Analysis of GDP's reaction to the COVID-19 pandemic

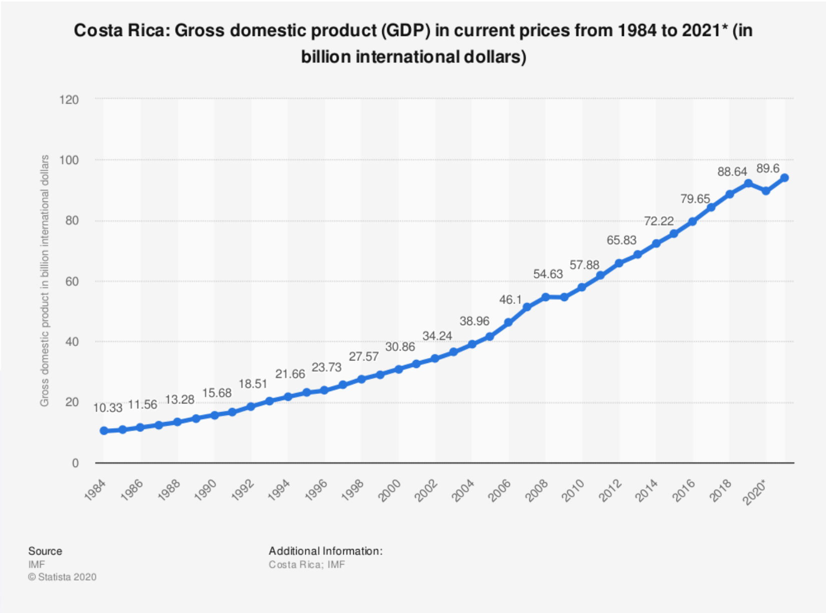
COSTA RICA

Due to the impact and the effects that the national economic situation has had as a result of the pandemic generated by the COVID-19 virus, the Government of the Republic of Costa Rica launched a set of actions that sought to protect liquidity and solvency of homes and businesses. These measures are framed within the Economic Strategy for Growth, Employment and Well-being, which was presented in September 2019 and was updated based on the actions implemented to mitigate the economic effects of the global health crisis. But with the passing of the months and with the government's fiscal proposals that forced a population drowned in taxes to raise their voice, it was concluded that the Economic Strategy for Growth, Employment and Well-being has not met its objective so far.

The global social and economic crisis caused by Sars-Cov-2 came to bury the Costa Rican economy, an economy that had already been in decline with a huge fiscal deficit, a large public debt and multiple monetary commitments with first world countries that in at some point they will request the repayment of those loans. The aforementioned is the reason why it is important to study the behavior of the Gross Domestic Product (GDP) before, during and after the pandemic.

The Central Bank of Costa Rica (BCCR) in the Macroeconomic Program 2020-2021, published in January of this year, projected a real economic growth for Costa Rica of 2.5% in 2020 and 3.0% in 2021. In relation to public finances, the BCCR projected a financial result of the central government (fiscal deficit) of -5.3% in 2020 and -5.1% in 2021. This improvement was attributed by the issuing entity mainly to the expected effects of the application of the fiscal rule and in the expectation of improvement in tax collection.

According to data from the Central Bank of Costa Rica (BCCR) in the first semester of 2020, the confinement and restriction measures on mobility meant a year-on-year drop in economic activity of 4.3%. This rate placed the level of the product below that estimated last April for the semester, projected in a reduction of 2.2%; that is, a contraction of an additional 2.1 percentage points (pp).



The pandemic has caused a considerable deterioration in the finances of the Central Government. Before the pandemic, it was projected that the fiscal imbalance would be reduced from 2020 as a consequence of the full entry into force of the provisions of the December 2018 tax reform. However, the economic contraction as a result of the coronavirus, tax collection has been hit hard, and to this is added the impact of the moratorium applied for the payment of taxes as a measure to mitigate the economic impact of the pandemic on households and companies. Thus, the accumulated figures as of September show a reduction in tax revenues of 11.5%. In the case of expenditures, despite higher expenses for pandemic care, in the nine months to September, there was less growth compared to the same period last year (3.4% versus 10.8%). Altogether, the financial deficit reached 6.7% of the Gross Domestic Product (GDP) and the primary deficit was 2.7% in the first nine months of the year (4.7% and 1.4%, respectively, in same period of 2019). In turn, the Central Government debt balance reached 67.3% of GDP in September (56.3% in the same month of 2019).

Internally, the lower contraction projected for 2020 with respect to what was foreseen in the Review of the Macroeconomic Program 2020-2021 of July issued by the Central Bank of Costa Rica (BCCR), is based on the lower estimated fall in manufacturing, services business and financial intermediation. For its part, the greater growth in 2021 with respect to this revision is explained by the more favorable behavior in the manufacturing and construction industries.

It is estimated that the current account deficit of the balance of payments would be 2.9% and 3.3% of GDP in 2020 and 2021, respectively (3.2% and 3.3% of GDP in the estimate of last July). The lower deficit for 2020 compared to what was estimated in July is due to an increase in exports, both observed and forecast for the remainder of the year, especially in those of the special regimes (free zones).

