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DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

COSTA RICA

EMERGENCY PROGRAM FOR FISCAL STRENGTHENING AND RESTORING GROWTH

(CR-L1148)

LOAN PROPOSAL

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2. Quantitative performance criteria, indicative targets, and structural benchmarks for the Extended Financing Facility with Costa Rica

ABBREVIATIONS

BCCR	Central Bank of Costa Rica
COVID-19	Coronavirus disease 2019
EFF	Extended Fund Facility
EMBI	Emerging markets bond index
FDI	Foreign direct investment
IMF	International Monetary Fund
RFI	Rapid Financing Instrument
SDL	Special Development Lending
SUGEF	Superintendency of Banks

Project Summary

Costa Rica
Emergency Program for Fiscal Strengthening and Restoring Growth
(CR-L1148)

Financial Terms and Conditions

Borrower		
Republic of Costa Rica		
Executing agency		
Ministry of Finance		
Source	**Amount (US$)**	**%**
IDB (Ordinary Capital):	250,000,000	100
Total:	250,000,000	100

Special Development Lending[a]	
Amortization period:	7 years
Disbursement period:	1 year
Grace period:	3 years
Interest rate:	3-month LIBOR in U.S. dollars, plus/minus the IDB funding margin, plus the variable interest spread for Ordinary Capital resources, plus the fixed loan spread premium of 1.15%
Front-end fee:	1% of the principal amount of the loan, payable within 30 days of the contract's entry into effect
Credit fee:	0.75%
Weighted average life:	5 years
Currency of approval:	U.S. dollar

Project at a Glance

Project objective/description: The specific objectives of this operation are to: (i) ensure fiscal sustainability; and (ii) maintain monetary and financial stability. Achieving these objectives will contribute to the general objective of supporting the government's policies to boost economic recovery while preserving macroeconomic stability.

The program objectives and components are aligned with the Extended Fund Facility (EFF) approved by the International Monetary Fund (IMF) on 1 March 2021. The Policy Matrix (Annex II) is synchronized with the first review of the EFF. In particular, the Matrix includes quantitative criteria and indicative targets to be achieved under the EFF by 31 July 2021. The budget support provided through Special Development Lending will help meet short-term financing needs and support economic recovery while providing backing for the government's reform program to restore debt sustainability, thus protecting spending on vulnerable groups and infrastructure investment.

Policy actions and disbursement of loan proceeds: The single disbursement of the loan proceeds will be carried out in accordance with the provisions established in the corresponding loan contract between the borrower and the Bank, including the provision that the IMF-approved EFF funds have been or are being disbursed. The Bank's disbursement will be subject to compliance with the policy measures agreed with the IMF under the first review of the EFF, summarized in the Policy Matrix (Annex II) and in the Policy Letter (paragraph 4.2).

Exceptions to Bank policies: None.

Strategic Alignment

Challenges:[b]	SI ☐	PI ☐	EI ☐
Crosscutting themes:[c]	GE ☐ and DI ☐	CC ☐ and ES ☐	IC ☒

[a] Under the Special Development Lending category (document AB-3134) and its operational guidelines (document GN-2031-17), this operation will be documented under the Flexible Financing Facility with limited debt management options. The borrower has the option of requesting currency, interest rate, and commodity conversions. The Bank will take operational and risk management considerations into account when reviewing such requests. The amortization schedule that will apply to this loan will consist of equal, semiannual payments that begin to accrue at the end of the grace period.

[b] SI (Social Inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

[c] GE (Gender Equality) and DI (Diversity); CC (Climate Change) and ES (Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problem addressed, and rationale

1.1 **Macroeconomic situation.** Prior to the coronavirus disease 2019 (COVID-19) crisis, macroeconomic conditions in Costa Rica were fairly stable, though not without weak points. Between 2015 and 2019, the economy grew 3.3%, outpacing the average for Latin America and the Caribbean, as a result of a growth model based on trade openness and integration and on the attraction of foreign direct investment (FDI). Maintaining a sound macroeconomic framework supported by an inflation-targeting regime, which anchored economic agents' expectations, kept inflation low and stable (1.2% between 2015 and 2019) while the country has adopted a more flexible foreign exchange policy. Given the country's buoyant exports (especially service exports), the current account deficit remained moderate (average of -2.8% of GDP), comfortably financed by FDI (average of 4.7% of GDP). This led to an accumulation of international reserves totaling 13.9% of GDP in 2019, which are sufficient to deal with external shocks and cover debt obligations (see Table 1). Nevertheless, a high unemployment rate combined with a slowdown in growth in recent years led to weaknesses in macroeconomic conditions.

Table 1. Main macroeconomic indicators 2015-2020

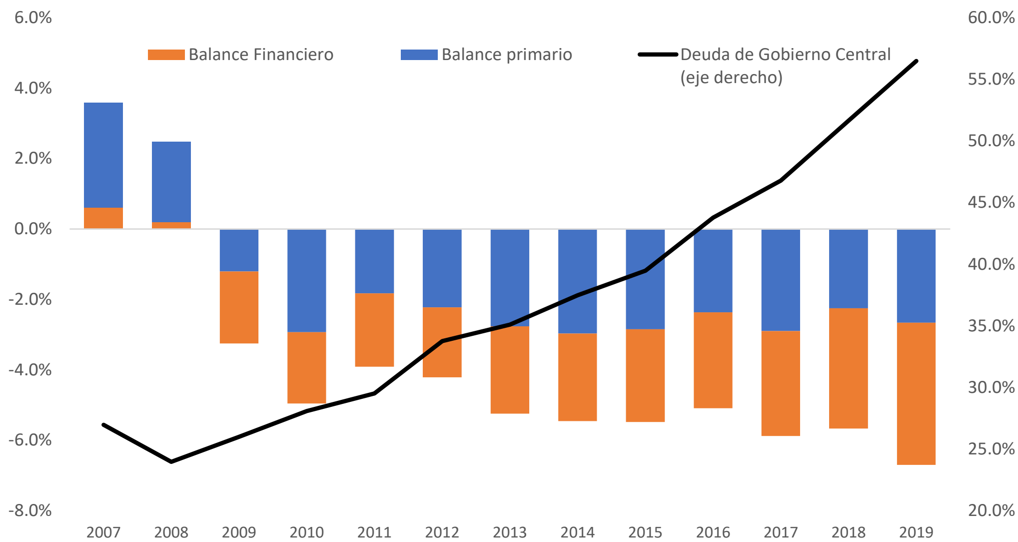
	2015	2016	2017	2018	2019	2020
Real GDP growth rate (%)	3.7	4.2	4.2	2.1	2.2	-4.5
Unemployment rate (%)	9.6	9.5	9.4	12.0	12.4	20
Inflation (%)	-0.8	0.8	2.6	2.0	1.5	0.9
Current account (% of GDP)	-3.40	-2.14	-3.54	-3.03	-2.02	-2.4
FDI (% of GDP)	5.2	4.5	4.9	4.6	4.1	3.3
International reserves						
International reserve balance (US$ billion)	7.834	7.574	7.150	7.495	8.912	7.225
International reserve balance (% of GDP)	13.9	12.9	11.9	12.0	13.9	11.7
Exchange rate (colones per US$)	537.5	556.2	570.2	609.6	573.2	615.4
Central government public finances (% of GDP)						
Primary balance	-2.8	-2.4	-2.9	-2.3	-2.7	-3.4
Fiscal balance	-5.5	-5.1	-5.9	-5.7	-6.7	-8.1
Tax revenue	12.7	13.0	12.8	12.7	13.0	12.1
Current expenditure (primary)	14.9	14.8	14.8	14.7	14.9	15.4
- Wages	7.0	6.8	6.7	6.7	6.6	6.9
- Current transfers	7.3	7.4	7.5	7.4	7.7	7.9
Interest	2.6	2.7	3.0	3.4	4.0	4.7
Public investment	1.7	1.8	1.9	1.3	1.9	1.2
Public debt	39.5	43.8	46.8	51.7	56.5	67.5
Standard & Poor's credit rating	BB	BB-	BB-	B+	B+	B
Emerging markets bond index (EMBI)	530	449	367	540	402	631

