

## CENTRAL AMERICA AND MEXICO

### COSTA RICA

*GDP increased by 5.5%, which was slightly higher than the target figure. The successful performance of the economy was due to a relatively flexible monetary and fiscal policy that sought to stimulate economic activity. The central government's deficit, at 2.9%, was smaller than the previous year's (3.9%), while the external sector's deficit remained almost unchanged (3.6% of GDP). Starting at the end of the third quarter, monetary policy was made more restrictive in order to avert an excessive expansion that might unleash an inflationary process and lead to greater external imbalance.*

The Asian financial crisis did not lead to serious problems, thanks to the small size of Costa Rica's capital market and the fact that a large proportion of its exports go to markets that have not yet been affected by the crisis. Nevertheless, the country did not escape the effects of widening interest rate spreads and did experience some capital flight. It benefited, however, from substantial foreign investment and from the export activity of the facilities recently set up in the country by Intel, the microchip manufacturer. The net effect of these factors was a loss of US\$ 80 million in international reserves.

Increased economic activity translated into a 23.6% rise in central government revenues in nominal terms. Tariffs were a particularly important contributing factor because of the increase in imports, but higher revenues from income and excise taxes also played a role.

#### COSTA RICA: MAIN ECONOMIC INDICATORS

	1996	1997	1998 <sup>a</sup>
	<i>Annual rate of variation</i>		
Gross domestic product	-0.5	3.7	5.5
Consumer prices	13.9	11.2	12.9
Real wages	-2.1	0.8	...
Money (M1)	17.5	43.2	11.8
Real effective exchange rate <sup>b</sup>	-1.0	2.2	0.7
Terms of trade	-5.1	6.0	3.9
	<i>Percentages</i>		
Urban unemployment rate	6.6	5.9	5.4
Fiscal balance/GDP	-5.2	-4.0	-2.9
Real deposit rate	3.1	1.6	-0.6
Real lending rate	11.0	10.2	8.0
	<i>Millions of dollars</i>		
Exports of goods and services	4 861	5 472	6 600
Imports of goods and services	5 036	5 723	6 765
Current account	-109	-329	-375
Capital and financial account	54	545	295
Overall balance	-55	216	-80

**Source:** See the statistical appendix.

<sup>a</sup> Preliminary estimates.

<sup>b</sup> A negative rate signifies an appreciation of the currency in real terms.

The central government's expenditures rose more slowly than revenues, and the deficit (3.9% of GDP in 1997) consequently fell to 2.9% in 1998. The

consolidated public sector's deficit was 3.1% of GDP. This was due to the fact that the central bank's losses were not totally offset by the customary surplus posted by public enterprises and decentralized institutions, which narrowed this year owing to higher expenditures for investment.

Nonetheless, the improvement seen in public accounts is primarily attributable to the upturn in economic activity rather than to the solution of problems of a more structural nature, such as the inflexibility of expenditure entailed by the public sector's commitments in relation to the service on the domestic debt, pension payments and the required outlays for tax credit certificates.

During the first eight months of the year, monetary aggregates expanded more than planned (total liquidity increased 13.3% between January and September), and this, along with low interest rates, provided a strong stimulus for economic activity. The combined effect of these low rates and the reductions made in reserve requirements –until they settled at 15% in March 1998– was to generate an abundant supply of credit in the economy, particularly for the private sector, where the rise for the year was over 30%. Credit for the public sector, on the other hand, followed a much more moderate trend, growing by 4.4%.

Meanwhile, the lag in interest rates was also reflected in a stronger preference on the part of the general public for dollar-denominated deposits.

The exchange rate was devalued 12% during the year, i.e., around a point and a half below inflation, under a crawling peg regime.

With regard to the level of economic activity, the 16.3% boom in investment in real terms was the greatest force driving the economy, while exports of goods and services also showed much more strength than in previous years, rising 13% at constant prices. These two variables were strongly influenced by investment and by the start-up of Intel's foreign sales. Gross fixed investment not only increased in the

private sector, but also rose in the public sector, where it had been subject to heavy restrictions prior to 1997.

The manufacturing sector grew at a real rate of 7.4%, exceeded only by construction and some services, such as electricity and water, transport, storage and communications. In manufacturing as well as construction, the greater availability of domestic credit at lower interest rates had a positive effect, as did the influx of foreign investment into the country's export processing zones (EPZs).

The agricultural sector, on the other hand, though it performed better than in 1997, recorded real growth considerably below the GDP rate of 3.2% due to extremely adverse weather conditions that affected the harvests of several important crops. During the first six months of the year the effects of El Niño hurt basic grain crops and the livestock industry, but traditional agricultural exports actually benefited. On the other hand, in October traditional crops (coffee in particular) were seriously damaged by Hurricane Mitch.

The consumer price index (CPI) increased at a pace slightly above the previous year's (12.9% as opposed to 10.7% as of October when measured year-on-year). This can be attributed to some degree of demand pressure, given the quickening pace of economic activity and the economy's abundant liquidity. The CPI would have risen more had it not been for the downturn in fuel prices.

The two increases in minimum wages made during the year amounted to a rise of 14% in this indicator in nominal terms, which translated into a slight wage increase in real terms.

Unemployment fell as the economy expanded. A significant portion of new job creation was probably due to the strength of the labour-intensive construction sector, which saw a rapid expansion.

Exports increased by 23.9%, while imports, though very strong owing to the expansion of the economy, rose less steeply (19.3%), and the country therefore had a more favourable merchandise trade balance than the year before.

The export activity of Intel was what contributed the most to the upturn in exports (as well as imports). Exports from the EPZs (including Intel's external sales) rose 80% between January and September in comparison with the previous year.

The services trade balance showed an improvement over the previous year thanks to the performance of the tourism industry, which expanded by 15%. The current account balance was very similar to the previous year's, although it did take a slight turn for the worse, chiefly as a result of the level of interest payments and other external expenditures by the private sector.

Reserves fell 25% between December 1997 and the end of September 1998 (from US\$ 1.141 billion to US\$ 910 million), but then recovered most of the ground they had lost. This was due primarily to the outflow of private capital, since the level of capital inflows, particularly in the form of foreign direct investment, was even higher than in 1997. The outflow of capital was attributable to a preference on the part of the private sector for dollar deposits outside the country, since for the greater part of the year, domestic interest rates were lower than those available abroad.

