

## Costa Rica Macro View

### This Smell is so Familiar

- After a long hiatus, we are once again turning our eyes back to Costa Rica's local markets. Interestingly, the country's return to external debt markets was what put the local bond market in the spotlight again, as it marked a serious reshuffling of financing sources.
- Whenever there is interest in Costa Rica's local market, the comparisons with 2007 and early 2008 are inevitable. Today FDI is not as high as it was during those days, but is almost entirely financing the current account deficit. Today's appreciation pressures (on the local currency) are not considered to be as strong as those in 2007 and early 2008, but that has not prevented portfolio inflows from reaching levels similar to those of that period.
- We believe the authorities' dislike for portfolio inflows coming into the local market has not changed throughout all these years. We would not be surprised if the government tries to discourage portfolio inflows through some kind of capital controls. The central bank's quasi-fiscal deficit does not provide too much room to stretch the international reserve accumulation program further.
- The local bond market story could be appealing but is not flawless. Fiscal challenges remain unsolved, and therefore there is a risk that the government aggressively comes back again for domestic financing. Finally, the government is unlikely to tolerate the *Colón* contributing to any potential upside on local market securities.

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#### Jorge A Pastrana

+1-212-816-5728

jorge.armando.pastranavillegas@citi.com

#### Camilo Gonzalez

+1-212-816-9901

camilo.gonzalezgarcia@citi.com

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# This Smell is so Familiar

## Back in the spotlight

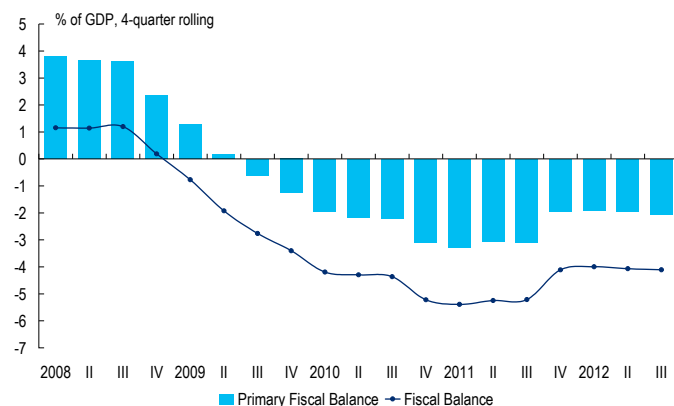
**After a long hiatus, we are once again turning our eyes back to Costa Rica's local markets.** For quite a long time, we have been focusing entirely on topics that were relevant for the country's external debt prices. Among those topics, the most important was always the (failed) fiscal reform. After a constitutional setback to the reform, the country had to look for a Plan B, and therefore to seek external financing. Interestingly, this shift in the country's plan to finance the fiscal deficit has put local market topics in the spotlight again. In this Macro View we address some of those topics.

**The comparisons between today and 2007 (and early 2008 too) seem inevitable.** It is worth remembering that, back in those days, the country's Pacific Coast experienced a surge of foreign direct investment (FDI). The money that came in at that time translated into a boom in high-end construction projects. The money flowing into that sector pushed FDI well above the current account deficit at a time during which the Central Bank of Costa Rica (BCCR) launched its transition to a more flexible exchange rate regime. Today the story is not necessarily the same, but there are topics that inevitably bring back memories of that period.

## Reshuffling the sources of financing

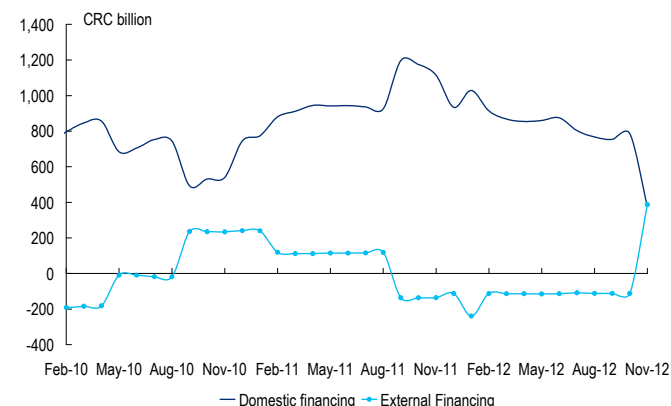
**Costa Rica is embarking on a serious reshuffling of its financing sources.** Last year's external debt issuance was the first step to balance the mix between domestic and external financing. The widening of the fiscal deficit during the past few years had been mostly financed by domestic sources. In our view, the government realized that they were flooding the market with local paper and that its relatively low external indebtedness gave them room to seek other financing sources. Last year, the local Congress approved a bill that allows the government to issue as much as US\$4 billion in external debt over the next 10 years. The bill imposes a cap in issuance of US\$1 billion per year. In 2012 the government maxed out the cap, but this year is free to issue another billion. Given that the fiscal situation remains unsolved, we would expect the government to tap global markets again sometime over the next 12 months.