Sources: Central Bank of Costa Rica (BCCR) and Ministry of Finance.

1.2 **Fiscal position.** Among the weaknesses in the pre-COVID-19 period, the fragile fiscal position was the main challenge for ensuring macroeconomic stability. Since the last decade's global financial crisis, the fiscal position has deteriorated

significantly, driven in part by relatively low tax revenue but primarily by constant, accelerated growth in government current expenditure, which has taken away headroom for expenditure on infrastructure investment.[1] Persistent deficits (in excess of 5% of GDP on average over the past decade) have resulted in high public debt, with the burden on the economy more than doubling as the debt rose from 24% of GDP in 2008 to 52% in 2018 (Figure 1). In addition, the interest bill rose from under 2% of GDP in 2012 to 3.42% in 2018, when one-fifth of tax revenue went to interest payments.

Figure 1: Fiscal balances and central government debt (% of GDP)



Source: Ministry of Finance. Note: Financial balance equals primary balance plus interest expenditure.

1.3 To address these structural challenges, in December 2018 the authorities approved the comprehensive fiscal reform contained in the Strengthening Public Finances Act. Successful implementation of this reform should shrink the central government deficit and stabilize the debt path in the medium term.[2] Gradual implementation of the reform began in 2019, and some results have already materialized. As of March 2020, the cumulative primary deficit was at its lowest level since 2009 (0.1% of GDP compared to 0.7% over the 2010-2019 period). This result stemmed from 12.2% growth in total revenue (3.2% over the same period in 2019) and a reduction

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1 While tax collection decreased as a percentage of GDP between 2008 and 2018, government current expenditure increased more than five percentage points, reducing public investment to historically low levels (1.3% of GDP in 2018). In real terms, whereas tax revenue grew 30% cumulatively during the period, current expenditure more than doubled.

2 The 2018 fiscal reform comprises three major components: (i) on the revenue side, replacement of the general sales tax with a value-added tax and enhancement of the progressive nature of the individual income tax; (ii) on the expenditure side, introduction of consolidation measures for such headings as wages and current transfers; and (iii) at the institutional level, introduction of a fiscal rule that limits public expenditure growth in line with economic growth and debt levels.

in primary expenditure (-9.6% compared to 12.9% in 2019), mainly under the transfers heading, as well as a slowdown in wage expenditure.[3] However, the COVID-19 shock abruptly interrupted this favorable momentum in public finances because of its effects on economic activity, as described below.

1.4 **The COVID-19 pandemic and its impact.** The first cases of COVID-19 were reported in early March 2020, and by late February 2021 there had been a total of 203,097 cases (26,761 of which are active) and 2,785 deaths. The number of daily infections (seven-day moving average) dropped from 1,098 in December 2020 to 355 in February 2021, and the infection rate in February 2021 stood at 0.89 (100 people infect 89 others).[4] The government began its vaccination campaign on 24 December 2020 with the goal of vaccinating 74% of the population in 2021. To reach this goal, the authorities approved their first special budget for a total of US$77 million to purchase 7.41 million doses (by 23 February, 101,183 people had already been vaccinated) from Pfizer-BioNtech, AstraZeneca, and the COVAX facility (World Health Organization).

1.5 **Macroeconomic effects.** The pandemic hit the economy hard. The BCCR estimates a 4.5% decrease in GDP in 2020, a contraction comparable only to the 7.3% decline experienced in 1982. The public health measures instituted to try to contain the pandemic, such as border closures, vehicle mobility restrictions, and the mandatory shutdown of businesses, led to a drop of 40.7% in accommodation and restaurant services, 22.3% in transportation services, 10.5% in construction, and 10% in trade. The only sectors that reported growth were manufacturing (3.3%) and information and communication services (2.3%). The growth in manufacturing was driven by free trade zones, whose performance offset the decline in production among non-free-trade-zone businesses, with the exception of telecommunication services. The unemployment rate peaked at 24.4% in July (12.3% in 2019), hitting the informal sector the hardest. Poor households have borne the brunt of the economic crisis, as the unemployment rate among the poor climbed to 40% (25.8% in 2019), in contrast with a rate of 11.1% among the nonpoor (5.9% in 2019). The fragile economic recovery in the second half of the year brought the unemployment rate down to 20% by late 2020 and pushed the informality rate to 44.5%, similar to the rate seen in 2019. Poverty rose by 5.2 points in 2020, standing at 26.2% at year's end, the highest it has been in 28 years. To mitigate the decline in income among the poorest households, the government increased subsidies by 153%, primarily through the Bono Proteger subsidy,[5] which accounted for 0.7% of GDP.

1.6 **Policy responses.** The government, the BCCR, and financial system regulators implemented various measures to mitigate the economic and social impact of COVID-19. The following paragraphs describe the main fiscal, monetary, and financial measures.

