



Mexico and Central America

Costa Rica

1. General trends

Real GDP grew by 5.9% (up from 4.1% in 2004) on the strength of export growth (12.6%), which was primarily due to the recovery of external sales of microprocessors produced by the Intel plant, as well as the buoyancy of tourism and international business services. In per capita terms, GDP rose by 4.1%, while national disposable income expanded by only 1.9% owing to losses generated by worsening terms of trade.

External factors affecting the country's economic performance included the high international prices of petroleum and some of the main raw materials imported by Costa Rica. These trends added to the exacerbation of the terms of trade, the widening of the trade gap and rising domestic prices. This situation was aggravated by the uncertainty stemming from the lack of parliamentary support for Executive-branch initiatives, particularly fiscal reform and the Dominican Republic — Central America — United States Free Trade Agreement (CAFTA-DR) and the worsening social and political climate at a juncture dominated by the elections of February 2006.

Despite rapid economic growth, the open unemployment rate rose slightly, from 6.5% to 6.6%. At the same time, real average wages in the formal sector retreated again (-1.9%), while minimum wages

increased by only 0.3% in the wake of the 1.6% dip posted in 2004. The central government was able to keep finances under control thanks to higher revenues and restraint in spending. The global deficit of the narrowly-defined public sector shrank from 3.6% of GDP to 2.3%. Faced with strong inflationary pressures (14.1%) and growing imbalances in the external sector, monetary policy was tightened during the second half of the year. The balance-of-payments current account deficit widened to 4.8% owing to a marked increase in the trade gap.

For 2006, ECLAC estimates an economic growth rate of 4.3%. According to the central bank's monetary programme for 2006-2007, inflation will fall to 11%. The consolidated public-sector deficit is expected to grow to 3.4% of GDP, while the balance-of-payments current account deficit will shrink to 4.6%.

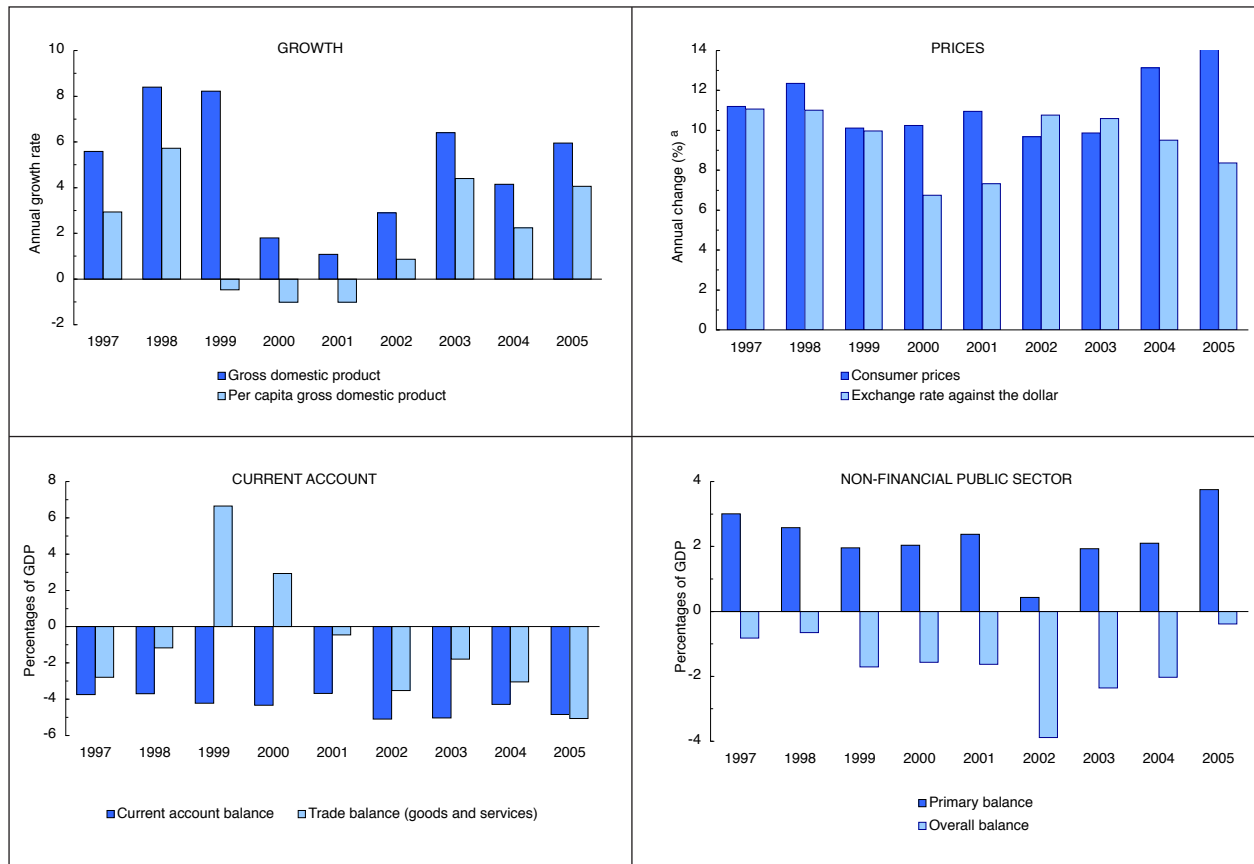
2. Economic policy

In 2005, various external and domestic factors encumbered the management of economic policy and prevented compliance with some of the goals of the monetary programme. Because fiscal policy had little manoeuvring room, a large part of the adjustment burden was borne by monetary policy. The economy was, however, able to absorb much of these factors' destabilizing effect.

After a hiatus of 20 years, former President Oscar Arias Sánchez was re-elected to the presidency of Costa

Rica in February 2006 and took office in May. The new government's economic policy will give priority to strengthening integration with the world economy, solving fiscal problems and effectively combating poverty and inequality. Monetary and exchange policies will gradually take on a greater role in making significant reductions in inflation and, to this end, the government plans to capitalize the central bank. Many of the relevant proposals will require congressional approval, however.

Figure 1
COSTA RICA: MAIN ECONOMIC INDICATORS



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a December-December variation.

As the government does not have a majority in Congress, it will have to seek the necessary consensus in order to achieve their implementation.

(a) Fiscal policy

One of the primary objectives of the new government is to put public finances on a sounder footing. The fiscal deficit is one of the factors behind the fact that the country's interest rates are high relative to international levels, which encourages inflows of speculative capital, on the one hand, and raises the cost of open-market operations, on the other, thereby making monetary policy less effective. The high level of indebtedness also places a considerable burden on public finances.

The plans of the new government, which include a commitment to narrowing the fiscal deficit and raising expenditure on investment and poverty reduction,

will require an increase in tax revenues estimated at 4 percentage points of GDP. The government plans to achieve this increase by enacting progressive reforms in the tax system (particularly regarding its organization and legal framework) and combating tax evasion. Measures will also be taken to contain the growing public debt, improve its profile, and reduce its cost with a view to allowing an increase in investment spending, especially on social services.

In public spending, priority will be given to expanding comprehensive public services, particularly health and education (with the goal of increasing sectoral spending on the latter to 8% of GDP), creating jobs by developing production linkages and supporting micro-, small and medium-sized enterprises, stimulating domestic and foreign private investment that contributes to knowledge-based economic growth and developing infrastructure.

In 2005, the global deficit of the narrowly-defined public sector shrank from 3.6% of GDP to 2.3%. With the exception of the central bank, this performance was attributable to all the components of that sector, including both the central government and the rest of the non-financial public sector (NFPS).

Increased revenues and controlled spending narrowed the central government's financial imbalance from 2.7% of GDP to 2.1%. In contrast to previous years, when a significant portion of the fiscal deficit was financed by issuing bonds on international capital markets, borrowing requirements in 2005 were covered by placing debt on the local market.

Current income rose from 13.6% of GDP to 13.8%, with receipts from customs duties, income taxes and the general domestic sales tax showing the sharpest increases. Total expenditure dropped from 16.4% of GDP to 15.9% owing primarily to the use of the single Treasury account. The stagnation of wages and salaries in real terms (30% of total expenditure) contributed as well. In contrast, higher interest payments (+4.5%) had an adverse effect on government efforts to reduce spending, although interest payments on foreign debt dipped slightly in real terms.

The net result for the rest of the NFPS also improved on the preceding year, as it posted a surplus equivalent to 1.2% of GDP. This reflected a larger positive balance on the accounts of the Costa Rican Electricity Institute and the Costa Rican Social Security Fund as a result of lower capital expenditure and reduced purchases of goods and services. The improvement in the Costa Rican Petroleum Refinery's finances was largely attributable to the rise in revenues from fuel sales.

The central bank's deficit (1.4% of GDP) increased slightly. This result reflected the financial cost, in the absence of any further capitalization operations on the part of the government, of active monetary management in response to significant inflows of foreign capital.

The ratio of total public debt to GDP declined for the third consecutive year owing primarily to the shrinkage of the central government's debt and its financing strategy. Nevertheless, debt continues to be one of the most serious problems facing the Costa Rican economy, representing around 55% of domestic production.

(b) Monetary policy

At the beginning of 2005, the central bank continued raising interest rates for open-market operations and announced its intention to implement a restrictive monetary policy in order to curb the upswing in inflation. It also maintained the level of the legal reserve requirement (12%) in place since October 2004 and reduced the devaluation rate to 15 centavos per day in accordance with the inflation

target (10%). However, high interest rates and the relative stability of the exchange market resulting from the policy of mini-devaluations boosted the returns on investments in colones relative to those offered by other options for financial investment in the domestic and international markets. This spurred the inflow of capital and interfered with efforts to manage the money supply, since the central bank's participation as a net buyer of foreign currency had an expansionary monetary effect that had to be sterilized to avoid domestic-spending pressures.

The central bank gradually lowered its deposit rates, raised the legal reserve requirement from 12% to 15% and stepped up its open-market operations. However, the rise in the principal monetary aggregates was greater than the increase in nominal GDP, and the expansion of credit extended to the private sector was greater than in 2004 due to the relative stability of lending rates and strategies implemented by banks to stimulate credit demand. Real borrowing rates held steady at an average of 1%, while lending rates dipped from 8.7% to 8.2%.

The primary objective of the central bank's monetary policy in 2006 has been to bring inflation down to around 10% in the next biennium. To this end, it will continue with a tight monetary policy based on open-market operations.

In order to improve the transmission mechanism for monetary policy and the efficiency of monetary policy tools, the central bank plans to introduce changes in the mechanisms it uses to obtain funds, such as the auctioning of bonds, and will use new monetary absorption instruments. These improvements are aimed at heightening the efficiency of monetary absorption without obliging the central bank to hike interest rates to any significant degree. It is hoped that these measures will influence the savings and investment decisions of economic agents by discouraging present consumption and thereby reducing inflationary pressures.

An "electronic deposit window" will also be opened for investment in monetary-stabilization bonds. This will allow the bank to provide economic agents with an instrument to replace time certificates of deposit offered by financial intermediaries. This mechanism is intended to improve the interest rate's effectiveness as a transmission mechanism for monetary policy, promote greater competition in the financial market and raise real returns for savers.

(c) Exchange-rate policy

On average, the real effective exchange rate dropped by 1.5% in 2005. The central bank will continue in 2006 with its policy of daily adjustments or mini-devaluations. In order to achieve greater consistency between the inflation target and exchange-rate policy, the nominal exchange

Table 1
COSTA RICA: MAIN ECONOMIC INDICATORS

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a
	Annual growth rates^b								
Gross domestic product	5.6	8.4	8.2	1.8	1.1	2.9	6.4	4.1	5.9
Per capita gross domestic product	2.9	5.7	-0.5	-1.0	-1.0	0.9	4.4	2.2	4.1
Gross domestic product, by sector									
Agriculture, livestock, hunting, forestry and fishing	1.5	8.2	4.5	0.7	1.4	-3.3	7.4	0.1	3.3
Mining	13.0	9.2	-6.1	6.3	6.4	-3.1	4.2	7.7	-2.0
Manufacturing	7.7	11.4	24.7	-2.9	-9.1	3.4	8.4	3.6	11.8
Electricity, gas and water	5.6	8.7	6.2	6.4	45.2	-1.5	4.8	6.3	-0.2
Construction	6.1	17.4	-1.6	4.4	-18.0	5.3	5.8	4.0	4.8
Wholesale and retail commerce, restaurants and hotels	6.1	8.5	2.4	1.5	1.9	1.6	3.4	4.2	3.8
Transport, storage and communications	9.9	8.1	6.9	10.2	9.3	12.0	13.7	11.9	9.8
Financial institutions, insurance, real estate and business services	4.8	4.7	7.6	8.1	6.8	4.7	7.1	6.6	4.8
Community, social and personal services	2.6	4.6	3.0	2.6	2.0	3.0	3.0	1.3	2.2
Gross domestic product, by type of expenditure									
Consumption	5.1	5.0	2.1	1.1	1.4	3.0	2.8	3.0	3.6
General government	4.6	2.2	1.8	1.4	3.6	2.2	-0.2	1.3	1.2
Private	5.1	5.4	2.2	1.0	1.1	3.2	3.2	3.3	3.9
Gross domestic investment	24.9	26.3	-15.6	-1.5	31.4	8.4	-4.2	9.8	11.5
Exports (goods and services)	8.6	26.7	21.3	-0.3	-9.8	4.3	12.0	8.2	12.6
Imports (goods and services)	14.7	25.2	0.4	-2.6	1.1	6.9	1.0	9.1	11.7
	Percentages of GDP								
Investment and saving^c									
Gross domestic investment	18.1	20.5	17.1	16.9	20.3	22.6	20.6	22.9	25.5
National saving	14.3	16.8	12.9	12.6	16.6	17.5	15.6	18.6	20.7
External saving	3.7	3.7	4.2	4.3	3.7	5.1	5.0	4.3	4.8
	Millions of dollars								
Balance of payments									
Current account balance	-481	-521	-666	-691	-603	-857	-880	-796	-960
Merchandise trade balance	-498	-399	580	-210	-820	-1 278	-1 089	-1 421	-2 142
Exports, f.o.b.	4 221	5 538	6 576	5 813	4 923	5 270	6 163	6 370	7 100
Imports, f.o.b.	4 718	5 937	5 996	6 024	5 743	6 548	7 252	7 791	9 242
Services trade balance	140	234	471	679	746	685	776	857	1 140
Income balance	-249	-469	-1 822	-1 252	-679	-440	-776	-444	-227
Net current transfers	126	113	104	93	151	175	209	212	270
Capital and financial balance ^d	288	16	896	539	616	1 020	1 219	876	1 350
Net foreign direct investment	404	608	614	400	451	625	548	557	696
Financial capital ^e	-116	-592	282	138	165	395	671	319	655
Overall balance	-193	-504	230	-152	13	163	339	80	391
Variation in reserve assets ^f	-216	150	-481	152	-13	-163	-339	-80	-391
Other financing ^g	409	355	251	0	0	0	0	0	0
Other external-sector indicators									
Real effective exchange rate (index: 2000=100) ^h	101.1	99.8	101.8	100.0	97.0	97.4	103.4	106.8	108.4
Terms of trade for goods (index: 2000=100)	125.9	117.5	106.9	100.0	98.4	96.9	95.5	91.9	88.3
Net resource transfer (percentage of GDP)	3.5	-0.7	-4.3	-4.5	-0.4	3.4	2.5	2.3	5.7
Gross external public debt (millions of dollars)	2 640	2 872	3 057	3 151	3 175	3 281	3 733	3 884	3 626
Gross external public debt (percentage of GDP)	20.6	20.4	19.3	19.8	19.4	19.5	21.3	20.9	18.1
Net profits and interest (percentage of exports) ⁱ	-4.7	-6.8	-22.1	-16.1	-9.9	-6.2	-9.5	-5.2	-2.3
	Average annual rates								
Employment									
Labour force participation rate ^j	53.8	55.3	54.8	53.6	55.8	55.4	55.5	54.4	56.8
Open unemployment rate ^k	5.7	5.6	6.0	5.2	6.1	6.4	6.7	6.5	6.6
Visible underemployment rate ^k	11.0	11.7	12.0	9.7	9.5	11.2	13.2	12.5	13.0
	Annual percentages								
Prices									
Variation in consumer prices (December-December)	11.2	12.4	10.1	10.2	11.0	9.7	9.9	13.1	14.1
Variation in producer prices industrial (December-December)	10.1	8.8	11.3	10.2	8.6	8.4	11.0	17.7	12.1
Variation in nominal exchange rate (December-December)	11.1	11.0	10.0	6.8	7.3	10.8	10.6	9.5	8.4
Variation in average real wage	0.8	5.6	4.7	0.8	1.0	4.1	0.4	-2.6	-1.9
Nominal deposit rate ^l	12.7	13.3	14.6	12.9	11.3	11.6	10.9	10.0	10.4
Nominal lending rate ^m	22.7	23.0	26.0	24.0	22.2	24.2	23.4	21.2	22.0

Table 1 (concluded)

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a
	Percentages of GDP								
Central government									
Total income	24.3	24.0	23.0	23.5	25.5	24.7	25.0	24.4	25.1
Current income	24.3	24.2	22.6	24.0	24.8	24.8	24.7	24.5	25.2
Tax revenue	12.8	12.8	12.2	12.6	13.5	13.6	13.9	13.9	14.1
Capital income	0.0	-0.2	0.4	-0.5	0.7	-0.1	0.4	0.0	0.0
Total expenditure ⁿ	25.1	24.6	24.7	25.0	27.1	28.6	27.4	26.5	25.5
Current expenditure	20.5	20.0	19.8	20.6	22.2	23.3	22.8	22.3	21.7
Interest	3.8	3.2	3.7	3.6	4.0	4.3	4.3	4.1	4.1
Capital expenditure	4.6	4.6	4.9	4.4	4.8	5.2	4.5	4.1	3.8
Primary balance	3.0	2.6	2.0	2.0	2.4	0.4	1.9	2.1	3.8
Overall balance	-0.8	-0.6	-1.7	-1.6	-1.6	-3.9	-2.4	-2.0	-0.4
Central government debt	...	...	...	41.8	43.5	45.4	46.3	48.3	42.7
Domestic	...	...	...	26.6	28.1	28.7	27.1	27.7	25.4
External	...	...	...	15.1	15.3	16.6	19.2	20.6	17.3
Money and credit^o									
Domestic credit ^p	24.7	26.4	26.2	26.7	24.7	27.0	29.3	31.7	33.1
To the public sector	11.8	11.6	10.0	8.3	3.9	3.7	5.3	7.1	7.2
To the private sector	12.9	14.8	16.2	18.3	20.7	23.1	23.8	24.3	25.4
Other	0.0	0.0	0.0	0.1	0.1	0.1	0.2	0.3	0.5
Liquidity (M3)	28.1	27.9	27.9	30.3	31.4	32.8	33.9	37.8	40.1
Currency in circulation and local-currency deposits (M2)	18.2	17.1	16.5	17.9	17.8	17.8	18.6	19.2	19.5
Foreign-currency deposits	10.0	10.9	11.4	12.3	13.6	14.9	15.4	18.6	20.5

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a Preliminary figures. ^b Based on figures in local currency at constant 1991 prices. ^c Based on figures in local currency expressed in dollars at current prices. ^d Includes errors and omissions. ^e Refers to the capital and financial balance (including errors and omissions), minus net foreign direct investment. ^f A minus sign (-) denotes an increase in reserves. ^g Includes the use of IMF credit and loans and exceptional financing. ^h Annual average, weighted by the value of merchandise exports and imports. ⁱ Refers to net investment income as a percentage of exports of goods and services as shown on the balance of payments. ^j Economically active population as a percentage of the working-age population; nationwide total. ^k Unemployment and underemployment rates as percentages of the economically active population; nationwide total. ^l Depósitos a 90 días de bancos estatales. ^m Rate on loans to industry from State-owned banks. ⁿ Includes net lending. ^o The monetary figures are annual averages. ^p Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions.

rate will be adjusted primarily according to the inflation target and the rise in prices estimated for Costa Rica's principal trading partners, rather than past inflation.

Taking into account expectations regarding the difference between domestic and external inflation, as well as the performance of the United States dollar relative to the currencies of other trading partners, in 2006 the central bank decided to change the daily currency-adjustment rate to an annual variation of 6.6% in the price of the United States dollar in colones (8.3% in 2005).

The new Administration's plans include the adoption of a more flexible exchange-rate system. Considering the financial system's high level of dollarization, this could create problems unless this shift is coupled with measures to strengthen the financial system.

(d) Trade policy

In October 2005, the executive branch sent the text of the free trade agreement with the United States, Central America and the Dominican Republic (CAFTA-DR) to the legislative assembly. A free trade agreement with the countries of the Caribbean Community (CARICOM) took effect in 2005.

The new Administration has expressed its determination to strengthen the economy's export orientation. To this end, one of its main priorities is CAFTA-DR ratification. A similar agreement with the European Union (the principal market for some of Costa Rica's most successful exports) is also being considered, as are negotiations to bring Costa Rica closer to the Asia-Pacific region.

Table 2
COSTA RICA: MAIN QUARTERLY INDICATORS

	2004				2005 ^a				2006 ^a	
	I	II	III	IV	I	II	III	IV	I	II
Gross domestic product (variation from same quarter of preceding year) ^b	4.2	5.1	4.2	3.1	2.7	5.7	9.2	6.2	7.0	...
Merchandise exports, f.o.b. (millions of dollars)	1 571	1 636	1 523	1 568	1 596	1 853	1 791	1 787	1 989	2 086
Merchandise imports, c.i.f. (millions of dollars)	2 015	2 079	2 080	2 094	2 140	2 411	2 546	2 714	2 708	2 835
International reserves (millions of dollars)	1 749	1 637	1 659	1 922	2 105	2 194	2 373	2 313	2 766	2 504 ^c
Real effective exchange rate (index: 2000=100) ^d	106.0	106.0	106.4	109.0	109.1	108.7	108.4	107.4	107.5	108.8
Consumer prices (12-month percentage variation)	11.3	11.9	13.8	13.1	13.6	13.8	13.4	14.1	12.2	12.4
Average nominal exchange rate (colones per dollar)	423	433	443	453	464	473	483	492	501	509
Average real wage (variation from same quarter of preceding year)	0.0	-3.1	-4.0	-3.6	-1.0	-2.4	-1.2	-3.1	1.3	...
Nominal interest rates (annualized percentages)										
Deposit rate ^e	10.1	10.0	10.0	10.0	10.1	10.5	10.6	10.4	10.7	10.0
Lending rate ^f	21.0	20.9	21.3	21.4	21.5	22.2	22.3	22.0	22.0	21.4
Interbank interest rate ^g	13.5	13.6	14.0	14.3	14.8	15.4	15.4	15.3	15.3	14.2
Domestic credit (variation from same quarter of preceding year) ^h	23.1	27.2	26.6	26.2	32.1	20.0	19.1	19.4	20.0	19.3
Non-performing loans as a percentage of total credit ⁱ	1.6	1.7	2.0	1.9	1.7	1.5	1.6	1.4	1.4	1.5

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a Preliminary figures. ^b Based on figures in local currency at constant 1991 prices. ^c Data to May. ^d Quarterly average, weighted by the value of merchandise exports and imports. ^e 90-day deposits at state-owned banks. ^f Rate on loans to industry from State-owned banks. ^g Reference rate (monthly average), calculated by the Central Bank of Costa Rica. ^h Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions. ⁱ Refers to total credit extended by the banking system.

3. The main variables

(a) Economic activity

The growth rate in 2005 was 5.9%, up from 4.1% the year before. Economic activity cooled in the first five months due to worsening terms of trade, an austere fiscal policy and the effect that the prospects of a rise in interest rates had on domestic spending. Certain short-term weather factors weighed in as well, mainly affecting banana and sugar-cane production. During the rest of the year, however, economic activity rebounded on the back of buoyant exports, especially in the high-technology sector.

