreign currency deposit ceiling to B3 from B2; and the local currency bond and deposit ceilings to Ba1 from Baa3. The short-term foreign currency bond ceiling and the short-term foreign currency deposit ceiling remain unchanged at Not Prime (NP).

RATINGS RATIONALE

RATIONALE FOR THE DOWNGRADE TO B2

FIRST DRIVER: HIGH FISCAL DEFICITS WILL LEAD TO UPWARD TREND IN DEBT METRICS

Fiscal deficits averaging over 6% of GDP since 2015 have pushed government debt/GDP higher than 'B' rated peers. Despite fiscal consolidation measures approved in 2018, Moody's expects these adverse fiscal trends to continue. As a result, Costa Rica's fiscal deficits, debt ratios, and interest burden will remain materially higher than those of similarly-rated peers for the foreseeable future.

Moody's projects government debt to reach 63% of GDP in 2020, higher than the 56% 'B' peer median. Because the Costa Rican government collects comparatively less revenues than its peers, its government debt-to-revenue ratio will reach 415% in 2020 compared to 263% for peers. Interest payments have been steadily increasing, and will account for over 30% of government revenues this year compared to only 10% for peers.

Although Moody's expects the 2018 fiscal reform to reduce deficits, this will happen only gradually. Last year Costa Rica's fiscal deficit reached 7% of GDP, more than double the median for similarly rated sovereigns. In 2020-22, Moody's forecasts only a small decline, with annual deficits coming just under 6% of GDP. Based on current trends, Moody's projects debt will continue to rise approaching 70% of GDP by 2022.

The fiscal reform approved in 2018 aimed to reduce the overall fiscal deficit through a combination of increased revenues and slower current expenditure growth. As full implementation will be a multi-year process that will span more than one administration, execution risks are material. Moreover, the 2019 fiscal results highlight the difficulties Costa Rica faces in its fiscal consolidation efforts. Despite an 8% increase in overall revenues last year, the government deficit was more than 1% of GDP wider than the authorities' original target, driven by increased interest costs and higher capital spending.

SECOND DRIVER: RECURRING FUNDING CHALLENGES RESULTING FROM RELATIVELY LARGE BORROWING REQUIREMENTS

A combination of high fiscal deficits and a large debt repayments pushed the government's overall funding needs to over 12% of GDP last year. Despite a small drop for 2020, funding needs will remain high. Moody's expects financing requirements close to 11% of GDP in 2020, and projects average annual funding needs to

remain above 12% of GDP in 2021-22, nominal amounts that will test markets' willingness and ability to cover the government's financing needs.

Relatively large funding needs will pose recurrent financing challenges to the government. Even though funding rates have declined since the government experienced a very tight liquidity position in 2018 - a condition that required an emergency loan from the central bank - Costa Rica's international borrowing rates remain among the highest in the region, exposing the government to changes in market appetite for its debt.

Costa Rica's main funding source is local with the domestic financial markets providing three-quarters of all government funding. As the country's domestic markets lack the size and depth to meet all government funding needs over time, Costa Rica must periodically tap international capital markets. In the past, when access to international capital markets was constrained, it has resulted in pressures on domestic interest rates as the government increased its local market funding.

RATIONALE FOR THE STABLE OUTLOOK

The recommendation to assign a stable outlook reflects reduced funding concerns relative to 2018. Although Moody's expects debt to continue to rise and fiscal deficits to fall only gradually, Costa Rica has shown improved market access in the last year and Moody's base scenario is that this will continue.

WHAT COULD CHANGE THE RATING UP

Given the recent downgrade, a rating upgrade is unlikely. The current rating would be strengthened if the government effectively implements structural budgetary adjustments that materially reduce fiscal deficits, limiting the expected worsening in government debt indicators and, as a result, easing funding risks.

WHAT COULD CHANGE THE RATING DOWN

Prospects of continued fiscal deterioration that result in higher government debt metrics than what Moody's currently projects, as well as a deterioration in market access conditions associated with materially higher funding costs, could lead to a negative rating action. Evidence of stress in the banking system, or a significant increase in the level of financial dollarization could also place downward pressure on the rating.

GDP per capita (PPP basis, US$): 17,566 (2018 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 2.6% (2018 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 2% (2018 Actual)

Gen. Gov. Financial Balance/GDP: -5.9% (2018 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -3.1% (2018 Actual) (also known as External Balance)

External debt/GDP: 48.4 (2018 Actual)

Economic resiliency: baa3

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 31 January 2019, a rating committee was called to discuss the rating of the Costa Rica, Government of. The main points raised during the discussion were: The issuer's fiscal or financial strength, including its debt profile, has materially decreased. The issuer has become increasingly susceptible to event risks.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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