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[3] However, interest expenditure grew 42% (compared to 12% in 2019).

[4] Source: Costa Rican Ministry of Health.

[5] Bono Proteger is a subsidy of up to US$205 for three months provided to 676,340 people affected by the crisis.

a. **Fiscal measures:** (i) a three-month moratorium on tax payments from April to June; (ii) a freeze on raises for government employees; and (iii) payment of subsidies to 700,000 beneficiaries whose employment was affected by the pandemic.[6]

b. **Monetary measures:** (i) a 200-basis-point cut to the monetary policy rate, bringing it to an all-time low of 0.75% per annum;[7] (ii) participation by the BCCR in the integrated liquidity market in dollars; (iii) the possibility of the BCCR buying up to US$400 million (0.7% of GDP) in government bonds on the secondary market in the event of systemic liquidity stress;[8] and (iv) the creation of a credit facility in colones for financial entities equivalent to US$1.37 billion (2.3% of GDP) so that financial intermediaries supervised by the Costa Rican Superintendency of Banks (SUGEF) can adjust the conditions for loans to the private sector.

c. **Financial measures:** (i) authorization for employees whose working hours were reduced or who were laid off to withdraw funds from their Labor Capitalization Fund[9] (as of December 2020, these withdrawals amounted to 0.21% of GDP); (ii) authorization for financial institutions to modify original loan terms (through extensions, refinancing, or adjustments) without the need to subject debtors to a stress test;[10] (iii) temporary flexibilization measures for capital requirements associated with the term of operations and the measurement of market risks; and (iv) temporary suspension of the "special operation"[11] concept to allow institutions to continue their efforts to modify the contractual terms of loans without affecting debtors' credit ratings.

1.7 **Effects on the fiscal position.** The macroeconomic program presented in January 2020 projected an improvement in the primary balance of 1.5% of GDP that year as a result of an increase in tax revenue (0.4%), accompanied by a decrease in public expenditure (1.1%) and, particularly, current expenditure, in line with the implementation of the Strengthening Public Finances Act. This would have kept public debt at close to 60% of GDP. However, COVID-19 dealt a hard blow to the public finances, deteriorating the fragile fiscal position even further. The economic contraction reduced tax collection by about 11%, driven primarily by a decrease in collection of income taxes (-11%), fuel taxes (-21%), and other taxes associated with domestic demand (-22%) combined with a slowdown in collection of the value-added tax on locally-produced goods (7.2% compared to 23% in 2019). Meanwhile, current expenditure increased 1.5%, despite the cap of 4.7% on

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6 This package of fiscal measures amounts to 1.4% of GDP (0.8% for expenditure measures and 0.6% for revenue measures).

7 The rate was cut by 50 points in January, by 100 points in March, and lastly by 50 points in June.

8 In practice, use of this measure has been minimal. As of January 2021, this operation amounted to around US$3 million.

9 Savings contributed by the employer as part of the worker's severance. This consists of a monthly employer contribution equivalent to 3% of the paid salary, plus returns from the management of investments made by the Fund manager.

10 As of December 2020, financial institutions had modified approximately 48% of their loan portfolios.

11 According to the SUGEF debtor rating regulation, a special credit operation is an operation that can be used to avoid default due to its contractual payment terms or that may be concealing default through modification of the contractual payment terms.

growth set by the fiscal rule, implemented for the first time in 2020, and suspension of the rule for certain institutions involved in the COVID-19 emergency response.[12] Expenditure was contained by reducing current transfers to the public sector and freezing cost of living salary increases. These measures offset the increase in transfers to the private sector in response to COVID-19 (0.8% of GDP), mainly by way of the Bono Proteger subsidy. As a result, the primary and financial deficits stood at 3.4% and 8.1% of GDP, respectively (2.7% and 6.7% in 2019), whereas debt increased to 67.5% of GDP (56.5% in 2019), eight percentage points above the level projected in the macrofiscal scenario presented at the beginning of the year.

1.8 The government's financing needs will remain high over the next few years. For 2021, financing needs are estimated at 13.5% of GDP (US$8.24 billion), with debt service in U.S. dollars in the final quarter accounting for 1.7% of GDP (US$1.02 billion). For 2022 and 2023, financing needs are projected at 12.1% and 11% of GDP, respectively. Access to financing in the foreign market became difficult in 2020. Country risk, measured using the EMBI, peaked in April 2020 (921 basis points). Though it has trended downward since then, it has been unable to return to pre-pandemic levels. In fact, as of end February 2021, country risk was approximately 100 basis points above February 2020 levels (452 basis points) and around 275 basis points above the Central American regional average.[13] Between April and June 2020, the leading rating agencies downgraded Costa Rica's sovereign debt ratings and currently maintain a negative outlook.[14] The domestic market, however, is contending with constraints on its ability to absorb the sheer size of the current needs.[15] In the absence of access to external financing, more domestic financing would increase pressure on the domestic credit market, driving up the already high interest rates even further.[16] This would reduce credit to the private sector and increase financial institution's portfolios at risk.[17]

B. Program with the IMF

1.9 **IMF Extended Fund Facility (EFF).** On 1 March 2021, the IMF approved an arrangement with Costa Rica under the EFF for approximately US$1.75 billion.[18] The pillars of the EFF are to: (i) implement fiscal reforms to ensure debt sustainability, while protecting the most vulnerable; (ii) maintain monetary and

[12] Noninterest current expenditure decreased by about 1% in 2020.

[13] The EMBI average in February 2021 for Central American countries, excluding Costa Rica and El Salvador, was 275 basis points, compared to around 550 basis points for Costa Rica.

[14] In 2020, Moody's downgraded its rating from B1 to B2, Fitch from B+ to B, and Standard & Poor's from B+ to B, levels considered to be highly speculative.

[15] Domestic financing sources averaged 11% of GDP between 2017 and 2019.

[16] The weighted average interest rate for domestic debt in 2020 was 7.59%.