The expansion of economic activity was fuelled by the dynamism of external demand. Goods and services exports posted a growth rate of 12.6%, which was substantially higher than the 2004 rate of 8.2%. Domestic demand,

in contrast, slackened as a result of reduced growth in consumption, which tempered the impact of the surge in investment on domestic spending.

A strong recovery in gross fixed capital formation (7.3%) was driven by investment in capital goods, especially by companies operating under the free-zone regime. Investment in new construction slackened, however, owing largely to the reduction in public works. Private consumption (3.9%) suffered from the decline in the growth rate of disposable national income, but benefited from rising employment and an increase in bank financing for consumption and housing. Public consumption grew only slightly as a result of efforts to curb public spending.

At the sectoral level, goods production was notably buoyant (8.2%) as a result of a higher level of value added in the manufacturing sector (11.8%), thanks mainly to the

production activities of companies operating in the free zones and Costa Rican firms' exports, most of which go to other Central American countries. The agricultural sector also experienced an upswing (3.3%).

Services were up by 4.9%, largely due to transport, telecommunications (especially mobile telephones and Internet services), hotels, financial services and international business services (especially software production, call centres and business centres).

(b) Prices, wages and employment

The rate of inflation, measured by the annual variation in the consumer price index, stood at 14.1%. This rate not only overshoot the target set by the central bank at the beginning of 2005 by four percentage points, but also marked the highest level recorded in the last 10 years.

This development was largely attributable to external shocks that boosted the prices of tradable goods. The price index for tradables showed an annual variation of 18%. This mainly reflected rising international hydrocarbon, coffee and beef prices, much of whose effect was passed on to domestic prices. Even though such external shocks are transitory, in this case their magnitude and duration appear to have heightened inflationary expectations. In addition, efforts to hold down price levels have been hindered by the strong inertial component of inflation in the Costa Rican economy.

Economic growth translated into a considerable upturn in employment, especially in the formal sector. However, as a consequence of the expansion of the labour supply, the national open unemployment rate edged up from 6.5% to 6.6%. At the same time, real average wages in the formal

sector retreated by 1.9%, while nominal minimum wage adjustments barely compensated for price increases.

(c) The external sector

The balance-of-payments current account deficit widened to the equivalent of 4.8% of GDP (in 2004 it amounted to 4.3%). The narrowing of the deficit on the income account (thanks to decreased repatriation of profits and dividends from foreign direct investment (FDI)) was more than offset by the surge in of the trade deficit, which jumped from 3.0% to 5.0% of GDP. The inflow of foreign financial capital caused international assets to swell by US\$ 391 million.

In 2005, FDI inflows reached US\$ 696 million, equivalent to 3.5% of GDP. Among the most significant investments were those linked to the expansion of companies located in the country's free trade zones, such as Intel, as well as the establishment of new industrial and services companies. New acquisitions and reinvestments by large retailers were also a significant factor.

Goods exports grew by 11.4%. Products showing particularly high growth included coffee (due to rebounding international prices) and non-traditional agricultural goods such as pineapples, melons, flowers, foliage and household plants. Industrial goods for export showing notable increases included microprocessors, sound amplification equipment, dental equipment, integrated circuits, electrical conductors, refrigerators and medicine. The expansion of imports (18.6%) was concentrated in raw materials and intermediate goods, largely because of the country's rising oil bill and external purchases by companies located in its free zones.

El Salvador

1. General trends

In 2005, GDP in El Salvador grew by 2.8%, resulting in the largest increase in per capita GDP (1%) for six years. The increase in agricultural production and the improved performance of the construction sector offset the lower growth of previous years. Nevertheless, this growth rate was lower than in the other Central American countries and below the average for Latin America. Increased public investment (24.9%) had a significant multiplying effect on consumption, and family remittance income was equivalent to 16.7% of GDP.

Economic activity was held back by higher international oil prices and, to a lesser extent, by the hike in international interest rates which resulted in a slight increase in debt servicing. Annual inflation stood at 4.3% and the current account deficit was 4.6% of GDP. The floods caused by tropical storm Stan, and the eruption of the Ilamatepec volcano in October 2005, caused damage and losses estimated at US\$ 355

million, but this did not affect the main macroeconomic balances.¹

The economy is expected to grow by 3.5% in 2006, driven by reconstruction works, the buoyant growth of world markets, and improved results for agriculture and tourism. The main planks of economic policy are to maintain fiscal discipline and encourage production, especially in manufacturing and agriculture, as well as tourism activities.

2. Economic policy

In view of the absence of monetary and exchange-rate policy, economic policy was focused on fiscal policy, the main feature in 2005 being the successful implementation of the tax reform.

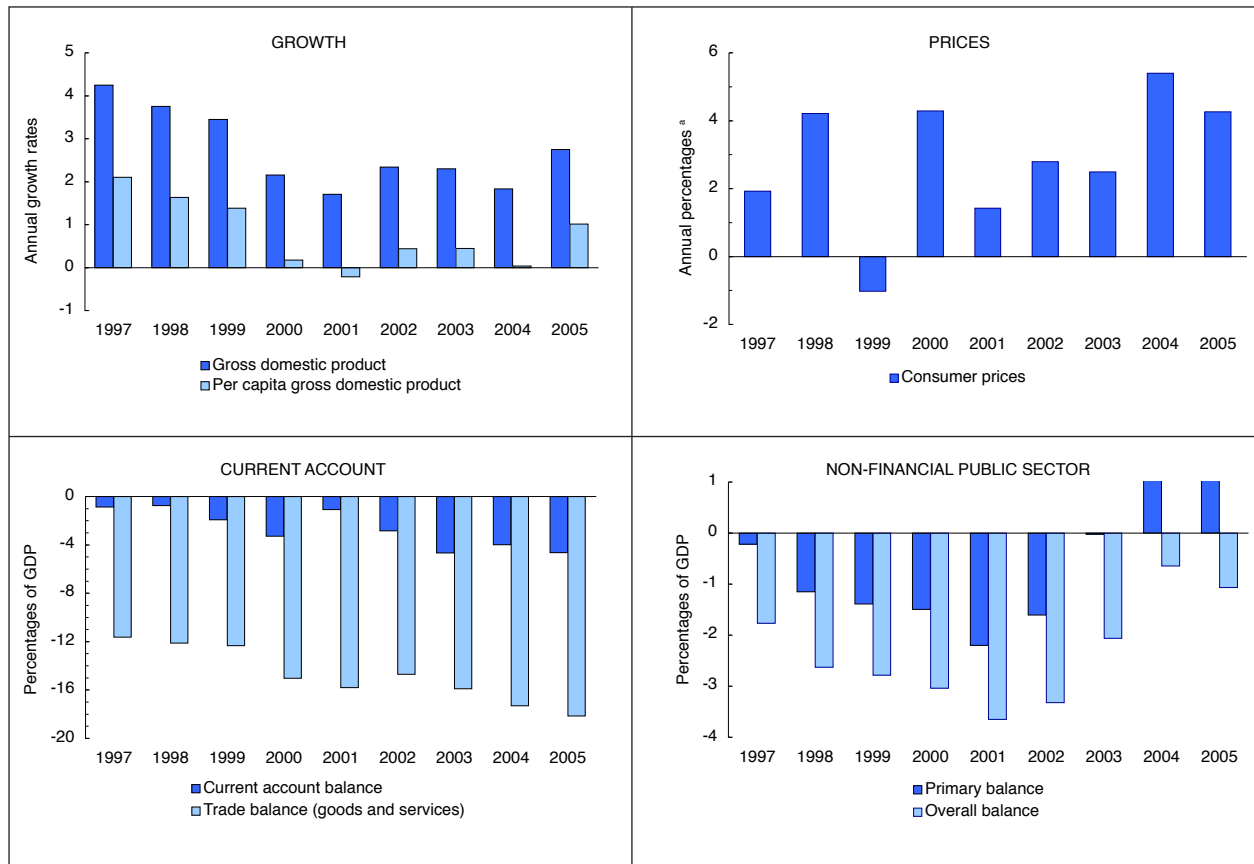
(a) Fiscal policy

The goal of fiscal policy in 2005 was to improve results through fiscal reform. Although this reform's positive effects were offset by the costs of reconstruction work following the natural disasters, the central government

deficit dropped from 1.1% of GDP in 2004 to 1.0% in 2005. The tax reform generated additional income of US\$ 170 million, owing to amendments to the tax code and the laws governing pensions, banking and income tax. The tax burden was 12.6% of GDP, which was one percentage point higher than in the previous year and was also the target amount. The taxes showing the highest real growth were the tax on consumption of goods and services (22.8%), income tax (19.6%), VAT (10.7%) and property and other taxes (2.3%). Meanwhile, non-tax revenue fell by 49.7%.

¹ See Economic Commission for Latin America and the Caribbean (ECLAC), *Efectos en El Salvador de las lluvias torrenciales, tormenta tropical Stan y erupción del volcán Ilamatepec (Santa Ana)*, October 2005 (LC/MEX/R.892), and *Perfiles de proyecto* (LC/MEX/R.892/Add.1), Mexico City, ECLAC subregional headquarters in Mexico, November 2005.

Figure 1
EL SALVADOR: MAIN ECONOMIC INDICATORS



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a December-December variation.

Current expenditure rose by 3% in real terms, mainly because of the increase in debt servicing and the burden of the pension system (US\$ 327.1 million). It is estimated that pension costs will rise by 22% in 2006, judging by the recent trend in pension system transition costs. Investment expenditure grew by 25%, after two years of sharp contraction. As a result of these different trends, total expenditure was 6% higher.

In order to attenuate the impact of rising oil prices and protect low-income families, subsidies were introduced for public transport (US\$ 8.9 million) and for consumption of electricity (US\$ 33.4 million) and liquefied petroleum gas (LPG) (US\$ 55.6 million). These measures, together with reconstruction expenditure and pension costs, resulted in a non-financial public sector (NFPS) deficit equivalent to 3% of GDP, one half of a percentage point more than in 2004. If pension payments are excluded, the deficit rose from 0.6% of GDP in 2004 to 1.1% of GDP in 2005. In view of the upward trend in fossil fuel prices, it is expected that the subsidies

will continue in 2006 and the NFPS deficit will remain at the same levels.

The successful adoption of the budget led to a recovery in public-sector investment (24.9%), after a fall of 43.2% in 2004. Growth is expected to be even higher in 2006, owing to infrastructure investments in the La Unión and Acajutla ports, which are 50% completed.

Public external debt (US\$ 4.976 billion dollars) rose by 4%. Bonds worth US\$ 401.8 million were issued in 2005, of which US\$ 375 million were on the international market. In 2006 a bond issue for US\$ 663.7 million is expected, which would include US\$ 563.7 million on the international market (US\$ 400 million had been placed by April 2006) and US\$ 100 million on the national market, to meet financing needs (capital expenditure, debt servicing and pension costs). The pension debt will be covered by 60% of this bond issue. Internal public debt increased by 8.9% in relation to 2004 and reached US\$ 2,727,600,000, while total public debt amounted to 45% of GDP.

In 2006 the government plans not to increase taxes but to make efforts to combat evasion and smuggling and to encourage compliance with tax obligations. Judging by the general budget allocations to each area, the government's priorities for 2006 are spending on social development (37.4%), repayment of public debt (18.8%) and compliance with general obligations (11.4%).

(b) Monetary policy

The hike in international interest rates in 2005 resulted in a slight increase in nominal interest rates in El Salvador, which has not yet been reflected in real deposit rates, as the rates for 180-day deposits were close to those in 2004 (-1.1%), standing at -1.2% in 2005. The interest rates for one-year loans rose from 1.8% in 2004 to 2.1% in 2005. Domestic credit to the public sector grew by 44.5% and to the private sector by 7.7%.

In December 2005, banking indicators improved slightly compared with the same month in the previous year. In 2005 the Central Reserve Bank held net international reserves of US\$ 1.83 billion (3.1% less than in the previous year), equivalent to three months' goods and services imports.

(c) Other policies

2005 saw the adoption of the consumer protection law, providing greater security to the population in the purchase of goods and services.

Despite the fact that the government of President Antonio Saca has launched a number of crime reduction programmes, National Police statistics indicate that violence increased by almost 33% in 2005. The National Institute of Forensic Medicine reported 3,697 homicides (54 homicides for every 100,000 inhabitants), a rise of 26% compared with 2004. The United Nations Development Programme (UNDP) estimated that the cost of violence in El Salvador was equivalent to 11.5% of GDP.

The authorities sought to boost tourism, with the adoption of a general tourism law and the identification of immediate measures to improve infrastructure in the ten major areas of tourism development in the country. This led to the design and construction of the first stage of the tourism complex "La Libertad" and the granting of facilities for private investment in various tourism enterprises.

Developments expected in 2006 include an increased number of tourists (over one million), the implementation of the National Tourism Plan 2014, the application of the implementing regulations of the legislation on tourism and the creation of an inter-agency commission for tourism development.

In March 2006 the Dominican Republic-Central America-United States Free Trade Agreement (CAFTA-DR) came into force, and El Salvador was the first country in the region to approve the set of reforms needed for its implementation. The treaty is expected to offer greater incentives and facilities for exports and foreign direct investment (FDI), especially in non-traditional and ethnic products.

3. The main variables

(a) Economic activity

Economic activity in 2005 showed the highest growth for six years (2.8%), driven by favourable export prices for some agricultural goods and the recovery of gross fixed investment (5.7%), which compensated for the previous year's 5% fall. A significant contribution was made by the increase in public spending (24.9%), compared to private investment which expanded by only 3.6%. Investment in machinery and construction grew at similar rates, close to 6%. Remittances have had an impact on domestic demand and have boosted private consumption (2.6%). In 2005, exports of goods and services rose very slowly (0.4%), while on the supply side, goods and services imports increased by 0.8%.

The agricultural sector experienced growth of 5.8% in 2005, owing to the rise in basic grains production and the hike in international coffee and sugar prices. The basic services sector (electricity, gas, water, transport, storage and communications) expanded by 4.2%, while the construction sector, after a fall of 11.4% in 2004, posted an increase of 3.4%, owing to higher levels of public and private investment in the works at the La Unión and Acajutla ports, and to the expenditure on reconstruction work in the aftermath of the natural disasters of October 2005 (which will have a greater impact in 2006). Financial services grew by 2.9% and the manufacturing sector expanded by 1.4% despite the exit of some maquila companies.

The decline in maquila production, which accounts

Table 1
EL SALVADOR: MAIN ECONOMIC INDICATORS

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a
	Annual growth rates^b								
Gross domestic product	4.2	3.7	3.4	2.2	1.7	2.3	2.3	1.8	2.8
Per capita gross domestic product	2.1	1.6	1.4	0.2	-0.2	0.4	0.4	0.0	1.0
Gross domestic product, by sector									
Agriculture, livestock, hunting, forestry and fishing	0.4	-0.7	7.7	-3.1	-2.6	0.4	0.9	3.0	5.8
Mining	6.5	5.3	0.4	-4.7	11.7	5.5	3.5	-16.0	3.5
Manufacturing	8.0	6.6	3.7	4.1	4.0	2.9	2.2	0.9	1.4
Electricity, gas and water	4.2	6.1	2.7	-2.3	4.7	7.3	4.4	3.3	3.1
Construction	6.2	8.5	-1.8	-3.4	9.6	6.7	3.2	-11.4	3.4
Wholesale and retail commerce, restaurants and hotels	2.9	4.0	2.0	3.6	1.9	1.5	2.7	2.4	1.6
Transport, storage and communications	7.7	4.2	9.5	6.1	4.3	5.0	3.4	5.4	4.3
Financial institutions, insurance, real estate and business services	4.4	3.7	3.0	3.0	-0.8	2.7	2.6	2.5	2.9
Community, social and personal services	3.4	1.2	1.0	1.1	-0.3	-0.6	0.5	1.8	1.7
Gross domestic product, by type of expenditure									
Consumption	3.0	2.4	3.4	3.7	3.2	1.5	1.9	2.7	2.5
General government	2.8	2.5	0.4	0.9	4.6	0.1	-0.3	1.9	1.7
Private	3.0	2.4	3.7	3.9	3.1	1.6	2.1	2.8	2.6
Gross domestic investment	6.5	22.8	-4.0	2.7	5.1	-2.7	7.8	-4.5	2.6
Exports (goods and services)	30.2	6.2	7.1	16.8	-0.2	6.0	4.7	6.6	0.4
Imports (goods and services)	16.8	9.2	2.7	14.5	4.2	1.5	4.8	4.3	0.8
	Percentages of GDP								
Investment and saving^c									
Gross domestic investment	15.1	17.6	16.4	16.9	16.7	16.4	17.0	16.0	15.4
National saving	14.2	16.8	14.5	13.6	15.6	13.6	12.3	12.0	10.8
External saving	0.9	0.8	1.9	3.3	1.1	2.8	4.7	4.0	4.6
	Millions of dollars								
Balance of payments									
Current account balance	-98	-91	-239	-431	-150	-405	-702	-632	-786
Merchandise trade balance	-1 143	-1 306	-1 356	-1 740	-1 933	-1 865	-2 287	-2 662	-3 008
Exports, f.o.b.	2 437	2 460	2 534	2 963	2 892	3 020	3 153	3 337	3 432
Imports, f.o.b.	3 580	3 765	3 890	4 703	4 824	4 885	5 439	5 999	6 440
Services trade balance	-152	-149	-183	-235	-250	-240	-107	-78	-72
Income balance	-163	-163	-282	-253	-266	-323	-423	-460	-571
Net current transfers	1 361	1 527	1 582	1 797	2 298	2 023	2 114	2 568	2 865
Capital and financial balance ^d	460	394	447	385	-27	282	1 019	579	728
Net foreign direct investment	59	1 103	162	178	289	496	123	430	300
Financial capital ^e	401	-709	285	207	-316	-214	895	150	427
Overall balance	363	303	208	-46	-178	-124	316	-52	-59
Variation in reserve assets ^f	-363	-303	-208	46	178	124	-316	53	59
Other external-sector indicators									
Real effective exchange rate (index: 2000=100) ^g	104.0	101.9	100.4	100.0	99.6	99.6	100.1	100.3	101.7
Terms of trade for goods (index: 2000=100)	95.0	95.8	99.6	100.0	102.5	101.6	97.7	96.8	96.8
Net resource transfer (percentage of GDP)	2.7	1.9	1.3	1.0	-2.1	-0.3	4.0	0.8	0.9
Gross external public debt (millions of dollars)	2 689	2 646	2 789	2 831	3 148	3 987	4 717	4 778	4 976
Gross external public debt (percentage of GDP)	24.1	22.0	22.4	21.6	22.8	27.9	31.3	30.2	29.3
Net profits and interest (percentage of exports) ^h	-5.6	-5.3	-8.9	-6.9	-7.4	-8.5	-10.3	-10.4	-12.5
	Average annual rates								
Employment									
Labour force participation rate ⁱ	50.9	53.5	52.6	52.2	53.3	51.2	53.4	51.7	52.4
Open unemployment rate ^j	8.0	7.5	7.0	6.7	7.0	6.2	6.9	6.8	7.8
Visible underemployment rate ^k	...	3.2	3.5	3.4	3.4	4.1	4.5	4.5	5.8
	Annual percentages								
Prices									
Variation in consumer prices (December-December)	1.9	4.2	-1.0	4.3	1.4	2.8	2.5	5.4	4.3
Variation in real minimum wage	-4.3	3.3	2.4	-2.2	-3.6	-1.8	2.1	-1.4	-4.5
Nominal deposit rate ^l	...	...	...	6.5	5.5	3.4	3.4	3.3	3.4
Nominal lending rate ^m	...	...	...	10.7	9.6	7.1	6.6	6.3	6.9

Table 1 (concluded)

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a
	Percentages of GDP								
Non-financial public sector									
Total income ⁿ	15.3	14.9	15.0	15.8	14.9	15.5	16.2	16.2	16.4
Current income	15.1	14.8	14.7	14.9	14.4	14.7	15.7	15.9	16.1
Tax revenue	10.3	10.2	10.2	10.2	10.5	11.1	11.5	11.5	12.6
Capital income	...	...	...	...	0.0	0.5	0.0	0.0	0.0
Total expenditure ^o	17.1	17.6	17.8	18.8	18.5	18.8	18.3	16.9	17.5
Current expenditure	13.2	13.8	14.5	15.5	14.0	13.9	14.6	14.6	14.7
Interest	1.6	1.5	1.4	1.5	1.4	1.7	2.0	2.1	2.3
Capital expenditure	4.0	3.8	3.2	3.3	4.5	4.9	3.7	2.3	2.8
Primary balance	-0.2	-1.2	-1.4	-1.5	-2.2	-1.6	-0.0	1.5	1.2
Overall balance	-1.8	-2.6	-2.8	-3.0	-3.6	-3.3	-2.1	-0.6	-1.1
Central government debt									
Domestic	36.2	33.3	25.2	27.2	30.7	35.2	37.2	38.0	37.8
External	12.0	11.2	7.2	9.6	11.7	11.1	11.0	11.8	12.7
Domestic	24.1	22.0	18.0	17.5	19.1	24.2	26.2	26.2	25.1
External	...	...	...	...	...	...	...	...	...
Money and credit^p									
Domestic credit ^q	...	...	...	...	...	37.5	37.9	38.7	36.5
To the public sector	...	...	...	...	...	-1.1	-0.5	1.0	0.8
To the private sector	...	...	...	...	...	40.2	40.5	40.2	39.5
Liquidity (M3)	42.0	44.3	44.7	45.1	43.9	41.9	39.9	38.4	36.2

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a Preliminary figures. ^b Based on figures in local currency at constant 1990 prices. ^c Based on figures in local currency expressed in dollars at current prices. ^d Includes errors and omissions. ^e Refers to the capital and financial balance (including errors and omissions), minus net foreign direct investment. ^f A minus sign (-) denotes an increase in reserves. ^g Annual average, weighted by the value of merchandise exports and imports. ^h Refers to net investment income as a percentage of exports of goods and services as shown on the balance of payments. ⁱ Economically active population as a percentage of the working-age population; nationwide total. ^j Unemployment rate as a percentage of the economically active population, nationwide total. ^k Underemployment rate as a percentage of the economically active population; urban total. ^l Reference rate for deposits of up to 180 days in the financial system. ^m Reference rate for 1-year loans in the financial system. ⁿ Includes grants. ^o Includes net lending. ^p The monetary figures are annual averages. ^q Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions.

for 12% of the manufacturing sector (-3.3% in 2004 and -6% in 2005), together with the loss of competitiveness in a number of productive sectors and continuing insecurity in the country led the Government of El Salvador to design an economic programme to boost the productive sectors.

In September 2005, the government announced an industrial policy proposal (implementation will begin in 2006) which is intended to strengthen the competitiveness of the manufacturing sector, promote economic diversification and eliminate coordination and information failures. This policy has a reactivation fund of US\$ 30 million which will be managed by the Multisectoral Investment Bank and will be used to support strategic projects and sectoral studies. The sector is expected to post growth rates of 7% over the next five years and contribute up to 30% of national GDP, starting from a base level of 24%.

In 2006 a series of measures will be implemented in the agricultural sector to increase productive capacity and efficiency. In addition, the government plans to encourage

other key areas of national development. To help to open up external markets, treaty administration will be strengthened and a National Management Commission for Trade Treaties (Conatco) will be established, while trade negotiations will be concluded with Canada and initiated with the European Union, Taiwan province of China and CARICOM. As for competitiveness and productivity, efforts will be made to improve the business climate and attract new investments. Lastly, the government will launch a national energy policy to encourage an expansion of electricity generating capacity using renewable resources. The financing of this policy, however, requires urgent attention.

The country's economic activity as measured by the economic activity index (IVAE)² (trend cycle) posted an annual increase of 5.6% in the first quarter of 2006. This expansion of economic activity was due to the rapid growth in the sectors of electricity, gas and water, transport, storage and communications, financial services, agricultural activities and commerce. Economic activity was also supported by a higher growth rate for exports.

