Costa Rica Viewpoint

Jaguar economy and the spillovers from export-led growth.

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GEM Economics
LatAm | Costa Rica

Alexander Müller
Andean(ex-Ven) Carib Economist
BofAS
+1 646 855 5750
alexander.muller@bofa.com

Pedro Diaz
Caribbean Economist
BofAS
+1 646 855 2575
pdiaz2@bofa.com

Lucas Martin, CFA
Sovereign Debt FI Strategist
BofAS
lucas.martin@bofa.com

Jane Brauer
Sovereign Debt FI Strategist
BofAS
jane.brauer@bofa.com

GEMs FI Strategy & Economics
BofAS

LatAm FI Strategy & Economics
BofAS

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Strong growth and deflation: Export-led growth explains it

Costa Rica is achieving a remarkable combination of strong growth and deflation. We believe that this apparent puzzle can be explained because Costa Rica's growth has become more export-led since the outbreak of the pandemic. We see an analogy to the East Asian "tiger" economies that developed rapidly from the 1960s by focusing on capital accumulation, export-oriented manufacturing, and human capital development.

"Jaguar" vs. East Asian "tiger" economies

The Costa Rican "jaguar" economy has some key differences with the East Asian "tiger" economies. Costa Rica is currently at a higher level of economic development than those economies were in the 1960s and its workforce boasts high education and health indicators compared to the region. In addition, Costa Rica's export mix is not restricted to manufactured goods but includes a significant share of non-tourism services.

Costa Rica's unique free trade zone policy

There is less state intervention than happened in East Asia, though Costa Rica's free trade zone policy is clearly part of the success. A unique feature of Costa Rica is that its free trade zones are not restricted to specific geographic locations. It is a differentiated tax regime that can be claimed by any qualifying business, in both goods and services. This flexibility is an important driver of the outperformance of this sector, in our view.

Three benefits from export-led growth

Export-led growth is having at least three additional desirable effects on the macroeconomy: 1) a decline in the natural unemployment rate, with favorable implications for monetary policy, 2) an improvement in balance of payments, and 3) perhaps a stronger fundamental value of the Costa Rican Colon, which can be critical to bring down the public debt ratio.

Stronger Costa Rican Colon: Balassa Samuelson effect

We have revised up our GDP growth forecasts for 2024, to 4.2% (from 3.8%), and 2025, to 3.8% (from 3.5%). Labor productivity in Costa Rica is growing 5x faster than in the US. Real wages are growing at the fastest pace in over 20 years. These are signals of something that economists call the "Balassa Samuelson effect" which makes the real exchange rate stronger. Hence, we also changed our USDCRC forecasts to 505 (year-end 2024) and 518 (year-end 2025). This is an out-of-consensus view for a stronger CRC.

Summary of investor trip: A solid case

Costa Rica is one of the very few LatAm countries, in our view, where the economy seems on track to achieve substantial and sustained progress. Some locals push back by saying crime is on the rise or criticizing the government's style of doing politics (vinegary with the press and opposition parties). Nevertheless, the broad picture looks quite positive when contrasted with the region.

The economy is growing robustly, led by exports, amid (temporary) deflation. The opposite of stagflation, one could say. The balance of payments and fiscal conditions are on an improvement trend, which we think will trigger more credit rating upgrades. Meeting with policymakers and experts from different sectors (financial, multilaterals, independent economists), during our recent trip to San Jose, reaffirmed our conviction that Costa Rica is a solid case.

Revised up GDP growth forecasts for 2024 and 2025

We have revised up our GDP growth forecasts for 2024, to 4.2% (from 3.8%), and 2025, to 3.8% (from 3.5%). Growth in 2023 was 5.1%. Exports of goods and services (10.5%) and investment (8.6%) were particularly strong. Exports of goods and services have grown at rates above 10% for three consecutive years. December's GDP proxy showed a slowdown at the margin, but nothing that changes our opinion about the broad picture.