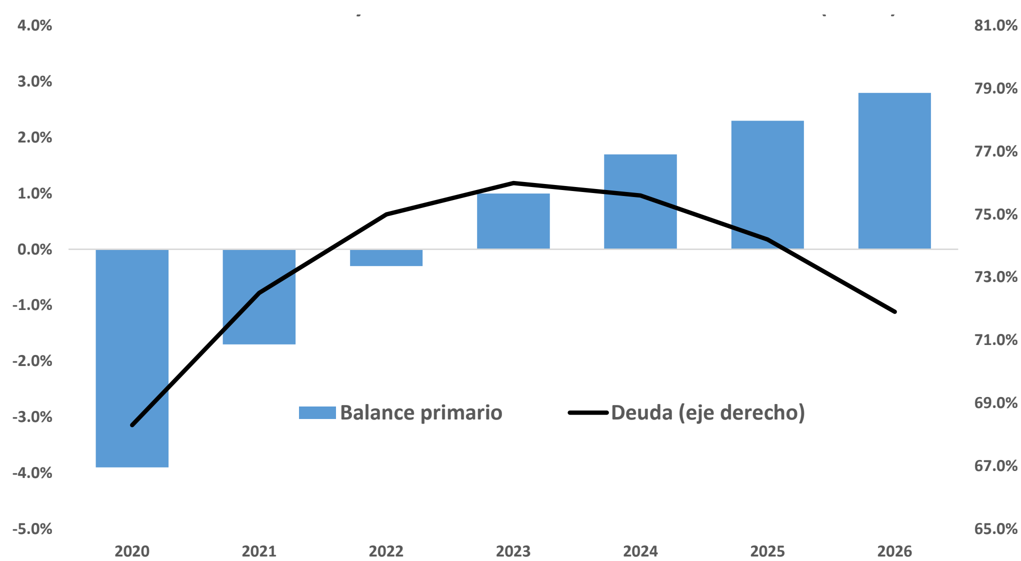
[17] The growth of credit to the private sector has been slowing since 2016 and contracted in 2019. The default rate in the financial system rose from 2.4% in December 2019 to 2.6% in November 2020.

[18] The EFF is an instrument established to provide assistance to countries facing balance of payments problems because of structural weaknesses or slow growth. This type of program is structured based on compliance with policy conditions. Under this type of arrangement, countries implement policies that help to achieve a sustainable growth path, while allowing the IMF to meet the external financing needs of countries in crisis situations.

financial stability; and (iii) advance structural reforms to promote inclusive and sustainable growth.[19] The program duration is 36 months and will involve five semiannual reviews, which will provide access to program funds if completed successfully.[20]

1.10 The program is structured around fulfilment of quantitative performance criteria, indicative targets, and structural benchmarks.[21] The program's objective under its fiscal pillar is to achieve a primary surplus of 1% of GDP in 2023 in order to stabilize the debt-to-GDP ratio, which will begin to decrease from that year onward (Figure 2).[22] In that respect, the fiscal quantitative performance criteria include a floor on the central government's primary fiscal balance, a ceiling on the accumulation of new external payment arrears, and an indicative target (ceiling on the central government's debt stock). In monetary terms, the program targets are to keep inflation low and stable and to ensure sufficient international reserves (see optional link 2 for details on all EFF targets and their timing).

Figure 2: Central government debt and primary balance 2020-2026 (% of GDP)



Source: IMF.

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[19] Measures associated with the latter are expected to be introduced in the second half of 2022, which is why they are not part of this Bank program.

[20] The program provides for access to up to US$583 million in 2021, half of which will be disbursed prior to the legislative ratification of the EFF. The other half hinges on completion of the first review, slated for October 2021.

[21] If a country misses a quantitative performance criterion condition, the IMF Executive Board may approve a formal waiver to complete the review if it is satisfied that the program will still succeed, either because the deviation was minor or temporary or because the country authorities have taken corrective actions. Missed structural benchmarks and indicative targets do not require waivers but are assessed in the context of overall program performance. See the IMF Conditionality factsheet.

[22] The expected change in the primary balance per year, in percentage of GDP, is 2.2% (2021), 1.4% (2022), and 1.3% (2023).

1.11 **Fiscal strengthening measures.** Considering the fragile public finance situation, the program's emphasis is fiscal consolidation. To achieve the expected outcome target of deficit reduction, the program plans to implement fiscal reforms on both the revenue and the public expenditure side. With respect to taxes, measures include the elimination of exemptions and the reform of the individual income tax, which are estimated to yield 1.4% of GDP by 2023. Expenditure rationalization measures involve mainly containing the wage bill and rationalizing current transfers, which would amount to a savings of approximately 2.3% of GDP by program end.[23] Implementation of measures to contain current expenditure is key to ensuring compliance with the fiscal rule, which was first applied in the 2020 fiscal year, and is consistent with the objective of protecting productive infrastructure investment during the fiscal consolidation process.[24] On the whole, the combination of revenue and expenditure measures will contribute to the gradual and sustained reduction of the primary deficit over the next three years, reversing the rapid growth in public debt seen in recent years. In the absence of consolidation measures, public debt will continue to grow, climbing to 84% of GDP in 2025, above the thresholds typically associated with a debt crisis in emerging countries,[25] and the interest burden will continue to become heavier until it represents close to half of tax revenue by 2025.

1.12 Aside from the fiscal consolidation measures, the fiscal measures for structural reform (structural benchmark) supported by the program include legislative approval of the public employment enabling act,[26] improved coverage of the medium-term fiscal framework, publication of a medium-term debt strategy, centralization and digitization of the payment system for social welfare programs, and measures to enhance fiscal transparency in the public enterprise sector.

1.13 **Flexibility to adverse shocks and expenditure protection in vulnerable households.** The program entails contingency measures to increase emergency expenditure in a scenario where the pandemic lasts longer than expected. Specifically, the program includes a flexibility mechanism that can be used to increase COVID-19-related expenditure to 0.3% of GDP in 2021 to provide health care services, targeted support to households and businesses affected by the crisis, and higher budget allocations to social support programs for vulnerable groups. Beginning in 2021, the program includes a structural increase of 0.1% of GDP for spending on targeted social programs, which should help expand coverage to beneficiaries in the poorest income decile, thus reducing poverty by 0.25 percentage points and inequality by 8%.[27]

[23] In addition to the structural adjustment of 3.7% of GDP consisting of the revenue and current expenditure measures described thus far, the expiration of the temporary measures implemented in 2020 to offset the pandemic (0.6% of GDP) and the economic recovery from 2021 onward (0.6% of GDP) will also help reduce the deficit.

[24] After hitting a floor of 1.3% of GDP in 2018, and in line with the program-supported current expenditure adjustment, public investment should recover and reach at least 2% of GDP in the medium term.

[25] See, for example, Badia et al. (2020).

[26] Since this law is also supported by the programmatic series for Fiscal Sustainability Support (initiated in 2019), it is not included in the Policy Matrix of this operation (paragraph 2.7).