## EL SALVADOR

*GDP expanded by 3.5% in 1998, which was very close to the 1997 rate. Its growth was driven principally by non-traditional exports, a sustained increase in remittances from family members residing abroad and maquila operations, even though coffee exports fell sharply (31%) owing to a decline in international prices. Although the strong increase in imports was reflected in a large deficit on the current account, reserves rose considerably, and it is estimated that the fiscal deficit will amount to 1.6% of GDP.*

Inflation stayed at very low levels during almost the entire year. Nevertheless, the sharp increase in prices in November (2.2%) contributed to a 4.3% rate for the period November 1997-November 1998.

Inflows of foreign capital increased substantially, and the resulting high level of liquidity facilitated the growth of the credit supply, a reduction in interest rates and the continuing stability of the exchange rate. Gross fixed investment increased at a faster pace than the year before, especially in the public sector.

El Salvador, like Guatemala, Honduras and Nicaragua, was hit hard by Hurricane Mitch, which damaged both export crops and the livestock industry.

It is expected that the hurricane's greatest impact on economic activity will be felt in 1999.

In 1998, the basic objectives of **economic policy** remained the same as before: to maintain price and exchange-rate stability and to bolster the stability of the financial system. Under a policy aimed at maintaining a **fiscal balance**, the deficit rose slightly to 1.6% of GDP. The current revenues of the non-financial public sector through September 1998 were up by 11.5% over the same period for the previous year as the result of a 7.2% increase in revenue from income and value added taxes and a 33.1% increase in non-tax revenues. Current expenditures of the non-financial public sector rose 12.2%, driven in large part by increases in consumption and gross investment. Current savings rose by 140.2 million colones, thanks to which there was an overall surplus (including grants and donations) of almost 500 million colones. Capital expenditures rose 6.8% as the result of an increase in gross investment.

**Monetary policy** was, as before, geared to regulating liquidity and reducing gluts in order to maintain stability and ward off inflationary pressures. Up through the third quarter, inflows of foreign capital generated an upswing of 12.1% in liquidity (as

## EL SALVADOR: MAIN ECONOMIC INDICATORS

	1996	1997	1998 <sup>a</sup>
	<i>Annual rate of variation</i>		
Gross domestic product	2.0	4.0	3.5
Consumer prices	7.4	1.9	4.3
Money (M1)	17.5	-1.9	7.7
Real effective exchange rate <sup>b</sup>	-7.8	-0.3	-1.0
Terms of trade	-14.4	15.5	2.5
	<i>Percentages</i>		
Urban unemployment rate	7.5	7.5	7.2
Fiscal balance/GDP	-2.0	-1.1	-1.6
Real deposit rate	6.2	9.7	7.7
Real lending rate	10.6	13.9	12.4
	<i>Millions of dollars</i>		
Exports of goods and services	2 203	2 706	2 740
Imports of goods and services	3 466	3 885	4 340
Current account	-99	97	-235
Capital and financial account	264	267	635
Overall balance	165	364	400

Source: See the statistical appendix.

<sup>a</sup> Preliminary estimates.

<sup>b</sup> A negative rate signifies an appreciation of the currency in real terms.

measured by M3) over the same period in 1997, with a more pronounced rise being observed in foreign-currency and time deposits. Nominal deposit and lending rates for both domestic and foreign currency fell throughout the year. The economy's high liquidity led to an expansion of credit, especially for construction and housing (23%), services (25%) and the agricultural sector (10%). In 1998, as in the previous two years, the exchange rate held steady thanks to intervention by the Central Reserve Bank and the sterilization of excess inflows of dollars through open market operations.

The aim of the **tariff reduction programme** was to reach a floor rate of 5% and a ceiling of 10% for intermediate goods and of 15% for final products. (Tariffs on raw materials and capital goods had already been lowered to zero as of December 1996.) Accordingly, in July 1998 the rate for intermediate goods subject to a 10% tariff was lowered to 7%; the rate for intermediate goods subject to a 15% tariff was reduced to 12%; and the rate for final products subject to 20% tariff rates was set at 17%. In addition, a free trade treaty with the Dominican Republic was approved which is to enter into effect in January 1999.

An important step forward in the area of **structural reform** was the start-up of the country's five new pension fund management boards (AFPs), whose operations are based entirely on domestic capital. Another highly significant event was the amendment of the law under which the Fund for the Economic and Social Development of Municipalities (the FODES Act) had been created, which, starting this year, calls for an annual allocation from the central government of 6% of the national budget's gross current revenues. The Free Zone and Marketing Act was also modified in an effort to protect sensitive sectors of the national economy, particularly agriculture.

**Economic activity** was buttressed by the buoyancy of the external sector (including the *maquila* industry), rising FDI (especially in connection with the purchase of State-owned enterprises), the growth in credit for the various sectors of the economy and a decline in interest rates.

All sectors of the economy turned in positive performances. The sectors showing the strongest growth included construction (3.7%), mining (5.5%), and manufacturing (7%). Agriculture remained the slowest-growing sector (0.2%). Salient features in the construction sector were the development of public infrastructure, with a focus on health, education, marketing and urban roadways. In the private sector, housing, hotels and agricultural projects were the most active areas. Outstanding performances in the manufacturing sector were posted for sugar (9.5%),

clothing (7.2%), metal products (7.2%) and non-metallic minerals (7%).

The **employment** situation improved in 1998. The number of workers registered with the Salvadoran Institute of Social Security was up by 7.3% in July 1998 as compared with July 1997. According to multi-purpose household surveys, the urban unemployment rate averaged 7.2% from May to October, compared with 7.5% during that period in 1997.

The National Minimum Wage Council ordered a 9% nominal increase in the minimum **wage** starting in May. This was the first increase since July 1995.

The **current account deficit** for the year is estimated at close to US\$ 240 million. Nevertheless, thanks to the country's abundant inflows of hard currency in the form of foreign investments and loans, the overall balance showed a surplus of US\$ 400 million.

In the first nine months of the year, a **trade deficit** of US\$ 1,044,500,000 was recorded, which was 11.8% above the figure for the corresponding period of the

preceding year. On the one hand, exports rose by only 2.2% —as opposed to the 35% increase registered the previous year— due to the decline in coffee sales (-30%). Nevertheless, *maquila* exports continued to post high rates of growth (17.7%), as did sales of non-traditional products to markets outside of Central America (24.9%). On the other hand, imports expanded 18%, an increase over the 16% figure registered in 1997.