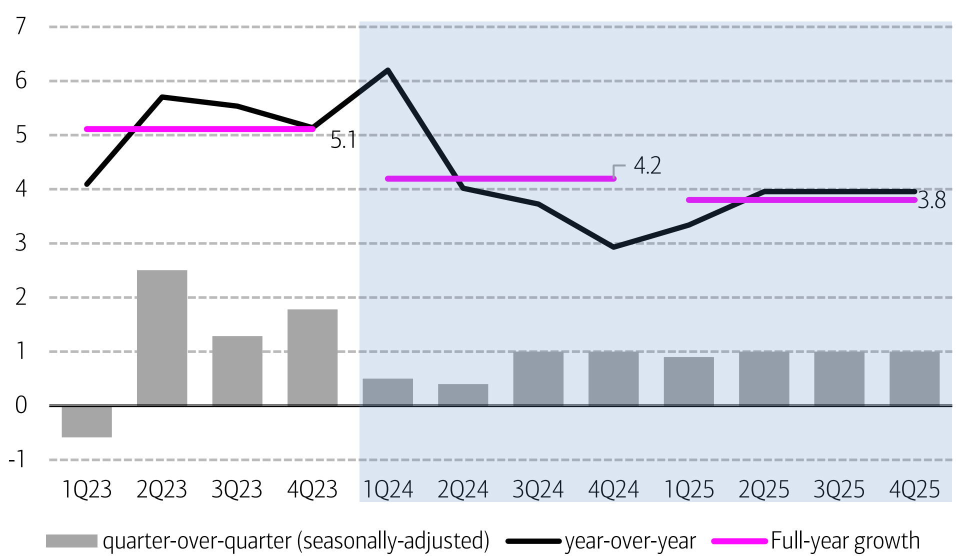
Nearshoring, luxury properties, trickle-down effects

Locals say there is tangible evidence on nearshoring of US investments to Costa Rica (Intel, Johnson & Johnson, Abbot, among others), mainly in the export-oriented free trade zones. They also highlight a boom in the construction of luxury properties along the Guanacaste coast, and trickle-down effects of robust economic growth for the population.

The Statistics Institute's (INEC) household survey estimates the poverty rate fell to 21.8% in 2023 (from 23% in 2022). More high frequency data shows real wages are growing 14% yoy (December 2023, latest data point). Conversely, some business associations complain that the appreciation of the Costa Rican Colon is eroding the cost-competitiveness of domestic producers.

Exhibit 1: GDP growth forecasts

We forecast GDP growth hovering around 4%, higher than the mean of the last fifteen years (3.3%)



Source: BofA Global Research, Central Bank (BCCR)

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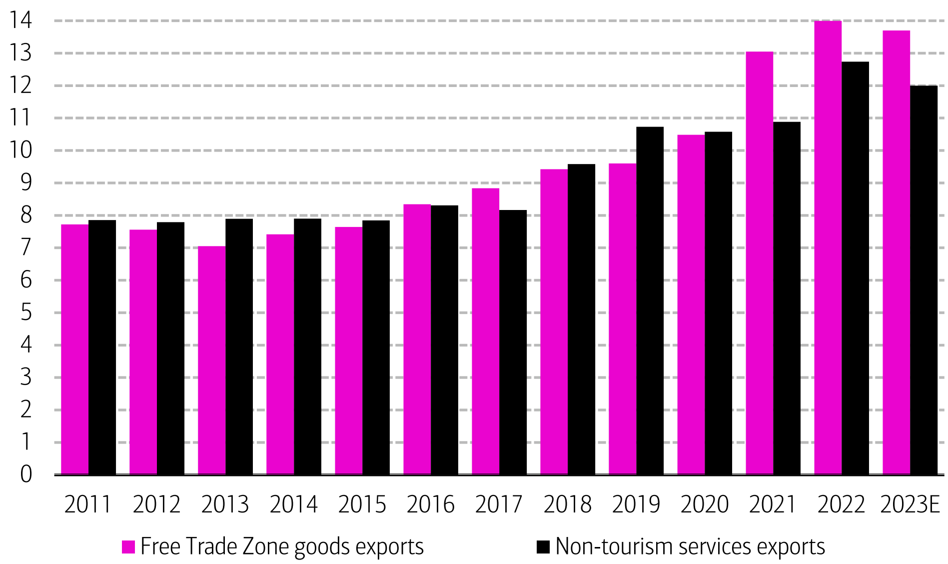
Export-led growth strengthens macroeconomic stability

GDP driven by exports is a much healthier way for an economy to grow, compared to public sector demand-led or consumption-debt expansions that are less sustainable because of their proclivity to create macro imbalances.