[27] Priority programs include noncontributory pension plans, the National Network for Child Care and Development, and Child Education, Nutrition, and Holistic Care Centers.

1.14 **Other structural reforms.** In addition to the fiscal pillar, the EFF supports reforms to ensure monetary and financial stability and to drive sustainable growth. With respect to the first point, the plan is to continue to strengthen the BCCR's governance and operational autonomy. As for the second point, the program supports the development of a roadmap to improve the resilience of climate change infrastructure as part of the implementation of the National Decarbonization Plan[28] (see optional link 2 for a complete list of structural benchmarks and their timing).

1.15 **Additional multilateral support.** The EFF aims to catalyze additional multilateral and bilateral support for Costa Rica. In all, 65% of the high short-term financing needs should be covered by domestic debt, while the remaining 35% would be covered with resources from multilateral organizations and bilateral debt in 2021 (Table 2). Access to external financing should reduce the burden on internal financing, thereby easing pressures on local market interest rates. Access to these resources, coupled with the projected placement of external bonds from 2022 onward (US$1 billion annually until 2025), would lead to interest savings that year and beyond.[29]

Table 2. Multilateral financing sources in 2021 (budget support)

Source	Amount (US$ million)	Status
IMF*	583	Approved
Development Bank of Latin America	550	Approved
Central American Bank for Economic Integration	550	In preparation
World Bank	500	In preparation
IDB (SDL)	250	In preparation
IDB (programmatic policy-based loan)	250	In preparation
Total	**2,683**	**4.4% of GDP**

Source: Prepared by the authors.
* Pending ratification by the Legislative Assembly.

II. ELIGIBILITY CRITERIA

2.1 **SDL eligibility criteria.** The SDL category, established in the Proposal to Create a Special Development Lending Category (document AB-3134), approved by the Board of Governors on 30 June 2017 pursuant to Resolution AG-9/16, and the Special Development Lending Operational Guidelines (document GN-2031-17), is a budgetary support lending instrument for dealing with macroeconomic crises[30] and preserving social gains and economic growth in the countries of the region. The Government of Costa Rica meets the eligibility criteria for

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[28] The policy reforms associated with the plan's implementation are supported by the Bank through "Towards a Green Economy: Support for Costa Rica's Decarbonization Plan" (loan 4988/OC-CR).

[29] According to Ministry of Finance estimates, each time the interest rate is cut by 100 basis-points, government financial expenditure decreases by approximately ₡35 billion per year, for a potential savings of 0.1% of GDP annually.

[30] Defined as a situation in which the country lacks or potentially lacks sufficient financing on affordable terms to meet its net international payments, such as paying imports or external debt redemptions, while maintaining prudent reserve buffers (document GN-2031-17).

this loan (document AB-3134) because: (i) it is experiencing a macroeconomic crisis (paragraphs 1.5, 1.7, and 1.8);[31] and (ii) the IMF approved an EFF on 1 March 2021 for US$1.75 billion. The SDL operation amount (US$250 million) falls within the established maximum limit of 2% of the country's GDP or US$500 million.[32]

2.2 This program's Policy Matrix includes the quantitative performance criteria and indicative targets from the EFF with Costa Rica and is timed to coincide with the EFF's first review, which will assess progress toward achieving the fiscal and monetary targets as of 31 July 2021. The operation is part of a broader financing package that includes the IMF program as the main component and credit from other multilateral sources, which together cover 35% of the government's financing needs for 2021 (paragraph 1.15).

2.3 **The Bank's operational work and technical support in the country.** The Bank has been supporting the government with the diagnostic assessment, design, and implementation of structural reforms aimed at strengthening fiscal sustainability. First, the Bank is supporting the approval and implementation of the comprehensive fiscal reform contained in the Strengthening Public Finances Act. Specifically, it has spearheaded support for the diagnostic assessment and preparation of proposals to strengthen the macrofiscal management framework (independent fiscal council and the fiscal rule) and technical assistance for the ongoing modernization of the tax system, with financing from technical-cooperation operations ATN/FI-12917-CR (2011) and ATN/FI-14553-CR (2014). Second, in the area of public expenditure, the Bank has prepared various studies on wage policy, in particular the first work to propose a single salary methodology for Costa Rica.[33] In addition, through technical-cooperation operation ATN/OC-17557-CR (2019), the Bank is supporting approval and implementation of public employment reform as well as implementation of the administrative reform. Building off the foundation established by this technical cooperation assistance, the Bank is financing the programmatic series for the Fiscal Sustainability Support Program, whose first operation was approved and disbursed in 2019 (loan 4819/OC-CR) and whose second operation is being prepared.

2.4 **The Bank's experience in the region and lessons learned.** The Bank has experience assisting the countries of the region in overcoming macroeconomic crises. Through its SDL instrument, the Bank supported the Government of Ecuador in its efforts to reestablish macroeconomic stability, restore fiscal sustainability, and safeguard social expenditure in support of the vulnerable population through the Emergency Program for Macroeconomic Sustainability and Prosperity (loan 4771/OC-EC). Likewise, in Barbados, the Macroeconomic Emergency Programme to Protect Economic and Social Progress (loan 4656/OC-BA) provided support for the government's efforts to regain macroeconomic stability and foster a sustainable fiscal balance in the short and

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31 In particular, Costa Rica is facing a wide financing gap in a context of tightening external and internal financial conditions that could entail a lack of access to sources of affordable financing to meet its international obligations.

32 Whichever is less. This is the limit for fresh funds by country (paragraph 4.6 of document AB-3134).

33 Green, M. and M. Lafuente. (2013). Costa Rica: Estudio de Empleo Público y Política Salarial. IDB.

medium term, protecting social spending to safeguard social gains achieved. Both operations were approved under EFF programs, like this operation. In the context of the Bank's immediate response to the COVID-19 pandemic, the SDL contributed to efforts aimed at containing the health crisis and mitigating its effects on the economies of Honduras (loan 5069/BL-OC), the Dominican Republic (loan 5066/OC-DR), and Panama (loan 5055/OC-PN), under the IMF's Rapid Financing Instrument (RFI) and Stand-By Arrangement.[34]

2.5 This experience has yielded several lessons learned that have been incorporated into the design of this operation: (i) the Bank's SDL instrument is an effective vehicle for swiftly channeling budgetary support resources in crisis situations; (ii) its main value-added, other than the financial value-added, is that it leverages and strengthens the IMF program and adds a layer of technical support to help the government carry out the agreed measures; (iii) it is important to align operation preparation timelines with the timing of discussions with the Legislative Assembly in cases where the regulatory framework prescribes prior ratification; and (iv) providing support through technical cooperation assistance and maintaining an ongoing dialogue with the authorities are key to supporting and meeting the commitments made to the IMF. To provide close technical support to the Ministry of Finance, a combination of regional technical assistance through a technical cooperation instrument (operation ATN/OC-18055-RG) and client support (operations ATN/OC-18133-CR and ATN/OC-17557-CR) will help support implementation of the reforms and achievement of the objectives of this operation (paragraph 2.7).

