COSTA RICA

The economy is projected to continue to expand at a strong pace. Growth will be driven by robust household consumption and increased exports due to stronger demand in the United States. Investment will be led by public infrastructure planned in the coming years. Inflation is starting to pick up and will return to the central bank's target range of 2-4% at the end of 2016.

Although a strong recovery is underway, unemployment rates remain high, especially for the poor who also suffer from high informality and are increasingly leaving the labour force. Targeted policies are needed to make the labour market more inclusive, especially for women. Improving the quality of education and enhancing the effectiveness of cash transfers would help reduce high poverty.

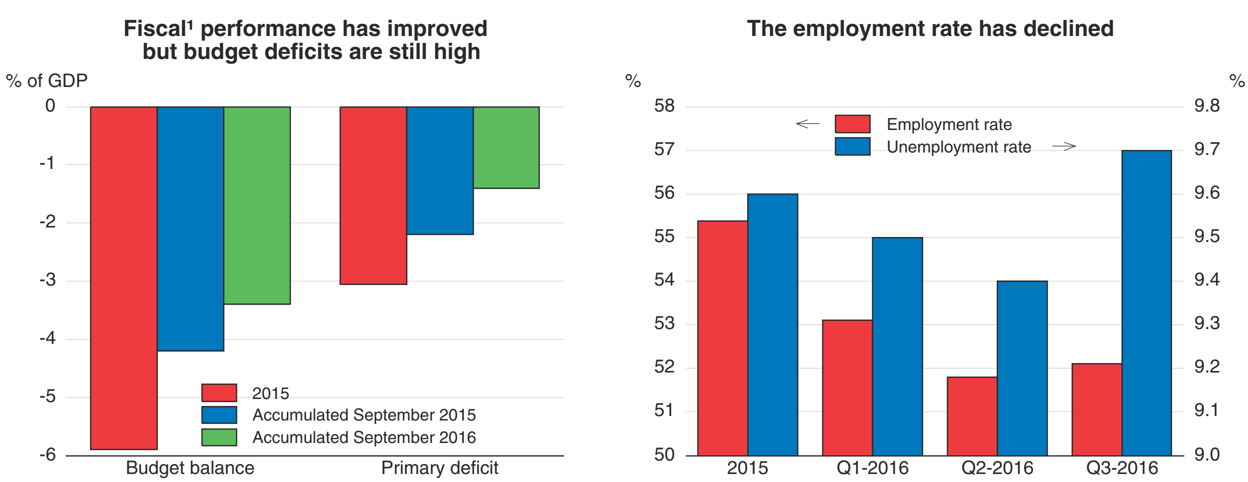
Fiscal reform is urgent. During the first half of 2016, fiscal performance has improved due to spending restraint and better tax collection. However, central government debt continued to raise, because of high interest payments that restrict fiscal space. Spending restraints will keep weighing on domestic demand until tax reforms are implemented.

The economy is recovering at a good pace

The economy grew strongly during the first half of 2016, driven by household consumption. Government spending decelerated because of public expenditure containment. Despite strong growth, labour markets remain weak with falling employment rates. The unemployment rate has fallen mostly due to workers withdrawing from the labour force.

Consumer prices fell in the first half of 2016, owing to declining oil prices and the stability of the exchange rate. Due to monetary policy easing, inflation started to pick up during the third quarter of 2016 and is set to reach the central bank's target range of 2-4% at the end of the year.

Costa Rica



1. Central Government.
Source: Costa Rica's Finance Ministry and Central Bank data.

StatLink http://dx.doi.org/10.1787/888933437542

Costa Rica: **Demand, output and prices**

	2013	2014	2015	2016	2017	2018
	Current prices CRC trillion	Percentage changes, volume (2012 prices)				
GDP at market prices	24.8	3.0	3.8	4.1	4.0	4.0
Private consumption	16.5	3.5	4.4	4.6	4.6	4.4
Government consumption	4.4	2.9	2.4	1.3	2.5	3.2
Gross fixed capital formation	4.8	2.9	8.5	2.2	5.1	5.0
Final domestic demand	25.7	3.3	4.8	3.5	4.3	4.3
Stockbuilding[1]	- 0.2	-0.4	0.0	0.2	0.6	0.0
Total domestic demand	25.5	2.9	4.8	4.3	4.6	4.3
Exports of goods and services	7.8	3.4	2.5	8.9	5.3	5.1
Imports of goods and services	8.5	3.1	5.5	9.0	6.7	5.7
Net exports[1]	- 0.7	0.0	-1.2	-0.4	-0.8	-0.5
Memorandum items						
GDP deflator	_	5.7	3.3	0.8	4.0	5.5
Consumer price index	_	4.5	0.8	0.0	2.5	3.0
Private consumption deflator	_	4.2	0.2	-0.6	1.6	1.9
Unemployment rate	_	9.6	9.6	9.5	9.3	9.0
Current account balance[2]	_	-4.8	-4.3	-2.6	-3.0	-3.5

1. Contributions to changes in real GDP, actual amount in the first column.
2. As a percentage of GDP.
Source: OECD Economic Outlook 100 database.

StatLink http://dx.doi.org/10.1787/888933439326

The fiscal reform is urgent

The central government deficit fell in the first half on 2016, driven by spending containment measures and buoyant revenue. However, fiscal space is limited given the still rising debt-to-GDP ratio and high interest payments, which absorb 20% of total revenue. There has been some progress on the tax reform, with 6 out of 13 projects of the reform package approved. However, two important bills to replace the sales tax with a full-fledged VAT system and a reform of the income tax are still under discussion in the legislative assembly.

It is urgent to approve the tax reform. The VAT and the income tax reform would cut the deficit by about 2% of GDP, which would help stabilise the debt-to-GDP ratio. The reforms are well thought out as they will broaden tax bases and the introduction of a VAT is a growth-friendly way to raise revenues. Additional fiscal or expenditure control measures of 1% of GDP will be needed to put debt on a firm downward path. These should focus on reforming the public employment system to prevent excessive automatic salary increases and raise public sector efficiency.

GDP growth is projected to be robust but with significant uncertainties on the domestic front

Growth is projected to remain strong. Household consumption will drive growth, supported by still-low oil prices, low interest rates and credit expansion. Investment growth will pick up, boosted by planned infrastructure investments. Other factors supporting strong growth include a projected solid US recovery sustaining export expansion, firm credit expansion and continued monetary stimulus.

Disappointing labour productivity growth calls for measures to promote innovation and access to finance, competition and transport infrastructure. Raising the quality of education and work prospects for women would decrease inequality by expanding opportunities and sharing prosperity more widely.

The main risk to the current outlook concerns fiscal developments. Rising public debt makes the economy vulnerable to sudden changes in financial market conditions. In addition, large government gross financing requirements could push up domestic interest rates, weighing on private investment and consumption, and limiting the transmission of the monetary stimulus to lending rates. Furthermore, as Costa Rica is a small open economy, external developments are critical, such as higher international energy prices and extreme bouts of market volatility. Uncertainty in the international markets, and currency depreciation could create problems for the stability of the banking system given its high dollarisation.