Moreover, in the case of Costa Rica, we will argue export-led growth is having at least three additional desirable effects in economic conditions: 1) a decline in the natural unemployment rate, with favorable implications for monetary policy, 2) an improvement in balance of payments, the easiest to observe; and 3) perhaps a stronger fundamental value of the Costa Rican Colon (more difficult to prove), which can be critical to bring down the public debt ratio.

Exhibit 2: The booming Free Trade Zone goods exports and non-tourism services exports (% of GDP)
Between 2019 (pre-pandemic) and 2023, free trade zone goods exports jumped from 9.6% to 13.7% of GDP, while non-tourism services exports rose to 12% of GDP (from 10.7%) driven by professional services



Note: Data for 2023 are rolling four quarters ended in 3Q2023 (latest data point in the balance of payments).
Source: Central Bank (BCCR), BofA Global Research

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Decline in natural unemployment rate

Unemployment rate at historical lows

Costa Rica's unemployment rate declined to 7.3% in 4Q2023 (from 11.7% in 4Q2022), the lowest on-record, well below what consensus considers to be the natural rate of unemployment (around 10%, like the historical median). Economists generally say structural unemployment in Costa Rica is high because the tax wedge on labor costs imputable to social security is twice the OECD average, among other reasons. Yet currently, with the rate at 7.3%, the economy is not exhibiting symptoms of overheating. In fact, the number of employed workers dropped 4.2% yoy in 4Q2023, which is very puzzling for an economy that grew more than 5% in 2023.

Falling participation rate is only a partial explanation

An arithmetical explanation is that the participation rate is much lower than last year (53.8% in 4Q2023 vs. 59.7% in 4Q2022). If less people are looking for jobs, then the number of unemployed individuals goes down mechanically. Locals say the falling participation rate may be attributable to i) women attending childcare responsibilities (drop is sharper in female population); ii) older cohorts rushing to retire (because of recent changes in early retirement laws); and iii) people reevaluating their life choices after the pandemic.

Export-led growth on the back of labor-intensive, formal, activities

In our interpretation, the structural decline in the unemployment rate must also be related to export-led growth. Between 2019 (pre-pandemic) and 2023, free trade zone goods exports jumped from 9.6% of GDP to 13.7% of GDP, while non-tourism services exports rose to 12% of GDP (from 10.7%) driven by professional services. These are labor-intensive activities that predominantly operate in the formal sector and pay higher wages. They are absorbing jobs from the less productive, more informal, non-tradable sectors.

Tellingly, data from the Social Security Institute (CCSS) shows the number of people affiliated to social security (proxy for formal employment) is up 3.8% yoy. Meanwhile, delving into the labor market data one can see that the category in which employment is falling the most is "household employment" (part of the informal economy).

Monetary policy: more degrees of freedom because of lower U-star

A lower natural unemployment rate (U-star) should be welcomed by the Central Bank (BCCR) because it will allow them to achieve higher economic growth and a lower unemployment rate without fanning inflation. It may help to solve the puzzle for why Costa Rica's inflation is so low now. CP inflation is running at -1.9% yoy (January 2024), and core (CPI excluding volatile food & fuels) is at -0.3% yoy.

We think deflation is driven by the exchange rate appreciation (related to Balassa-Samuelson effect), flexible regulation of fuel and food prices (international variations are quickly passed along to consumers), and a labor market than is less tight than what would assume by simply looking at the unemployment rate. Looking ahead, we expect the BCCR to cut in tandem with the US Fed in 2024 (25bp in June, September, and December) taking the policy rate to 5%. For 2025, we expect two additional 25bp cuts.

Improvement in the balance of payments

Narrowing of current account deficit will probably stick

We estimate Costa Rica's current account deficit narrowed to 1.5% of GDP in 2023, from 3.7% in 2022, much smaller than its long-term average (4%). At the outset, the deficit seems small for a year in which oil prices were relatively high (US$/bbl 80 on average), the exchange rate was supposed to be overvalued (that's what locals say), and the economy grew above 5% (exceeding the potential rate, ~3.5%-4%) putting pressure on demand for imports.