2.6 **Coordination with other donors.** Since the SDL is an instrument that must be accompanied by an approved IMF program that is disbursing funds, preparation of this operation required coordination with the IMF mission team for Costa Rica. The Bank is also coordinating actively with other donors that will help finance the balance of payments gap, including the Central American Bank for Economic Integration, the World Bank, and the Development Bank of Latin America (see Table 2).[35] Specifically, these three institutions have already approved or are preparing budgetary support loans to be disbursed in 2021, in support of the policy reforms contained in the Bank's two ongoing programmatic series in Costa Rica: the "Fiscal Sustainability Support Program," and "Towards a Green Economy: Support for Costa Rica's Decarbonization Plan" (loan 4988/OC-CR) (paragraph 2.7). As a whole, multilateral support plays a significant role in closing the financing gap in a context of tighter financial conditions. To streamline and facilitate the ratification process, the preparation timeline for this operation has been coordinated so that the government can submit the joint multilateral financing package to the Legislative Assembly (paragraph 3.6).

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[34] In April 2020, the IMF approved Costa Rica's request for emergency financial assistance under the RFI in the amount of US$504 million, funds that were disbursed in September 2020 to close the financing gap created by COVID-19. In June 2020, the Bank approved an SDL for Costa Rica (loan 5054/OC-CR), aligned with the RFI. The SDL was canceled because the legislature did not ratify it to bring it legally into effect by the deadline stipulated by the instrument.

[35] The main coordination mechanism will be biweekly meetings between the agencies involved to monitor progress in the preparation of 2021 operations as well as changes in the completion status of the policy actions they contain.

2.7 **Complementarity with other Bank operations.** The Bank is helping the country with the process of approving and implementing comprehensive fiscal reform through a programmatic series, the "Fiscal Sustainability Support Program" (loan 4819/OC-CR, approved in 2019, and a second operation currently in processing). The main components of the reform contained in the Strengthening Public Finances Act (fiscal rule, tax reform, expenditure control) form the basis or starting point for additional fiscal consolidation measures supported by this operation. First, the strict implementation of the fiscal rule for expenditure is a fundamental pillar of the consolidation strategy that will directly contribute to the outcomes of this operation. Second, the yields from the tax reform contained in Law 9,635 are part of the mix of policies designed to strengthen revenue mobilization. Third, the public employment reform supported by the programmatic series is a key measure for simplifying the compensation system, attracting better talent, and putting wage expenditure on a sustainable path, in line with the EFF. This operation complements the programmatic series by supporting the additional measures required to restore fiscal sustainability in response to the legacy of the COVID-19 shock on the public finances. Its value-added lies in not only financial considerations (helping to close the 2021 financing gap) but technical ones as well by offering a supplementary degree of monitoring for implementation of the measures and achievement of targets under the EFF. In addition to the loan program, and to provide guidance in implementing the policy reforms under this operation, the Bank will support the Ministry of Finance with technical assistance resources, through the combination of regional technical cooperation funding (operation ATN/OC-18055-RG) and client support resources. In particular, technical cooperation operation ATN/OC-17557-CR supports the design and implementation of the public employment reform, and operation ATN/OC-18133-CR is helping the Ministry of Finance build capacity to improve the Medium-term Fiscal Framework, public expenditure efficiency, and tax compliance. This array of operational and technical assistance will contribute to the sustainability of the reforms supported by this operation and achievement of the program's outcome targets. Fiscal support will also be supplemented with structural reform support for the gradual transition to net zero greenhouse gas emissions by 2050 through the programmatic series, "Towards a Green Economy: Support for Costa Rica's Decarbonization Plan" (loan 4988/OC-CR, approved in 2020), which not only promotes sustainable and green growth but also furthers fiscal sustainability by supporting a more resilient economy.

2.8 **Strategic alignment.** The program is consistent with the second Update to the Institutional Strategy (document AB-3190-2) and is strategically aligned with the crosscutting theme of institutional capacity and rule of law through the implementation of reforms to build government capacity. The program will also contribute to the Corporate Results Framework 2020-2023 (document GN-2727-12) through the "countries with strengthened tax and expenditure policy and management" indicator. The program is aligned with the Sector Strategy on Institutions for Growth and Social Welfare (document GN-2587-2), in the area of strengthening fiscal management, and it is consistent with the Fiscal Policy and Management Sector Framework Document (document GN-2831-8), as it promotes actions to strengthen fiscal sustainability in the medium term. Lastly, the program is aligned with the IDB Group Country Strategy with Costa Rica 2019-2022 (document GN-2977), through the priority

area of strengthening of public finance. The operation's expected outcomes directly address the strategic objectives of: (i) improving the institutions for public expenditure control; and (ii) improving the country's revenue collection levels.

A. Objectives, components, and cost

2.9 **Program objective.** The specific objectives of this operation are to: (i) ensure fiscal sustainability; and (ii) maintain monetary and financial stability. Achieving these objectives will contribute to the general objective of supporting the government's policies to boost economic recovery while preserving macroeconomic stability.

2.10 The program objectives and components are aligned with the EFF approved by the IMF on 1 March 2021. The Policy Matrix (Annex II) is synchronized with the first review of the EFF. In particular, the Matrix includes quantitative criteria and indicative targets expected to be achieved under the EFF by 31 July 2021.[36] The budget support provided through SDL will help meet short-term financing needs and support economic recovery while providing backing for the government's reform program to restore debt sustainability, thus protecting spending on vulnerable groups and infrastructure investment. Financing will be provided under the following components.

2.11 **Component 1. Ensuring fiscal sustainability** by meeting the quantitative performance criteria and indicative targets agreed with the IMF by 31 July 2021. The quantitative criteria are: (i) for the central government's primary balance to be equal to or greater than the floor of -₡390 billion; and (ii) for the accumulation of new external payment arrears to not exceed the ceiling of US$0. The indicative target is for the central government's debt stock to not exceed the ceiling of ₡26.625 trillion.

