CAPITAL ECONOMICS

LATIN AMERICA ECONOMICS UPDATE

Costa Rica: bright outlook amid short term headwinds

- **Growth in Costa Rica is likely to slow by more in 2024 than officials currently expect amid weaker growth in the US, high commodity prices and tight fiscal policy. Further ahead, though, a burgeoning medical goods sector, robust FDI inflows and the potential to benefit from "friendshoring" mean that Costa Rica's economy is likely to outperform others in the region.**

- **The pandemic proved to be a double edged sword for Costa Rica**. On the one hand, the country's openness to trade led to an initial sharp economic contraction following the outbreak of the pandemic. This, alongside its vulnerability to tight external financing conditions and its weak fiscal position, forced officials to turn to the IMF for a $ 1.8bn package in 2021.

- **On the other hand, a surge in global demand for medical goods – Costa Rica's main export – led to a boom in exports**. (See Chart 1.) Net trade contributed more than 3%-pts to headline GDP growth in 2022 and continues to flare up growth in 2023. (See Chart 2.) This, in turn, helped the economy to post one of the strongest post-pandemic recoveries in the region, with GDP now back in line with its pre-pandemic trend – one of the few countries in Latin America where that's the case. (See Chart 3.)

- The latest data suggests that Costa Rica's economy has continued to hold up well this year, helped by strong private consumption growth. But while we expect **Costa Rica's economy to expand by an above-consensus 5.3% in 2023, we think that a slowdown is on the cards for next year.**

- **For one thing, the external environment is likely to turn less favourable**. The US economy – the destination for more than 40% of Costa Rica's exports – is set to slow in the coming quarters. Based on its past relationship, our US GDP forecast points to a sharp slowdown in growth in Costa Rica. (See Chart 4.)

- **What's more, continued tight fiscal policy imposed by the fiscal rule, as well as being a condition of the IMF deal, will limit public spending.** The primary balance is expected to remain in a surplus of around 2% of GDP in the coming years. This will help to bring down the debt-to-GDP ratio, which currently stands at 63%. Equally, though, this will weigh on consumption and investment. Indeed, we doubt that the above-trend consumption growth rate recorded so far this year will be maintained. Higher oil prices and adverse economic effects owing to El Niño pose further headwinds to the economy.

- **The crumb of comfort is that two factors will help to limit the scale of the slowdown**. First, with tourist arrivals still some way *below* their pre-pandemic levels, there's scope for a recovery in the tourism sector. (See Chart 5.) **And second, monetary policy will become less restrictive**. Admittedly, following a period of deflation on the back of an appreciation of the colon and falls in global food and energy prices, inflation is set to rise again. But we think it will remain within the BCCR's target range of 3±1%, paving the way for cumulative rate cuts of 150bp, leaving the policy rate at 4.75% by the end of 2024. (See Chart 6.)

- **Taken together, we think that growth in Costa Rica's economy will slow to 3.3% in 2024. This is well below the 4.3% expansion that Costa Rica's central bank has pencilled in.**

- **Although Costa Rica faces headwinds in the near-term, the long-term outlook is bright.** Nearly 90% of Costa Rica's medical goods exports head to the US and EU, two economic blocs with ageing populations and thus increasing demand for medical goods.

- What's more, with some of the largest FDI inflows relative to its economic size, its proximity to the US and free trade agreements with countries comprising two-thirds of global GDP, Costa Rica stands to benefit from so-called "friendshoring". **We think that these factors will help Costa Rica's economy to grow by an average of around 3.5% from the middle of this decade onwards, outperforming most of the major economies in the region.**

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Chart 1: Exports by Category (12m sum, Q4 2019 = 100)

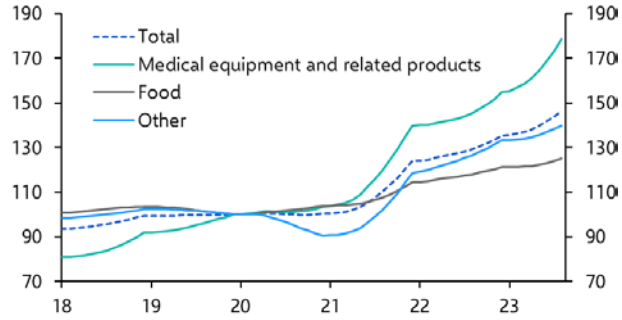


Chart 2: Contribution to y/y GDP Growth (%-pts)