² The IVAE includes eleven of the twelve activities that make up GDP, with coverage of 84.5%. The activities added in 2006 are: fishing, cotton production, mining and quarries, water supply services, communications, restaurants and hotels, business services, and community, social and personal services. The number of establishments surveyed in the trade and industry sector has been expanded and the number of products has been increased.

Table 2
EL SALVADOR: MAIN QUARTERLY INDICATORS

	2004				2005 ^a				2006 ^a	
	I	II	III	IV	I	II	III	IV	I	II
Gross domestic product (variation from same quarter of preceding year) ^b	1.9	1.8	1.8	1.9	1.7	3.1	3.3	2.9	3.2	...
Merchandise exports, f.o.b. (millions of dollars)	815	807	844	829	821	919	865	784	909	...
Merchandise imports, c.i.f. (millions of dollars)	1 462	1 542	1 535	1 730	1 542	1 759	2 327	1 696	1 777	...
International reserves (millions of dollars)	1 787	1 689	1 768	1 754	1 587	1 928	1 643	1 723	1 681	2 034 ^c
Real effective exchange rate (index: 2000=100) ^d	100.7	99.5	99.7	101.3	101.6	101.7	102.1	101.5	102.3	102.4
Consumer prices (12-month percentage variation)	3.0	4.6	5.3	5.4	4.7	4.3	4.4	4.3	4.0	4.4
Average nominal exchange rate (colones per dollar)	8.75	8.75	8.75	8.75	8.75	8.75	8.75	8.75	8.75	8.75
Nominal interest rates (annualized percentages)										
Deposit rate ^e	3.4	3.4	3.3	3.3	3.2	3.4	3.4	3.7	4.1	4.2
Lending rate ^f	6.6	6.2	6.3	6.1	6.9	6.8	6.9	6.9	7.6	7.4
Interbank interest rate	...	...	...	...	...	5.8	4.5	5.3	...	6.0 ^c
Domestic credit (variation from same quarter of preceding year) ^g	9.0	9.5	6.2	3.2	3.6	-4.7	0.1	5.2	7.2	2.4 ^c
Non-performing loans as a percentage of total credit ^h	2.7	2.6	2.7	2.4	2.5	2.1	2.2	2.0	1.9	2.1 ^c

Source: Comisión Económica para América Latina y el Caribe, sobre la base de cifras oficiales.

^a Preliminary figures. ^b Based on figures in local currency at constant 1990 prices. ^c Data to May. ^d Quarterly average, weighted by the value of merchandise exports and imports. ^e Reference rate for deposits of up to 180 days in the financial system. ^f Reference rate for 1-year loans in the financial system. ^g Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions. ^h Refers to total credit extended by the banking system.

(b) Prices, wages and employment

Annual inflation of 4.3%, exceeding the target range of between 3% and 4%, was attributable to price rises caused by temporary food shortages resulting from the floods and high oil prices, which in turn increased transport costs and led to higher prices for pulses, vegetables and electric power. The sectors which had inflation equal to or higher than the average were alcohol, tobacco and narcotics (16.6%), transport (8.1%), foodstuffs and non-alcoholic beverages (4.7%) and housing, water, electricity, gas and other fuels (4.3%).

In April 2006 twelve-month inflation was at 4.2%. For the rest of 2006 price rises are expected to fall back to the 3%-4% range, despite wage increases for public officials and rising oil prices. The industrial price index in 2005 was 6.9%, almost half the 2004 level (13%), and in April 2006 it went up again, to 9.6%.

In 2005, the fifth consecutive year, there was no increase in the minimum wage and families' purchasing power diminished. This was partially mitigated by the subsidy programme to help low-income groups. Despite economic growth, job losses in the maquila sector caused the unemployment rate to rise by one percentage point, to 7.8%.

The wage increases for public employees in 2006 were the first since 1998, and the total cost was US\$ 40 million. Salaries of up to US\$ 400 per month will increase by 10%, those between US\$ 401 and US\$ 700 by 8%, those between US\$ 701 and US\$ 1,000 by 6% and those of US\$ 1,001 and above by 3%. In addition, staffing in the health and education sector will be expanded to 23,227 employees, costing nearly US\$ 12.5 million.

(c) The external sector

In 2005, exports of goods increased only slightly (2.7%), as a result of the fall in maquila exports (5.4%), which accounted for 54% of total exports. This was offset by the improvement in the prices of some agricultural products, including coffee and sugar. CAFTA-DR will benefit sugar exports in 2006 in view of the doubling of the import quota for the United States market. There was a 10.1% rise in exports of non-traditional goods and growth of 40.6% in exports of traditional goods, but the latter represented only 6.9% of total goods exports. The export sector is expected to improve its performance in 2006. In the first quarter of 2006 it posted growth of 10.8%.

Meanwhile, goods imports increased by 6.9%. Almost

50% were purchases of intermediate and capital goods, 30% were consumer goods and the remaining 20% were maquila inputs. Imports of consumer goods (13.2%) and intermediate goods (11%) were the most buoyant. In the case of intermediate goods this was due to the high prices of oil and petroleum products. In March 2006 the growth rate for imports reached 13.8%, and the current account deficit is expected to increase in 2006.

In 2005 income from tourism was US\$ 629 million, owing to promotional activities conducted abroad by the newly-created Ministry of Tourism.

The economy received a significant external boost from increased family remittances (11.1%), associated with efforts to counteract the impact of natural disasters and with the strong performance of the United States economy. Remittances (US\$ 2.83 billion) sustained private consumption and covered almost 94% of the trade gap,

but the terms of trade worsened for the third consecutive year (-2.3%). These trends led to a balance-of-payments current account deficit of 4.6% of GDP.

The financial account showed a positive balance of US\$ 722.9 million, an increase of over US\$ 600 million compared to 2004. This was due to the 37.5% rise in the net inflow of foreign direct investment, which amounted to US\$ 517 million. One of the contributing factors was non-recurring receipts from the sale of bank assets, although there was a drop in assets under the heading of “other investment”. Portfolio investments grew by US\$ 93.6 million, reversing a six-year downward trend.

In May 2006 the three main international rating agencies did not alter their risk ratings for El Salvador’s long-term debt instruments. Among the Central American countries, it is the only holder of the “investment grade” rating awarded by Moody’s Investors Service.

Guatemala

1. General trends

The Guatemalan economy grew by 3.2%, the best performance of the past five years. GNP growth was driven by private consumption and inflation was at 8.6%, a moderate reduction from the 2004 level of 9.2%. No unemployment survey was carried out in 2005, but the economic growth would be consistent with an unemployment rate similar to that of 2004, while the underemployment rate would be almost 30%.

The current account deficit of 4.1% of GDP was due to a negative balance on the goods and services account equivalent to 14% of GDP, mitigated by current transfer income equivalent to 10.9% of GDP, consisting mainly of family remittances from the United States. The negative current-account balance was more than offset by capital flows, which increased international reserves by US\$ 250 million. The terms of trade continued to deteriorate and despite improved export prices, the price rises for oil and other raw material imports were even higher.

Economic performance in 2005 reflected efforts by the monetary authorities to moderate the impact on inflation of higher fuel prices and measures taken in connection with the foreign-exchange market, such as the introduction of an explicit intervention rule to prevent

any sudden appreciation of the national currency, a policy strongly supported by the fiscal authorities. In September, the government deficit was 0.6% of GDP, and by the end of the year it had risen to 1.5% of GDP, owing to the increase in spending in the fourth quarter, especially capital spending.

If the Banco de Guatemala's growth projection of 4.4% for 2006 is accurate, it will be the first time in this decade that growth is higher than the average rate recorded in the 1990s; the projections call for inflation of between 5% and 7%, a fiscal deficit of 2.5% of GDP, owing to the process of reconstruction after the damage caused by tropical storm Stan, and a current account deficit of 3.8% of GDP. Risk factors include the sustained increase in oil and petroleum product prices and their impact on domestic and global inflation.

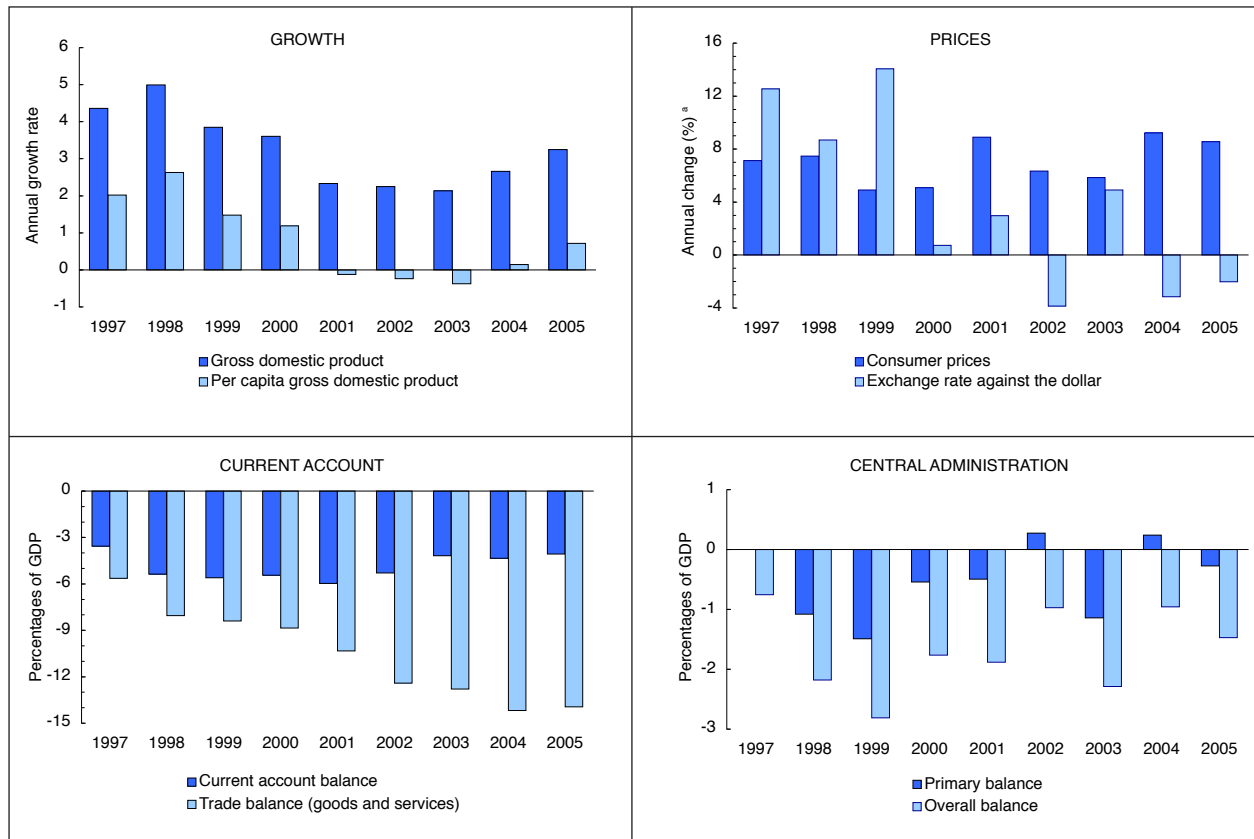
2. Economic policy

The monetary authorities tried to establish a balance between boosting the economy and ensuring stable domestic prices in view of the high oil prices. Prudent fiscal policies contributed to achieving this goal and exchange-rate policy moderated the appreciating trend caused by growing remittance and capital flows.

(a) Fiscal policy

Total revenue in real terms was down by 2.2% despite efforts by the Office of the Superintendent of Tax Administration to increase collection. Tax revenue diminished by 2.3%, although direct tax receipts grew by

Figure 1
GUATEMALA: MAIN ECONOMIC INDICATORS



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
^a December-December variation.

3.7%, mainly owing to increased income tax revenues. The take from indirect taxes contracted by 4.3%, and from VAT by 5.5%. As a result, the tax burden declined from 10.1% to 9.5% of GDP. September saw the restoration of the fuel distribution tax, after its suspension by the Constitutional Court at the end of 2004. A special tariff had been applied to fuels between January and August in order to compensate for this suspension.

Total expenditure grew by 2.7% and current expenditure was down by 0.4%. There were savings in public debt servicing, thanks to improvements in interest rates and terms for domestic borrowing, and this contributed to the growth of 9.6% in capital expenditure. It was also possible to assign resources according to the priorities established in the peace agreements. Social spending rose by an estimated 11.8% in real terms compared to 2004, mostly benefiting the education and health sectors.

The fiscal deficit of 1.5% of GDP was financed entirely by domestic borrowing, and domestic debt rose from 12.84 billion quetzales in 2004 to 16.425 billion in

2005, which is equivalent to 6.7% of GDP and the highest figure since 1992.

The law against tax evasion was passed in mid-2006. If collection does not improve in the second half of the year, some budgetary spending items may have to be cut.

(b) Monetary policy

The central bank authorities made progress toward the adoption of a comprehensive inflation target system, which includes measures such as the adoption of a flexible exchange-rate regime and monetary stabilization operations. The inflation rate of 8.6% in 2005 was much higher than the annual target of 4%-6%.

The Government sought to moderate the monetary base by keeping central bank deposits above the planned level (in September they exceeded the original target by 1.265 billion quetzales); in addition, 2005 saw a 15% increase in the placement of monetary regulation instruments. These movements only partially countered the monetization resulting from the monetary authority's

purchases of foreign currency. M1 expanded by 8.5% in real terms (17.7% in nominal terms) while liquidity in national currency (M2) and broad liquidity (M3) grew at a slower rate (5.5%). The abundant liquidity in the economy was reflected in a substantial increase in credit to the private sector (11.8%).

At the beginning of the year the central bank announced that the interest rate for seven-day deposit certificates would be the benchmark rate for short-term monetary stabilization operations. In view of the persistence of inflationary pressures, the monetary authority gradually increased that rate from 2.6% at the beginning of 2005 to 4.0% by the end of the year. The weighted average interest rate of all monetary stabilization operations rose from 6.3% at the beginning of 2005 to 6.5% in November. Despite these increases, however, both rates remained negative in real terms.

In 2005 the banking system benefited from stable interest rates. There was substantial credit expansion, together with improvements in portfolio quality and a reduction in non-performing assets. The banking system showed moderate levels of liquidity in national and foreign currency and channelled more resources towards the private sector. Non-performing loans remained at about 6% of the total portfolio.

The legal instruments adopted in 2005 included a law to prevent and counteract the financing of terrorism, which complemented the regulations against the laundering of money and other assets and the investment rules for banks in relation to securities issued by private entities.

In order to counteract the inflationary pressures of the “second round”,¹ the monetary policy interest rate

was increased by 0.5% in the first few months of 2006, and in May it stood at 4.5%. In 2006 the actual inflation rate will probably be close to the upper limit of the annual inflation target (7%).

(c) Exchange-rate policy

The monetary authorities continued to face the appreciation of the national currency that was caused by the easy availability of foreign currency in the Guatemalan economy, fuelled by massive inflows of financial capital and family remittances (13.9% of GDP).

Exchange-rate policy in 2005 sought to hold back any sudden appreciation and minimize exchange-rate volatility. The central bank bought US\$ 467 million in 2005, and the annual average real appreciation was 7.1%. In the first half of 2006 the value of the quetzal remained stable at 7.6 quetzales to the dollar, and with lower domestic inflation, real appreciation was reduced.

(d) Other policies

In 2005 the Congress of the Republic approved the Dominican Republic-Central America-United States Free Trade Treaty (CAFTA-DR), which was due to enter into force on 1 January 2006. Owing to delays in the approval of some of the regulations, it actually entered into force on 3 July 2006. The treaty opens up opportunities for more rapid growth of non-traditional exports and an influx of new foreign investment over the next few years.

3. The main variables

(a) Economic activity

GDP grew by 3.2%, which was higher than the 2.7% recorded in 2004.² Per capita GDP growth was up (0.7%) for the first time since the year 2000. In a context of macroeconomic stability, the factor which most contributed to growth was the increase in domestic demand (3.7%), driven by family remittances.

In the public sector, consumption was 5.3% higher owing to increased health and education spending, which offset the 10.1% drop in 2004. Private spending grew by 4.6%, mainly owing to family remittances, while gross fixed investment expanded by 11%, driven by construction and rising purchases of capital goods. In contrast, external demand was only 0.2% higher.

In October 2005, Guatemala was ravaged by tropical

¹ The expression “second round” refers to the increase in prices of those goods and services which do not include petroleum products in their cost structure, but which are affected indirectly by the increase in transport, electricity and other prices.

² The estimates of the system of national accounts (SNA) and the balance of payments are being updated. The current series in constant 1958 quetzales (compiled according to 1953 SNA) will be replaced in 2006 by series in constant 2001 quetzales (compiled according to 1993 SNA). In addition, the new balance of payments series will be compiled in accordance with the fifth manual of the International Monetary Fund. The new statistics will be submitted to the Monetary Board of the Bank of Guatemala in June 2006.

Table 1
GUATEMALA: MAIN ECONOMIC INDICATORS

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a
	Annual growth rates^b								
Gross domestic product	4.4	5.0	3.8	3.6	2.3	2.2	2.1	2.7	3.2
Per capita gross domestic product	2.0	2.6	1.5	1.2	-0.1	-0.2	-0.4	0.1	0.7
Gross domestic product, by sector									
Agriculture, livestock, hunting, forestry and fishing	2.9	3.7	2.1	2.6	1.2	1.8	3.1	3.7	2.3
Mining	24.6	21.0	-1.9	-8.5	0.8	9.8	4.1	-8.2	-1.1
Manufacturing	2.7	3.6	2.5	1.9	1.1	0.8	1.0	2.3	2.7
Electricity, gas and water	14.7	5.8	11.0	17.4	-3.0	9.1	4.4	6.0	3.5
Construction	10.0	9.3	7.8	-18.3	12.2	-15.3	-3.3	-19.6	3.0
Wholesale and retail commerce, restaurants and hotels	3.7	5.3	3.2	4.1	2.7	2.8	1.9	3.2	2.6
Transport, storage and communications	5.9	7.5	6.8	7.6	6.8	5.7	4.8	9.2	8.4
Financial institutions, insurance, real estate and business services	4.7	5.9	4.6	3.1	0.3	2.2	2.2	2.5	2.3
Community, social and personal services	4.7	4.1	4.7	4.6	3.5	1.2	-0.2	-2.8	2.9
Gross domestic product, by type of expenditure									
Consumption	4.2	5.1	3.7	4.2	4.0	3.0	2.9	2.3	4.7
General government	6.2	9.7	5.2	10.4	5.4	-2.1	-0.6	-10.1	5.3
Private	4.0	4.6	3.6	3.5	3.8	3.6	3.3	3.7	4.6
Gross domestic investment	20.1	36.3	-0.4	2.5	6.4	14.3	4.0	7.0	-1.4
Exports (goods and services)	8.1	2.4	4.6	3.8	-4.0	-6.7	-0.2	6.6	0.2
Imports (goods and services)	19.5	24.5	0.7	6.0	6.9	6.6	5.3	7.2	3.5
	Percentages of GDP								
Investment and saving^c									
Gross domestic investment	13.7	17.4	17.4	17.8	17.8	19.1	18.8	19.8	18.4
National saving	10.1	12.0	11.8	12.4	11.8	13.8	14.6	15.5	14.3
External saving	3.6	5.4	5.6	5.4	6.0	5.3	4.2	4.4	4.1
	Millions of dollars								
Balance of payments									
Current account balance	-634	-1 039	-1 026	-1 049	-1 253	-1 235	-1 039	-1 188	-1 303
Merchandise trade balance	-940	-1 409	-1 445	-1 660	-2 282	-2 972	-3 116	-3 760	-4 272
Exports, f.o.b.	2 603	2 847	2 781	3 082	2 860	2 819	3 060	3 430	3 855
Imports, f.o.b.	3 543	4 256	4 226	4 742	5 142	5 791	6 176	7 189	8 127
Services trade balance	-62	-152	-91	-48	117	79	-68	-115	-194
Income balance	-239	-184	-205	-209	-84	-318	-318	-319	-329
Net current transfers	607	705	715	868	997	1 976	2 462	3 006	3 492
Capital and financial balance ^d	863	1 275	901	1 703	1 727	1 257	1 589	1 797	1 553
Net foreign direct investment	84	673	155	230	456	111	131	155	198
Financial capital ^e	779	602	746	1 474	1 271	1 146	1 458	1 642	1 355
Overall balance	230	235	-125	654	474	22	550	609	250
Variation in reserve assets ^f	-258	-263	125	-654	-474	-22	-550	-609	-250
Other financing ^g	28	28	0	0	0	0	0	0	0
Other external-sector indicators									
Real effective exchange rate (index: 2000=100) ^h	88.3	88.1	98.7	100.0	95.7	88.5	88.6	86.0	79.9
Terms of trade for goods (index: 2000=100)	97.9	115.3	101.9	100.0	96.7	95.8	93.0	92.1	91.3
Net resource transfer (percentage of GDP)	3.7	5.8	3.8	7.7	7.8	4.0	5.1	5.4	3.8
Gross external public debt (millions of dollars)	2 135	2 368	2 631	2 644	2 925	3 119	3 467	3 844	3 723
Gross external public debt (percentage of GDP)	12.0	12.2	14.4	13.7	13.9	13.4	13.9	14.1	11.6
Net profits and interest (percentage of exports) ⁱ	-7.5	-5.3	-5.9	-5.4	-2.2	-8.0	-7.7	-6.9	-6.4
	Average annual rates								
Employment									
Labour force participation rate ^j	54.4	54.7	55.0	56.3	56.9	61.4	60.9	56.1	...
Open unemployment rate ^k	5.1	3.8	...	...	...	3.1	3.4	3.1	...
	Annual percentages								
Prices									
Variation in consumer prices (December-December)	7.1	7.5	4.9	5.1	8.9	6.3	5.9	9.2	8.6
Variation in nominal exchange rate (December-December)	12.5	8.7	14.1	0.7	3.0	-3.9	4.9	-3.2	-2.0
Variation in average real wage	2.8	3.6	5.8	3.8	0.5	-0.9	0.4	-2.4	...
Nominal deposit rate ^l	5.8	5.4	7.9	10.2	8.8	7.1	5.2	4.5	4.6
Nominal lending rate ^m	18.7	16.5	19.4	20.9	19.0	16.9	15.0	13.8	13.0

Table 1 (concluded)

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a
	Percentages of GDP								
Central Administration									
Total income	9.9	10.3	11.0	11.0	11.1	11.4	11.0	10.8	10.2
Current income	9.9	10.3	11.0	11.0	11.0	11.4	11.0	10.8	10.2
Tax revenue	9.4	9.3	9.9	10.0	9.7	10.6	10.3	10.1	9.5
Capital income	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	10.7	12.5	13.8	12.8	12.9	12.4	13.3	11.8	11.7
Current expenditure	6.7	7.9	8.6	9.1	9.2	8.6	8.9	8.0	7.7
Interest	0.8	1.1	1.3	1.2	1.4	1.2	1.1	1.2	1.2
Capital expenditure	3.9	4.6	5.2	3.7	3.7	3.8	4.5	3.7	3.9
Primary balance	-0.0	-1.1	-1.5	-0.5	-0.5	0.3	-1.1	0.2	-0.3
Overall balance	-0.8	-2.2	-2.8	-1.8	-1.9	-1.0	-2.3	-1.0	-1.5
Debt of the central administration	14.0	14.6	17.5	16.9	18.0	16.4	18.4	18.8	17.6
Domestic	5.4	5.0	5.8	5.8	5.6	4.5	5.6	5.9	6.7
External	8.5	9.6	11.8	11.2	12.4	11.9	12.8	12.9	10.9
Money and creditⁿ									
Domestic credit ^o	...	...	...	15.8	16.2	15.5	15.0	14.7	15.2
To the public sector	...	...	...	-2.2	-2.0	-2.7	-2.9	-2.8	-3.0
To the private sector	...	...	...	16.7	16.9	17.1	17.1	17.0	17.7
Other	...	...	...	1.3	1.3	1.1	0.8	0.6	0.5
Liquidity (M3)	...	...	...	...	26.5	26.6	27.4	27.7	27.9
Currency in circulation and local-currency deposits (M2)	22.4	23.0	23.1	23.8	25.1	25.1	25.2	24.8	24.8
Foreign-currency deposits	...	...	...	...	1.4	1.5	2.1	2.9	3.2

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a Preliminary figures. ^b Based on figures in local currency at constant 1958 prices. ^c Based on figures in local currency expressed in dollars at current prices. ^d Includes errors and omissions. ^e Refers to the capital and financial balance (including errors and omissions), minus net foreign direct investment. ^f A minus sign (-) denotes an increase in reserves. ^g Includes the use of IMF credit and loans and exceptional financing. ^h Annual average, weighted by the value of merchandise exports and imports. ⁱ Refers to net investment income as a percentage of exports of goods and services as shown on the balance of payments. ^j Economically active population as a percentage of the working-age population; nationwide total. ^k Unemployment and underemployment rates as percentages of the economically active population; nationwide total. ^l Average rate for deposits in the banking system. ^m Average rate for loans in the banking system. ⁿ The monetary figures are annual averages. ^o Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions.

storm Stan, which caused the death of 669 persons, the disappearance of another 884, and material damage and losses estimated at 7.473 billion quetzales, equivalent to US\$ 983 million (3.4% of GDP). The agricultural sector was one of the worst affected, as the tropical storm caused damage to approximately 61,000 hectares of crops, mainly white corn, sesame, bananas and various non-traditional export products, including mini-vegetables, snow peas and ornamental products.³

Despite the material damage, all productive sectors posted positive growth except for mining (-1.1%). Agriculture grew by 2.3% (3.7% in 2004); in 2005 sugar cane and cardamom production was down, but countered by the increase in banana production and the improvement in basic grains (excluding corn), pulses and vegetables; there was no change in coffee production.

