MOODY'S
RATINGS

# Rating Action: Moody's Ratings upgrades Costa Rica's ratings to Ba3, maintains positive outlook

18 Sep 2024

New York, September 18, 2024 -- Moody's Ratings (Moody's) has today upgraded the Government of Costa Rica's long-term local and foreign currency issuer ratings to Ba3 from B1 and maintained the positive outlook. Concurrently, we have upgraded the foreign currency senior unsecured debt rating to Ba3 from B1.

The decision to upgrade the rating is driven by our assessment of Costa Rica's strengthened fiscal profile that is benefitting from a marked improvement in debt affordability as a result of stronger debt management and lower borrowing costs, coupled with a steady reduction in government debt ratios driven by stronger-than-expected economic growth that we project will be reinforced by favorable trends from nearshoring. Government liquidity has materially improved with treasury deposits reporting consistently higher levels than in the past, providing a financial buffer against adverse shocks.

The positive outlook reflects the possibility that, the authorities will continue making progress on establishing a favorable track record of fiscal and debt management, including continued compliance with rules and targets embedded in the government's medium-term fiscal framework which would improve Costa Rica's institutions and governance strength. Additionally, if approved, a proposed constitutional amendment would allow the sovereign to issue external debt with more flexibility reducing refinancing risks.

Costa Rica's local and foreign currency country ceilings have been raised to Baa2 from Baa3 and to Ba1 from Ba2, respectively. The four-notch gap between the local currency ceiling and the sovereign rating reflects limited government intervention in the economy, high predictability and reliability of institutions, overall low political risk and relatively contained external imbalances. The Ba1 foreign-currency ceiling, two notches below the local currency ceiling, reflects the economy's moderate level of external indebtedness, open capital account a low level of policy effectiveness.

RATINGS RATIONALE

## RATIONALE FOR THE UPGRADE TO Ba3

### IMPROVED DEBT AFFORDABILITY FROM STRONGER DEBT MANAGEMENT AND LOWER BORROWING COSTS

Primary surpluses and stronger-than-expected growth have led to a steady decrease in government debt metrics. Over the past three years, fiscal outturns have consistently exceeded government and International Monetary Fund (IMF) projections. Under an IMF Extended Fund Facility (EFF) and Resilience and Sustainability Facility (RSF), the authorities have raised the primary balance on by over four percentage points of GDP (as compared to pre-pandemic levels) through significant cuts in spending and increased revenues from the 2018 tax reform such that the adjustment is structural and we expect continued, sustained, primary surpluses. Adherence to the fiscal rule that was adopted in 2018, alongside the tax reform, has increased fiscal policy credibility leading to a steady decline in debt ratios. Supported by primary surpluses in the order of 3% of GDP at the central government level debt declined to 61.1% of GDP in 2023, lower than our 62.5% estimate at the end of last year. Furthermore, the debt ratio could fall below 60% of GDP by 2026 if the authorities continue to meet targets set in the government's medium-term fiscal framework.

Real GDP growth in 2023 at 5.1% significantly exceeded our 3.6% projection, driven by robust external demand, recovering investment and stronger household consumption. Economic activity in the Free Trade Zones continues to support growth and has been outpacing activity in the rest of the economy. Costa Rica continues to benefit from the global nearshoring trend, particularly in the healthcare and service-related export sectors, supported by strong foreign direct investment (FDI) inflows. Real GDP growth remained robust at 4.2% year-on-year in the second quarter of 2024, from 4.6% in the first quarter, reflecting moderating but still strong private consumption that has benefited from continued real wage increases. We have revised up our real GDP growth forecast for 2024 to 3.9% but expect annual growth will converge in 2025-27 to Costa Rica's long-run potential at around 3.5%. The economy's comparatively strong growth prospects will continue to support a decline in government debt, even if primary surpluses weaken under a scenario where the government eases primary surplus targets.

Sovereign borrowing costs have declined and will continue to support favorable debt dynamics. Costa Rica's external bond yields have come down significantly converging with those of strong 'Ba' credits. On the domestic front, low inflation should allow the central bank to accommodate falling interest rates, helping to reduce high borrowing cost in local currency. Combined, these factors have improved debt affordability.

In addition to using the resources from external issuances to retire costly domestic debt, the government is concentrating more of its domestic issuance at longer maturities (15 and 30 years) to gradually extend the average life of domestic debt, resulting in an improving debt structure with longer maturities. Longer average life of domestic debt coupled with lower structural fiscal deficits will allow financing needs to stabilize. We estimate that - on average - annual government financing needs in 2024-26 will remain at 9% of GDP, a level similar to that observed in 2022-23, but much lower than the 15% of GDP observed prior to the pandemic.