Yet that overlooks what is going on the exports part of the equation. As we mentioned above, goods exports from free trade zones and services exports have increased a lot compared to the pre-pandemic year (more than 5pp of GDP, added up together). That change is structural, we think, and should get reinforced by the ongoing nearshoring of US investments which is flowing into the free trade zones. We forecast the current account deficit at 1.7% of GDP for 2024 and 2025 (from 2.5% and 2.7% in our previous scenario, respectively).

Improvement is also visible on funding side and international reserves position

On the funding side, net FDI is strong (above 4% of GDP, almost tripling the current account deficit). Net FDI grew 19% yoy in the first three quarters of 2023. Also, Costa Rica is receiving large loans from multilateral institutions (see exhibit 4), and the government's access to markets is much better than a few years ago (Eurobonds' risk premium, measured by the EMBI, has fallen below some investment-grade countries like Colombia, Mexico, and Panama). Furthermore, international reserves are at historical highs (US$ 13.2bn, +55% yoy, 15.3% of GDP). Roughly around 140% of the IMF's recommended ARA metric. If reserves get to 150%, maybe the Central Bank will prepay the Latin American Reserve Fund's (FLAR) loan (US$ 1.1bn, borrowed in 2022).

Stronger balance of payments can induce rating upgrade and stronger currency
Rating agencies pay attention to the external position of countries. We believe the stronger balance of payments will be part of the rationale when Costa Rica's credit rating gets upgraded again, this year. Moreover, better external conditions can also imply a permanently stronger Costa Rican Colon, from a fundamental valuation perspective.

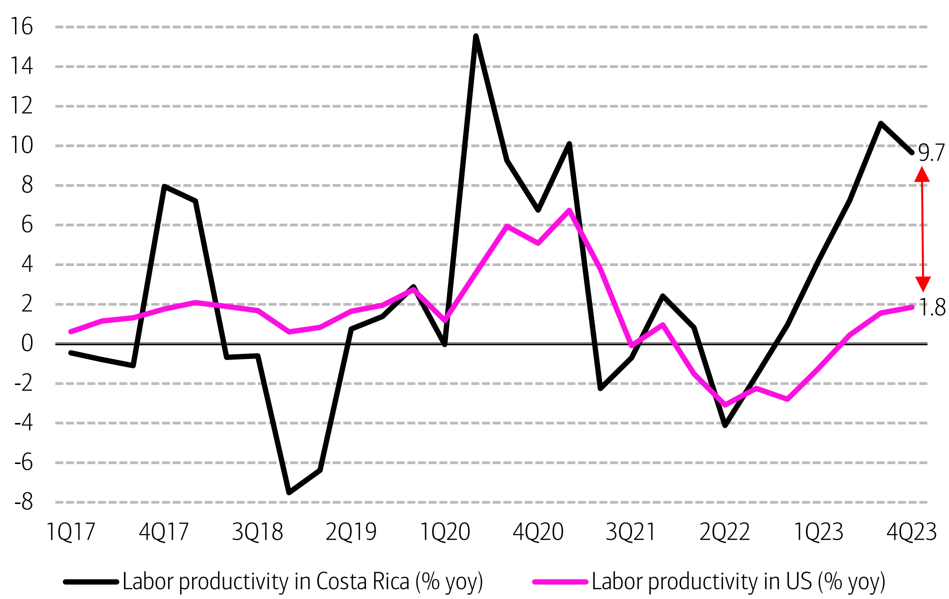
Stronger Costa Rican Colon: Balassa Samuelson effect

We have changed our USDCRC forecasts for year-end 2024, to 505 Colones to the US Dollar (from 564 in our previous scenario), and year-end 2025, to 518 (from 571). Currently the spot exchange rate is at 517. This is an out of consensus view considering the central bank's survey of macroeconomic expectations says local experts expect the CRC to weaken to around 535 in the next twelve months (2.6% from January 2024).