Figure 1. Costa Rica: Central government fiscal accounts



Source: BCCR, Hacienda and Citi Research

Figure 2. Costa Rica: Financing sources



Source: BCCR, Hacienda and Citi Research

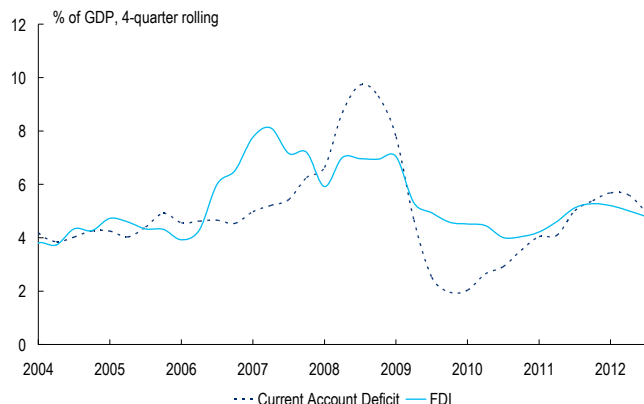
**A single large issuance has changed the financing picture.** Figure 2 shows the central government's 12-month rolling net financing, both domestic and external. November's external debt issuance by itself changed the whole picture. Net external financing was negative before the issuance, and after the government tapped global markets net domestic and external financing became roughly the same. In 2013, the expected external debt amortizations are roughly US\$340 million (of which US\$250 million are from the bond due January 31). If the government taps again global markets with US\$1 billion before 2013, we could witness a significant jump in net external financing.

## FDI and portfolio inflows contribute to currency strength

**The latest available data shows that FDI and the current account deficit are roughly balanced.** The four-quarter rolling current account deficit was 5% of GDP as of 3Q12, while the four-quarter rolling FDI amounted to 4.8% of GDP. FDI is not as high as it was at some point of 2007 (8% of GDP), but is by itself financing most of the current account. We expect the current account deficit to amount to US\$2.7 billion (5.5% of GDP) in 2013, and FDI to reach US\$2.5 billion (5.1% of GDP). Thus, we do not expect any major change in the way the country finances its current account deficit.

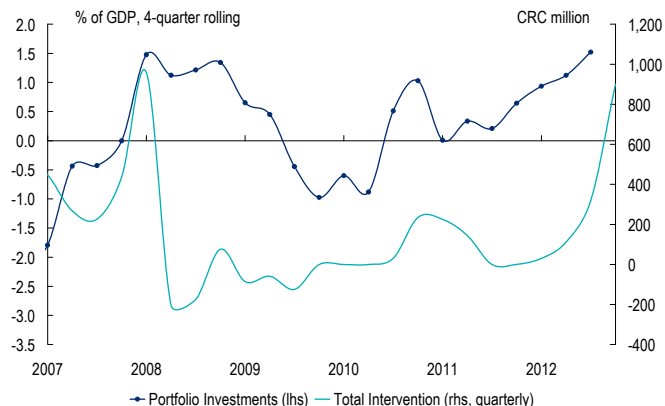
**Portfolio inflows are contributing to the local currency's strength too.** Since FDI is almost entirely financing the current account, portfolio inflows are providing a surplus of hard currency in the local market. As of 3Q12, portfolio inflows amounted to roughly 1.5% of GDP—the same amount than that of 1Q08. In our view, 1Q08 was the time at which local and foreign investors positioned for a potential abandonment of the FX band regime and the likely strengthening of the local currency that was expected to follow. That transition to a floating regime never happened, and the country still has an FX band. This time around we do not think that investors are positioning for a change in the floor of the FX band, but rather to take advantage of still high interest rates under a stable currency. What is worth noting is that in 4Q12, FX intervention to defend the floor of the band amounted to US\$900 million, which is comparable to the intervention of 1Q08 (US\$959 million).