Trade with the rest of Central America slowed. Exports grew 7.2%, whereas the previous year's figure was 25%, while imports rose only 4.8%, versus the previous year's 14%.

As of September, copious inflows of foreign exchange had boosted net international reserves to close to US\$ 1.8 billion, or 41% above the 1997 level.

**Foreign direct investment** has been one of the key factors in the economy. As of October it had reached US\$ 867.7 billion thanks to investments by recently privatized energy-distribution companies and telecommunications firms.

## GUATEMALA

*GDP grew 4.5% in 1998, a figure slightly above the previous year's rate (4.1%). The adoption of more expansionary monetary and fiscal policies and the continuing strong performance of the export sector were influential factors in this regard. The relative stability of the nominal exchange rate and favourable trends in import prices, particularly for oil, resulted in an annual inflation rate that was within the range anticipated by the authorities.*

One of the main factors influencing Guatemalan society in 1998 was the need to move forward with the implementation of the peace accord. On the other hand, the adverse effects that Hurricane Mitch and El Niño had on the country during the year were compounded by the international climate of uncertainty engendered by the crisis in financial markets. In addition, the local financial system was

shaken by a liquidity crisis in the second half of the year.

Progress was made during the year in implementing the agreements contained in the peace accord. The major portion of a planned divestiture of assets was accomplished with the completion of the process involved in privatizing the State's electricity and telecommunications companies.

Gross capital formation increased slightly faster than the year before (16.4% versus 15.2%), in part thanks to new investment projects in both the public and private sectors.

For the third year in a row, economic policy was not supervised by the International Monetary Fund, since the failure to arrive at an agreement on tax issues prevented the conclusion of a stand-by arrangement.

**GUATEMALA: MAIN ECONOMIC INDICATORS**

	1996	1997	1998 <sup>a</sup>
	<i>Annual rate of variation</i>		
Gross domestic product	3.0	4.1	4.5
Consumer prices	10.9	7.1	7.4
Money (M1)	12.8	31.3	18.1
Real effective exchange rate <sup>b</sup>	-4.8	-5.0	-0.1
Terms of trade	-30.3	26.4	5.3
	<i>Percentages</i>		
Unemployment rate	3.7	5.0	5.9
Fiscal balance/GDP	-0.1	-1.1	-1.6
Real deposit rate	-2.9	-1.5	-0.3
Real lending rate	10.7	10.9	10.1
	<i>Millions of dollars</i>		
Exports of goods and services	2 767	3 175	3 685
Imports of goods and services	3 534	4 187	4 980
Current account	-391	-547	-700
Capital and financial account	567	834	900
Overall balance	176	287	200

Source: See the statistical appendix.

<sup>a</sup> Preliminary estimates.

<sup>b</sup> A negative rate signifies an appreciation of the currency in real terms.

**Monetary policy** was generally expansionary. The timetable for lowering the reserve requirement which had been approved in late 1997 was put into operation, and the 24.6% requirement in effect in December 1997 had thus been reduced to 19.6% by June. In addition, the authorities continued with their policy of refraining from engaging in open market operations, and net placements of financial instruments used for purposes of monetary regulation were actually negative. On the other hand, the amount of credit extended by the Banco de Guatemala to the Government was slightly lower in net terms. Liquidity in the banking system consequently rose rapidly,

expanding at an annualized growth rate of more than 24%.

By the fourth quarter of the year, however, a lack of liquidity in the banking system had become evident. This may have been due to excessive haste on the part of financial institutions in placing the fresh resources that had become available, which in turn may have led to a deterioration in the quality of their portfolios. To forestall any major problems, the authorities decided to inject additional liquidity into the system, and by early December the liquidity squeeze appeared to be under control.

All the main sectors of activity benefited from the availability of additional credit. Commerce, consumption, and other areas received 54% of the new funds, while industry and agriculture, taken together, received 23%.

Quasi-money deposits were down, and a tendency to substitute dollar deposits for local-currency deposits was in evidence. The average deposit and lending rates remained at much the same levels as those seen at the end of 1997, and spreads stayed in the neighborhood of 10 points.

**Fiscal policy** also showed signs of an expansionary stance, with the central government's deficit increasing from 1.1% of GDP in 1997 to 1.6% in 1998. On the other hand, owing to the authorities' decision to cease open market operations, quasi-fiscal losses fell from 0.5% to 0.2% of GDP. Government expenditure again rose sharply (27%), in part because of the need to fulfil commitments made in connection with the peace accord.

Public finances exhibited their customary vulnerability in the area of tax revenues. The peace accord called for a tax take of 10% in 1998, but the level actually reached was barely 9.1%. Consequently, a decision was made to modify the timetable for the achievement of fiscal targets. A more balanced approach to the use of direct and indirect taxes was also adopted as a means of correcting the Government's tendency towards an over-reliance on

indirect taxes. Nonetheless, preliminary data for 1998 point to an increase in the level of indirect taxes.

The country's new Tax Administration Superintendency (SAT) became operational in 1998.

The nominal **exchange rate** registered a moderate devaluation (4.6%). In order to ward off greater pressures on the currency, the authorities decided to draw upon the country's international reserves. As a result, the Banco de Guatemala's net sales of dollars for the year amounted to US\$ 408 million.

Guatemala's electricity company (EEGSA) and telecommunications firm (GUATEL) –the country's two largest State-owned enterprises– were **privatized**. The new postal system also began operation under private management. In addition, progress was made in drawing up the necessary plans for the privatization of the country's main airports and ports. Plans for rehabilitating the railroad lines for which concessions had been awarded in 1997 were delayed, however.

The **economy** grew 4.7% in 1998, a higher rate than in the preceding year (4.1%). Both the agricultural sector and manufacturing expanded at a rate of 3%. The mining sector maintained its elevated growth rate, thanks to the results for oil production and exploration, while the construction sector grew 9.5%. With respect to total supply and demand, the substantial increase in the pace of gross capital formation and the favourable trends observed in public and private consumption account for the sectoral patterns that materialized.

The relative stability of the exchange rate allowed the country to post a November-to-November **inflation**

rate of 7.4% despite the steep rise in prices registered in November (2.65%) as a consequence of Hurricane Mitch.