Manufacturing industry grew by 2.7%, the best result of the last seven years, owing to the recovery in exports of industrial products; the increase in investment brought higher demand for industrial products as well as cement and iron. Trade slowed its growth from 3.2% in 2004 to

2.6%, reflecting the downturn in agriculture and slower growth in foreign purchases. The construction subsector showed signs of recovery (3%) following its 20% fall in 2004, owing to the boom in private construction. That boom compensated for the drop in public works, which consisted only of highway maintenance activities. The transport and communications sector continued its rapid expansion (8.4%).

(b) Prices, wages and employment

The twelve-month variation of consumer prices in 2005 was 8.6%, slightly less than in 2004 (9.2%). The rise in international prices for oil and petroleum products contributed to the rise, as did temporary shortages of some products caused by tropical storm Stan. In 2005, according to the central bank, imported inflation accounted for 2.5 percentage points of annual inflation. Year-on-year inflation stood at 7.5% in April 2006.

By sector of activity, the annual price rises were significant for foods, non-alcoholic beverages and

³ See Economic Commission for Latin America and the Caribbean (ECLAC), *Efectos en Guatemala de las lluvias torrenciales y la tormenta tropical Stan, octubre de 2005 (LC/MEX/R.895)*, Mexico City, ECLAC subregional headquarters in Mexico, November 2005.

Table 2
GUATEMALA: MAIN QUARTERLY INDICATORS

	2004				2005 ^a				2006 ^a	
	I	II	III	IV	I	II	III	IV	I	II
Merchandise exports, f.o.b. (millions of dollars)	1 174	1 257	1 344	1 262	1 293	1 455	1 392	1 241	1 385	...
Merchandise imports, c.i.f. (millions of dollars)	2 194	2 374	2 358	2 549	1 971	2 249	2 223	2 369	2 734	...
International reserves (millions of dollars)	2 862	2 872	2 896	3 426	3 563	3 636	3 706	3 664	3 982	4 061 ^b
Real effective exchange rate (index: 2000=100) ^c	89.0	86.3	85.0	83.7	81.7	80.2	79.3	78.2	78.0	77.4
Consumer prices (12-month percentage variation)	5.8	7.4	8.0	9.2	9.5	8.8	9.4	8.6	7.3	7.6
Average nominal exchange rate (quetzales per dollar)	8.10	7.99	7.90	7.79	7.71	7.61	7.61	7.64	7.62	7.60
Nominal interest rates (annualized percentages)										
Deposit rate ^d	4.4	4.4	4.5	4.5	4.6	4.6	4.6	4.6	4.6	4.7
Lending rate ^e	13.9	13.9	13.8	13.6	13.5	13.0	12.9	12.7	12.7	12.7
Interbank interest rate	1.9	2.0	2.4	2.4	2.3	2.0	2.3	3.5	4.2	4.4
Domestic credit (variation from same quarter of preceding year) ^f	9.8	5.4	9.1	5.2	12.3	16.3	21.2	32.1	...	...
Non-performing loans as a percentage of total credit ^g	7.0	7.0	7.5	5.9	6.9	6.5	6.1	5.1	6.1	6.3 ^b

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a Preliminary figures. ^b Data to May. ^c Quarterly average, weighted by the value of merchandise exports and imports. ^d Average rate for deposits in the banking system. ^e Average rate for loans by the banking system. ^f Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions. ^g Refers to total credit extended by the banking system.

meals outside the home (12.4%) and for transport and communications (7.9%), while gasoline prices were up by about 30%, and urban transport prices by only 5.6%. All other items were below the annual 7% rate, with the lowest increases in clothing and footwear prices (3.5%).

There was no adjustment to the minimum wage in 2005, but there was a 10% raise in January 2006. There were also no unemployment surveys in 2005. In 2004 the national open unemployment rate was estimated at 3.1% and the equivalent unemployment rate (which includes visible underemployment) was 29% of the economically active population (EAP).

(c) The external sector

The deficit in goods and services was around US\$ 4.5 billion, reflecting the upward trend in foreign purchases that began in 1997. In 2005, as in 2004, large purchases of oil and fuels contributed to a goods deficit of US\$ 4.27 billion.

The deficit of around US\$ 200 million on the non-factor services account was small thanks to the growing foreign-currency income from tourism, which amounted to US\$ 864 million, despite the problems caused by tropical storm Stan. The current transfer balance was

US\$ 3.5 billion, which included family remittances estimated at US\$ 2.9 billion.

Income from family remittances and donations counteracted the deficit in non-factor goods and services, so that the balance-of-payments current account deficit was US\$ 1.3 billion. This was financed with room to spare by income on the capital and financial accounts, leaving an overall balance of US\$ 250 million. This improvement boosted international reserves to US\$ 3.782 billion, which covers five months of imports of goods and services.

In 2005, exports of goods expanded to US\$ 3.85 billion, an increase of 12.4%, similar to that in 2004. Traditional exports (20%) contributed strongly to this growth, boosted by the recovery of prices, especially for foreign sales of coffee, whose export value increased by 43.5%, and of petroleum (26%). In contrast, the growth of non-traditional exports (12%) was reduced almost by half. The external sales which generated the greatest amounts of foreign currency were rubber articles (19%), clothing (18%) and chemical products (17%). Although fruit exports recovered by 50%, the amount exported was the same as the 2000 level, while there was a drop in exports of food products and, in particular, tobacco.

With few exceptions, it was the recovery in the prices of exported goods that contributed the most to total exports in 2005. The fastest growth in export volume was for cardamom (21%) and bananas (8%), while exports were down for oil (7%) and sugar (4%).

The growth of exports to Central American countries slowed to 12% (15% in 2004). Maquila value added fell by 1.2% compared to the increase of 14.6% in 2004. External sales were affected by Asian competition in the textiles sector and the closure of some maquila enterprises.

Goods imports maintained the upward trend observed since 2000 (13% in 2005). As in 2004, this was due to the significant hike in the oil bill (44%), which jumped from US\$ 1.09 billion in 2004 to US\$ 1.57 billion in

2005. Purchases of intermediate goods for industry grew by 9% and for construction by 22%, but those for agriculture were down (-26%). Purchases of capital goods declined once again (18%), although those for the industrial sector continued their rapid growth (15%). The expansion in consumer goods imports slowed from 13% to 8%, and what growth there was in 2005 was entirely due to purchases of non-durable goods.

Guatemala's external public debt burden (11.6% of GDP) continued to be one of the lowest in Latin America and the Caribbean, and remained below critical levels; the external debt stood at US\$ 3.723 billion, a nominal reduction of 3%; between 2004 and 2005, it diminished from 83% to 73% as a proportion of exports of goods and services.

Honduras

1. General trends

Stimulated by a generally favourable external environment, the Honduran economy recorded 4.1% growth (compared with 5.0% in 2004). GDP growth was led by domestic demand, especially private consumption (7.9%), and by significant inflows of family remittances. Notwithstanding the high cost of fuel, annual inflation stood at 7.7% (down from 9.2% in 2004). National open unemployment diminished from 5.9% to 4.1%. The balance-of-payments current-account deficit hit a record low of 0.5% of GDP, owing to copious inflows of current transfers, which offset the chronic trade deficit.

In April, following several years of negotiations and reforms, Honduras reached the completion point for the Heavily Indebted Poor Countries (HIPC) Debt Initiative. This achievement brought relief in the service of external debt owed to various creditors.

In January 2006, Manuel Zelaya took office as president of the country. The new government's priority objectives were to promote public sector transparency, reduce poverty and combat corruption. Projections for 2006 are for 4.8% GDP growth, an inflation target of between 5.5% and 6.5%, a fiscal deficit equivalent to

2.5% of GDP and a balance-of-payments current-account deficit of 0.2% of GDP. Continued growth is expected in remittances and exports, especially the value added of the maquila industry, in a year marked by the entry into force in April of the Dominican Republic-Central America-United States Free-Trade Agreement (DR-CAFTA). Potential risk factors are high prices for oil and petroleum products and their implications for domestic and world inflation, more intense pressure for a nominal appreciation of the Honduran currency and demands for wage hikes in the public sector.

2. Economic policy

The Honduran authorities continued to develop their economic policy in accordance with the IMF Poverty Reduction and Growth Facility (PRGF) arrangement. In the fiscal area, there was no significant progress in reducing expenditure on wages and allocating additional resources to public investments. The monetary policy modernization programme adopted in 2004 as part of the reform plan is now being implemented.

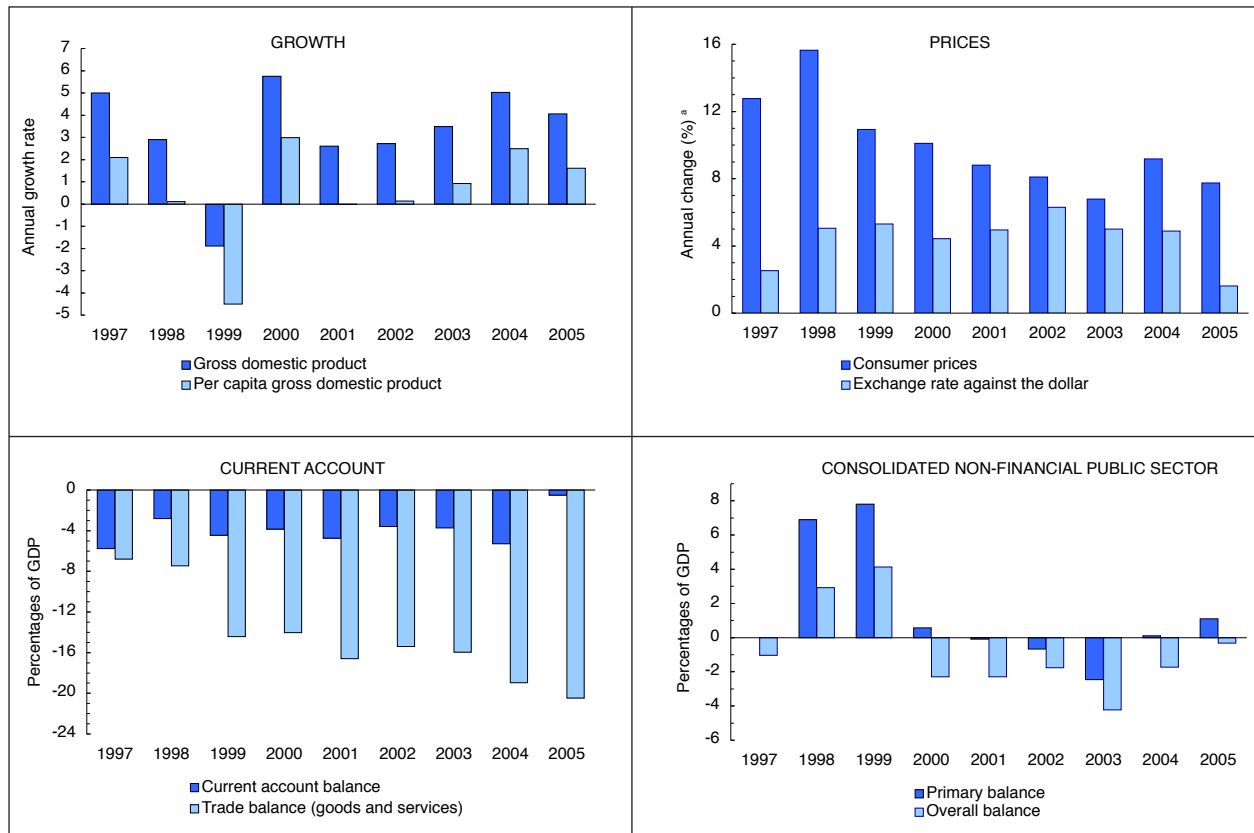
(a) Fiscal policy

The fall in the government deficit as a percentage of GDP from 3.1% in 2004 to 2.4% in 2005 was a positive

development for an electoral year, although it was due to a reduction in capital expenditure.

Total revenues in real terms increased by 7.9%. Tax revenue rose by 5.8%; proceeds from direct taxation were up by 13.8%, owing to higher receipts from income tax and the tax on property and net assets, and revenue from indirect taxes grew by 3.1%. Receipts from the general sales tax picked up by 6.9%, but proceeds from the taxes on petroleum products and beer production and consumption, and those from the tax on the production and consumption of cigarettes declined by 13%. The tax on foreign trade brought in 3.5% more. These figures were unimpressive in a year of economic expansion. Non-tax

Figure 1
HONDURAS: MAIN ECONOMIC INDICATORS



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
^a December-December variation.

revenues showed a 4.8% rise, while grants increased by more than 50%.

Total expenditure grew by 4.4% in real terms. Current expenditure increased by 8.5%; interest payments on public external debt diminished by 5%, reflecting lower overall external debt payments, compared with a sharp increase in domestic debt servicing. Payroll expenditures rose by 1.6%, while procurement of goods and services expanded substantially (35%). Capital expenditure declined by 8.5% mainly owing to a contraction in physical investment (17%). As much as 73% of the fiscal deficit was covered through external sources.

A fiscal deficit equivalent to 2.5% of GDP is projected for 2006 and will be financed essentially with external resources. The financial constraints affecting some non-financial public sector (NFPS) corporations and some local governments deserve special attention. The gradual phasing out of tariffs under DR-CAFTA is likely to result in a decline in tax revenues, which could be mitigated by higher revenues if the projected increase in economic activity materializes.

(b) Monetary policy

In May 2005, the monetary policy modernization programme began to be applied. Its objective is to make economic agents more aware of monetary policy and to regulate the financial sector's short-term liquidity. Short-term open-market operations (weekly auctions) were separated from medium and long-term operations (fortnightly auctions).

A seven-day interest rate was established as the monetary policy reference rate and a methodology was put in place for forecasting the financial system's liquidity requirements. This rate remained at 7% from May 2005, then was cut to 6.75% in March 2006 and to 6.5% in April.

The build-up of international reserves (US\$ 355 million) caused a flurry of open-market operations designed to sterilize the increased liquidity; placements of monetary absorption certificates increased by 15% and the average weighted yield in December was 9.2%.

Notwithstanding these measures by the monetary authority, there was strong real growth of the monetary aggregates: M1 and M3 expanded by 11% and M2 by 15%. This was due in part to confidence among economic agents. Credit in the financial system grew by 10%, reflecting a more proactive credit policy in a context of falling interest rates. The real average lending rate stood at 9.2% (10.9% in 2004) and the deposit rate was -0.65% (0.04% in 2004).

In February 2005, the central bank approved regulations for last-resort loans to resolve temporary liquidity problems. This system provides for financial institutions whose solvency is good to receive short-term help when they have temporary cash-flow difficulties.

In May 2006, the central bank presented its first of its six-monthly monetary programmes, the purpose of which is to reduce uncertainty for economic agents in the medium term. The bank set its inflation target at between

5.5% and 6.5% for 2006 and 2007 and gave priority to stabilization of interest rates for deposits and loans at positive real values.

(c) Exchange-rate policy

The lempira recorded a nominal average annual depreciation of 3%, which occurred mainly in the first half-year, since from mid-2005 to mid-2006, the nominal rate of exchange remained stable at 19 lempiras to the dollar. As a result, there was a slight real appreciation (1%) in 2005.

Thanks to the massive remittance and capital inflows, the results were positive. It may be difficult to avoid a more significant real appreciation of the lempira in the coming months, owing to the continually growing amounts of remittances. In the first four months, these totalled US\$ 680 million, a 30% increase over the same period in 2005.

3. The main variables

(a) Economic activity

GDP grew by 4.1% in 2005, down from 5% in 2004. However, with this trend, per capita GDP increased substantially for the second consecutive year (1.6% in 2005, 2.5% in 2004). GDP growth was driven by external and domestic demand; one of the significant components of the latter was private consumption (7.9%), boosted by the massive inflow of remittances. Public consumption was also robust at 9.3%.

Domestic investment fell (2.8%) after expanding in 2004 (13.2%). This was due to the decline in gross fixed capital investment (8%) following a reduction in private-sector investment (12.7%). Investment in construction, especially for commercial and industrial premises suffered the sharpest contraction. Public sector investment grew by 7.8%, however.

External demand grew by 6% (down from 9.7% in 2004). This result reflects weak growth in traditional exports, especially bananas and coffee.

All productive sectors performed well, although growth in the agricultural sector was minimal (0.5%). Among the crops geared mainly to the export market, coffee recorded a 16% decline in production; banana production contracted by 5% compared with a 19% expansion in 2004. Conversely, sugar cane was up by 2.7%, continuing the positive trend of recent years.

With respect to production for the domestic market, the African palm performed remarkably well (18%), following a decade of sustained growth. Basic grains rallied (after a contraction in the previous year): corn expanded by 18.2% and beans, by 9.7%. Fishery output increased by 1.2%, with tilapia and shrimp performing particularly well, but lobster production was down by 16%.

The transport and communications subsectors were also buoyant (6.3%), with strong results in communications and manufacturing (5.1%), which benefited from 11.7% growth in the textile industry (including maquila operations); the other branches of industry were below average, although construction expanded by 3%, making up for the previous year's decline.

(b) Prices, wages and employment

Twelve-month inflation to December was 7.7% (9.2% in 2004), partly owing to rising prices for oil and petroleum products, although strong domestic demand also played a part. However, the appreciation of the lempira mitigated the rise in the prices of imported goods. In April 2006, year-on-year inflation was down to 5.8%, almost two percentage points less than at the end of 2005.

The consumer price index (CPI) components that contributed most to inflation were education (11.6%), housing, water, electricity and gas (8%) and above all

Table 1
HONDURAS: MAIN ECONOMIC INDICATORS

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a
	Annual growth rates^b								
Gross domestic product	5.0	2.9	-1.9	5.7	2.6	2.7	3.5	5.0	4.1
Per capita gross domestic product	2.1	0.1	-4.5	3.0	-0.0	0.1	0.9	2.5	1.6
Gross domestic product, by sector									
Agriculture, livestock, hunting, forestry and fishing	4.3	-1.9	-8.5	11.7	-0.5	4.9	2.6	7.0	0.5
Mining	4.9	3.7	5.4	1.7	-0.8	4.2	3.2	-2.3	4.0
Manufacturing	6.1	3.4	2.6	5.5	5.2	3.8	3.7	4.1	5.1
Electricity, gas and water	7.6	4.9	2.1	10.6	-1.8	5.6	10.1	6.4	12.8
Construction	-3.0	5.3	10.5	1.5	-5.2	-14.2	13.8	-1.2	3.0
Wholesale and retail commerce, restaurants and hotels	3.5	3.1	0.7	3.7	3.0	2.9	3.1	4.7	4.9
Transport, storage and communications	4.4	2.7	1.7	5.0	5.3	3.5	3.7	5.3	6.3
Financial institutions, insurance, real estate and business services	7.8	7.2	0.8	2.6	3.4	2.8	2.7	3.7	5.6
Community, social and personal services	5.1	3.4	-0.9	10.5	11.0	6.9	1.3	6.2	5.3
Gross domestic product, by type of expenditure									
Consumption	2.7	5.7	0.4	7.9	5.3	4.8	3.4	4.5	8.1
General government	-1.0	15.4	9.8	15.7	12.1	0.5	0.8	3.4	9.3
Private	3.1	4.5	-0.9	6.8	4.3	5.5	3.8	4.7	7.9
Gross domestic investment	7.9	1.9	8.1	-2.8	-3.8	-5.8	6.7	13.2	-2.8
Exports (goods and services)	1.3	1.6	-11.2	7.3	3.2	4.9	5.3	9.7	6.0
Imports (goods and services)	-1.4	7.5	4.3	3.8	4.0	2.4	7.3	14.0	9.3
	Percentages of GDP								
Investment and saving^c									
Gross domestic investment	32.2	30.9	34.7	30.7	29.6	25.6	26.6	30.4	29.9
National saving	26.4	28.1	30.2	26.9	24.8	22.0	22.9	25.1	29.4
External saving	5.8	2.8	4.4	3.9	4.7	3.6	3.7	5.3	0.5
	Millions of dollars								
Balance of payments									
Current account balance	-272	-148	-241	-232	-303	-237	-260	-399	-42
Merchandise trade balance	-294	-323	-753	-658	-834	-829	-945	-1 278	-1 536
Exports, f.o.b.	1 857	2 048	1 756	2 012	1 935	1 977	2 090	2 398	2 652
Imports, f.o.b.	2 150	2 371	2 510	2 670	2 769	2 806	3 035	3 677	4 188
Services trade balance	-26	-70	-28	-188	-228	-184	-163	-150	-176
Income balance	-212	-204	-155	-133	-170	-193	-258	-359	-314
Net current transfers	260	449	696	747	929	969	1 106	1 388	1 984
Capital and financial balance ^d	454	-8	53	178	302	301	33	772	259
Net foreign direct investment	122	99	237	282	193	176	247	325	272
Financial capital ^e	333	-107	-185	-104	109	125	-214	448	-13
Overall balance	182	-155	-188	-54	-1	64	-227	373	216
Variation in reserve assets ^f	-308	-230	-442	-119	-147	-214	88	-504	-372
Other financing ^g	126	385	630	173	148	150	139	131	156
Other external-sector indicators									
Real effective exchange rate (index: 2000=100) ^h	119.0	108.8	104.5	100.0	97.1	96.9	98.4	100.0	100.1
Terms of trade for goods (index: 2000=100)	125.5	108.9	107.5	100.0	94.8	92.0	88.0	87.2	87.2
Net resource transfer (percentage of GDP)	7.8	3.3	9.7	3.6	4.4	3.9	-1.2	7.2	1.2
Gross external debt (millions of dollars)	4 073	4 369	4 691	4 711	4 757	4 922	5 242	5 912	5 223
Gross external debt (percentage of GDP)	86.4	83.0	86.5	78.2	74.3	74.8	75.5	78.4	62.4
Net profits and interest (percentage of exports) ⁱ	-9.7	-8.4	-7.0	-5.3	-7.0	-7.7	-9.6	-11.5	-9.2
	Average annual rates								
Employment									
Labour force participation rate ^j	53.1	52.9	55.7	...	52.5	51.7	50.0	50.6	50.9
Open unemployment rate ^k	3.6	3.5	3.5	...	4.1	3.9	5.3	5.9	4.5
Visible underemployment rate ^k	3.0	2.1	2.7	...	4.4	3.9	6.4	6.9	8.1
	Annual percentages								
Prices									
Variation in consumer prices (December-December)	12.8	15.7	10.9	10.1	8.8	8.1	6.8	9.2	7.7
Variation in nominal exchange rate (December-December)	2.5	5.1	5.3	4.4	5.0	6.3	5.0	4.9	1.6
Variation in real minimum wage	6.3	1.8	-3.0	3.1	2.5	2.1	8.6	0.8	5.8
Nominal deposit rate ^l	21.3	18.6	19.4	15.9	14.5	13.7	11.5	11.1	10.9
Nominal lending rate ^m	32.1	30.6	30.2	26.8	23.8	22.7	20.8	19.9	18.8

