

# Fitch Revises Costa Rica's Rating Outlook to Stable

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Fitch Ratings-New York-04 October 2006: Fitch Ratings has revised the Rating Outlook on Costa Rica's foreign currency and local currency Issuer Default Ratings (IDRs) of 'BB' and 'BB+' respectively, to Stable from Negative. Fitch also affirms Costa Rica's country ceiling at 'BB+'. 'The revision in the Rating Outlook reflects the improvement in Costa Rica's fiscal balances over the past two years, an appreciable decline in its government debt burden, and a further improvement in its external solvency and liquidity ratios,' said Shelly Shetty, Senior Director at Fitch. The revision in Outlook also takes into account the greater economic dynamism of Costa Rica, with its growth expected to reach close to 7% in 2006 driven by expansion in the tourism, construction, mobile telecommunication and other export-oriented industries. In addition, while Fitch remains concerned about the Costa Rican banking sector, the recent foreign acquisition of large local private banks is likely to reduce risks associated with their offshore banking activities and improve the technical and risk management capabilities of these banks. Finally, Costa Rica's relatively mature democratic institutions and political stability are among its chief credit strengths, setting it apart from other countries in this rating category. Even without a tax-enhancing fiscal reform, the government has been gradually tightening its fiscal belt since 2004, with the 2005 fiscal performance surpassing most expectations. In 2005, the central government fiscal deficit declined to 2.1% of GDP from 2.7% in 2004, reflecting the success of tax administrative measures as well as tight control over both current and capital expenditures. More impressively, fiscal consolidation has been embraced by all the levels in public sector, with the social security institute increasing its surplus and ICE (the state electricity and telecom monopoly) running a balanced position. Lower fiscal deficits and a strong growth have led to a decline in the general government debt from 51% of GDP in 2002 to 46% in 2005, which is in line with the 'BB' median. Over the past three years, external solvency and liquidity ratios have also improved due to both robust CXR growth and increases in international reserves. Net external debt fell from 45% of CXR in 2002 to 29% in 2005, and is below the 'BB' median. More impressively, the net public external debt has declined from 16% of CXR in 2002 to 5% in 2005, which is also below the 'BB' median of 24%. While Costa Rica's current account deficit remains large, strong FDI flows financed over 90% of the current account deficit in 2005 and are expected to finance 80% of the deficits in the coming two years, thereby reducing the external vulnerability of Costa Rica. Robust inflow of FDI has not only fuelled investment growth, it has also bolstered the diversity of Costa Rica's export base (the commodity dependence of Costa Rica is 35%), and improved the resilience of the country to deal with the oil price shock. On the negative side of the ledger, Costa Rica has suffered from reform inertia due to its fractious Congress, and cumbersome legislative rules that prevent early passage of legislation. For example, while most of the other countries in Central America have implemented CAFTA, the Costa Rican Congress has not even approved the treaty. The approval of the treaty is necessary for Costa Rica to integrate further with its main trading partners and to encourage a greater inflow of FDI. However, some political parties and the unions remain opposed to opening the state monopolies and implementing CAFTA, which could make the approval of CAFTA fairly contentious and a long-drawn process. Costa Rica's other credit weaknesses include its high inflation rate, continued structural weaknesses in its public finances, and a weak banking sector. In Fitch's view, tax-enhancing measures need to be implemented in order to sustain the fiscal consolidation process, accommodate the rising spending pressures and to recapitalize the central bank. However, the political parties in Congress are divided on tax policy, making it difficult to predict which of the tax bills submitted by the Arias government will be passed. Fitch notes that the central bank's intention to move toward the exchange rate bands system from the crawling peg regime in the coming months could improve its ability to implement monetary policy. Yet, the recapitalization of the central bank is a prerequisite for the institution to fight

inflation more aggressively and to further liberalize the exchange rate regime and adopt inflation targeting. Fitch's concern regarding the Costa Rican banking sector relate to its high incidence of state ownership, widespread dollarization, and the presence of a largely unsupervised off-shore banking system. Fitch will continue to monitor the progress made by the Arias administration in advancing its reform agenda. Further improvements in Costa Rica's creditworthiness would depend on the ability of the government to increase its tax base, recapitalize the central bank and implement CAFTA. Contact: Shelly Shetty +1-212-908-0324 or Morgan Harting +1-212-908-0820, New York. Media Relations: Christopher Kimble, New York, Tel: +1 212-908-0226. Fitch's rating definitions and the terms of use of such ratings are available on the agency's public site, '[www.fitchratings.com](http://www.fitchratings.com)'. Published ratings, criteria and methodologies are available from this site, at all times. Fitch's code of conduct, confidentiality, conflicts of interest, affiliate firewall, compliance and other relevant policies and procedures are also available from the 'Code of Conduct' section of this site.