Figure 3. Costa Rica: FDI and current account



Source: BCCR and Citi Research

Figure 4. Costa Rica: Portfolio investments and FX intervention



Source: BCCR and Citi Research

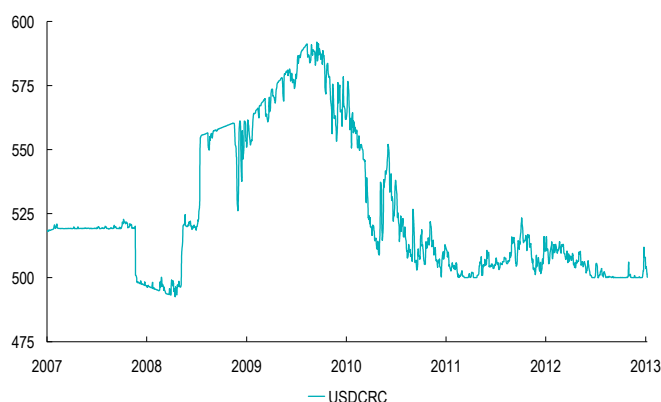
## Same mindset but different tools

**We would not be surprised if the government tries to discourage portfolio inflows through some kind of capital controls.** In our opinion, Costa Rica's exporting sector (of both goods and services) has significant lobbying power to exert pressure on authorities. In other words, it is unlikely that the authorities do what they did in 2007 (when they lowered the floor of the band) or accept a stronger local currency beyond the current floor of the band (USDCRC500). In fact, President Laura Chinchilla was quoted by the local newspaper *El Financiero* (January 9) saying that the government is assessing the possibility of putting limits to the arrival of "speculative" inflows. She said that "we are not going to allow that speculative inflows come here to do whatever they want with the Costa Rican economy". What surprises us is that the government has no problem with welcoming the money from purchases of external debt, but is unhappy if too much money comes to the local market, especially at a time when it needs to finance relatively high deficits.

**The quasi-fiscal deficit gives little room to deepen the use of reserve accumulation further.** As of January 7, net international reserves stood at almost US\$6.9 billion, fueled by the recent external debt issuance and the BCCR's reserve accumulation program. This accumulation has its limits as its cost may push up the central bank's quasi-fiscal deficit. The quasi-fiscal deficit was running at about 0.6% of GDP in 3Q12. The BCCR has always been careful that this deficit does not become a source of concern and therefore, we deem it is unlikely that it will stretch the reserve accumulation program further to push the USDCRC away from the floor of the band.

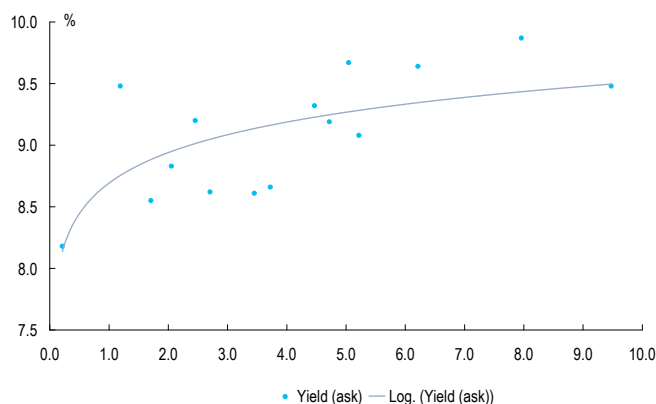
**We think that the government's dislike of portfolio inflows has not changed in all these years.** Although back then the government was run by another administration, it seems that the approach or views around the FX have not changed. In our view, today's pressure on the local currency to appreciate is not as strong as those of 5-6 years ago. The reason behind this view is that FDI back in those days was significantly higher than today's. However, it seems that the growth of the Costa Rican local market makes it easier for portfolio investors to access the country. If left unchecked this time around, we believe the amount of portfolio inflows could easily surpass the levels of 2007 and early 2008 amid low international interest rates, ample liquidity and investors' search for yield.