Table 1 (concluded)

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a
	Percentages of GDP								
Consolidated non-financial public sector									
Total income ⁿ	29.7	32.2	34.7	30.8	34.0	32.3	33.2	34.4	33.8
Current income	29.4	31.4	33.7	29.7	31.9	30.8	31.9	33.1	32.0
Capital income	0.4	0.1	0.3	0.0	0.0	0.2	0.1	0.3	0.5
Total expenditure ^o	30.8	29.3	30.6	33.1	36.3	34.0	37.4	36.1	34.1
Current expenditure	22.8	21.9	24.1	24.4	27.1	26.6	29.0	27.8	27.1
Interest	0.0	4.0	3.7	2.9	2.2	1.1	1.8	1.8	1.4
Capital expenditure	7.6	7.2	5.8	7.7	8.1	6.3	7.4	7.7	6.8
Primary balance	...	6.9	7.8	0.6	-0.1	-0.7	-2.5	0.1	1.1
Overall balance	-1.0	2.9	4.1	-2.3	-2.3	-1.8	-4.2	-1.7	-0.3
Public sector debt	45.3	41.1	42.7	49.1	50.7	66.5	63.5	51.1	50.4
Domestic	11.7	11.0	12.0	13.5	14.7	17.3	17.3	14.7	19.2
External	33.6	30.1	30.7	35.6	36.0	49.1	46.2	36.4	31.3
Money and credit^p									
Domestic credit ^q	23.5	27.6	25.6	24.6	27.7	27.0	28.7	30.5	29.6
To the public sector	-3.1	-6.2	-13.0	-13.7	-11.3	-11.8	-9.9	-8.0	-9.1
To the private sector	26.6	33.8	38.6	38.3	39.0	38.8	38.6	38.5	38.7
Liquidity (M3)	35.0	40.8	43.3	45.3	46.7	48.6	49.3	50.5	52.6
Currency in circulation and local-currency deposits (M2)	27.2	32.2	33.2	34.7	34.7	34.6	34.7	35.3	37.4
Foreign-currency deposits	7.8	8.6	10.1	10.6	12.0	14.0	14.6	15.2	15.2

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a Preliminary figures. ^b Based on figures in local currency at constant 1978 prices. ^c Based on figures in local currency expressed in dollars at current prices. ^d Includes errors and omissions. ^e Refers to the capital and financial balance (including errors and omissions), minus net foreign direct investment. ^f A minus sign (-) denotes an increase in reserves. ^g Includes the use of IMF credit and loans and exceptional financing. ^h Annual average, weighted by the value of merchandise exports and imports. ⁱ Refers to net investment income as a percentage of exports of goods and services as shown on the balance of payments. ^j Economically active population as a percentage of the working-age population; nationwide total. ^k Unemployment and underemployment rates as percentages of the economically active population; nationwide total. ^l Weighted average rate on time deposits. ^m Weighted average rate on loans. ⁿ Includes grants. ^o Includes net lending. ^p The monetary figures are annual averages. ^q Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions.

transport (14%), which was affected by rising prices for fuels and national and international transport services. By mid-year, food prices had increased by 12%, but they later subsided.

Wholesale prices increased by 10.2% in twelve months. Among the factors that had the strongest impact on inflation in 2005 were the steep rise in the cost of construction materials (18.4%) caused by the sector's remarkable recovery, and price increases in the agricultural sector (13%).

The nationwide open unemployment rate declined from 5.9% in May 2004 to 4.1% in September 2005, with improvements in both urban and rural areas. However, this lower unemployment went hand in hand with a reduction in workers' income, since the rate of visible underemployment¹ increased from 29.5% in May 2004 to 33.9% in September 2005.

As from 2005, the average nominal daily minimum wage increased by 9.7%, and real wages grew by only

1%. On 1 January 2006, minimum wages were raised by 9.2%, which could mean a higher real increase this year if the inflation target is met.

(c) The external sector

The non-factor goods and services deficit continued to widen; it stood at US\$ 1.71 billion in 2005, while the factor goods and services income balance diminished slightly to US\$ 315 million. These deficits were offset by current transfers so that the non-factor and factor goods and services deficit, which was equivalent to 25% of GDP, was offset by the positive transfer balance of 24.5% of GDP. As a result, the balance of payments current-account deficit amounted to only 0.5% of GDP, a figure unprecedented in the last twenty-five years.

The small current-account deficit meant that a major part of the capital inflows were used to swell international reserves, which expanded from US\$ 1.657 billion to

¹ This concept refers to those persons who work 36 hours per week or more, but whose monthly income is below the monthly minimum wage.

Table 2
HONDURAS: MAIN QUARTERLY INDICATORS

	2004				2005 ^a				2006 ^a	
	I	II	III	IV	I	II	III	IV	I	II
Merchandise exports, f.o.b. (millions of dollars) ^b	408	415	369	349	475	488	367	368	520	...
Merchandise imports, c.i.f. (millions of dollars)	920	935	984	1 078	999	1 133	1 135	1 217	1 157	...
International reserves (millions of dollars)	1 501	1 625	1 695	1 970	2 068	2 160	2 177	2 327	2 565	2 669 ^c
Real effective exchange rate (index: 2000=100) ^d	100.1	99.5	99.5	101.1	101.3	100.5	99.3	99.1	99.1	...
Consumer prices (12-month percentage variation)	6.7	8.3	8.4	9.2	9.5	9.0	9.3	7.7	6.2	5.7
Average nominal exchange rate (lempiras per dollar)	17.86	18.10	18.33	18.54	18.71	18.84	18.86	18.88	18.89	18.90
Nominal interest rates (annualized percentages)										
Deposit rate ^e	11.3	11.2	11.0	10.9	11.0	11.0	10.9	10.8	10.6	10.0 ^c
Lending rate ^f	20.1	20.0	19.7	19.6	19.3	19.0	18.6	18.5	18.3	17.8 ^c
Interbank interest rate	8.3	7.5	7.5	7.7	7.5	7.5	7.5	7.2	6.9	5.5
Domestic credit (variation from same quarter of preceding year) ^g	23.8	21.2	19.7	9.0	9.3	9.9	13.5	21.2	22.9	25.5 ^h
Non-performing loans as a percentage of total credit ⁱ	3.5	3.3	3.5	2.6	2.7	2.5	2.3	2.2	2.2	2.2 ^h

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a Preliminary figures. ^b Does not include maquila activities. ^c Data to May. ^d Quarterly average, weighted by the value of merchandise exports and imports. ^e Weighted average rate on time deposits. ^f Weighted average rate on loans. ^g Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions. ^h Data to April. ⁱ Refers to total credit extended by the banking system.

US\$ 2.012 billion. Thus, by the end of 2005, international reserves were equivalent to five months' goods and services imports.

The value of merchandise exports (including the net value added of the maquila industry) increased by 10.6%. This was due to the expansion of traditional exports (25%), including the substantial increase in earnings from coffee and bananas (which together account for 82% of this category), thanks to strong prices on international markets, although the volumes exported actually declined. Sugar sales recovered (82%) and timber exports were up (26%), reflecting volume and price increases, although they are still short of the 2001 figures. Exports of ores, especially gold and silver, showed a lacklustre performance.

Non-traditional exports grew by 0.8% in value terms, accounting for earnings of the order of US\$ 1 billion, export volumes having increased although prices deteriorated. This category includes shrimp, lobster, tilapia, melon and pineapple. The value added recorded by the maquila industry grew by 10%, despite competition from the Asian countries.

The value of imports continued to follow the sustained upward trend begun in 1990 (14.5%). This reflected the increasingly hefty bill for oil and petroleum products. Other imports rose by only 9% (20% in 2004).

In 2005, the oil bill amounted to US\$ 904 million (a 42% increase), almost doubling the figure for 2003.

Imports of consumer goods (especially non-durable goods) also increased substantially (21%); meanwhile raw material imports grew by 24%. Conversely, imports of capital goods slumped by 17%, mainly because of declining purchases for the industry sector. It should be borne in mind, however, that this is being measured against 2004, when extraordinary purchases were made by electric power generating companies.

Net non-factor services amounted to US\$ 177 million. The deterioration in this account was partly due to higher transport costs abroad in the 2004-2005 biennium. It was offset, however, by increasing inflows from tourism, which stood at US\$ 500 million in 2005, double the amount recorded in 2000.

In 2005, current transfers, which include family remittances from the United States (US\$ 1.763 billion) and non-refundable official development assistance (US\$ 221 million) totalled US\$ 1.984 billion, an unprecedented amount, 43% above the 2004 figure.

The factor income balance amounted to US\$ 315 million (US\$ 359 million in 2004); there were falls in net profit remittances and net interest payments, which was a result of higher revenues, since payments remained practically unchanged.

Net capital inflows (including errors and omissions) fell sharply, from US\$ 770 million in 2004 to US\$ 258 million in 2005. Foreign investment stood at US\$ 272 million, while net outflows of other capital

totalled US\$ 14 million, reflecting clearly the reduction in public external debt arising from the HIPC initiative.

In April 2005, following several years of negotiations, Honduras reached its completion point under the Heavily Indebted Poor Countries (HIPC) Debt Initiative,² enabling the member countries of the Paris Club to forgive US\$ 1.061 billion in external public debt. In December 2005, IMF cancelled the Honduran government's debt with the Fund. By mid-2006, the World Bank is expected to ratify this offer of debt relief; steps have been taken towards achieving a similar objective with the Inter-American Development Bank. Total relief (including the debts

written off by the Paris Club, IMF and the World Bank) is estimated at US\$ 2.875 billion, almost 60% of the external public debt, and will be implemented over a period of 15 years.

Honduras's external debt diminished for the first time since 1997, falling from US\$ 5.912 billion in 2004 to US\$ 5.170 billion in 2005 thanks to the reduction in public liabilities, while private debt continued to grow. In terms of GDP, the external public debt contracted from 70% in 2004 to 53.3% in 2005. As a percentage of goods and services exports, it diminished from 190% in 2004 to 150% in 2005.

² The completion point is the point at which the country has satisfied all the conditions relating to policy measures required under the Heavily Indebted Poor Countries (HIPC) Debt Initiative.

Mexico

1. General trends

The growth rate of the Mexican economy fell from 4.2% in 2004 to 3.0% in 2005. Economic policy continued to be guided by the principle of fiscal and monetary prudence and this contributed to market stability: interest rates trended downwards in the second half of the year and the exchange rate appreciated slightly in real terms, which helped to lower inflation.

The balance-of-payments current account deficit narrowed for the fifth year in a row to 0.6% of GDP, mainly thanks to oil revenues and a 20% increase in family remittances (which exceeded US\$ 20.0 billion). Inflows of foreign direct investment amounted to over US\$ 18.0 billion, while Mexican investment abroad has increased five-fold in the last three years and represented over US\$ 6.0 billion in 2005.

Private consumption remained buoyant on the back of increases in credit and remittances. Following a three-year period of decline, capital formation rose for the second consecutive year (7.6%) thanks to greater investment in machinery and equipment and a moderate upturn in construction driven by mortgage lending. Economic growth fuelled employment, while real wages held steady.

In the second half of 2006, the United States economy is expected to slow slightly, which would take some of the wind out of Mexico's export performance. GDP should grow by 4%, driven mainly by domestic demand, which will continue to draw strength from the expansion of private-sector credit and a low inflation rate (of around 3.5%). Monetary, foreign-exchange and fiscal policy stances will remain unchanged and the fiscal surplus is expected to weigh in at 0.2% of GDP. The presidential and legislative elections to be held in July 2006 are expected to be closely contested and the post-election climate may entail some financial volatility, but the transition is not expected to bring any great commotion on the economic front.

2. Economic policy

The overarching objective of economic policy was to reduce inflation. In a context of fiscal and monetary austerity and a floating exchange rate, windfall oil revenues afforded a degree of freedom that enabled the authorities to meet the fiscal deficit target comfortably and pay down public debt. Monetary policy remained tight in the early part of 2005 until inflation showed signs of abating then, in the second half of the year, interest rates came down in a trend that continued into the first few months of 2006.

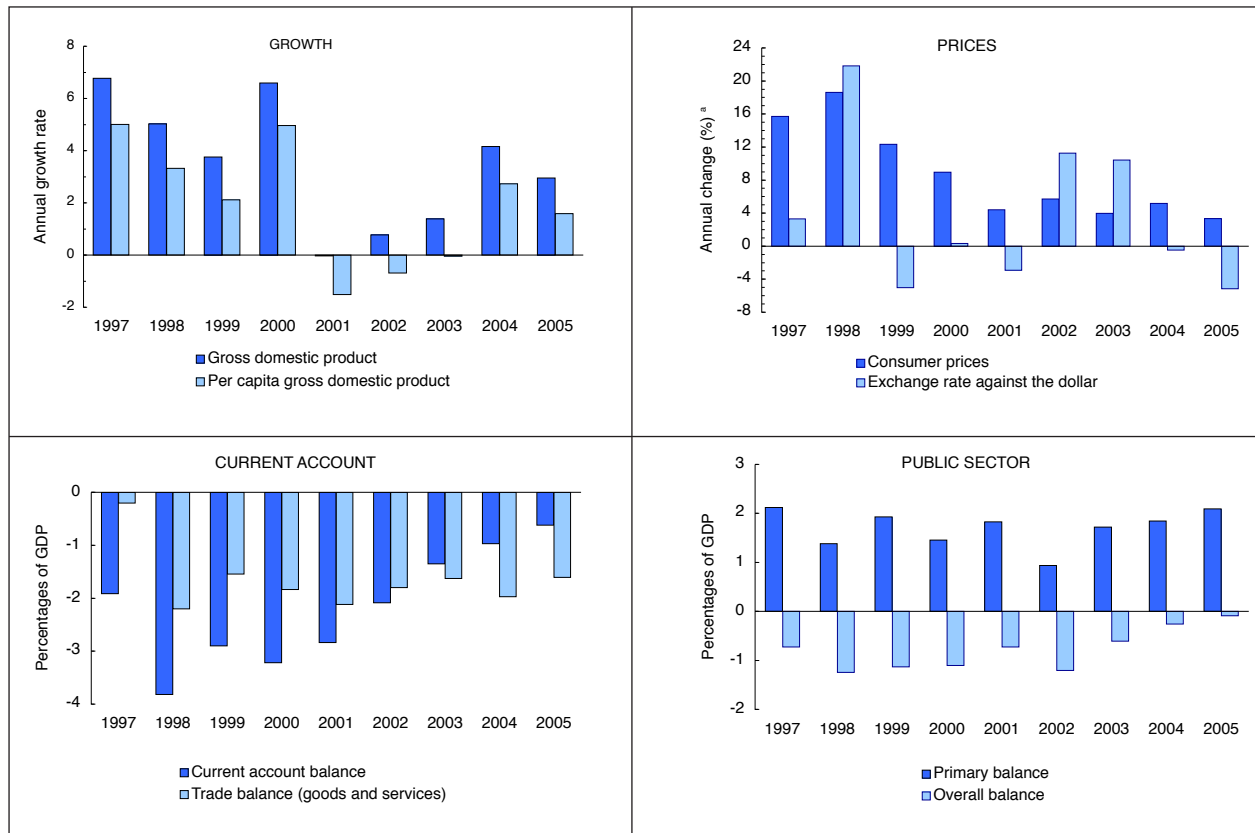
(a) Fiscal policy

Fiscal policy remained austere, amidst abundant oil revenues that were up by 9.6% in real terms and represented

37% of the total income of public-sector institutions included in the federal budget. These revenues facilitated the achievement of the target for the fiscal deficit, which at 0.1% of GDP was 0.13 percentage points smaller than predicted by the federal government at the beginning of 2005. Non-oil revenues expanded by 3.6%, with tax income growing strongly (6.4%) thanks to improved collection. Expenditure has remained almost constant in relation to GDP since 2003 (23.3% of GDP).

The public-sector borrowing requirement (PSBR), encompassing all public-sector activities (whether implemented by public or private entities), continued to trend downwards in 2005 and stood at 1.63% of GDP, not including excluding exceptional income from Banco de

Figure 1
MEXICO: MAIN ECONOMIC INDICATORS



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
^a December-December variation.

México (central bank) profits or from privatizations. In 2006, PSBR is expected to come to 1.5% of GDP.

As a result of amortization and prepayment of external obligations, external public debt dropped from 9.8% of GDP in 2004 to 7.7% in 2005, around which figure it is expected to remain in 2006. The domestic debt ratio remained unchanged, and total public sector debt fell to 31.6% of GDP.¹

In 2006, a lower take is expected from income tax (as a result of legislative reform) and from tax on non-recurrent income. Expenditure will therefore need to be adjusted in order to achieve the fiscal target. Outstanding tasks in the areas of public finances include the need to increase the tax burden, which fell from 10.0% of GDP in 2004 to 9.7% in 2005.

(b) Monetary policy

Monetary policy was directed towards keeping inflation within a range of one percentage point on either side of the target of 3%. One of the two main instruments of monetary policy is the “corto” (a compulsory level of commercial bank balances in the central bank), which was last raised to 79 million pesos per day in March 2005. The other instrument is the setting of minimum rates of interest, which the Banco de México uses to send clear signals to the markets on its desired monetary position. The tight monetary stance was in keeping with monetary policy in the United States, although expectations that inflation would remain under control gradually brought the benchmark interest rate (28-day

¹ Total public sector debt includes the balance of items included in the public-sector borrowing requirement (PSBR) and not included in the definition of traditional debt, such as the Bank Savings Protection Institute (IPAB), the Toll Road Rescue Trust for bailing out highway concessions (FARAC), the programme to restructure debts in inflation-indexed investment units (UDIs), Projects with a Deferred Impact on Public Expenditure Recording (PIDIREGAS) and bank debtor support programmes, which represented 14.8% of GDP in 2005. See Banco de México, *Informe anual 2005*, p. 87.

equilibrium interbank rate) down from 10.0% in the second quarter of 2005 to 8.7% at the year's end and 7.3% in mid-2006.

The nominal lending rate² followed the same trend, dropping from almost 10% in late 2005 to around 7.5% in the first half of 2006. The decline in interest rates is expected to tail off during the rest of the year, in line with the thrust of monetary policy.

The money supply swelled by 7.9% in real terms in 2005, while narrow money expanded by 7.1% (11.1% of GDP), which is evidence of the gradualness of the remonetization process. The decline in interest rates starting in the second half of 2005 helped to fuel expansion of M1 and other monetary aggregates, and this effect continued into the first few months of 2006. The growth of local-currency-denominated deposits slowed from a rate of 18% in November 2005 to 14% in March 2006. Rates of growth in foreign-currency deposits (a component of M3) went from 59% to 47% in the same period.

In a context of expanding credit supply, households absorbed 80% of total commercial bank lending in 2005 (with a 15% increase in the lending balance of this banking sector in 2005). Consumer credit, from both commercial banks and other sources of financing, was the most buoyant. Consumer credit from bank and non-bank institutions grew by 41% in real terms in 2005 and has kept up that rate in 2006. Mortgage lending is also continuing to expand in 2006 after having grown by 6.7% in 2005, driven by housing loans extended by non-bank intermediaries such as limited purpose financial institutions (SOFOLÉS). Corporate borrowing, on the other hand, contracted by 0.4% in 2005.

(c) Exchange-rate policy

Mexico's foreign-exchange policy has been based on a floating exchange-rate regime since the end of 1994. In 2005, the peso tended to appreciate slightly in the foreign-exchange market, especially in the second half of the year, when inflows of foreign exchange from FDI and exports firmed up. The average nominal exchange rate in 2005 was 10.9 pesos to one United States dollar, with real appreciation of 4% for the year as a whole.³

The foreign-exchange market experienced short-lived periods of volatility in 2006, caused by the prospect of an international liquidity squeeze and as a result of the domestic political context. On average, the exchange rate has fluctuated around 11 pesos to the dollar, and it is expected to stabilize and continue to record moderate real appreciation following the presidential elections. One contributing factor in this has been the weakening of the dollar in relation to several other currencies in the first half of 2006.

In response to the expansion of international reserves triggered by rising petroleum prices and increases in both exports and direct and portfolio investment, the Banco de México continued to hold foreign exchange auctions — the mechanism it has been using since March 2003 to slow the build-up of reserves. An average of US\$ 19 million was auctioned daily in 2005 and the picture was similar in 2006. In 2005 international reserves were up by US\$ 7.164 billion over the 2004 figure and the balance stood at US\$ 74.11 billion at the end of December. In May 2006, international reserves amounted to US\$ 75.0 billion, with growth expected to slow during the second half of the year.

3. The main variables

(a) Economic activity

Economic performance was notable for the slowdown seen in external demand and for rising domestic expenditure led by private consumption and investment. This rising expenditure, however, was not enough to prevent a fall in the GDP growth rate, from 4.2% in 2004 to 3.0% in 2005. Gross fixed capital formation swelled by 7.6%,

driven by the private sector component, which represented 80% of the total. This performance was largely thanks to purchases of machinery and equipment, especially from abroad, which were up by 15%. Public investment continued to decline (-0.5%), owing to declining purchases of machinery and equipment (-4.3%). Domestic demand continues to expand and exports again posted high growth rates in the last quarter of 2005 and the first few months

² The nominal lending rate refers to the cost of lending to companies, which is calculated approximately as the yield on the commercial paper they issue on the money market.

³ Appreciation was 3.4% on the basis of unit labour costs from the non-maquila manufacturing sector. See Banco de México, *Informe anual 2005*, p. 108.