The **employment** situation showed some improvement over the course of the year. Nevertheless, the impacts caused by Hurricane Mitch when it hit Guatemala in November 1998 included massive unemployment in some parts of the country. The **wages** of public-sector employees rose 10%, and a 12% increase in the minimum wage for industrial and farming activities was put into effect.

The deficit on the balance-of-payments **current account** was US\$ 700 million, a significantly higher figure than the previous year's US\$ 547 million. The result posted on the current account was largely attributable to a marked increase (of more than 50%) in the merchandise trade deficit (US\$ 1.423 billion), although this situation was eased somewhat by incoming transfers (US\$ 733 million).

The value of exports climbed at a slower rate (8.9%) than in 1997 (16%). Imports, however, increased significantly (20%) for the second year in a row (22% in 1997) in response to rising liquidity, the growth of the economy and the relative stability of the exchange rate.

The public external debt rose from US\$ 2.135 billion in 1997 to US\$ 2.248 billion in 1998. The service on the external debt amounted to US\$ 214 million.

Net international reserves trended downward in the course of the year, although they were boosted by the receipt of US\$ 512 million in revenues from the privatization of EEGSA in September.

## HONDURAS

*Economic growth in 1998 amounted to 2.8%, which was below both the figure for 1997 and the 5.6% rate that had been projected by the authorities at the start of the year. During the first 10 months, the economy was spurred by the steps taken to cut taxes and stimulate competitiveness and productivity, which*

*fuelled private domestic investment and consumption demand. Meanwhile, a prudent management of monetary policy held inflation to moderate levels until October (14.5%), although it then rose considerably in the last two months of the year.*

**HONDURAS: MAIN ECONOMIC INDICATORS**

	1996	1997	1998 <sup>a</sup>
	<i>Annual rate of variation</i>		
Gross domestic product	3.3	4.3	3.0
Consumer prices	25.3	12.7	15.1
Money (M1)	27.3	33.6	17.7
Real effective exchange rate <sup>b</sup>	1.6	-5.3	-7.9
Terms of trade	-12.9	29.2	7.6
	<i>Percentages</i>		
Urban unemployment rate	6.5	6.4	5.8
Fiscal balance/GDP	-3.8	-2.8	-3.5
Real deposit rate	-7.0	8.1	1.2
Real lending rate	3.5	17.7	11.6
	<i>Millions of dollars</i>		
Exports of goods and services	1 911	2 187	2 385
Imports of goods and services	2 118	2 472	2 880
Current account	-188	-191	-295
Capital and financial account	294	404	230
Overall balance	106	213	-65

**Source:** See the statistical appendix.

<sup>a</sup> Preliminary estimates.

<sup>b</sup> A negative rate signifies an appreciation of the currency in real terms.

Exchange-rate policy provided for the continued use of a crawling peg, and the existing policies for the liberalization of trade and promotion of foreign investment were maintained.

Late in October, in what proved to be the worst catastrophe in its entire history, Honduras was devastated by Hurricane Mitch. Preliminary estimates put the figures at 5,600 people dead, 8,000 people missing and approximately two million people injured or otherwise affected. A vast number of homes were ruined, nearly a third of the road network was damaged and a large number of bridges were destroyed. Extensive areas of farmland were damaged as well. As a result, the growth of the economy and exports slumped. Small businesses and microenterprises also sustained damage to inventories and facilities.

Estimates for the last two months of 1998 and at least part of 1999 indicate that both output and per capita income will drop, open unemployment will rise and productivity will decline. In addition, the external imbalance is expected to worsen due to a decline in exports and an increase in imports of food and building materials, among other things.

The fiscal deficit swelled to 3.5% of GDP in spite of the fact that, during the first 10 months of the year, the policies in effect had brought about such a notable improvement in public finances that fiscal accounts were showing a surplus as late as the end of the second quarter.

The new Administration approved the Production, Competitiveness and Human Development Promotion Act as a means of encouraging foreign and domestic investment and spurring job creation. Income tax cuts that lowered the rate from 42% to 25%, a reduction in export taxes and a gradual decrease in the wealth tax were approved. Customs duties on imports of raw materials and capital goods were also reduced. To offset the effect of these measures on tax revenues, the value added tax (VAT) was raised from 7% to 12%. The slackening of economic activity during the last two months of the year brought about a slight decline in tax revenues as a percentage of GDP. The deficit was financed chiefly with foreign funds.

Spending policy had two objectives: to curb the growth of expenditure while at the same time increasing the proportion of social spending (particularly on education and nutrition); and to promote agricultural activity, especially export crops. Government spending rose 18%, but real investment in social programmes was lower than in 1997.

The authorities' flexible exchange-rate policy tended to overvalue the lempira slightly but did not significantly affect the country's competitiveness. Up to October, the lempira had depreciated 3.4%. In March the central bank widened the exchange-rate band around the reference rate used for dollar auctions to 7%.

Implementation of the tariff rollback programme continued, and the tax benefits offered in Honduras' free zones were extended to the entire country. The Government signed a free trade agreement with the Dominican Republic and is in the midst of negotiating another such agreement with Mexico.

The main objective of monetary policy was to reduce inflation by attaining greater control over monetary aggregates –and, hence, liquidity– through the use of open market operations. The legal reserve requirement was reduced by two points in April. Credit to the central government continued to drop sharply, but lending to the private sector rose (51%) beyond the high levels of 1997. Lending rates tended to decline, but even so stood at an average of 30% as of September. When the events of November overtook the financial system, it was in the process of toughening up the capital adequacy requirements applying to the nation's banks and portfolios. The general public showed confidence in the system, deposits were maintained and the exchange rate fluctuated only during the first days after the hurricane.

During 1998 the external debt balance rose 2.5% to US\$ 4.146 billion. Arrears in servicing the debt amount to 2%. The Government is scheduled to enter into debt-reduction negotiations with the Paris Club with a view to the possibility of obtaining an adjustment in payments or an actual decrease in the balance of its multilateral debt as an essential step towards rebuilding the country.

In April 1998 a regulatory agency was formed to oversee the electricity sector and a bill was submitted to Congress to authorize the partial sale of Hondutel, the State-owned telecommunications company. The Government also plans to license private operators to take over responsibility for service infrastructure at the airports of Tegucigalpa, San Pedro Sula, Roatán and La Ceiba. In addition, the recently formed National Banking Commission stepped up its regulatory and oversight activities. The Secretariat of Tourism was also formed and a new law on police and internal security was enacted.