We have rethought the balance of forces that will shape the exchange rate in coming quarters. Appreciations seems likely to dominate in 2024 for the following reasons:

- Costa Rica is showing strong signals of the "Balassa Samuelson effect". According to this theory, if the productivity of tradable sectors in Costa Rica (such FTZ and services exports) grows faster than in trading partners, then these sectors should absorb labor and push up the wages of the economy, leading to a stronger exchange rate. Notably, labor productivity in Costa Rica is growing 5 times faster than in the US (9.7% yoy vs. 1.8%, see exhibit 3). and real wages are growing at the fastest pace in over 20 years.
- Global weakness of the US Dollar. Our G10 FX Strategy team expects the US Dollar to weaken against major currencies (6.5% versus the Euro and 5.3% versus the Yen, from spot levels) assuming the Fed starts cutting rates in June. The Costa Rican Colon is sensitive to the global USD moves.
- We believe the Central Bank will not cut rates until the US Fed does so, despite of headline inflation running at negative levels. The interest rate differential will not get any thinner. The BCCR is concerned about not inducing a more negative premium for saving in Colones. So, it's harder to envision firms and households switching their savings from Colones to USD-denominated assets.

Exhibit 3: Labor productivity (driven by tradable sectors), measured as output per worker, is growing more than five times faster in Costa Rica than in the US
This suggests the Balassa-Samuelson effect may be causing a permanently stronger Costa Rican Colon



Source: Central Bank (BCCR), Statistics Institute (INEC), US Bureau of Labor Statistics, BofA Global Research

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- The balance of payments is stronger, with higher exports, FDI, and reserves. We think the improvement will stick and may benefit further from the nearshoring of US investments. This is supportive for the CRC.

- Robust growth, improvements in the balance of payments, and falling public debt might nudge the rating agencies to upgrade Costa Rica's credit rating again in 2024. Moody's has a positive outlook. A better credit rating, holding everything else constant, is associated with a stronger currency.

- Government's external financing – in the form of Eurobond issuance (Congress already granted authorization for US$ 2bn in 2024-25) and multilateral loans (US$ 1.3bn only from IMF in 2024) – will increase the domestic supply of dollars.

For 2025, we do expect a moderate depreciation of the exchange rate, to 518 Colones to the Dollar. The main reason is that net issuance of Treasury/Hacienda securities is becoming smaller compared to 2023 and previous years, and Costa Rican institutional investors (mainly the pension funds, OPCs) will increasingly need to invest abroad amid the scarcity of domestic securities. This point was recurrently emphasized by local economists during our recent trip.

Exhibit 4: Central Government's funding needs and sources
Funding needs are substantially lower than in previous years, down from 10.9% of GDP in 2023

	2024		2025	
	US$ bn	**% of GDP**	**US$ bn**	**% of GDP**
Funding needs (= I + II)	**7.619**	**7.9**	**7.657**	**7.5**
I) Fiscal deficit	2.709	2.8	2.561	2.5
II) Amortizations (= a + b)	4.910	5.1	5.095	5.0
a) External	0.495	0.5	1.019	1.0
b) Domestic	4.415	4.6	4.076	4.0
Funding sources (= III + IV + V)	**7.612**	**7.9**	**7.559**	**7.4**
III) External (= c + d)	2.996	3.1	2.300	2.2
c) External bonds	1.000	1.0	1.000	1.0
d) Multilaterals	1.996	2.1	1.300	1.3
i) IMF EFF	0.553	0.6	0.000	0.0
ii) IMF RST	0.743	0.8	0.000	0.0
iii) Other multilaterals	0.700	0.7	1.300	1.3
IV) Domestic	4.616	4.8	5.259	5.1
V) Drawdown of cash deposits	0.000	0.0	0.000	0.0
Nominal GDP (US$ billion)	96.737		102.458	
USDCRC (Colones to US Dollar, average)	510		512	

Source: BofA Global Research, Ministry of Finance (Hacienda), Central Bank (BCCR)

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Debt ratio will likely fall, driven by primary surplus and FX

We expect the public debt ratio to fall below 60% in 2024 – the critical value in the Fiscal Rule – earlier than what is projected by the government (2025). The decline would be driven by a larger primary fiscal surplus and the appreciation of the exchange rate (38% of debt is denominated in foreign currency).