Table 1
MEXICO: MAIN ECONOMIC INDICATORS

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a
	Annual growth rates^b								
Gross domestic product	6.8	5.0	3.8	6.6	-0.0	0.8	1.4	4.2	3.0
Per capita gross domestic product	5.0	3.3	2.1	5.0	-1.5	-0.7	-0.0	2.7	1.6
Gross domestic product, by sector									
Agriculture, livestock, hunting, forestry and fishing	0.2	3.0	1.5	0.4	5.9	-0.9	3.8	3.2	-1.5
Mining	4.5	2.7	-2.1	3.8	1.5	0.4	3.7	3.4	1.2
Manufacturing	9.9	7.4	4.2	6.9	-3.8	-0.7	-1.3	4.0	1.2
Electricity, gas and water	5.2	1.9	15.8	3.0	2.3	1.0	1.5	2.8	1.4
Construction	9.3	4.2	5.0	4.2	-5.7	2.1	3.3	6.1	3.3
Wholesale and retail commerce, restaurants and hotels	10.7	5.6	3.1	12.2	-1.2	0.0	1.5	5.5	3.1
Transport, storage and communications	9.9	6.7	7.8	9.1	3.8	1.8	5.0	9.2	7.1
Financial institutions, insurance, real estate and business services	3.7	4.6	3.6	5.5	4.5	4.2	3.9	3.9	5.8
Community, social and personal services	3.3	2.9	2.1	2.9	-0.3	0.9	-0.6	0.6	2.1
Gross domestic product, by type of expenditure									
Consumption	6.0	5.0	4.4	7.4	1.9	1.4	2.1	3.6	4.8
General government	2.9	2.3	4.7	2.4	-2.0	-0.3	0.8	-0.4	0.5
Private	6.5	5.4	4.3	8.2	2.5	1.6	2.2	4.1	5.4
Gross domestic investment	24.8	10.5	4.0	11.7	-3.8	-1.1	-4.1	7.3	-0.2
Exports (goods and services)	10.7	12.1	12.4	16.3	-3.6	1.4	2.7	11.6	6.9
Imports (goods and services)	22.7	16.6	14.1	21.5	-1.6	1.5	0.7	11.6	8.7
	Percentages of GDP								
Investment and saving^c									
Gross domestic investment	25.9	24.3	23.5	23.8	20.8	20.6	20.5	22.0	21.8
National saving	24.0	20.5	20.6	20.6	18.0	18.5	19.1	21.1	21.2
External saving	1.9	3.8	2.9	3.2	2.8	2.1	1.4	1.0	0.6
	Millions of dollars								
Balance of payments									
Current account balance	-7 666	-16 073	-13 929	-18 683	-17 651	-13 528	-8 625	-6 616	-4 789
Merchandise trade balance	623	-7 915	-5 613	-8 337	-9 617	-7 633	-5 779	-8 811	-7 587
Exports, f.o.b.	110 431	117 459	136 362	166 121	158 780	161 046	164 766	187 999	214 233
Imports, f.o.b.	109 808	125 374	141 975	174 458	168 396	168 679	170 546	196 810	221 820
Services trade balance	-1 433	-1 350	-1 799	-2 323	-3 558	-4 048	-4 601	-4 649	-4 768
Income balance	-12 106	-12 820	-12 830	-15 017	-13 814	-12 116	-12 103	-10 200	-12 919
Net current transfers	5 250	6 012	6 313	6 994	9 338	10 268	13 858	17 044	20 484
Capital and financial balance ^d	28 126	12 572	18 206	25 793	24 976	20 618	18 063	10 674	11 953
Net foreign direct investment	12 831	11 897	13 631	17 588	22 747	17 384	12 930	14 242	11 884
Financial capital ^e	15 295	675	4 574	8 205	2 229	3 234	5 132	-3 568	69
Overall balance	20 460	-3 501	4 277	7 110	7 325	7 090	9 438	4 058	7 164
Variation in reserve assets ^f	-10 513	-2 118	-592	-2 824	-7 325	-7 090	-9 438	-4 058	-7 164
Other financing ^g	-9 948	5 619	-3 685	-4 286	0	0	0	0	0
Other external-sector indicators									
Real effective exchange rate (index: 2000=100) ^h	119.9	119.0	108.8	100.0	93.4	92.9	104.5	109.5	106.1
Terms of trade for goods (index: 2000=100)	89.5	90.6	99.3	100.0	97.4	97.9	98.8	101.6	103.6
Net resource transfer (percentage of GDP)	1.5	1.3	0.4	1.1	1.8	1.3	0.9	0.1	-0.1
Total gross external debt (billions of dollars)	149	160	166	149	145	135	132	131	127
Total gross external debt (percentage of GDP)	37.2	38.1	34.6	25.6	23.2	20.8	20.7	19.2	16.5
Net profits and interest (percentage of exports) ⁱ	-10.0	-9.9	-8.7	-8.4	-8.1	-7.0	-6.8	-5.1	-5.6
	Average annual rates								
Employment									
Labour force participation rate ^j	58.9	59.1	58.3	58.7	58.1	57.8	58.3	58.9	59.5
Open unemployment rate ^k	5.4	4.7	3.7	3.4	3.6	3.9	4.6	5.3	4.7
Visible underemployment rate ^k	14.8	12.2	11.3	11.7	11.1	10.0	10.5	11.6	...
	Annual percentages								
Prices									
Variation in consumer prices (December-December)	15.7	18.6	12.3	9.0	4.4	5.7	4.0	5.2	3.3
Variation in the national producer price index (December-December)	10.5	17.5	12.5	6.4	1.3	9.2	6.8	8.0	3.4
Variation in nominal exchange rate (December-December)	3.3	21.8	-5.0	0.3	-2.9	11.2	10.4	-0.5	-5.2
Variation in average real wage	-0.6	2.8	1.5	6.0	6.7	1.9	1.3	0.2	-0.1
Nominal deposit rate ^l	20.0	22.4	20.9	14.6	11.0	6.2	5.1	5.4	7.6
Nominal lending rate ^m	22.1	26.4	23.7	16.9	12.8	8.2	6.9	7.2	9.9

Table 1 (concluded)

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a
	Percentages of GDP								
Public sector									
Total income	23.1	20.4	20.8	21.6	21.8	22.2	23.2	23.0	23.3
Tax revenue	9.8	10.5	11.4	10.6	11.3	11.6	11.1	10.0	9.7
Total expenditure ⁿ	23.7	21.6	22.0	22.7	22.5	23.3	23.9	23.3	23.3
Current expenditure	12.8	12.4	12.5	13.0	13.3	13.8	14.6	13.6	14.0
Interest	2.8	2.6	3.1	2.6	2.6	2.1	2.3	2.1	2.2
Capital expenditure	3.5	3.1	2.8	2.7	2.6	3.2	2.9	3.5	3.4
Primary balance ^o	2.1	1.4	1.9	1.5	1.8	0.9	1.7	1.8	2.1
Overall balance ^o	-0.7	-1.2	-1.1	-1.1	-0.7	-1.2	-0.6	-0.3	-0.1
Public sector debt	31.1	33.5	30.1	27.0	25.8	27.5	27.6	25.8	24.1
Domestic	8.6	9.8	11.0	12.3	13.1	14.5	14.7	14.3	14.8
External	22.5	23.7	19.1	14.7	12.6	13.0	12.9	11.6	9.2
Money and credit^p									
Domestic credit ^q	35.6	36.8	33.1	30.2	29.1	28.3	28.1	26.2	26.6
To the public sector	12.7	12.5	11.6	11.3	11.3	10.7	11.4	10.3	10.2
To the private sector	20.7	22.2	19.0	16.7	16.3	15.7	15.1	14.0	14.8
Other	2.2	2.2	2.5	2.1	1.5	1.9	1.5	1.9	1.6
Liquidity (M3)	36.3	38.1	40.2	40.1	43.4	45.4	46.1	46.4	49.0
Currency in circulation and local-currency deposits (M2)	35.1	36.8	38.8	38.7	42.0	43.8	44.7	45.0	47.6
Foreign-currency deposits	1.3	1.3	1.4	1.4	1.5	1.6	1.4	1.4	1.5

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a Preliminary figures. ^b Based on figures in local currency at constant 1993 prices. ^c Based on figures in local currency expressed in dollars at current prices. ^d Includes errors and omissions. ^e Refers to the capital and financial balance (including errors and omissions), minus net foreign direct investment. ^f A minus sign (-) denotes an increase in reserves. ^g Includes the use of IMF credit and loans and exceptional financing. ^h Annual average, weighted by the value of merchandise exports and imports. ⁱ Refers to net investment income as a percentage of exports of goods and services as shown on the balance of payments. ^j Economically active population as a percentage of the working-age population, urban areas. ^k Unemployment and underemployment rates as percentages of the economically active population, urban areas. ^l Cost of term deposits in local currency in the multibanking system. ^m Lending rate published by IMF. ⁿ Includes non-budgeted expenditure. ^o Includes the non-budgetary balance. ^p The monetary figures are annual averages. ^q Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions.

of 2006. This was reflected in a first-quarter GDP growth rate of 5.5%: the highest in six years.

Private consumption was up by 5.4% in 2005, fuelled by remittances and increased employment. Another factor was the downward trend in interest rates in the second half of 2005 and the first few months of 2006; this also gave impetus to fixed investment, which rose by 7.6% (similar to the 7.5% recorded in 2004) and continued buoyant into 2006.

Albeit at a lower rate than in 2004, in 2005 production expanded across all branches of activity except agriculture, which declined by 1.5% owing to poor weather conditions, including the drought in the first semester and Hurricanes Stan and Wilma at the year's end.⁴ In the first quarter of 2006, manufacturing and construction performed very well, with growth rates of 7.1% and 8.3%, respectively. Services, which account for 65.7% of GDP, maintained a steady pace of growth during 2005 (6.4% for basic services and 3.5% for other services) and, like the other branches of the economy, have remained buoyant in 2006.

In the manufacturing sector, good performances were

turned in by the metal products and machinery and equipment segments. The latter includes the automobile industry, which has succeeded in repositioning in the United States market. In the light of changes in world competitiveness and demand, the manufacturing industry is shifting its production platform towards luxury automobiles for export. As a result, and thanks to increased demand from the United States (the main export market), the automobile industry's production rose by 6.6% in 2005, with 74% of output destined for the external market. This trend has strengthened in 2006, with production up by more than 35% in January-April. Japanese companies with operations in Mexico have stepped up production, encouraged by the benefits of the Economic Complementarity Agreement in place between the two countries since April 2005.

With readily available financing, construction continued to expand, although less vigorously than in 2004. Residential construction (48% of the total) fared particularly well, while infrastructure work slowed slightly. In 2006, construction in the petroleum and petrochemical sectors picked up as oil-industry surpluses were put to use, which

⁴ According to data from the Secretariat of Agriculture, Livestock, Rural Development, Fisheries and Food (SAGARPA), 1.6 million hectares were affected by drought and 254,000 hectares by hurricanes.

Table 2
MEXICO: MAIN QUARTERLY INDICATORS

	2004				2005 ^a				2006 ^a	
	I	II	III	IV	I	II	III	IV	I	II
Gross domestic product (variation from same quarter of preceding year) ^b	3.6	3.7	4.5	4.8	2.4	3.3	3.4	2.7	5.5	...
Merchandise exports, f.o.b. (millions of dollars)	43 193	47 388	47 874	49 543	46 895	53 977	54 183	59 178	58 879	...
Merchandise imports, f.o.b. (millions of dollars)	43 717	48 507	49 822	54 764	48 772	54 655	55 871	62 521	58 119	...
International reserves (millions of dollars)	61 591	60 409	62 209	64 141	64 054	65 551	69 930	74 054	75 950	81 383 ^c
Real effective exchange rate (index: 2000=100) ^d	106.5	110.5	111.0	109.9	108.9	106.9	104.7	103.7	102.4	110.2
Unemployment rate	5.4	5.1	5.8	4.8	5.1	4.7	5.1	4.1	4.5	...
Consumer prices (12-month percentage variation)	4.2	4.4	5.1	5.2	4.4	4.3	3.5	3.3	3.4	3.2
Average nominal exchange rate (pesos per dollar)	10.98	11.38	11.45	11.33	11.18	10.96	10.72	10.71	10.60	11.18
Average real wage (variation from same quarter of preceding year)	1.5	0.6	0.1	-0.9	-0.1	-0.1	-0.7	0.3	0.5	...
Nominal interest rates (annualized percentages)										
Deposit rate ^e	4.5	5.0	5.6	6.5	7.2	7.9	8.0	7.4	6.6	6.1
Lending rate ^f	6.0	6.7	7.5	8.6	9.4	10.0	10.1	10.1	7.9	7.3 ^c
Interbank interest rate	5.9	6.7	7.5	8.5	9.4	10.0	9.9	9.1	8.0	7.4
Sovereign bond spread (basis points)	183	215	188	166	180	168	136	126	127	138
Stock price index (in dollars, December 2000=100)	148	141	149	183	178	198	238	263	281	269
Domestic credit (variation from same quarter of preceding year) ^g	1.6	6.4	3.9	7.3	8.5	10.8	8.8	6.9	14.9	8.7 ^h
Non-performing loans as a percentage of total credit ⁱ	3.2	3.0	2.7	2.5	2.4	2.3	2.0	1.8	1.7	...

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a Preliminary figures. ^b Based on figures in local currency at constant 1993 prices. ^c Data to May. ^d Quarterly average, weighted by the value of merchandise exports and imports. ^e Cost of term deposits in local currency in the multibanking system. ^f Lending rate published by IMF. ^g Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions. ^h Data to April. ⁱ Refers to total credit extended by full-service banks.

suggests that public investment will be higher this year.

Services benefited from steady demand for traditional and mobile telephones, courier services and air transport. This was reflected in a 7.1% increase in the transport, storage and communications sector in 2005, which is expected to continue in 2006. Commerce, restaurants and hotels slowed to 3.1% in 2005 (down from 5.5% in 2004) as result of the damage wreaked by Hurricane Wilma in one of the tourist areas of Quintana Roo, although this activity is now picking up (5.3% in the first quarter of 2006) thanks to reconstruction efforts in the area. Financial services climbed 5.8% in 2005 and community, social and personal services by 2.1%.

(b) Prices, wages and employment

December-to-December inflation fell from 5.2% in 2004 to 3.3% in 2005, which was the lowest rate seen in decades. Contributing factors included the peso's nominal stability and trend towards real appreciation, less buoyant economic activity and the Banco de México's aforementioned efforts to neutralize domestic inflationary pressure. Core inflation⁵ stood at 3.12%, owing to smaller rises in prices for processed food and housing thanks, in turn, to the easing of international price volatility in raw materials, particularly steel, which boosted residential construction.

⁵ Core inflation covers merchandise (processed food, beverages and tobacco) and services (housing and others).

Non-core inflation⁶ was the determinant of the decline in overall inflation, dropping by more than four percentage points to stand at 3.76% at the end of 2005, mainly because the agricultural price index went from 10.1% growth in 2004 to a -0.2% decline in 2005.

In 2006, both components displayed similar patterns to the previous year, with moderate variations in the prices of fruit and vegetables and adjustments of controlled prices in the early months. If this trend continues, overall inflation is expected to end the year at around the 3.5% mark.

Despite the economy's lower growth, the open unemployment rate dipped from 3.9% in 2004 to 3.6% in 2005 and to 3.5% in the first quarter of 2006. This reflected the absorption of labour by the informal sector and, to a lesser extent, increased employment in labour-intensive activities such as construction. In 2005, 11.8 million people, representing over 28% of the employed population, were in informal employment. The average rate of underemployment⁷ was 7.5% of the employed population in 2005, retreating to 6.2% in the first quarter of 2006 in keeping with the economic buoyancy seen in that period.

As regards formal employment, the number of workers affiliated to the Mexican Social Security Institute swelled to 12.9 million in 2005, exceeding for the first time the previous record of 12.6 million recorded in 2000. This uptrend has continued into 2006 on the back of strong economic growth and the number of affiliates came to 13.5 million in March. One trend to be noted is the growing proportion of temporary workers, who represented 15.6% of the total in 2005 and 17.4% in March 2006 (compared with 6.9% 10 years earlier).

The services sector consolidated its position as the main generator of formal employment (45% of the total) and the largest absorber of labour in recent years. Manufacturing, which is the second largest employment generator (22.5% of the total), has recorded negative performances since 2001, although 2005 saw growth of 1.3% over 2004. This upswing is continuing in 2006 thanks to expanding external demand. The number of people employed by the maquila industry grew by 4.7% in 2005, which was similar to the 5% rate recorded in 2004. However, the number of jobs is still 10% below the peak registered in 2000. Employment in construction expanded by 6.5%, although this largely reflected the hiring of temporary workers.

Labour productivity in the manufacturing industry edged up by 2% in 2005 (compared with 7.1% in 2004), while real average wages declined (-0.1%), as did unit labour costs (-2.1%). Commerce recorded a 2.8% rise in productivity and a fall in both wages (-0.4%) and unit labour costs (-3.1%) over the same period.

(c) The external sector

The balance-of-payments current account deficit has been narrowing since 2001, due both to rising migrant remittances and to the fact that export growth has exceeded import growth. The current account deficit stood at 0.62% of GDP in 2005 (0.97% in 2004), or US\$ 4.789 billion. Unlike what occurred in 2001-2003, however, growth was strong in both exports (14%) and imports (13%) — and that trend has continued into 2006 as a result of rising external demand for automobiles and high petroleum prices. The merchandise trade deficit shrank from US\$ 8.811 billion to US\$ 7.587 billion in 2005. The goods and services trade deficit stood at US\$ 12.354 billion.

The year's most robust growth in trade occurred in the final quarter of 2005 and continued into the first quarter of 2006 (in which sales of land vehicles and fuels and minerals stood out with rates of 51% and 54%, respectively), far outstripping import growth.

High petroleum prices during 2005 (an average of US\$ 43 per barrel of Mexican mix) pushed up the value of oil sales by more than 33%. Rising world demand, tighter international supply and the geopolitical risk in the Islamic Republic of Iran and in Iraq seem to be driving this upward trend: by April 2006, the average price of Mexican mix had risen above US\$ 50 per barrel. Agricultural exports also expanded in 2005 (5.7%), since the fall in production did not affect export supply. Manufacturing exports were up by 11%, with decreases observed only in textiles and office equipment.

Worthy of note in relation to imports is the gradual growth in consumer goods purchases, which have exceeded those of capital goods since 2002. Consumer goods imports now represent 14.2% of total imports (11.7% in 2001), compared with 11.9% for capital goods (13.4% in 2001). This pattern is associated with more readily available consumer credit and with inflows of remittances. Growth in purchases of intermediate goods, which are closely linked to maquila plant imports, has risen to two-digit figures thanks to the upswing in the maquila industry.

⁶ Non-core inflation covers agricultural products (fruits and vegetables, meat and eggs); controlled goods and services; and education.

⁷ The underemployed are those who are willing and need to work more hours than their current employment permits.

The income account deficit widened slightly to stand at US\$ 12.919 billion, mainly as a result of interest payments on debt and profit remittances. The deficit on the trade and income accounts (US\$ 25.273 billion) was largely offset by the surplus on transfers. Transfers consist almost entirely of remittances from Mexicans living abroad, which accounted for US\$ 20.034 billion (20.6% more than in 2004; 2.6% of GDP; and 111% of foreign direct investment). Up to April 2006, remittances grew by 25%. If this trend continues, remittances will total US\$ 25.0 billion by the end of the year.

The financial account posted a surplus of US\$ 12.758 billion, which was the net outcome of the reduction in government debt (US\$ 10.165 billion), higher inflows of foreign direct investment (US\$ 18.055 billion gross, US\$ 13.0 billion net) and portfolio investment (US\$ 10.188 billion). Portfolio investment benefited from the interest rates prevailing in the first half of 2005 and from the country's

financial stability. In 2006, capital inflows continue to rise, partly due to the increased non-financial public sector borrowing being recorded since the last quarter of 2005.

Mexico's exports continued to lose competitiveness. Despite high economic growth in the United States, that country's demand for Mexican manufactures slackened in the face of competition from Asian countries, especially China, which has replaced Mexico as the second largest exporter to the United States after Canada. In the first few months of 2006, however, Mexican products seemed to be regaining market share from competitors such as China, Japan and Germany. In 2005, Mexico accounted for 10.2% of total United States imports (4% down on 2004), some way below Canada's 17.2% and China's 14.6%. Mexico's imports from China are also on the rise (23% more than in 2004) and represent 8% of the market, while imports from the United States edged up only slightly (7%) and their market share dropped to 53.4% (2.9 percentage points down on 2004).

Nicaragua

1. General trends

Real GDP grew by 4% in 2005, reflecting a loss of momentum of almost one percentage point with respect to 2004 and corresponding to per capita GDP of 1.9%. The open unemployment rate at the national level declined for the third consecutive year, from 6.5% to 5.6% national, while urban open unemployment stood at 7.0%. The real average wage increased significantly in the central government but remained unchanged for formal private-sector wage-earners. Official minimum wages were adjusted in May, when a nominal 16.5% increase was awarded for construction and financial sectors and 15% for other economic activities.

Although the expansion of the world economy and global trade favoured exports from the country, the surge in international prices for oil and some other industrial commodities led to a deterioration in the terms of trade, a slight rise in inflation (from 8.9% in 2004 to 9.6% in 2005), a real exchange rate appreciation against the United States dollar and a widening of the trade deficit.

Lack of parliamentary support for the projects of the Executive and mounting political tensions in the run-up to the November 2006 elections have generated a climate of uncertainty that is putting a damper on the economy. At the same time, the increase in the public budget in 2005 (beyond the figure originally agreed) and the meagre advances in the area of structural reform resulted in the suspension of the three-year programme signed with the International Monetary Fund (IMF) in December 2002; this led to a reduction in disbursements for budget and balance-of-payments support. Following negotiations during the year, however, the Fund, convinced of the government's commitment to achieving quantitative goals and conscious of its efforts to achieve a national consensus in order to fulfil the agenda of structural reforms before the year is out, decided to extend the programme to December 2006.

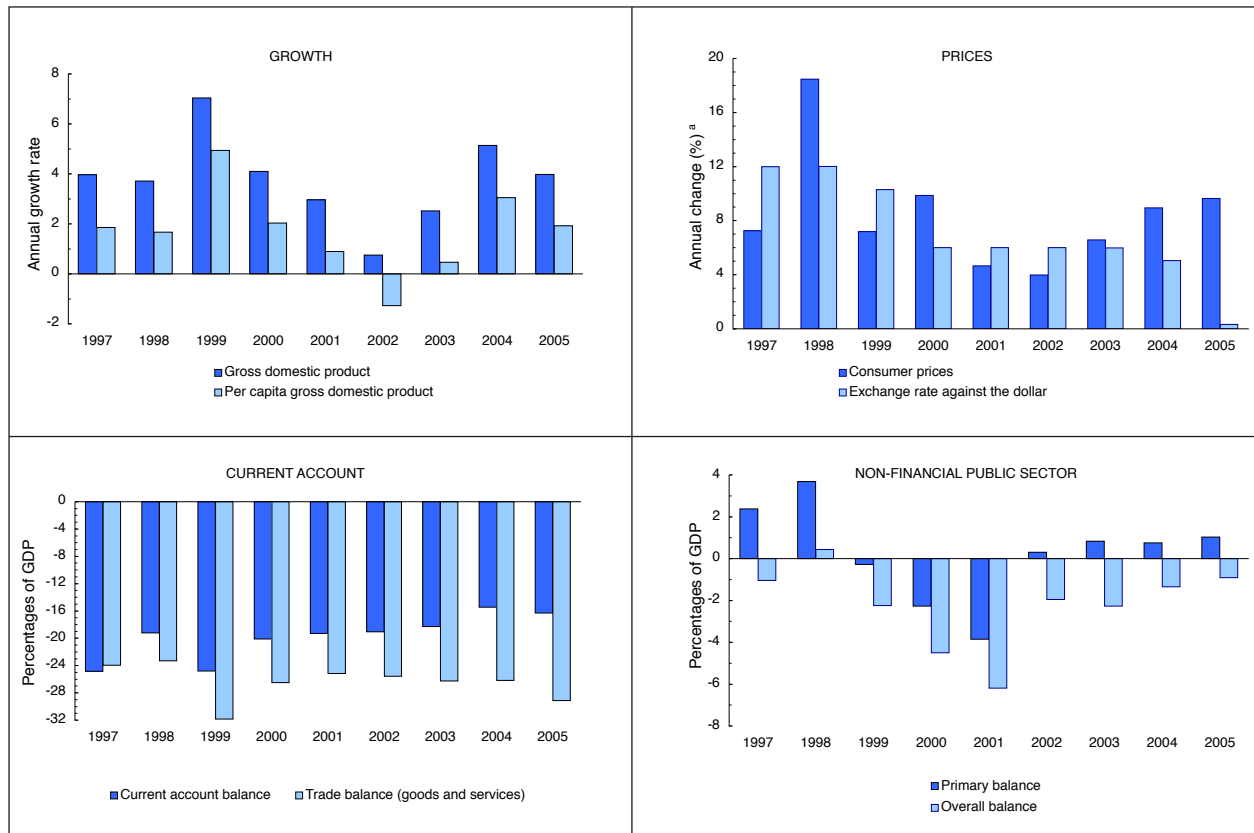
The fiscal discipline of the previous years was maintained, resulting in a reduction in the non-financial public sector deficit (before grants) from 5.8% to 4.3% of GDP, but without resorting to the cut in public spending, especially spending on the poverty reduction strategy.

Thus, public financing management also facilitated the fulfilment of the main monetary policy goals.