Spurred by increases in private investment and exports (nearly 4%), the economy performed so well during the first 10 months of the year that, as of September, an annual growth rate of 5.1% was expected.

The destruction caused by the hurricane drove down agricultural production (-1.5%), brought the expansion of government services to a standstill and, generally speaking, curbed the pace of nearly all production activities. GDP growth slowed to 2.8%.

The growth rate for exports of goods and services slumped, as the banana harvests of the last two months of the year were totally lost, as were portions of the shrimp and coffee harvests. Public investment declined due to the downturn of the last two months.

In contrast, construction, which had been displaying tremendous vitality after years of recession, was buoyed further (17%) by the rehabilitation and emergency work required late in the year.

Fiscal and monetary policies contributed to a slower rise in prices in the second half of the year, and the year-on-year rate of inflation as of November was therefore 15%. However, despite the Government's establishment of price controls, it is estimated that the year-end rate will be in excess of 16% due to supply problems.

The nominal minimum wage was raised by 17% at the start of the year. Open urban unemployment declined, falling to 5.8% by March. The *maquila* sector created 9,000 jobs, but in November a short-run decrease in employment amounting to approximately 23,000 jobs was registered.

As of October, the current account deficit was estimated at approximately 2% of GDP. The progress made in this connection was stymied by a drop in exports late in the year due to flood damage, however, and as a result the deficit climbed to the equivalent of 5% of GDP.

Imports were up by 18%, with especially strong increases being seen in imports of machinery, transport equipment and food, although the bill for petroleum products declined. The increase in the

external deficit was partially offset by a higher level of incoming private transfers and by inflows of private and banking capital. Even so, the overall balance

showed a deficit of US\$ 65 million, rather than the increase in reserves that had been expected prior to Hurricane Mitch.

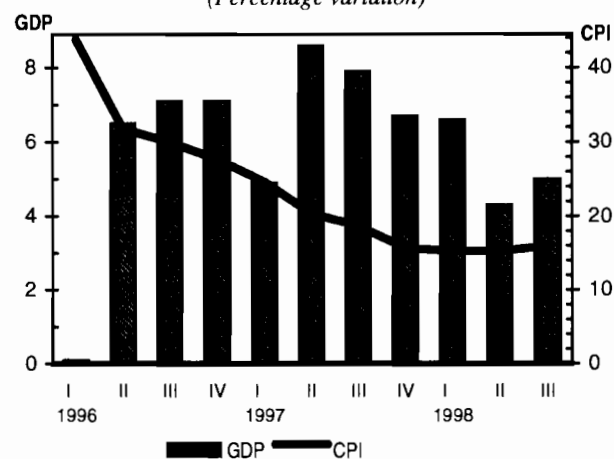
## MEXICO

*The Mexican economy performed well in 1998, with GDP expanding by more than 4.5%. Nonetheless, this was lower than the rate that had been projected at the start of the year (5.2%); the shortfall was attributable to the fairly unfavourable international economic climate, which was marked by plummeting oil prices and the volatility of short-term foreign capital flows. However, the domestic market remained on its strong growth path, thanks primarily to private consumption and investment. Exports rose, but their growth rate continued to slip, and higher imports resulted in an external deficit of 3.6% of GDP. Until the start of the third quarter, there were no reports of any fundamental changes in Mexico's financial markets, but in late August and early September pressure on the exchange rate began to build; in large part this was due to the deepening international crisis, which was reflected in larger outflows of financial capital and greater constraints on access to foreign funding. As the year drew on, government spending was adjusted downward and monetary policy became more restrictive. The exchange rate underwent a steep depreciation and inflation climbed, overshooting its target rate by six points.*

The chief aims of economic policy were to promote economic growth and employment –within the limits set by the severe constraints affecting the economy– and to reduce inflation through support for sound public finances and a flexible monetary policy capable of coping within the present adverse international economic environment.

The **public-sector deficit** rose to 1.4% of GDP (0.4% in 1997) as budgetary revenues fell by 9% in real terms owing to the sharp downturn in oil revenues. The 36% drop in the price of crude oil exports on the

**MEXICO: GROSS DOMESTIC PRODUCT AND INFLATION**  
(Percentage variation)



Source: ECLAC, on the basis of official figures.

international market drove down public-sector income by more than 1% of GDP. Tax revenues showed a real increase of 8.6% thanks to the higher level of economic activity and the adoption of various measures for improving tax collection. In the third quarter, income tax receipts rose 8.7%, revenues from the VAT climbed 10.3% and revenues from the special taxes levied on production and consumption jumped 51.2%. On the other hand, non-tax revenues (–28.9%) reflected the drop in oil prices. As a result, government spending was adjusted on three different occasions during the year to offset this decrease in revenues. The 3.1% decrease in funded discretionary expenditures in real terms was a reflection of cutbacks in capital expenditure, whose impact could be seen in the level of investment in the communications, transport and energy sectors, although current spending rose. In spite of these adjustments, social spending accounted for a larger proportion of total expenditure than before,

## MEXICO: MAIN ECONOMIC INDICATORS

	1996	1997	1998 <sup>a</sup>
	<i>Annual rate of variation</i>		
Gross domestic product	5.5	7.0	4.5
Consumer prices	27.7	15.7	17.4
Real wages	-11.1	-0.6	1.6
Money (M1)	39.6	29.4	15.0
Real effective exchange rate <sup>b</sup>	-11.0	-13.3	-1.5
Terms of trade	2.76	0.0	-2.6
	<i>Percentages</i>		
Urban unemployment rate	5.5	3.7	3.3
Fiscal balance/GDP	-0.1	-0.4	-1.4
Real deposit rate	-2.0	-0.8	-2.5
Real lending rate	...	...	...
	<i>Millions of dollars</i>		
Exports of goods and services	106 901	121 701	129 200
Imports of goods and services	100 060	122 109	137 400
Current account	-2 330	-7 449	-15 500
Capital and financial account	4 104	17 959	16 500
Overall balance	1 774	10 510	1 000

Source: See the statistical appendix.

<sup>a</sup> Preliminary estimates.

<sup>b</sup> A negative rate signifies an appreciation of the currency in real terms.

and this increase was particularly marked in the case of programmes designed to reduce extreme poverty. Non-discretionary expenditure declined 10% in real terms thanks to the fact that interest payments, commissions and other expenses related to the public-sector debt fell 15.2%.