We say "critical value" because when debt falls below 60% of GDP, then the expenditure cap of the Fiscal Rule becomes less stringent (for instance, wages are no longer frozen, and capex is liberated from the cap).

The Congress law that authorizes the government to issue US$ 1bn Eurobonds in 2024 and 2025 is conditioned by a floor of 1.85% of GDP for the primary fiscal surplus. It's a provision written in the law. The government is committed to achieving that target this year.

The Chaves administration's track-record of tight fiscal policy (primary expenditures barely increased 0.6% in 2023) gives them credibility. We believe there is a high probability that fiscal consolidation continues during the rest of the presidential term. The ongoing IMF programs (EFF and RST) will conclude in mid-2024. The government says it has met the IMF targets.

Exhibit 5: Summary of macroeconomic forecasts for Costa Rica

We expect robust GDP growth and a declining public debt ratio

Variable	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023f	2024f	2025f
GDP growth (%)	3.5	3.7	4.2	4.2	2.6	2.4	-4.3	7.9	4.6	5.1	4.2	3.8
Nominal GDP (US$ bn)	52.0	56.4	58.8	60.5	62.4	64.5	62.4	64.9	69.4	86.6	96.7	102.8
CPI inflation (eop, %)	5.1	-0.8	0.8	2.6	2.0	1.5	0.9	3.3	7.9	-1.8	2.3	3.0
Nominal exchange rate (CRC/US$, eop, + depreciation)	539	537	553	569	607	571	613	642	593	523	505	518
Monetary policy rate (eop, %)	5.25	2.25	1.75	4.75	5.25	2.75	0.75	1.25	9.00	6.00	5.00	4.50
Central Government primary balance (% of GDP)	-3.2	-2.9	-2.4	-2.9	-2.3	-2.6	-3.4	-0.3	2.1	1.6	1.9	1.9
Central Government overall balance (% of GDP)	-5.5	-5.5	-5.1	-5.9	-5.7	-6.6	-8.0	-5.0	-2.5	-3.3	-2.8	-2.5
Central Government gross public debt (% of GDP)	37.6	39.9	44.1	47.1	51.9	56.4	66.9	67.6	63.0	61.1	58.9	56.9
Current account balance (% of GDP)	-4.8	-3.4	-2.1	-3.6	-3.0	-1.3	-1.2	-3.1	-3.7	-1.5	-1.7	-1.7
International reserves (US$ bn)	7.211	7.834	7.574	7.150	7.501	8.937	7.232	6.921	8.554	13.225	13.025	12.775

Source: BofA Global Research, Ministry of Finance (Hacienda), Central Bank (BCCR)

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Research Analysts

LatAm FI/ FX Strategy & Economics

Claudio Irigoyen
Global Economist
BofAS
claudio.irigoyen@bofa.com

David Hauner, CFA >>
Global EM FI/FX Strategist
MLI (UK)
david.hauner@bofa.com

David Beker >>
Bz Econ/FI & LatAm EQ Strategy
Merrill Lynch (Brazil)
david.beker@bofa.com

Jane Brauer
Sovereign Debt FI Strategist
BofAS
jane.brauer@bofa.com

Natacha Perez
Brazil Economist
Merrill Lynch (Brazil)
natacha.perez@bofa.com

Carlos Capistran
Canada and Mexico Economist
BofAS
carlos.capistran@bofa.com

Sebastian Rondeau
Southern Cone & Venz Economist
BofAS
sebastian.rondeau@bofa.com

Alexander Müller
Andean(ex-Ven) Carib Economist
BofAS
alexander.muller@bofa.com

Lucas Martin, CFA
Sovereign Debt FI Strategist
BofAS
lucas.martin@bofa.com

Pedro Diaz
Caribbean Economist
BofAS
pdiaz2@bofa.com

Christian Gonzalez Rojas
LatAm Local Markets Strategist
BofAS
christian.gonzalezrojas@bofa.com

Antonio Gabriel
Global Economist
BofAS
antonio.gabriel@bofa.com

Ezequiel Aguirre
LatAm FI/FX Strategist
BofAS
ezequiel.aguirre2@bofa.com