MOODY'S
INVESTORS SERVICE

Rating Action: Moody's places Costa Rica's Ba2 ratings on review for downgrade

18 Oct 2018

New York, October 18, 2018 -- Moody's Investors Service (MIS) has today placed the Government of Costa Rica's Ba2 long-term issuer ratings and the Ba2 senior unsecured bond ratings on review for downgrade.

The key drivers for today's initiation of the review for downgrade are as follows:

1. Prospects of continuing worsening of fiscal and government debt indicators, coupled with evidence of increasing funding pressures

2. Reservations about the government's ability to implement an effective fiscal consolidation plan and revert negative fiscal trends.

During the review period Moody's will assess the likelihood of approval of a comprehensive fiscal reform that proves effective in arresting the persistent upward trend in government debt metrics. Similarly, the review will explore alternative funding scenarios to determine credit risks associated to restricted market access.

Costa Rica's long-term country ceilings are not affected by today's announcement. The foreign-currency bond ceiling remains at Baa3; the foreign-currency bank deposit ceiling remains at Ba3 and the local currency country ceilings for bonds and bank deposits remain at Baa1. The short-term country ceilings also remain unchanged at Prime-3 (P-3) for foreign-currency bonds and Not Prime (NP) for foreign-currency bank deposits.

RATINGS RATIONALE

DRIVERS FOR THE DECISION TO PLACE COSTA RICA'S Ba2 RATINGS ON REVIEW FOR DOWNGRADE

WORSENING FISCAL METRICS

Costa Rica has been reporting large government deficits for years and Moody's expects the 2018 fiscal deficit will end at 7.2% of GDP, compared to 4% of GDP in 2011. High deficits are increasing government debt, which Moody's estimates will reach 54% of GDP in 2018 up from 30% in 2011. Debt metrics are now materially worse than those of similarly-rated peers, more so in terms of the interest burden with interest payments currently equivalent to 24% of government revenue compared to an 8% median for the Ba group. With current trends pointing to continued fiscal deterioration, Moody's expects a fiscal deficit close to 8% of GDP and government debt close to 60% of GDP next year, if significant fiscal reforms are not enacted.

On 28 September, the Central Bank of Costa Rica announced it would purchase CRC$498 billion (US$860 million or about 1.4% of 2018 GDP) in Treasury notes from the Finance Ministry, an emergency financing mechanism that had not been used for over two decades. The authorities' decision to use the Central Bank facility highlights rising funding pressures as increased government reliance on domestic market funding has been pushing up local interest rates. Moody's anticipates continued pressures as government annual funding needs are likely to remain above 14% of GDP in 2018-19, compared to 11% of GDP in the previous five years.

DIFFICULTIES IMPLEMENTING FISCAL REFORM

Over the years, prior governments have repeatedly failed to enact effective fiscal consolidation efforts. President Carlos Alvarado Quesada, sworn in in May 2018, has prioritized approval of a fiscal reform, which is currently being debated in the country's Legislative Assembly. The proposal includes an expansion of the VAT to cover services and a reduction in benefits to public employees. But with his party holding only 10 out of 57 seats in the unicameral Legislative Assembly, getting sufficient votes to approve the initiative could be an uphill battled despite his best efforts. And even if approved the reform may still result in high deficits and be insufficient to materially arrest the deterioration in fiscal and debt metrics.

WHAT COULD CHANGE THE RATING DOWN/UP

During the review period Moody's will assess the content of the fiscal reform package, its potential effect on government debt metrics and its likelihood of approval. The review will also look at potential credit risks arising from the government's funding options in an environment characterized by rising interest rates and reduced market access.

Given a review for downgrade, a rating upgrade is unlikely. However, Moody's would stabilize the outlook at the current rating level if the rating agency expected the government to adopt structural budgetary adjustments that combined increased tax revenue and spending cuts and proved sufficient to arrest and eventually reverse the deteriorating trend in government debt indicators.

Prospects of continued fiscal deterioration associated with persistent increases in debt metrics would lead to a negative rating action. Lack of approval of a fiscal reform, or approval of a less comprehensive reform, could result in a multi-notch downgrade. Additionally, evidence of stress in the banking system or a significant increase in the level of financial dollarization could also place downward pressure on the rating.

GDP per capita (PPP basis, US$): 16,877 (2017 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 3.3% (2017 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 2.5% (2017 Actual)

Gen. Gov. Financial Balance/GDP: -6.2% (2017 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -3.1% (2017 Actual) (also known as External Balance)

External debt/GDP: 46.5% (2017 Actual)

Level of economic development: Moderate level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 15 October 2018, a rating committee was called to discuss the rating of the Government of Costa Rica. The main points raised during the discussion were: The issuer's fiscal or financial strength, including its debt profile, has materially decreased. The issuer has become increasingly susceptible to event risks. Other views raised included: The issuer's institutional strength/framework, have materially decreased.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2016. Please see the Rating Methodologies page on www.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.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

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