The external **public debt** reached US\$ 92 billion, 4.2% more than the balance as of December 1997. In the first half of the year, the public and private sectors underwrote more than US\$ 5 billion on international markets on relatively favourable terms, thus counteracting the contraction of capital flows to equity and money markets. Issues then declined in the third quarter as conditions in international markets

deteriorated. However, towards the end of the year the Government carried out more than US\$ 6 billion in financial operations, with half of these transactions taking the form of Pemex credits and debt issues and the other half being loans to the federal government.

In a departure from the course taken in 1997 and from what had originally been planned for 1998, **monetary policy** was tightened in response to the volatility displayed by financial markets. The use of a floating exchange rate and adjustments in interest rates were the main methods used to contend with the instability of international financial markets. Faced with the departure of capital from the country and a steeper depreciation of the peso, the monetary authorities also began to create a liquidity squeeze in order to oblige financial institutions to maintain a short daily position with the central bank. This mechanism was brought into use in March, with the central bank leaving the money market short 20 million pesos per day, but by December the figure had been raised to 130 million pesos per day. All of this exerted upward pressure on interest rates. In addition, the Banco de México decided to ask commercial banks for a deposit of 1.25 billion pesos per business day until reaching an accumulated amount of 25 billion pesos. This helped to drive up the interbank interest rate, which reached approximately 40% by September (about 20% in real terms).

The exchange-rate regime based on the **flotation of the currency** coped fairly well with the volatility of the international financial market and, as a result, the peso depreciated sharply, with an especially steep downturn being observed for a short time in late August. Consequently, the nominal appreciation of the dollar during the first 11 months of the year amounted to 25% (8% in real terms). This financial volatility had no major impact on the net international assets of the Banco de México, which totalled US\$ 21.7 million as of the end of November, or 9% more than at the end of 1997.

The financial indicators of the **banking system** showed that it had high, although declining, delinquency rates. For the first time since 1995, credit

showed signs of a rebound in real terms. The upward trend in non-performing loans had also come to an end, and loan-loss provision and capitalization indices were recovering. The rise in interest rates in August again had an impact in terms of the constraints on bank financing and put pressure on loan portfolios by increasing the risk that debtors might stop repaying their loans, which would result in another upswing in delinquency rates. This situation created uncertainty as to what sort of methods would have to be used to come up with a lasting solution to the problems of the country's savings deposit insurance fund (Fondo Bancario de Protección al Ahorro, also known as Fobaproa). The bill that the executive branch sent to Congress in March to authorize the conversion of these liabilities into public debt was not approved until 13 December and was heavily amended. The debt assumed by the public sector totalled 610 billion pesos (US\$ 60 billion).

The index of prices and quotations on the Mexican stock exchange trended downward, with a particularly marked slump beginning in the third quarter; the cumulative decrease for the first 11 months of the year amounted to 30% (36% in real terms and 44% in dollars). The steep slide in quotations was one of the reasons for the sharp reduction in the level of Mexican securities held by foreign institutional investors.

The executive branch sent various bills to Congress designed to carry forward the **reform of the financial system**. These bills would: (i) put the Banco de México in charge of exchange-rate policy; (ii) give autonomy to the National Banking and Securities Commission and strengthen its regulatory and oversight functions within the financial system; (iii) eliminate restrictions on foreign investment in the financial system; and (iv) consolidate Fobaproa's debt with the public debt of the federal government. Following a round of international bidding, the Government awarded US\$ 116 million worth of operating concessions for a number of airports as part of its **privatization** programme. Bids were also received for the Morelos petrochemical complex, and

it is expected that the successful bid will be announced in early 1999.

The main stimuli for growth came from domestic demand, which rose steadily; particularly strong upswings were seen in private consumption (7%) and investment (15%). On the other hand, the agricultural sector's GDP declined 1.6% in the first nine months of 1998 due to the effects of the droughts affecting the country during the first half of the year, which were followed by heavy rains in important farming areas; as a result, it was necessary to resort to an unusually high volume of basic grain imports (corn, beans, sorghum and wheat). The other sectors of activity in the economy expanded. Industrial production rose 7.1% in the first nine months of the year, with the manufacturing sector turning in the most dynamic performance thanks to the growth of the *maquila* industry. The automotive industry increased its output by 7% in the first 10 months of the year; this was chiefly attributable to the expansion of the domestic market (40%) since exports dropped 3%. The construction industry grew 5%, which was half as much as in 1997. The services sector also experienced widespread increases in activity. In particular, commercial establishments' retail sales rose 10% in the first 10 months of 1998.

**Inflation** continued to decline until mid-year, but the devaluation of the peso caused it to overshoot the official target of 12%; the overall figure for 1998 is estimated at 18%. Real wages made significant gains, the first since 1994. In addition, a 14% increase in the minimum wage took effect in December.

The open **unemployment** rate was 3.1% in October, which was virtually the same as the figure for October 1997 (3.2%). In the first 10 months, the number of workers registered with the Mexican Social Security Institute increased by 860,000 to 13.6 million. In the *maquila* sector, employment climbed by 10% in the first nine months of the year, bringing the total number of persons employed in that sector to over 1 million in September.

The **current account** of the balance of payments showed a deficit of US\$ 15.5 billion (3.6% of GDP), which was twice as much as in 1997. Transactions on the merchandise account slowed, but the trade deficit increased considerably, reaching US\$ 7.4 billion. Exports of goods rose 6%; non-oil exports were up 11% but oil exports plunged 35% due to plummeting prices, and the terms of trade therefore took a turn for the worse. With a growth rate of 13.5%, imports also lost some of the momentum they had displayed in 1997. The capital and

financial account yielded a surplus of US\$ 16.5 billion (8% less than in 1997). On the one hand, total foreign investment amounted to US\$ 8.5 billion, or 50% less than in 1997. Portfolio investment slid from US\$ 5.037 billion to US\$ -800 million, while direct investment was US\$ 9.3 billion, or US\$ 3 billion less than the year before. On the other hand, public and private liabilities and other short-term capital movements amounted to US\$ 7.7 billion, and international reserves were US\$ 1 billion higher than they had been in December 1997.