Since 2023, the year when the authorities adopted a prudential guideline that requires government liquidity to match - or exceed - 3-6 months of gross financing requirements, treasury deposits have been at materially higher levels than in the past, providing a buffer against funding shocks and allowing for greater financial flexibility. We expect government liquidity to be reinforced as external debt issuance provides resources to both retire expensive domestic debt and maintain a healthy level of treasury deposits.

## RATIONALE FOR THE POSITIVE OUTLOOK

The positive outlook reflects a balance of risks skewed to the upside.

The sovereign is making progress on establishing a track record that may improve institutions and governance strength backed by stronger debt and liquidity management, and continued compliance with fiscal rules embedded in the medium-term fiscal framework.

A proposed constitutional amendment to allow the sovereign to issue external debt for budget financing with more flexibility would help reduce refinancing risks.

Upside risks include the possibility of stronger economic growth from stronger-than-expected FDI inflows as a result of Costa Rica's attractiveness as a nearshoring partner to the US economy, especially in the healthcare and service-related export sectors. Stronger economic growth would quicken the decline in the sovereign's debt burden and enhance fiscal strength. The proposed constitutional amendment to allow the sovereign to issue external debt for budget financing with more flexibility would more closely align the budget and financing laws, improve the debt profile and reduce financing costs.

Meanwhile, some downside risks remain related to still-high interest payments that are a source of fiscal rigidity and given the sovereign's low tax take, rising spending pressures could jeopardize the fiscal trajectory outlined in the authorities' medium-term fiscal framework. Expenditure restraint will be an important factor in complying with the relatively high medium-term primary surpluses laid out in the fiscal framework, to ensure the downward trend in debt metrics. However, these risks are contained by the government's commitment to reduce debt and interest burdens and ensure fiscal sustainability, alongside various legislative initiatives to reinforce fiscal and debt management capabilities.

## ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Costa Rica's ESG Credit Impact Score of CIS-3 reflects the country's moderate exposure to environmental and social risk. It's governance profile remains moderately weak due to its track record of political gridlock.

The E-3 issuer profile score on environmental risk is related to physical climate risk. Lower crop yields because of weather events can harm the agricultural export sector and tourism revenues may be affected by wildfires, floods and increased storm severity.

The S-3 issuer profile score on social risk reflects labor and income, housing, and health and safety risks. Social considerations historically were not material to Costa Rica's credit profile given a long history of stable governments and democratic institutions but attempts to reduce fiscal deficits have encountered significant social resistance in prior years. Popular demands to reduce perceived inequalities and high rates of violence will continue to constrain domestic policy choices.

The G-3 issuer profile score on governance risk is related to the political inability of several administrations to address a fiscal crisis that led to substantial debt accumulation. Although budget management was weak, the authorities are slowly building a track record of credibility as fiscal deficits narrow. Governance risks are tempered by a very favorable institutional structure that safeguards democratic processes and upholds the respect for contracts.

GDP per capita (PPP basis, US$): 27,064 (2023) (also known as Per Capita Income)

Real GDP growth (% change): 5.1% (2023) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): -1.7% (2023)

Gen. Gov. Financial Balance/GDP: -2.1% (2023) (also known as Fiscal Balance)

Current Account Balance/GDP: -1.4% (2023) (also known as External Balance)

External debt/GDP: 44% (2023)

Economic resiliency: baa2

Default history: At least one default event (on bonds and/or loans) has been recorded since 1983.

On 13 September 2024, 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 economic fundamentals, including its economic strength, have materially increased. The issuer's governance and/or management, have materially increased. The issuer's fiscal or financial strength, including its debt profile, has materially increased. The issuer's susceptibility to event risks has not materially changed.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE

RATINGS

FACTORS THAT COULD LEAD TO AN UPGRADE OF THE RATINGS

Costa Rica's credit profile could improve as a result of a faster increase in debt affordability, that is, lower interest-to-revenue ratio, and a further narrowing of the fiscal deficit that leads to a more rapid reduction in government debt ratios than currently expected. Significant progress on reforms that boost structural government revenue, would create fiscal space and help narrow fiscal deficits further, helping to consolidate recent gains on establishing a track record of fiscal policy credibility and placing upward pressure on the ratings.

FACTORS THAT COULD LEAD TO A DOWNGRADE OF THE RATINGS

Costa Rica's rating could be subject to downward pressure in case of a re-emergence of liquidity and financing constraints, or if a reversal of fiscal policy leads to wider fiscal deficits that deviate materially from the medium-term fiscal framework resulting in an upward debt trajectory. Given the country's track record of political gridlock hindering reforms or the prompt adoption of corrective fiscal measures, downward pressure on the sovereign's credit profile could result from legislative deadlock, lack of swift and timely approval of external financing or political inability to support measures that have led to continued improvement of debt metrics.

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at https://ratings.moodys.com/rmc-documents/395819 . Alternatively, please see the Rating Methodologies page on https://ratings.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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