2.12 **Component 2. Maintaining monetary and financial stability** by meeting the quantitative performance criteria and the monetary policy consultation clause agreed with the IMF by 31 July 2021. The quantitative criterion is for the BCCR's net international reserve balance to be equal to or greater than the floor of US$3.66 billion. The monetary policy consultation clause is for inflation to remain within the target range of +/-3% relative to its center point.

B. Key results indicators and program beneficiaries

2.13 The operation's general development objective will be measured based on the economic growth rate. The specific objectives will be measured through indicators showing: (i) improvement in the primary balance, to reach a surplus of 1% of GDP in 2023; (ii) a reduction in primary current expenditure equivalent to three percentage points of GDP by program end; (iii) achievement of the inflation target in each year of the program; and (iv) an increase in the BCCR's international reserves of up to US$9.123 billion.

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[36] Although the first review entails a structural benchmark (legislative approval of the public employment law), this condition is not included in this operation because it is already supported by the Fiscal Sustainability Support Program (in preparation).

2.14 The program will benefit:

a. The Government of Costa Rica, in two ways: (i) by obtaining fast-disbursing resources to finance short-term balance of payments needs, including government financing requirements; and (ii) by having a strategic framework to advance the structural fiscal reform program.

b. The population at large, by supporting policies that preserve macroeconomic stability and enable economic recovery, including measures designed to achieve fiscal sustainability, protect spending on vulnerable groups and infrastructure investment, and maintain the stability of the monetary and financial system.

III. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

3.1 This SDL program will be financed with the Bank's Ordinary Capital resources and is part of the Bank's regular lending program approved in the Long-term Financial Plan. It will therefore not exceed the financing program. The operation was prepared in coordination with the EFF approved by the IMF. The single-tranche structure and complementary financing arrangements with the IMF provide a flexible and efficient mechanism for supporting policy reforms and meeting short-term financing needs. The SDL resources will be disbursed to the government in a single tranche into the bank account designated for this purpose by the Ministry of Finance.

3.2 The loan amount is US$250 million. In determining the loan amount, consideration was given to the following: the size of the package of measures needed to address the macroeconomic crisis; the short-term government financing and balance of payment shortfalls; and the threshold for funds per country (paragraphs 3.3 and 4.1 of the SDL guidelines, document GN-2031-17). The total financial requirements of the Costa Rican central government for 2021 are estimated to be approximately US$8.24 billion. This operation covers 3% of those requirements and accounts for 8.7% of the external financing expected by the Ministry of Finance for 2021.

B. Environmental and social risks

3.3 Pursuant to Directive B.13 of the Environment and Safeguards Compliance Policy (Operational Policy OP-703), no ex ante impact classification is required for this program. The operation supports the development of policies, regulations, management instruments, and other institutional strengthening actions, so no significant direct impacts on the environment or natural resources are expected.

C. Fiduciary risks

3.4 No fiduciary risks have been identified for this program. The proceeds will be disbursed directly into the treasury single account, which the Ministry of Finance will use to cover financing needs. The executing agency has the necessary financial management tools and control systems for this purpose. The proceeds will be disbursed once the measures defined in the loan contract have been fulfilled.

D. Other risks

3.5 **Economic/financial environment risks.** Two medium-high risks have been identified. The first concerns the high degree of uncertainty surrounding the severity of the impact of COVID-19 on the global and Costa Rican economies. If the pandemic lasts longer than expected, this could delay economic recovery, impacting government revenue and, by extension, the deficit and the debt. The second is a tightening of conditions on (domestic and/or foreign) capital markets, which could raise sovereign financing costs and delay the fiscal consolidation process in a context where gross financing needs remain high in the short and medium term. To mitigate these two risks, the Bank will continue to monitor the macroeconomic context and maintain ongoing dialogue with the authorities and other multilateral institutions (paragraph 2.6) to swiftly provide the technical foundation required to identify additional measures for a return to fiscal sustainability. Technical cooperation resources (operation ATN/OC-18055-RG) are available to that end (paragraph 2.7).

3.6 **Political risks.** Two medium-high risks have been identified. The first is related to delays in the legislative approval of reforms required to meet program objectives, which could compromise the cost adjustment and revenue increase, delaying fiscal consolidation. To mitigate this risk, the Bank will continue to support dialogue with all of the actors involved and provide technical support to build the consensus needed for these policies through technical cooperation resources (operation ATN/OC-18133-CR). It should be noted that the proposed reforms are the result of broadbased social and political dialogue. In particular, the government took the initiative to hold multisector round-tables involving the participation of representatives of more than 60 organizations, including entrepreneurs, unions, chambers of commerce, civil society, and the environmental sector. The objective of these events was to identify the necessary fiscal consolidation measures. The second risk is a significant delay in the legislative ratification of the EFF and this loan, which can result in disbursement delays and force the government to use alternative financing sources with higher costs, such as the domestic market. This risk could become more pronounced amid the lead-up to the 2022 presidential and legislative elections. To mitigate this risk, the Bank: (i) is maintaining ongoing fiscal dialogue with members of the Legislative Assembly and providing ongoing technical support to the Ministry of Finance; and (ii) coordinated the preparation timeline for this operation with the counterparty so that the government can submit the entire joint multilateral financing package to the Legislative Assembly to facilitate its discussion (paragraph 2.6).

IV. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

4.1 **Borrower and executing agency.** The borrower is the Republic of Costa Rica. The executing agency will be the Ministry of Finance, which will be responsible for: (i) submitting evidence that the measures agreed upon by the government and the Bank for disbursement of the loan have been met; (ii) promoting measures to achieve the objectives set in the program; and (iii) compiling,

maintaining, and providing to the Bank the necessary information, indicators, and parameters for monitoring and evaluating program outcomes.

4.2 **Policy actions and disbursement of loan proceeds. The single disbursement of the loan proceeds will be carried out in accordance with the provisions established in the corresponding loan contract between the borrower and the Bank, including the provision that the IMF-approved EFF funds have been or are being disbursed. The Bank's disbursement will be subject to compliance with the policy measures agreed with the IMF under the first review of the EFF, summarized in the Policy Matrix (Annex II) and in the Policy Letter.**

4.3 The Bank's financing will be disbursed to and executed by the Ministry of Finance. The expected expenditures are aligned with the areas of support envisaged for SDL in the respective operational guidelines (document GN-2031-17), especially as regards support for efforts to mitigate the effects of the crisis on the poor and vulnerable, supporting the gradual implementation of a progressive fiscal adjustment to ensure debt sustainability, and protecting expenditure on vulnerable groups and infrastructure investment, while maintaining flexibility to increase emergency-related expenditure in 2021, where necessary (paragraph 1.13).