## NICARAGUA

*The robust recovery the Nicaraguan economy had been experiencing slackened in 1998 as gross domestic product grew by 3.6%, a lower rate than the authorities had anticipated at the start of the year (6%). The performance of the economy was undermined by Hurricane Mitch, considered the worst natural disaster in the country's recent history, which took a high toll in human lives, property losses and damage to the environment. The preliminary estimate of property damage is US\$ 900 million; of that figure, 94% represents damage to capital assets and 6% direct production losses.*

In this situation, inflation more than doubled (18%). In the fiscal sphere, major progress was made in putting public finances on a sound footing. Foreign investment continued to flow into the country, supporting the process of remonetization and expanding the monetary aggregates, especially deposits in foreign currency. The exchange rate held to the announced rate of crawl, so that the córdoba depreciated in real terms in the face of higher inflation.

The natural disaster badly affected the export sector. However, with international grants and inflows of private funds from abroad, it was possible to finance a consistently high current account deficit.

Since 1997 **economic policy** has been oriented primarily toward narrowing a large external gap, and

### NICARAGUA: MAIN ECONOMIC INDICATORS

	1996	1997	1998 <sup>a</sup>
	<i>Annual rate of variation</i>		
Gross domestic product	4.8	5.0	3.5
Consumer prices	12.1	7.3	17.9
Real wages	-2.1	-0.2	7.7
Money (M1)	25.9	30.7	18.4
Real effective exchange rate <sup>b</sup>	2.2	4.7	2.0
Terms of trade	-8.09	-5.9	6.3
	<i>Percentages</i>		
Unemployment rate	16.0	14.3	12.2
Fiscal balance/GDP	-1.5	-1.5	-0.1
Real deposit rate	-1.2	1.7	0.3
Real lending rate	6.1	13.1	10.0
	<i>Millions of dollars</i>		
Exports of goods and services	807	867	800
Imports of goods and services	1 300	1 608	1 645
Current account	-698	-813	-805
Capital and financial account	215	820	640
Overall balance	-483	7	-165

**Source:** See the statistical appendix.

<sup>a</sup> Preliminary estimates.

<sup>b</sup> A negative rate signifies an appreciation of the currency in real terms.

to reforming and modernizing the State. In March 1998 the Government of Nicaragua signed an agreement with the International Monetary Fund for a new Enhanced Structural Adjustment Facility for the period 1998-2000 to achieve sustainability in its public finances and external sector and continue with structural reform.

In April the Consulting Group for Nicaragua announced the commitment of donor countries to provide financial assistance of US\$ 1.8 million during the period 1998-2000, earmarked for a programme to accelerate growth and reduce poverty.

Combatting poverty was recognized as crucial for maintaining political and social stability and was made a key part of the Government's strategy, which placed high priority on modernizing the rural sector, planning investments in rural infrastructure, creating loan funds for small farmers and expanding and improving social services.

The Government's **fiscal programme** sought to increase public saving significantly and make the public sector more efficient by modernizing State institutions and expediting the privatization of public utilities such as electricity and telecommunications. Thanks to the implementation of tax reform in 1997 and greater efficiency in the government Administration, it is estimated that the central government deficit will decrease from 1.5% to 0.1% of GDP.

**Monetary policy** was restrictive in order to neutralize the increase in bank liquidity caused by inflows of foreign capital. Although the increase was less than that posted the year before, the liquidity of the economy expanded in all respects, especially due to the increase in deposits in foreign currency.

With the change adopted in 1997 in the way in which negotiable investment certificates (CENIS) were issued, in 1998 it was possible to control the amounts issued and reduce the discount rate; the latter action brought about a slight drop in deposit and lending rates.

The **foreign exchange policy** remained unchanged, with daily crawl of the parity with respect to the dollar, resulting in a 12% devaluation in nominal terms.

Under current conditions, the Government of Nicaragua is committed to preserving a sound **economic policy**, in other words, to maintaining the country's financial stability and making progress in structural reforms, with only a few minor adjustments. However, it hopes to reduce its external debt and obtain new financing.

In 1998, according to preliminary official data, GDP increased only 3.6%, owing to the destructive effects of Hurricane Mitch, compared with the 6% that had been expected at the start of the year.

The **agricultural sector** grew by 3.4%, compared to 8.9% the previous year, in large part owing to the agricultural losses incurred during the last three months. It is estimated that the losses in the harvest of annual crops (bananas, sesame, soybeans, peanuts and tobacco) represented 43% of total agricultural losses, coffee and sugar cane 13% and other agricultural products (fruits and vegetables) 14.4%.

Growth in production of farmed shrimp slowed from its rate of 11% in 1997 to 1.5%, because of major damage to the industry's stock of capital assets.

It is estimated that **industrial activity** increased only 1.8%, rather than the 2.8% anticipated, owing to problems in supplying agricultural and fishing inputs for the food processing industries.

**Tertiary activities** expanded by 3.3%, less than the expected rate of 4.1% because of the destruction of the country's infrastructure.

It is estimated that **construction** grew by 6.6%, in part because of the momentum it exhibited until September and in part because of the initial work of reconstruction begun in the last two months of the year.

The year-on-year **inflation** rate (November-November) rose nearly 18%, disappointing expectations throughout most of the year that the rate would be around 10%. The shortage of agricultural products caused by the El Niño weather phenomenon and

subsequently by Hurricane Mitch explains the rise in prices.

As an annual average, open **unemployment** declined owing to the growth of employment, especially in primary and secondary activities. However, a major increase in unemployment is anticipated by the end of the year, although it could be partially offset by the start of reconstruction activities. During the first eight months, the average real wage in the formal sector rose considerably, in large part reflecting pay increases for central government employees, while wages in the private sector grew moderately.

It is estimated that the large **current account** deficit declined from US\$ 814 million to US\$ 805 million, chiefly owing to lower interest payments and increased family transfers from abroad. Although grants from abroad and foreign investment continued to increase, the current account deficit was financed largely with international reserves.

The trade deficit in goods f.o.b. widened by US\$ 110 million (16.5% more than the figure for 1997) as a result of a decrease in exports (13%) and a slight increase in imports (1.4%).

Merchandise exports declined because of the major reduction in non-traditional exports, in spite of growth in exports of traditional items, chiefly coffee, shrimp, lobsters and molasses.

On the other hand, there was an increase in imports of consumer goods, especially durables, and of capital goods. In contrast, imports of intermediate goods declined, owing to the lower cost of oil, despite increases in purchases of raw materials for manufacturing and construction.