On the other hand, in the financial account for the 2020-2021 biennium, a fall in the net income of resources is expected compared to 2019, mainly affected by lower direct investment flows. The balance of reserve assets would be at 14.5% of GDP by the end of 2020, a similar ratio to that observed at the end of 2019. In 2021, the rebound in financing, both public and private, would lead to an accumulation of reserve assets that would increase the balance to 15.6% of GDP.

Finally, inflation forecasting models indicate that inflation will remain low for the remainder of 2020 and 2021, with average rates of 0.7% and 1.5% respectively.

The previous projections incorporate the best information available as of October of this year. However, there are risks arising from the international and internal context that, if they materialize, could generate deviations in relation to the projected results for this year. In particular, macroeconomic projections by international financial organizations and national authorities are, at this juncture, covered with unusually high margins of error, associated with uncertainty about the duration of the pandemic and restrictive measures to contain it.

Thus, the main risk of the external context is identified with the trajectory of global economic growth, which could be higher or lower than expected, depending on the evolution of the pandemic and health measures. For their part, the main internal risks are related to a deterioration in public finances greater than expected and the absence or insufficiency of an agreement towards the necessary fiscal adjustment; a reduction in the rate of opening of the economy and partial confinement of the population due to an increase in the rate of contagion by COVID-19 and an increase in social tensions.

The Fiscal Studies Project of the Economics Faculty of the National University undertook the task of estimating possible production trajectories and the financial result of the central government, for the years 2020 and 2021, through the use of econometric intervention models, for different scenarios of prolongation of the health crisis and the application of economic rescue measures. A statistical treatment of seasonal adjustment and revision of the behavior of the trajectories of the main economic variables was applied during the 2009 crisis, the subsequent economic recovery and more recently the initial effect of the health crisis.

Based on the foregoing and adapting to the new reality, some lessons learned from the last international financial crisis in 2009, two analysis scenarios were constructed, which are analyzed below.

Scenario 1**:** The temporality of the pandemic is decreasing until the third quarter of the year and the Government applies the containment measures temporarily and gradually withdraws them.

The results of this scenario indicate that the real GDP for 2020 would contract -3.4%, with a recovery of 0.4% growth for next year. The trend of the estimates depend on the duration and intensity of the pandemic.

However, the reduction in production would result in a government financial deficit of -9.6% with respect to the GDP, explained by low revenue, anchored to lower economic activity due to sanitary restrictions and measures to support the families and businesses.

Scenario 2**:** The temporality of the pandemic extends until December and the economic containment package is extended, gradually being applied for the rest of 2020.

In this scenario, the results show for the year 2020, a contraction of the real GDP of -4.2% and a financial result of the central government of -10.2% with respect to GDP. For the year 2021, the GDP variation rate is projected to be -2.2% and with a financial result of the central government of -10.9% with respect to the GDP.

The findings generally point out that the expected trend in economic activity and the financial result of the central government will depend on the duration of the health emergency, that is, the period it takes to lift the measures implemented by the Government, particularly those referred to social distancing. The data generated by the estimation model show, as is to be expected, that the longer these measures are maintained, the greater the impact on national production and public finances will be.

Regarding the fiscal scenario, Law 9,030, the Tax Relief Law against COVID-19, established a moratorium on the payment of various taxes, which, in principle, would improve the cash flow of companies and businesses in the short term. Additionally, a series of extraordinary expenses related to emergency health care and support to people affected by the pandemic were generated. These circumstances led to a deterioration of the fiscal deficit during the first half of 2020.

Under the current scenario of lower tax collection, the result of the fiscal deficit compared to the one projected in the previous September will increase by 3.1 pp to place it at 9.3% of the GDP and in 2021 this amount amounts to 8.1% of national production. Of these figures, the largest proportion corresponds to the payment of interest on the debt, which amounts to 5.2% in 2020 and 5.6% in 2021, a consequence of the high level of debt that the country maintains, which is estimated at 70, 2% and 76.6% of the GDP for each year, respectively.

Worldwide, according to the International Monetary Fund, projections for world economic growth worsened by 1.9 pp to stand at -4.9% for the current year and a recovery of 5.4% for 2021. For the case of 2020, this growth rate represents the largest contraction since the Great Depression of 1929.

In this context, inflation for advanced and emerging economies during 2020 is estimated to be 0.3% and 4.4%, respectively. In 2021 an increase would be observed, in advanced economies it would be at 1.1%; in emerging economies, the increase would be just 0.1 pp to reach 4.5%. It is important to keep in mind that the impact of the economic contraction for the current year of the country's main trading partners (such as the United States) is higher than the world average. A fall of 7.0% is expected and with respect to 2021 the recovery would be 4.2%.

Likewise, international financial conditions have shown a deterioration for the country, despite the fact that different central banks around the world have exercised an accommodative monetary policy that puts downward pressure on interest rates; the risk of Costa Rican bonds in international markets showed more pronounced movements than those observed in the other economies of the region. In general, the risk increased more for countries, such as ours, with lower rating levels, which reflect greater fiscal vulnerability.

In this context, the BCCR foresees that the contraction of national production in real terms for 2020 of 5.0%, higher by 1.4 pp compared to the estimate in April and for 2021 the growth is maintained as expected in April 2,3%.

The projections for 2021 foresee a gradual recovery of all economic activities, as a consequence of the gradual relaxation of sanitary containment measures, with a scenario of preservation of macroeconomic and financial stability, and favorable credit conditions aimed at achieving an adequate business environment. The above as long as the economic reopening is maintained.