Notwithstanding the suspension of the IMF programme, the debt relief provided for under the heavily indebted poor countries initiative (HIPC) was not affected. At the end of December 2005, Nicaragua became eligible for external debt relief programmes that will cancel US\$ 3.761 billion of a total scheduled debt of US\$ 6,328 billion. As a result of the negotiations carried out during the year, the external debt balance was one of the lowest in the last 20 years. In addition, the Group of eight added Nicaragua to its list of countries for consideration under the debt-forgiveness plan for countries included in the HIPC initiative with IMF, the World Bank and the African Development Fund. This will imply a further external-debt reduction of approximately US\$ 800 million. In this political and economic context, Nicaragua ratified the Dominican Republic - Central America - United States Free Trade Agreement (DR-CAFTA), which entered into force in April 2006.

The trend towards a slowdown in the economy, noted in the last quarter of 2005, is expected to continue in 2006. Exports will continue to expand, but uncertainty surrounding the electoral process is expected to curb domestic demand and especially private investment. The economy is expected to grow by an estimated 3.5%. Nevertheless, a continued rise in international prices for oil and some industrial raw materials could cause economic activity to slow more than predicted, restricting GDP growth to between 3.2% and 3.4%.

Figure 1
NICARAGUA: MAIN ECONOMIC INDICATORS



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
^a December-December variation.

In terms of price trends, an increase of 7.3% is expected, but imported inflation could push up domestic inflation to between 8% and 10%. The central bank estimated that a 10% increase in the price of oil would translate into a 0.7 percentage-point increase in the inflation rate.

As regards monetary policy, one of the main objectives of the central bank is to build up international reserves. These are expected to stand at 15.2% of GDP, which will

bolster domestic stability and the exchange-rate, and improve vulnerability indicators, such as coverage of the monetary base (1.98 times) and of imports (3.2 months). Fiscal policy will be adjusted with a view to attaining this goal. The primary balance deficit of the public sector is expected to diminish, while the fiscal balance after grants should remain constant. In the external sector, the balance-of-payments current-account deficit will amount to 17% of GDP.

2. Economic policy

No significant changes are foreseen with respect to economic policy management in 2006. Monetary policy will continue to be oriented towards curbing inflation, countering the external vulnerability of the economy, and further strengthening net external assets and reducing central bank debt, provided that this does not have an adverse effect on economic activity. Despite the estimated

expenditure (1% of GDP) that the electoral process will entail, fiscal discipline is expected to be maintained. This will give the monetary authority more leeway in achieving its policy objectives.

Unlike the situation in previous elections, there is consensus among the contenders in the present electoral process on the need to preserve the existing macroeconomic

stability so that at the start of its mandate, the next administration does not have to correct huge imbalances. The extension of the IMF agreement will also have a positive effect by contributing to inflows of financial resources to shore up the budget and the balance of payments position and by facilitating access to international financial markets on concessional terms.

(a) Fiscal policy

In 2005, the results of the fiscal policy were a key factor for macroeconomic performance. The central government fiscal deficit before grants contracted, making it easier to achieve the monetary targets in terms of price and exchange-rate stability.

Current central government revenues expanded by 20.2% and the tax burden rose from 15.7% to 16.6% of GDP. However, with grants down from 4.7% of GDP to 3.3%, the share of total revenues in output (21.2%) diminished by half a percentage point.

For its part, total expenditure (including both current and capital expenditure), recorded similar levels to those of the previous year and stood at 23.1% of GDP. As a result, current savings represented 4.3% of GDP in 2005, up from 3.5% of GDP in 2004; the fiscal deficit (including grants) increased from 1.5% to 1.8% of GDP. It should be noted that the Government transferred the equivalent of 1.7% of GDP in recourses to the central bank, thereby improving its financial position.

The external public debt balance, which stood at US\$ 5.348 billion (equivalent to 109% of GDP), decreased slightly with respect to 2004. The appreciation of the dollar had a favourable effect: a more than US\$ 150 million reduction in the debt balance. The ratio of debt service to exports of goods remained constant at 10%.

(b) Monetary policy

One of the intermediate goals of the monetary programme in recent years was to build up reserves. This went hand in hand with a policy designed to reduce gradually the central bank's domestic borrowing, thus lessening its financial vulnerability and freeing up resources for the financial system; this has enabled it to increase the volume of intermediation and avoid sharp variations in interest rates. Reconciling currency stabilization with domestic debt reduction was contingent on coordination of monetary and fiscal policy. The measures adopted to reduce the deficit and increase external borrowing helped to boost reserves.

In 2005, the reserve requirement was maintained at 16.25%. Open market operations resulted in a reduction in the central bank's domestic debt, achieved through

the net redemption of private-sector securities. This was conducive to financial intermediation at lower interest rates.

The resources captured by the banking system were used to inject credit resources in the economy, which led to a 32% cumulative expansion in the loans portfolio. The credit expansion was concentrated in the private sector, since credit to the non-financial public sector declined. The structure of the loan portfolio revealed the buoyancy of household loans, loans to private businesses and finance companies. The expansion in the household loans portfolio (44%) was closely related to the increase in consumption. The fact that the financial system tends to direct its credit towards profitable and rapid recovery sectors is one of the factors that accounts for the strong expansion in consumer loans. This is reflected in the relationship between growth in aggregate consumption and the leverage of the financial system.

(c) Exchange-rate policy

In 2005, the government maintained its exchange rate policy of daily mini-devaluations consistent with a preannounced annual crawling-peg devaluation rate. Initially, the central bank policy was to reduce the crawling-peg rate, since inflation is closely related to the annual devaluation rate, which would help to moderate inflationary pressures. However, given the climate of political and economic uncertainty, as well as the high inflationary pressures, it decided to leave the crawling-peg rate at 5% per year, which led to a real exchange-rate appreciation.

(d) Other policies

As part of the complementary agenda associated with the entry into force of the DR-CAFTA agreement, progress was made in readjusting the legal framework of the country, principally on issues linked to market competition, the environment, the labour market, microfinance, free zones, mediation and trade arbitration. In general terms, this is expected to have a positive impact on the domestic economy. It will be recalled that in terms of tariffs, the agreement provides for preferential treatment for Nicaragua, guaranteeing most of its exports immediate access to the other markets and offering more vulnerable national products gradual, long-term liberalization.

Other negotiations in 2005 led to access to the European Union's new Generalized System of Preferences, which entered into force on 1 January 2006. Most of the exports under this system (excepting meat and dairy products) will enjoy favourable tariffs.

Table 1
NICARAGUA: MAIN ECONOMIC INDICATORS

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a
	Annual growth rates^b								
Gross domestic product	4.0	3.7	7.0	4.1	3.0	0.8	2.5	5.1	4.0
Per capita gross domestic product	1.9	1.7	4.9	2.0	0.9	-1.3	0.5	3.0	1.9
Gross domestic product, by sector									
Agriculture, livestock, hunting, forestry and fishing	-0.6	-0.4	6.0	12.1	2.7	-0.3	1.9	4.7	3.1
Mining	16.1	36.2	18.4	-15.5	13.6	5.6	-10.6	19.7	-5.7
Manufacturing	7.6	-0.3	7.0	4.3	5.9	2.1	2.4	8.6	4.8
Electricity, gas and water	4.9	11.0	0.1	8.9	8.3	1.4	5.1	5.0	3.4
Construction	-8.6	-1.4	36.4	-1.0	2.1	-13.3	2.7	10.7	6.0
Wholesale and retail commerce, restaurants and hotels	5.6	7.2	9.4	1.7	1.6	3.3	1.4	5.1	4.9
Transport, storage and communications	3.9	6.5	8.3	0.9	3.7	2.7	9.7	3.0	3.4
Financial institutions, insurance, real estate and business services	6.3	8.4	7.6	5.1	3.9	2.3	6.8	8.2	4.0
Community, social and personal services	3.8	2.6	4.5	2.3	5.1	2.0	2.4	2.6	2.7
Gross domestic product, by type of expenditure									
Consumption	3.7	4.7	6.1	5.2	4.1	3.6	2.1	3.7	3.2
General government	-4.1	4.4	8.2	4.8	-2.9	-4.6	5.6	4.9	0.5
Private	4.6	4.7	5.9	5.3	4.9	4.5	1.8	3.6	3.5
Gross domestic investment	23.6	4.3	27.1	-16.8	-8.4	-7.1	-1.0	4.2	10.1
Exports (goods and services)	14.4	5.8	12.4	12.5	7.3	-3.5	9.2	16.1	5.3
Imports (goods and services)	22.1	7.2	21.1	-4.7	0.7	-0.1	3.5	8.2	6.2
	Percentages of GDP								
Investment and saving^c									
Gross domestic investment	31.2	31.0	38.4	31.0	28.2	26.1	25.9	27.1	29.4
National saving	6.3	11.8	13.5	10.9	8.9	7.0	7.6	11.6	13.1
External saving	24.8	19.2	24.8	20.1	19.3	19.1	18.3	15.5	16.3
	Millions of dollars								
Balance of payments									
Current account balance	-841	-687	-928	-792	-796	-767	-749	-696	-800
Merchandise trade balance	-728	-749	-1 071	-921	-910	-918	-972	-1 075	-1 314
Exports, f.o.b.	745	761	749	881	895	917	1 050	1 365	1 552
Imports, f.o.b.	1 473	1 510	1 820	1 802	1 804	1 834	2 021	2 440	2 865
Services trade balance	-83	-84	-120	-122	-129	-112	-106	-101	-117
Income balance	-265	-185	-197	-202	-240	-200	-191	-192	-119
Net current transfers	235	331	460	453	483	462	519	673	750
Capital and financial balance ^d	548	285	533	336	304	366	280	617	766
Net foreign direct investment	203	218	337	267	150	204	201	250	230
Financial capital ^e	344	66	196	69	154	162	78	432	536
Overall balance	-293	-402	-395	-456	-492	-401	-470	-78	-34
Variation in reserve assets ^f	-173	30	-157	17	114	-85	-69	-169	-46
Other financing ^g	466	372	552	439	379	486	538	247	80
Other external-sector indicators									
Real effective exchange rate (index: 2000=100) ^h	101.2	101.3	101.9	100.0	101.1	103.1	106.8	108.9	108.3
Terms of trade for goods (index: 2000=100)	82.0	79.6	95.3	100.0	88.4	87.0	84.1	82.5	81.4
Net resource transfer (percentage of GDP)	22.1	13.2	23.7	14.6	10.7	16.2	15.3	15.0	14.8
Gross external public debt (millions of dollars)	6 001	6 287	6 549	6 660	6 374	6 363	6 596	5 391	5 348
Gross external public debt (percentage of GDP)	177.4	176.0	175.0	169.1	154.5	158.0	160.8	119.9	108.9
Net profits and interest (percentage of exports) ⁱ	-29.4	-19.6	-20.4	-18.3	-21.5	-17.5	-14.6	-11.7	-6.4
	Average annual rates								
Employment									
Labour force participation rate ^j	...	...	...	...	...	57.5	53.7	53.1	53.8
Open unemployment rate ^k	14.3	13.2	10.7	7.8	11.3	11.6	10.2	9.3	7.0
	Annual percentages								
Prices									
Variation in consumer prices (December-December)	7.3	18.5	7.2	9.9	4.7	4.0	6.6	8.9	9.6
Variation in nominal exchange rate (December-December)	12.0	12.0	10.3	6.0	6.0	6.0	6.0	5.0	0.3
Variation in average real wage	3.7	4.0	4.0	0.0	1.0	3.5	1.9	-2.2	0.2
Nominal deposit rate ^l	...	...	11.8	10.8	11.6	7.8	5.6	4.7	4.0
Nominal lending rate ^m	...	...	17.6	18.1	18.6	18.3	15.5	13.5	12.1

Table 1 (concluded)

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a
	Percentages of GDP								
Non-financial public sector									
Total income ⁿ	23.4	24.3	25.9	24.0	22.4	24.3	26.6	28.7	29.4
Current income	20.1	22.1	20.6	19.4	18.6	...	...	...	...
Tax revenue	16.3	17.9	17.9	18.1	17.3	14.2	15.9	16.5	17.4
Capital income	0.1	0.1	0.2	0.1	...	...	...	...	...
Total expenditure	24.5	23.9	28.1	28.5	28.6	26.3	28.9	30.1	30.3
Current expenditure	15.6	16.3	15.5	16.7	18.3	...	...	...	...
Interest	3.4	3.2	2.0	2.2	2.3	2.2	3.1	2.1	1.9
Capital expenditure	8.8	7.6	12.7	11.8	10.3	...	...	...	...
Primary balance	2.4	3.7	-0.3	-2.3	-3.8	0.3	0.8	0.8	1.0
Overall balance	-1.0	0.4	-2.2	-4.5	-6.2	-1.9	-2.3	-1.3	-0.9
Debt of non-financial public sector	122.4	125.4	120.2	114.7	111.3	134.1	138.0	100.0	91.8
Domestic	...	...	...	...	...	21.5	22.5	21.3	20.9
External	122.4	125.4	120.2	114.7	111.3	112.6	115.5	78.7	70.9
Money and credit^o									
Domestic credit ^p	...	...	...	...	78.0	77.2	77.3	68.7	64.2
To the public sector	...	...	...	...	74.7	72.4	67.1	56.2	47.5
To the private sector	...	...	...	...	17.7	17.8	20.2	21.7	24.8
Other	...	...	...	...	-14.4	-13.0	-9.9	-9.2	-8.2
Liquidity (M3)	28.6	33.5	35.8	36.2	35.7	38.0	38.8	38.7	38.9
Currency in circulation and local-currency deposits (M2)	11.1	12.3	13.0	12.9	12.0	12.0	11.5	12.3	12.6
Foreign-currency deposits	17.4	21.2	22.9	23.3	23.6	26.0	27.3	26.4	26.3

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a Preliminary figures. ^b Based on figures in local currency at constant 1994 prices. ^c Based on figures in local currency expressed in dollars at current prices. ^d Includes errors and omissions. ^e Refers to the capital and financial balance (including errors and omissions), minus net foreign direct investment. ^f A minus sign (-) denotes an increase in reserves. ^g Includes the use of IMF credit and loans and exceptional financing. ^h Annual average, weighted by the value of merchandise exports and imports. ⁱ Refers to net investment income as a percentage of exports of goods and services as shown on the balance of payments. ^j Economically active population as a percentage of the working-age population; nationwide total. ^k Unemployment rate as a percentage of the economically active population, urban total. Up to 1999 the figures refer to the nationwide total. ^l Weighted average rate on 30-day deposits. ^m Weighted average rate on short-term loans. ⁿ Includes grants. ^o The monetary figures are end-of-period balances. ^p Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions.

As regards structural reforms, mention should be made of a set of political commitments adopted in 2005 for accelerated approval in October and November of a series of bills which will lead to the conclusion of a new

agreement with IMF. These include the approval of the Tax Code, the adoption of the government budget for 2006 and reforms for strengthening the regulatory framework of bank supervision and risk management.

3. The main variables

(a) Economic activity

In 2005, real production growth moderated from 5.1% to 4%. The increase in GDP was triggered both by the expansion in exports (5.3%) and by growth of domestic demand (4.5%). If restocking is not included, however, the rise in domestic demand is much smaller (3.8%) owing to the contraction in real terms of public investment (-5.6%) and the weak growth in public consumption. Conversely, private investment picked up (10.8%), boosted by expenditure on construction

and investment in machinery and equipment. Private spending on consumption grew at a similar rate to that recorded in 2004.

The economic expansion is attributable to various factors: growth in the world economy and in particular in the United States and the countries that make up the Central American Common Market (CACM) fuelled external demand for the country's goods and services; stronger external demand stimulated production in the export sectors, especially of agricultural goods (sugar, sesame, seafood, meat and beef on the hoof) and industrial

Table 2
NICARAGUA: MAIN QUARTERLY INDICATORS

	2004				2005 ^a				2006 ^a	
	I	II	III	IV	I	II	III	IV	I	II
Merchandise exports, f.o.b. (millions of dollars)	187	197	188	184	221	216	212	209	248	...
Merchandise imports, c.i.f. (millions of dollars)	506	551	531	624	615	670	642	668	690	...
International reserves (millions of dollars)	571	613	601	668	640	619	629	728	787	817 ^b
Real effective exchange rate (index: 2000=100) ^c	108.6	107.8	108.9	110.4	111.9	108.3	106.6	106.7	108.6	107.0
Consumer prices (12-month percentage variation)	7.3	7.7	9.0	8.9	8.4	9.7	10.8	9.6	10.9	10.8
Average nominal exchange rate (córdobas per dollar)	15.65	15.84	16.03	16.23	16.22	16.32	16.37	16.52	17.08	17.16
Average real wage (variation from same quarter of preceding year)	-1.6	-1.5	-2.3	-3.0	-1.1	-0.1	0.3	1.6	3.4	...
Nominal interest rates (annualized percentages)										
Deposit rate ^d	4.8	4.9	4.8	4.4	3.9	3.9	4.0	4.3	4.6	4.8 ^b
Lending rate ^e	14.6	12.9	13.4	13.1	13.0	12.9	11.7	10.8	12.6	8.3 ^b
Interbank interest rate	39.2	35.9	37.0	38.4	40.3	39.6	39.8	41.7	43.5	39.5 ^b
Domestic credit (variation from same quarter of preceding year) ^f	4.1	0.3	1.3	1.6	5.0	11.6	7.8	8.0	2.5	2.6 ^g
Non-performing loans as a percentage of total credit ^h	2.6	2.5	2.5	2.1	2.3	2.2	2.3	2.0	2.0	2.4 ^b

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a Preliminary figures. ^b Data to May. ^c Quarterly average, weighted by the value of merchandise exports and imports. ^d Weighted average rate on 30-day deposits. ^e Weighted average rate on short-term loans. ^f Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions. ^g Data to April. ^h Refers to total credit extended by the banking system.

products (food and beverages, textiles and clothing, footwear, wood products and chemicals). A strong performance by the tourism sector also contributed to these positive results.

In the merchandise production sectors as a whole (which account for more than 40% of total GDP), the manufacturing industry and construction grew at a higher rate than the average for the economy, and agricultural production showed lower growth (3.1%). This growth is due essentially to the increase in the production of basic grains, the significant increase in exports of beef on the hoof to Mexico and other Central America countries and the recovery in shrimp and fish production. The expansion of the manufacturing industry is attributable to the production of textiles and clothing, foodstuffs, beverages and rum, tobacco, wood products, non-metallic products and chemicals. Construction was buoyed up by private investments in commercial, industrial and residential sectors.

Services also contributed to the expansion of the economy. The most dynamic sectors were commerce, financial services, transport and telecommunications. Performance in the construction, commerce and financial services sectors was determined to a large extent by higher wages in the public sector, the credit boom

recorded in the economy and the substantial growth in family remittances.

(b) Prices, wages and employment

Inflation stood at 9.6%, above the rate planned at the beginning of the year. The international price for oil was one of the strongest factors of inflation, with a direct impact on fuel prices (27.1%), electricity (13.0%) and transport (13.4%), (in other words the essential inputs of the production system), and repercussions on the prices of other goods and services. Thus, the main determinants of the slight rise in inflation in 2005 were primary inputs and a limited set of related products in the production chain. The surge in inflation is therefore attributable to the strong external shock which occurred in a context of domestic vulnerabilities, including wage pressures in the public sector, disruptions in the agricultural sector and excess liquidity in the economic system.

According to the results of the household survey for measuring employment, job creation outpaced economic activity. New jobs showed a 5.5% increase over November 2004. The main employment-generating sectors were the manufacturing industry, community and social services and commerce. In addition, the process of labour market

formalization intensified and was reflected in the higher membership in the Nicaraguan Social Security Institute. Open unemployment fell for the third consecutive year in November 2005 to stand at 5.6%. In 2005, the real average wage increased by 5.3%, mainly as a result of adjustments in wages paid to central-government employees (9.3%), since the real average wage of formal private-sector wage-earners showed no increase. Official minimum wages were adjusted in May, when a nominal 16.5% increase was approved for construction workers and financial employees and a 15% increase for those engaged in other economic activities.

(c) The external sector

The expansion of economic activity was accompanied by a sharper imbalance in the external sector. The current-account deficit (US\$ 800 million) widened from 15.5% of GDP in 2004 to 16.2% in 2005. This was due to the significant increase in the deficit on the merchandise trade balance (27.4% of GDP) since the income account deficit contracted sharply, reflecting the reduction in interest paid and the substantial increase in current transfers (11.5%), especially family remittances, the equivalent of 12.5%

of GDP and 75% of the current account deficit. The reduction in the official capital flows was compensated by private capital inflows. The higher net capital inflows were sufficient to finance the external imbalance, which led to a slight increase in the very limited net international reserves.

In 2005, foreign direct investment diminished slightly, from US\$ 250 million to US\$ 230 million. The services sector received the strongest inflows (83.7%), the principal beneficiaries being commerce, communications, the energy sector and the sugar industry.

Exports (including those from the free zones) expanded by 13.9%, while imports were up by 18.4%. The recovery in sales of traditional products and the expansion in non-traditional sales both contributed to growth in exports. Other factors include the buoyancy of exports from the free zones, especially those from the textile maquila, and the income generated by the tourist industry.

All the other import categories, except consumer goods, showed substantial increases. In particular, raw materials and intermediate goods were up, owing mainly to the higher import bill for oil and oil products (33.8%) and to purchases of capital goods required by the expansion of investment.

Panama

1. General trends

Panama's economy continued to register a high level of growth (6.4%) thanks to favourable external conditions and buoyant domestic demand. The unemployment rate came down to 9.6% and the fiscal deficit narrowed to 2.5% of GDP. The balance-of-payments current account deficit also shrank to the equivalent of 5.3% of GDP, while inflation exceeded usual levels with an increase of 3.4%.

International service sectors such as the Colón Free Zone, the international banking centre, the Panama Canal, ports and tourism — as well as exports of national products — all benefited from the expansionary phase of the world economy and from the buoyancy of raw materials exports from South American countries. In these circumstances, rising international interest rates and high oil prices had a limited impact.

The government's agenda for 2005 included four main projects: fiscal reform, social security reform, the conclusion of free-trade negotiations with the United States and a referendum on the widening of the Panama Canal. Only the first two were achieved, and not without difficulty, since more than a month of strikes and protests followed the social security reform proposal. The government plans

to push ahead with the other two projects during 2006. Given its potential impact on the future of Panama's economy, the most important event in 2006 will be the referendum on the widening of the Panama Canal, due to be held at the end of the year.

In 2006, the rate of growth is expected to remain high, at around 6%, thanks to the continuation of trends observed in 2005. A number of new developments, including the construction of luxury apartment buildings in Panama City and the upgrading of sanitation in the Bay of Panama, could offset a slight slowdown in the growth of the international service sectors. The consolidation of the fiscal position is expected to continue and inflation will remain above usual levels but slightly lower than in 2005.

2. Economic policy

In 2005, government efforts were aimed at carrying forward fiscal rehabilitation, increasing transparency, continuing free trade negotiations and restructuring the public debt.