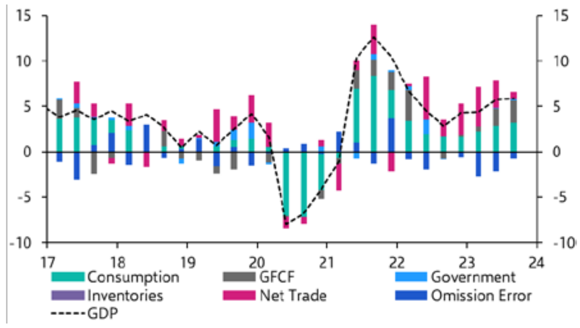


Chart 3: GDP (SA, Q4 2019 = 100)

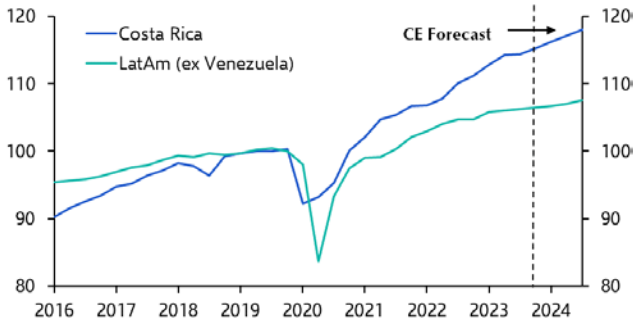


Chart 4: US & Costa Rica GDP (% y/y)

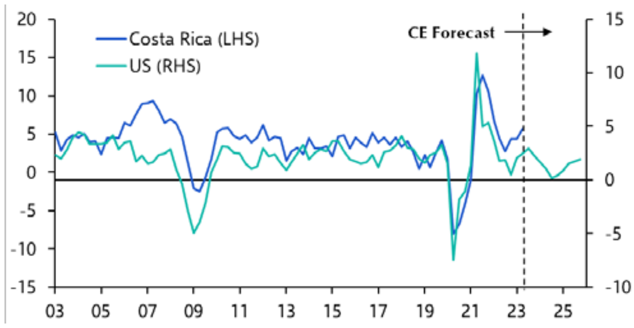


Chart 5: Tourist Arrivals (SA, Thousands)

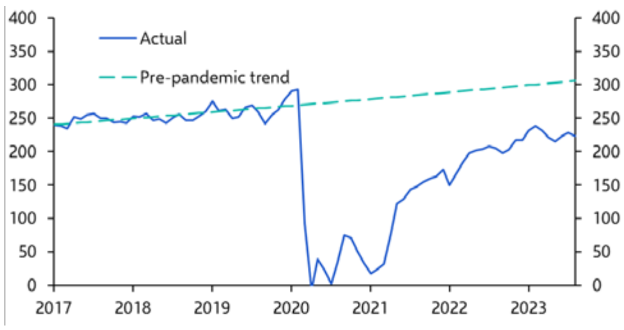
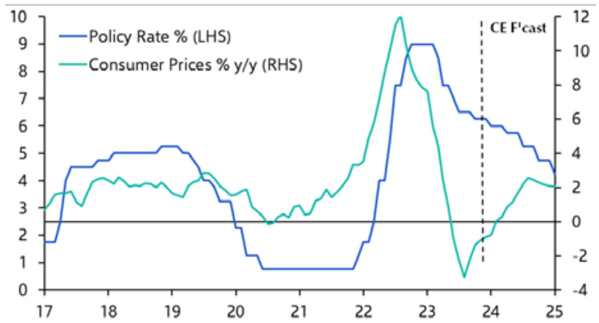


Chart 6: Consumer Prices & Policy Rate



Sources: Capital Economics, BCCR, ICT. Refinitiv