Figure 5. Costa Rica: The Colón is trading slightly above 500



Source: BCCR and Citi Research

Figure 6. Costa Rica: Local yield curve (January 9, 2013)



Source: Citibank Costa Rica, Bloomberg and Citi Research

## What to watch for those involved in Costa Rica

**We acknowledge that the local markets story could be appealing for some investors.** The change in the financing mix certainly put the local bond market in the spotlight. We also expect the flows to continue favoring a strong *Colón* (against the US dollar) but, in our view, there is no political room to let the local currency appreciate further. Therefore, we must highlight that there are some risks for those involved (or willing to get involved) in local markets.

**Fiscal challenges remain unsolved at a time when the electoral cycle is beginning to steam up.** The country will hold its presidential election in 2014. This gives little room to undertake a serious fiscal adjustment. Moreover, after the failure to deliver a fiscal reform in 2012, the Chinchilla administration was left with little political capital to look for a thorough reform. Even if the government were to push in this direction, we think it would not be as ambitious as the watered down version that the government unsuccessfully tried to get through in 2012. If authorities were unable to contain the central government deficit, they would continue to rely aggressively on the local market for financing.

**The government is unlikely to tolerate the *Colón* from contributing to any potential upside on local market securities.** We are not expecting the government to lower the floor of the band, since the government does not want to negatively affect the exporting sector. We believe this puts all the local currency risk on the downside. In addition, the government could put in some controls to discourage portfolio investments.

## Costa Rica — Selected Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
	Act.	Act.	Act.	Act.	Act.	Act.	Act.	Act.	Exp	Exp	Exp
Nominal GDP (US\$ bn)	18.6	20.0	22.5	26.4	29.8	29.4	36.4	40.7	45.1	48.8	53.3
GDP per capita (US\$)	4,450	4,680	5,174	5,941	6,582	6,366	7,971	8,857	9,601	10,383	11,100
Population (millions)	4.2	4.3	4.4	4.4	4.5	4.6	4.6	4.6	4.7	4.7	4.8
<b>ECONOMIC ACTIVITY</b>											
Real GDP growth (yoy)	4.3	5.9	8.8	7.9	2.7	-1.0	4.7	4.2	5.0	4.0	5.5
<b>PRICES</b>											
Consumer Price Inflation (yoy, eop)	13.1	14.1	9.4	10.8	13.9	4.0	5.8	4.7	4.6	4.5	4.3
Exchange Rate (local currency to USD, eop)	457.0	495.2	517.1	496.0	549.8	568.0	513.0	511.0	502.0	505.0	510.0
<b>EXTERNAL SECTOR</b>											
Current Account Balance (% of GDP)	-4.3	-4.9	-4.5	-6.2	-9.3	-2.0	-3.6	-5.4	-5.2	-5.5	-5.0
Current Account Balance (in US\$ bn)	-0.8	-1.0	-1.0	-1.6	-2.8	-0.6	-1.3	-2.2	-2.3	-2.7	-2.7
Foreign Direct Investment (in US\$ bn)	0.7	0.9	1.5	1.9	2.1	1.3	1.4	2.2	2.4	2.5	2.5
International Reserves (in US\$ bn)	1.9	2.3	3.1	4.1	3.8	4.1	4.6	4.8	5.4	5.8	6.2
<b>PUBLIC SECTOR</b>											
Central Gov. Primary Budget Balance (% of GDP)	1.6	2.5	2.7	3.7	2.4	-1.3	-3.1	-1.9	-2.5	-3.0	-3.5
Central Gov. Budget Balance (% of GDP)	-2.7	-2.1	-1.1	0.6	0.2	-3.4	-5.2	-4.1	-4.5	-5.0	-5.5
Central Gov. Revenues (% of GDP)	13.3	13.5	13.9	14.9	15.3	13.4	13.0	13.3	13.3	13.4	13.4
<b>DEBT INDICATORS</b>											
Gross Government Debt (% of GDP)	46.9	42.9	38.4	31.7	29.7	34.0	36.2	38.0	41.0	44.0	46.0
Domestic (% of GDP)	27.6	25.5	23.4	19.5	18.0	22.9	25.6	27.0	28.0	30.0	30.0
External (% of GDP)	19.3	17.4	15.0	12.2	11.7	11.0	10.5	11.0	13.0	14.0	16.0
<i>Memorandum items</i>											
Workers' Remittances (US\$ Bn)	0.3	0.4	0.5	0.6	0.6	0.5	0.6	0.7	0.7	0.8	0.8
Source: BCCR, Hacienda, Haver and Citi Research											

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