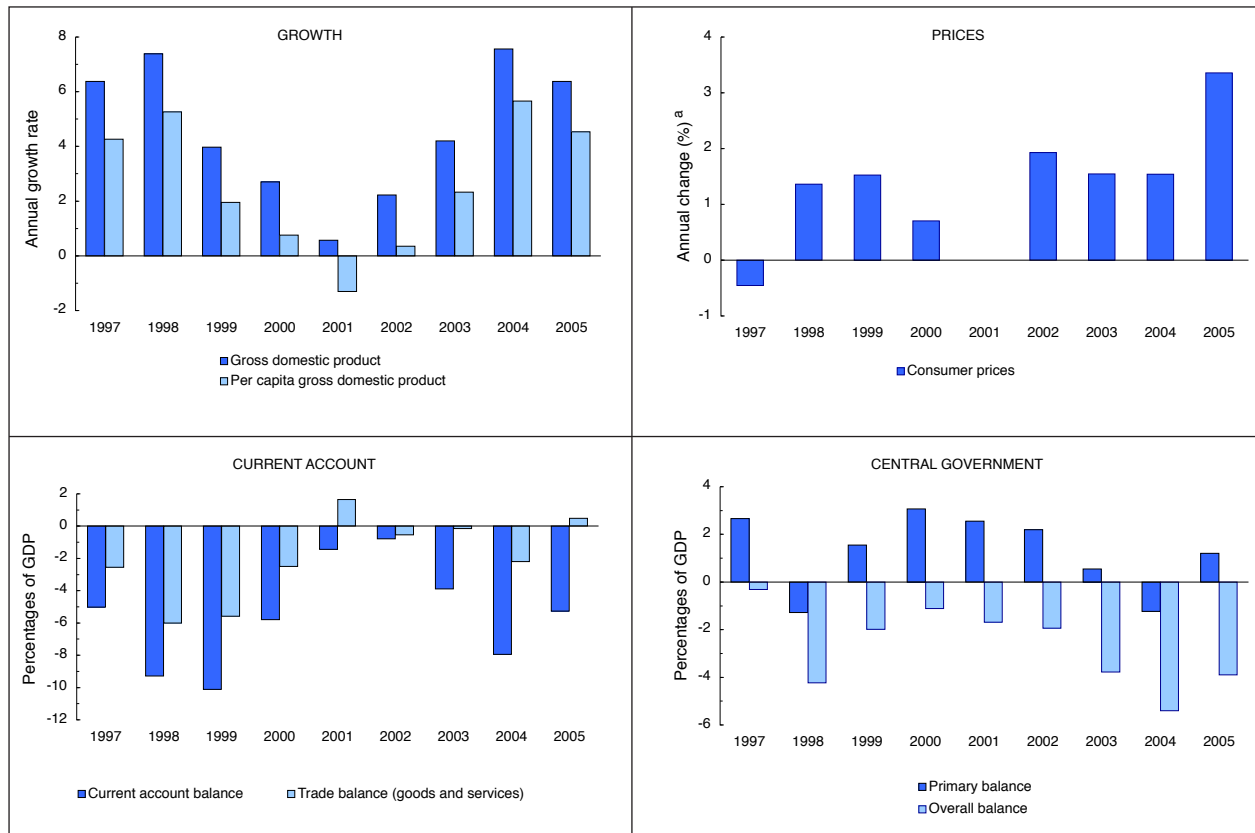
(a) Fiscal policy

At the end of 2004, the government adopted more orthodox methods to compile the fiscal accounts, giving a deficit of 4.9% of GDP for that year. In 2005, the deficit of the non-financial public sector (NFPS) narrowed to

2.5%. This reflected a 12.5% increase in revenues in real terms which, in turn, was partly attributable to buoyant production activity and the fiscal reforms. The surplus on the accounts of public enterprises swelled by about 60%. At the same time, expenditure held steady thanks to an explicit policy of spending restraint, while capital expenditure decreased by 10% in real terms. Having been negative by US\$ 217 million in 2004, current saving turned positive (US\$ 33.3 million) in 2005.

The central government deficit narrowed from 5.4% of GDP to 3.9%. Revenues were up by 11.7%, whereas

Figure 1
PANAMA: MAIN ECONOMIC INDICATORS



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
^a December-December variation.

expenditure expanded by only 2% in real terms. Tax revenues swelled by 7.8%, mainly owing to increased income-tax receipts (16%), while non-tax revenues rose by 18.6%.

In February 2005, the authorities adopted the Fiscal Equity Act, which provides for spending cuts (especially in the State payroll) and a restructuring of the tax system, including the elimination of many preferential regimes and tax exemptions (the latter are estimated to have represented US\$ 53.9 million in 2005). Another piece of legislation approved was the Social Security Fund Act, which combines the increased contribution parameters with the introduction of a system of individual accounts. This measure is intended to reverse the widening of the actuarial deficit, given that the operating deficit of the Social Security Fund weighed in at US\$ 369.7 million in 2005 (US\$ 1.4 million more than in 2004).

Another important initiative was the launch of the “Panamacompra” programme to facilitate government procurement and reduce corruption through increased transparency. The US\$ 369 million in accounts payable from the end of 2004 was whittled down to US\$ 164 million a year later. For 2006, US\$ 800 million is budgeted for investment, which is twice as much as in previous years.

The government continued to take an active approach to public debt management, taking advantage of low international interest rates. Between November 2005 and January 2006, the external debt was restructured to replace high-interest medium-term bonds with lower-interest long-term instruments. The debt swap involved US\$ 2.34 billion and extended extends the average maturity from 12 to 16 years, reducing the need for refinancing in the next few years. The measures pave the way for a future improvement in the risk rating of Panama’s debt, with a

view to achieving investment grade in the medium term. This would also help with the widening of the Panama Canal, as almost half of the financing will need to come from external sources.

The cost of restructuring, combined with increased liabilities to bilateral and multilateral lenders, was reflected in the US\$ 360 million increase in external public debt. As a proportion of GDP, however, this debt decreased from 50.8% to 48.8%, thanks to strong economic growth. Domestic debt fell from 19.4% of GDP to 17.2%, as the smaller fiscal deficit implied a lower borrowing requirement.

(b) The international banking centre and credit policy

In 2005, the international banking centre turned in a good performance on the back of economic growth in Panama and region-wide, especially in South America. Banks took advantage of the high growth rates being posted by countries exporting raw materials (particularly petroleum) to step up their operations. At the national level, banks reaped the benefits of trends in private consumption and property investment.

The assets of the international banking centre rose 11.7% to US\$ 38.652 billion. Profits stood at US\$ 792 million, liquidity remained high and the ratio of capital to risk-weighted assets was 17.2%. Portfolio quality indicators also remain very favourable: reserves cover 131% of the non-performing portfolio, which represents only 1.6% of the total.

The loan portfolio increased significantly (14.8%), driven by the surge in international credit (21.6%). The expansion of net domestic credit was smaller (13.2%) but nonetheless significant. The buoyant economic conditions were reflected in an expansion in mortgage, consumer and business loans (19.5%, 14.3% and 9.0%, respectively). Contrasting with the upward trend in international interest rates, Panama's nominal interest rates remained stable, partly because they had not fallen as steeply as rates in the rest of the world had done and partly because of abundant liquidity in the international markets. Real interest rates dipped slightly as a result of higher inflation.

Consolidation of the bank regulation and supervision framework continued and received the endorsement of the International Monetary Fund (IMF). The sector now

complies with 90% of the principles of the Basel Capital Accord (Basel I) and has taken measures to combat money laundering and the financing of terrorism. In 2006, efforts will focus on the New Basel Capital Accord (Basel II) and on strengthening regional cooperation. This is vital, given the strong expansion of regional banking groups. Also in 2005, the granting of seven new banking permits attests to international interest in the activities of the international banking centre.

The positive trends carried over into the first quarter of 2006: profits were up by 32%, assets by 14% and domestic private-sector credit by 13.7%. However, interest rates are beginning to climb in the wake of international rates.

(c) Trade policy

The policy of liberalizing trade through free-trade agreements continued in 2005 and received even greater impetus in 2006. Negotiations with the United States continued in 2005 but were not concluded on account of a number of divergences, mainly on agricultural issues. The free-trade agreement with Singapore, on the other hand, was concluded and ratified and came into effect. As a result, previously scarce Singaporean investment in Panama soared in excess of US\$ 100 million. After stalling at the end of 1990s, negotiations with Chile were reopened and rapidly concluded, and the agreement could enter into force in 2006.

In 2006, Panama defined its position in relation to negotiations with the European Union. Since in this instance the European Union negotiates only with regional blocs, not individual countries, Panama had to choose either the Andean Community or the Central American Common Market (CACM) as a regional integration partner, and opted ultimately for the latter. In May it was decided to initiate negotiations between the European Union, the Central American countries and Panama, with a view to forging a cooperation accord that would include a free trade agreement. Such an agreement presupposes stronger integration on the Central American isthmus; accordingly, Panama reopened free trade negotiations, which had stalled four years earlier, with the countries with which it does not yet have a free trade agreement (Costa Rica, Guatemala, Honduras and Nicaragua). The aim is to conclude the negotiations in the course of 2006.

Table 1
PANAMA: MAIN ECONOMIC INDICATORS

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a
	Annual growth rates^b								
Gross domestic product	6.4	7.4	4.0	2.7	0.6	2.2	4.2	7.6	6.4
Per capita gross domestic product	4.3	5.3	2.0	0.8	-1.3	0.4	2.3	5.7	4.5
Gross domestic product, by sector									
Agriculture, livestock, hunting, forestry and fishing	3.3	6.6	1.8	9.6	6.5	3.3	9.3	1.6	2.9
Mining	80.8	26.1	23.9	-10.6	-4.1	18.1	35.4	12.7	0.4
Manufacturing	3.3	2.2	1.1	-7.2	-6.3	-2.6	-3.4	3.5	1.8
Electricity, gas and water	6.2	-2.5	12.0	9.3	-4.7	6.9	1.4	6.3	2.8
Construction	6.7	11.9	36.0	1.3	-21.8	-7.1	32.5	13.9	1.0
Wholesale and retail commerce, restaurants and hotels	12.1	6.8	-3.9	3.8	3.7	-0.9	2.4	11.1	9.3
Transport, storage and communications	10.0	14.6	6.7	12.5	2.5	2.0	10.9	14.1	10.9
Financial institutions, insurance, real estate and business services	5.2	7.8	5.8	5.9	-0.5	-0.2	0.5	3.7	7.9
Community, social and personal services	3.1	4.2	3.7	-0.4	3.9	4.5	1.8	3.5	1.4
Gross domestic product, by type of expenditure									
Consumption	6.8	16.1	0.6	0.2	3.9	7.3	7.3	9.4	5.5
General government	-0.6	4.7	1.5	1.8	8.1	9.1	0.4	1.9	1.0
Private	8.5	18.5	0.4	-0.1	3.1	6.9	8.7	10.8	6.3
Gross domestic investment	4.2	10.9	3.5	-9.2	-24.2	-5.4	19.0	11.4	3.6
Exports (goods and services)	7.4	-0.9	-12.4	18.5	0.3	-2.5	-10.1	11.1	14.4
Imports (goods and services)	7.0	7.8	-14.7	10.3	-4.3	0.7	-3.5	14.5	8.1
	Percentages of GDP								
Investment and saving^c									
Gross domestic investment	25.7	27.2	25.8	24.1	17.6	15.7	19.0	19.3	20.8
National saving	20.7	17.9	15.7	18.4	16.2	15.0	15.1	11.4	15.5
External saving	5.0	9.3	10.1	5.8	1.4	0.8	3.9	7.9	5.3
	Millions of dollars								
Balance of payments									
Current account balance	-507	-1 016	-1 159	-673	-170	-96	-503	-1 127	-818
Merchandise trade balance	-685	-1 296	-1 340	-1 143	-696	-1 035	-1 202	-1 588	-1 358
Exports, f.o.b.	6 670	6 332	5 288	5 839	5 992	5 315	5 072	6 133	7 188
Imports, f.o.b.	7 355	7 627	6 628	6 981	6 689	6 350	6 274	7 722	8 546
Services trade balance	428	638	701	854	890	968	1 195	1 275	1 433
Income balance	-400	-517	-691	-560	-590	-272	-742	-1 042	-1 136
Net current transfers	151	159	171	177	226	244	246	228	243
Capital and financial balance ^d	850	911	1 350	595	803	242	236	732	1 493
Net foreign direct investment	1 299	1 203	864	624	467	99	771	1 012	1 027
Financial capital ^e	-449	-292	485	-29	336	143	-535	-280	466
Overall balance	343	-105	191	-77	633	146	-267	-395	675
Variation in reserve assets ^f	-611	20	-185	109	-622	-138	267	396	-521
Other financing ^g	268	85	-7	-32	-11	-8	1	-1	-154
Other external-sector indicators									
Real effective exchange rate (index: 2000=100) ^h	102.5	100.1	100.7	100.0	103.0	100.8	101.8	107.0	109.6
Terms of trade for goods (index: 2000=100)	103.9	104.7	104.6	100.0	102.7	101.6	97.2	95.3	93.5
Net resource transfer (percentage of GDP)	7.1	4.4	5.7	0.0	1.7	-0.3	-3.9	-2.2	1.3
Gross external public debt (millions of dollars)	5 051	5 349	5 568	5 604	6 263	6 349	6 504	7 219	7 580
Gross external public debt (percentage of GDP)	50.1	48.9	48.6	48.2	53.0	51.7	50.3	50.8	48.8
Net profits and interest (percentage of exports) ⁱ	-4.8	-6.3	-9.7	-7.2	-7.4	-3.6	-9.8	-11.8	-11.0
	Average annual rates								
Employment									
Labour force participation rate ^j	61.5	62.2	61.2	59.9	60.5	62.6	62.8	63.3	63.6
Unemployment rate ^k	13.4	13.6	11.8	13.5	14.0	13.5	13.1	11.8	9.6
	Annual percentages								
Prices									
Variation in consumer prices (December-December)	-0.5	1.4	1.5	0.7	0.0	1.9	1.5	1.5	3.4
Variation in real minimum wage	-1.3	2.7	3.4	3.8	7.0	-1.2	0.7	0.9	-3.0
Nominal deposit rate ^l	...	6.8	6.9	7.1	6.8	5.0	4.0	2.2	2.7
Nominal lending rate ^m	...	9.9	10.1	10.3	10.6	9.2	8.9	8.2	8.2

Table 1 (concluded)

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a
	Percentages of GDP								
Central government									
Total income ⁿ	16.6	16.2	17.0	18.2	17.7	16.8	15.4	14.4	15.1
Current income	15.8	15.6	16.9	18.1	17.2	16.1	15.2	14.2	15.0
Tax revenue	10.3	10.1	10.6	9.6	8.8	8.6	8.7	8.5	8.6
Capital income	0.0	0.0	0.0	0.0	0.5	0.7	0.3	0.1	0.0
Total expenditure	16.9	20.4	19.0	19.3	19.4	18.8	19.2	19.8	19.0
Current expenditure	14.7	16.4	15.6	16.9	16.7	16.1	16.1	16.6	16.5
Interest	3.0	2.9	3.5	4.2	4.2	4.1	4.3	4.2	5.1
Capital expenditure	2.2	3.9	3.4	2.4	2.7	2.7	3.1	3.2	2.5
Primary balance	2.7	-1.3	1.6	3.1	2.6	2.2	0.5	-1.2	1.2
Overall balance	-0.3	-4.2	-2.0	-1.1	-1.7	-1.9	-3.8	-5.4	-3.9
Central government debt	63.4	62.0	66.0	65.5	70.1	69.0	66.6	70.0	66.6
Domestic	17.2	15.9	18.4	18.0	17.7	17.7	16.7	19.4	17.2
External	46.2	46.1	47.6	47.5	52.4	51.3	49.9	50.5	49.4
Money and credit									
Domestic credit ^o	63.4	70.1	82.0	92.5	95.6	92.5	87.1	84.5	83.0
To the public sector	-6.8	-7.6	-7.7	-7.3	-9.7	-7.4	-4.8	-1.5	-2.6
To the private sector	70.2	77.7	89.7	99.8	105.3	99.9	91.9	86.1	85.6
Liquidity (M3) ^p	58.1	61.0	65.8	70.2	75.3	76.3	73.3	72.1	69.5

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a Preliminary figures. ^b Based on figures in local currency at constant 1996 prices. ^c Based on figures in local currency expressed in dollars at current prices. ^d Includes errors and omissions. ^e Refers to the capital and financial balance (including errors and omissions), minus net foreign direct investment. ^f A minus sign (-) denotes an increase in reserves. ^g Includes the use of IMF credit and loans and exceptional financing. ^h Annual average, weighted by the value of merchandise exports and imports. ⁱ Refers to net investment income as a percentage of exports of goods and services as shown on the balance of payments. ^j Economically active population as a percentage of the working-age population; nationwide total. ^k Unemployment rate as a percentage of the economically active population, nationwide total. Includes hidden unemployment. ^l Six-month deposits in the local banking system. ^m One- to five-year loans for commercial activities in the local banking system. ⁿ Includes grants. ^o Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions. ^p End-of-period figures.

3. The main variables

(a) Economic activity

Although the 6.4% growth rate was below the 7.6% recorded in 2004, it nevertheless represented a continuation of the expansionary phase of the business cycle, which could last for at least another five years, thanks to the project to widen the Panama Canal, which will require US\$ 5.25 billion in investment. In addition, plans have been announced to build two oil refineries in the next few years, which would involve several billion dollars in investment. Lastly, over US\$ 3.0 billion is to be invested in various tourism and real estate projects and the construction of a mega-port on the Pacific coast.

In 2005, growth was driven by external demand (up 14%), while domestic demand was less buoyant (6%). Gross domestic investment expanded by around 6%, mainly on the back of private investment, while the public component stood still. A similar pattern occurred

in consumption, with the private component up by 6.3% and the public component by only 1%. This pattern is now in its second year and is the result of efforts to rehabilitate public finances. In the first quarter of 2006, GDP grew by 7.9%.

Agriculture recorded an expansion of 2.9%, mainly thanks to buoyant non-traditional exports (melon, watermelon, pineapple and cattle on the hoof). Traditional export products, on the other hand, returned negative figures or stood still. Results were good in the production of beef and pork livestock, vegetables and cereals for the domestic market, while growth in the fishing sector remained low (2.6%).

Mining and construction both posted a meagre expansion (0.4% and 1%, respectively). The lacklustre performance of construction was the result of a strike over the social security reform, which paralysed the sector for an entire month. The manufacturing industry

Table 2
PANAMA: MAIN QUARTERLY INDICATORS

	2004				2005 ^a				2006 ^a	
	I	II	III	IV	I	II	III	IV	I	II
Gross domestic product (variation from same quarter of preceding year) ^b	5.6	10.6	9.1	5.1	7.5	6.2	6.8	5.1	7.9	...
International reserves (millions of dollars)	974	792	469	631	1 039	1 139	894	1 211	1 193	1 235 ^c
Real effective exchange rate (index: 2000=100) ^d	105.9	106.2	106.7	109.2	109.8	109.7	109.7	109.1	110.3	110.7
Consumer prices (12-month percentage variation)	1.0	1.9	1.7	1.5	3.0	2.4	3.5	3.4	2.0	3.0
Average nominal exchange rate	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Nominal interest rates (annualized percentages)										
Deposit rate ^e	2.3	2.2	2.2	2.2	2.6	2.7	2.8	2.7	3.1	3.5
Lending rate ^f	8.4	8.0	8.0	8.5	8.5	8.3	8.1	8.0	8.2	8.1
Interbank interest rate ^g	1.6	1.7	2.1	2.2	2.7	3.0	3.3	3.5	3.9	...
Domestic credit (variation from same quarter of preceding year) ^h	4.4	8.5	8.8	9.9	5.8	6.5	8.4	9.4	14.8	14.0 ⁱ
Non-performing loans as a percentage of total credit ^j	2.6	1.9	1.9	1.7	2.0	1.9	1.9	1.7	1.6	...

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a Preliminary figures. ^b Based on figures in local currency at constant 1996 prices. ^c Data to May. ^d Quarterly average, weighted by the value of merchandise exports and imports. ^e Six-month deposits in the local banking system. ^f Préstamos para actividades comerciales, a un año de plazo de la banca panameña. ^g 30-day rate. ^h Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions. ⁱ Data to April. ^j Refers to total credit extended by the multibanking system.

has been restructuring for over ten years to adapt from a high protection environment to a more open one, and this was reflected in growth of 1.8%.

Electricity, gas and water expanded by 2.8%. This was well below the figure of 10.9% returned in the transport, storage and communications sector which was driven, in turn, by a 12.2% increase in port activity (mainly thanks to movements of container freight). As for land transport, railway freight activity surged by an extraordinary 128%. This trend continued in the first quarter of 2006, with a growth rate of 102%. Air transport increased by 18%, with the continued expansion of Copa airlines and the renovation of Tocumen airport strengthening Panama's position as a regional air transport hub.

Panama Canal activities climbed by 4%, which was the result of a slight reduction in the number of transits but an increase in the size of vessels. The financial balance was much improved (11.9%) by the higher tolls. Total income exceeded US\$ 1.0 billion for the first time ever in the 2005 fiscal year and this trend continued into the first six months of 2006, with a 4.5% rise in transits of Panamax ships (the largest vessels the Panama Canal can accommodate) and a 17% increase in container ship tonnage.

Commerce, restaurants and hotels also posted buoyant growth, of 9.3%. Retail performance was average (4.5%), although this was compensated by a 13.1% expansion in the activity of the Colón Free Zone. This pattern

has continued in the first four months of 2006. Tourism continued to boom as tourist spending climbed by 19.8% and arrivals by 17.9%.

Financial institutions, insurance, property and services expanded by 7.9%, with growth of 16.4% in the banking sector alone. The balance for personal, community and social services (1.4%) was affected by a 0.7% decrease in governmental services.

(b) Prices, wages and employment

Price trends were markedly unfavourable. The consumer price index (CPI) was up by 2.9% as an annual average in 2005, compared with 0.5% the previous year. Although this figure is low for developing countries in general, it is nonetheless relatively high compared to the usual patterns in Panama's economy. In December 2005, inflation stood at 3.4%. Food and beverages (4.8%) played the most significant part in the overall increase, closely followed by housing, water, electricity and gas (4.7%) and transport (3.8%). The increase in transport prices reflected higher international prices for petroleum and petroleum products.

The wholesale price index climbed by 5.7%, compared with 4.4% the previous year. The increase was due to higher import prices (10.4%), as industrial prices rose by only 1.6% and agricultural prices fell by 0.2%. The fact that wholesale prices affect retail prices, combined with

continuingly high oil prices, suggests that inflation will remain high in 2006. This is confirmed by data from the first four months of the year, with 12-month consumer price inflation of 2.9% and a rise of 6.9% in the wholesale price index.

Although minimum wages are usually adjusted every two years, no adjustment was made in 2004 or 2005. A wage hike came in 2006, with an 8% increase from April. Labour-market indicators improved considerably as the unemployment rate dropped from 11.8% to 9.6% and the number of employed increased by 5%.

(c) The external sector

The buoyancy of the world economy fuelled strong growth not only in Panama's traditional economic specialty of services, but also in merchandise exports. This narrowed the current account deficit from the equivalent of 7.9% of GDP to 5.3%. The financial account recorded large inflows of US\$ 1.49 billion from banking operations and foreign direct investment (FDI).

Robust growth of merchandise exports (17%), combined with a more moderate increase in imports (11%), helped to shrink the merchandise trade deficit. Re-exports from the Colón Free Zone, which represent the bulk of goods exports, grew by around 20% for the second consecutive year.

National exports expanded by 8.3%, which is slightly less than the 10.5% growth recorded the previous year.

Good performances were recorded for sugar (128%) and fruit such as watermelon and pineapple (68%). Lobster, shrimp and other sea products also fared well, while banana exports declined for the sixth year running (-10.8%). For 2006, agricultural exports are expected to increase by more than 20%.

The pattern of merchandise imports contrasted with the export trend: free zone imports increased by 7%, while those to the rest of the country were up by 14.8%. Imports of consumer goods rose by 20%, reflecting the good overall state of the economy. Capital goods imports also expanded considerably (16.6%) thanks to strong private investment, while intermediate goods were up 8.6%.

The balance of trade in services recorded a fresh gain, as its surplus swelled from US\$ 1.275 billion in 2004 to US\$ 1.433 billion in 2005. Transport services expanded 15% thanks to buoyant international trade. Tourist services have been the fastest-growing item in recent years, however. The income and transfers balances deteriorated slightly.

Net inflows of FDI recorded in the financial account represented US\$ 1.027 billion, which was US\$ 15 million up on 2004. These large inflows reflect the abundant liquidity in international markets combined with the particular features of Panama's economy that make it attractive to investors: the use of the dollar as legal tender, its deep, sophisticated financial market and the legal certainty it offers. Hefty inflows were also recorded by banks, partly due to the establishment of new banking institutions in Panama.