In 1998, most of the existing external debt was duly serviced. At the end of September 1998, Nicaragua's external debt totalled US\$ 6.28 billion.

## PANAMA

*In 1998 gross domestic product grew by 3.5%, compared to 4.7% in 1997. This change reflected a fall in agricultural output and a decline in activity in the Colón Free Zone owing to lower demand from its usual Latin American customers; growth in other economic activities was satisfactory. Investment remained highly dynamic, as in 1997, partly owing to increased public spending, while expanded credit helped to sustain consumption growth.*

The central government fiscal deficit increased, although the financial imbalance for the public sector as a whole was small. The September-to-September inflation rate was 0.8%; the unemployment figure remained at 13.4%; and real wages increased in a number of sectors.

The main **economic policy** objectives of previous years remained unchanged in 1998: modernization

and reform of the State through privatization, external debt reform and trade liberalization.

The goal of **fiscal policy** was to maintain financial balance in the public sector. Central government revenue grew by 5%, but expenditure increased even more, producing a deficit of 4% of GDP. However, thanks to the profits of State-owned enterprises and entities, the overall deficit was only 0.7% of GDP.

Receipts from indirect taxation were up by 15% as of October, while those from direct taxes fell by 5.5%, partly because taxation on income within the Colón Free Zone was eliminated. Overall central government spending expanded by 26.5% in the first half of the year, with an exceptionally large increase in capital expenditure (119%) due to infrastructure investment (highway construction and repair and urban road works).

## PANAMA: MAIN ECONOMIC INDICATORS

	1996	1997	1998 <sup>a</sup>
<i>Annual rate of variation</i>			
Gross domestic product	2.7	4.4	3.5
Consumer prices	2.3	-0.5	1.5
Terms of trade	0.10	10.5	-1.8
<i>Percentages</i>			
Urban unemployment rate	16.7	15.4	15.6
Fiscal balance/GDP	-1.7	-0.6	-4.0
<i>Millions of dollars</i>			
Exports of goods and services	7 510	8 440	8 540
Imports of goods and services	7 501	8 605	8 965
Current account	-159	-309	-595
Capital and financial account	442	786	1 195
Overall balance	283	477	600

Source: See the statistical appendix.

<sup>a</sup> Preliminary estimates.

The government external debt rose to US\$ 5.35 billion, 6% more than in 1997, and the cost of debt servicing was reduced to US\$ 460 million, half as much as the previous year, as a result of major debt repayments. In April, the Government placed a US\$ 300 million bond issue on international markets (maturity of 10 years at a rate of 8.875%). The proceeds were used to redeem Brady bonds with a face value of US\$ 71 million and to help finance the public budget.

The **trade liberalization policy** begun in mid-1997 was strengthened in January 1998. Tariffs were cut to a maximum of 15% and a minimum of zero, apart from special rates for motor vehicles (15%-20%), rice (49%) and milk (50%). In addition, 50% of the shares in electric power generation and distribution companies were sold off, for a total of US\$ 603 million.

Deposits attracted by the international banking centre in the first nine months of the year were up 6.4% compared with the same period in 1997. These additional resources made possible a considerable increase (18.1%) in domestic credit, especially for commerce (22%), personal consumption (25.8%), finance and insurance (62%) and mortgages (10%). The foreign loan portfolio grew by 3.1%, with particularly large increases in credit to North America (41%) and Central America (19%), whereas there was a reduction in lending to South America (4.6%).

Operations in the Colón Free Zone slowed, with a 2.7% decline in re-exports and an increase of only 1.4% in imports, owing to reduced demand from Colombia, Ecuador and Venezuela.

During the 1997-1998 fiscal year the number of transits through the Panama Canal fell by 1%, but the average size of the ships increased, as did the volume of cargo transported. Income was up (11%) owing to a new increase in rates and charging for deck cargo. Container cargo handling in the Balboa and Cristóbal ports also increased substantially, and the numbers of tourists and their average spending in the country rose.

**Agricultural production** suffered a setback for the second consecutive year (1%). There was a substantial drop in banana production owing to the effects of a prolonged strike and the lower quota imposed by the European Union. Adverse weather conditions also led to reduced output of fruit and vegetables and basic grains. On the other hand, livestock production improved, particularly pigs and poultry, as did catches of shrimp and fish.

The **manufacturing sector** grew by 5% while adapting to trade liberalization. Production increased in the categories of foods and beverages, rubber footwear, publishing, and glass and glassware; there was also increased output of cement (24% to September) and metal products. The petroleum refinery resumed operations, and output in the first half of the year rose by 34.2%. There were setbacks in other areas, however, including tobacco, paper products, leather footwear and wearing apparel.

Over the first 10 months of 1998 **consumer prices** in Panama City rose by only 1.5%. This modest increase reflected falling prices in transport and communications and furniture and household furnishings and fittings, but there were significant price increases in medical and health care and in recreation, education and cultural services. Wholesale prices also fell by 4.4% in the first nine months, owing to lower prices for imports (6.5%) and industrial products (3.5%).

**Employment** rose by 3.2% between August 1997 and August 1998, but the open unemployment rate stayed at the same level, owing to an increase in the economically active population, as reflected in household surveys. There were considerable improvements in nominal wages in the first half of the year: 3.6% in manufacturing, 3.2% in hotels and restaurants, and 2% in other services.

The country's **foreign trade** slowed considerably in 1998. Combined export and import flows were barely 1% higher, compared to 14% in 1998; this was mainly due to reduced merchandise demand from Latin

America. In terms of financial flows, considerable foreign direct investment continued, attracted by the privatization of electric power companies.

Re-exports from the Colón Free Zone totalled US\$ 4.36 billion during the period from January to September, 2.4% less than in the same period in 1997. Imports, on the other hand, totalled US\$ 4.07 billion for those nine months, an increase of 1.4%. Merchandise volumes were 3.4% and 4.3% higher, respectively.

A 6.5% increase in domestically-produced exports is expected for the year as a whole (US\$ 702 million). Banana sales were down 28%, but this was made up for by increased exports of refrigerated fish and shrimp, coffee, clothing and petroleum products.

Imports for the domestic market rose by 7% (US\$ 3.203 billion); there were increased purchases of foodstuffs, various intermediate goods and, above all, capital goods. The value of petroleum purchases was 30% lower than in the first nine months of 1997.