B. Summary of arrangements for monitoring results

4.4 **Monitoring.** The borrower and the Bank will meet regularly to monitor the measures described in the Policy Matrix.[37] The Bank will also maintain regular contact with the IMF's mission in Costa Rica, take note of any IMF decision related to the EFF, and coordinate with the other multilateral institutions (paragraph 2.6). The executing agency will compile and process all data necessary for program monitoring and evaluation, which will be available to the public (paragraph 4.5). Consulting engagements to verify Results Matrix and Policy Matrix indicators will be financed with the Bank's administrative funds.

4.5 **Evaluation.** After the EFF has concluded in late 2023, the Bank will evaluate the agreed indicators and the respective targets of this operation, which will constitute inputs for the overall evaluation of the effectiveness of the SDL instrument.

4.6 **Policy letter.** The Policy Letter issued by the Government of Costa Rica, reiterating the country's commitment to the objectives of this operation, is aligned with the program's Policy Matrix and Results Matrix.

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[37] The main monitoring mechanism will be biweekly meetings between the project team and their technical counterparts at the Ministry of Finance and the BCCR to monitor progress made on the fiscal and monetary indicators.

RESULTS MATRIX

Project objective:	The specific objectives of this operation are to: (i) ensure fiscal sustainability; and (ii) maintain monetary and financial stability. Achieving these objectives will contribute to the general objective of supporting the government's policies to boost economic recovery while preserving macroeconomic stability.

GENERAL DEVELOPMENT OBJECTIVE

Indicator	Unit of measurement	Baseline value	Baseline year	Expected year achieved	Target	Means of verification	Comments
General development objective: Boost economic recovery while preserving macroeconomic stability							
Indicator 1. GDP growth	%	-4.8	2020	2023	3.1	Central Bank of Costa Rica (BCCR)	Source: Extended Fund Facility (EFF) baselines and targets: Costa Rica Staff Report

SPECIFIC DEVELOPMENT OBJECTIVES

Indicator	Unit of measurement	Baseline value	Baseline year	Year	Project end	Means of verification	Comments
Specific development objective 1: Ensuring fiscal sustainability							
Indicator 1. Primary fiscal balance as % of GDP	%	-3.9	2020	2023	1	Ministry of Finance	Source: EFF baselines and targets: Costa Rica Staff Report
Indicator 2. Primary current expenditure as % of GDP	%	16.3	2020	2023	13.2	Ministry of Finance	Source: EFF baselines and targets: Costa Rica Staff Report
Specific development objective 2: Maintaining monetary and financial stability							
Indicator 1. Percentage of years in the 2021-2023 period in which inflation is within the target range	%	0	2020	2023	100	National Statistics and Census Institute of Costa Rica	Source: EFF baselines and targets: Costa Rica Staff Report Inflation target range as specified in the EFF monetary policy consultation clause
Indicator 2. BCCR international reserves (US$ billion)	US$	7.232	2020	2023	9.123	BCCR	Source: EFF baselines and targets: Costa Rica Staff Report

OUTPUTS[1]

Indicator	Unit of measurement	Baseline value	Baseline year	Year	Project end	Means of verification
Component 1: Ensuring fiscal sustainability						
Report with quantitative performance criteria met under the EFF program	Report	0	2020	2021	1	Staff report for the First Review Under the Stand-By Arrangement
Report with indicative targets met under the EFF program	Report	0	2020	2021	1	Staff report for the First Review Under the Stand-By Arrangement
Component 2: Maintaining monetary and financial stability						
Report with quantitative performance criteria met under the EFF program	Report	0	2020	2021	1	Staff report for the First Review Under the Stand-By Arrangement
Report with monetary policy consultation clause met under the EFF program	Report	0	2021	2021	1	Staff report for the First Review Under the Stand-By Arrangement

1 The quantitative performance criteria and indicative targets are outlined in the operation's Policy Matrix (Annex II).

POLICY MATRIX

Objective: The specific objectives of this operation are to: (i) ensure fiscal sustainability; and (ii) maintain monetary and financial stability. Achieving these objectives will contribute to the general objective of supporting the government's policies to boost economic recovery while preserving macroeconomic stability.

Components/ Policy objectives	Conditions for the single-tranche operation	Status of fulfillment of conditions[1]
Component 1. Ensuring fiscal sustainability		
Ensuring fiscal sustainability	I.a. The borrower will have complied with the following quantitative performance criteria agreed with the International Monetary Fund (IMF) under the Extended Fund Facility (EFF) by 31 July 2021: (i) the central government's primary balance is equal to or greater than the floor of -₡390 billion. (ii) the accumulation of new external payment arrears does not exceed the ceiling of US$0.	Pending (July 2021)
	I.b. The borrower will have complied with the following indicative target agreed with the IMF under the EFF by 31 July 2021: (i) the central government's debt stock does not exceed the ceiling of ₡26.625 trillion.	Pending (July 2021)
Component 2. Maintaining monetary and financial stability		
Maintaining monetary and financial stability	II.a. The borrower will have complied with the following quantitative performance criterion agreed with the IMF under the EFF by 31 July 2021: (i) the net international reserve balance of the Central Bank of Costa Rica is equal to or greater than the floor of US$3.66 billion.	Pending (July 2021)
	II.b. The borrower will have complied with the following monetary policy consultation clause agreed with the IMF under the EFF by 31 July 2021: (i) inflation remains within the target range of +/-3% relative to its center point.	Pending (July 2021)

[1] This information was merely indicative as of the date of this document. Fulfillment of all the specified conditions for disbursement will be verified by the Bank at the time of the borrower's request for the corresponding disbursement and reflected in a disbursement eligibility memorandum as required. The first review is currently scheduled for October 2021, but the reporting deadline will be July 2021.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-___/21

Costa Rica. Loan ____/OC-CR to the Republic of Costa Rica
Emergency Program for Fiscal Strengthening and Restoring Growth

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Costa Rica, as borrower, for the purpose of granting it a financing to cooperate in the execution of the Emergency Program for Fiscal Strengthening and Restoring Growth. Such financing will be for the amount of up to US$250,000,000 from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on __ ____________ 2021)

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