

# Review of the Economy for 2005

## Overview

The Barbados economy registered strong growth in 2005, expanding by an estimated 4.1%, slightly below the rate of increase recorded for 2004, a year in which revised data show growth at 4.8%. However, the rise in total real output was fuelled primarily by the non-traded sectors, particularly construction and wholesale and retail trade. The relatively faster growth rate in non-traded activities spurred continued high spending on retained imports, which, although growing more slowly than in 2004, was still significant, chiefly because of the large price effect of payments for fuel. Despite a major improvement in the value of domestic exports, this outcome, combined with estimated sluggish tourism receipts, resulted in a larger external current account deficit.

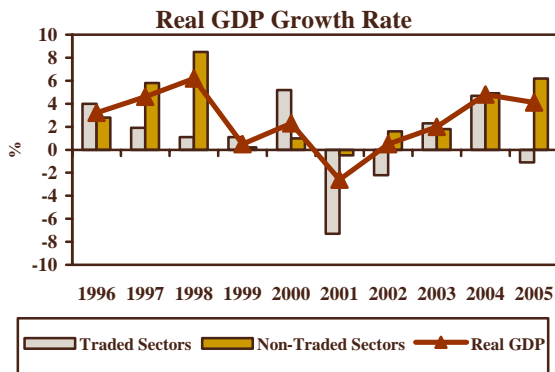
However, this was fully offset by higher capital and financial inflows mainly for

private sector-related projects and the proceeds from an international bond issue, leading to an increase of \$47.4 million in the net international reserves. Underlying the strong consumer and business expenditure was the unrelenting borrowing from commercial banks. This prompted the Central Bank to raise the minimum deposit rate four times during 2005.

The rate of inflation, measured by retail prices, rose steadily, reflecting the pass-through effects of significantly higher world oil prices and the hikes in domestic petroleum prices in June 2004, and more recently, in April 2005.

## Sectoral Analysis

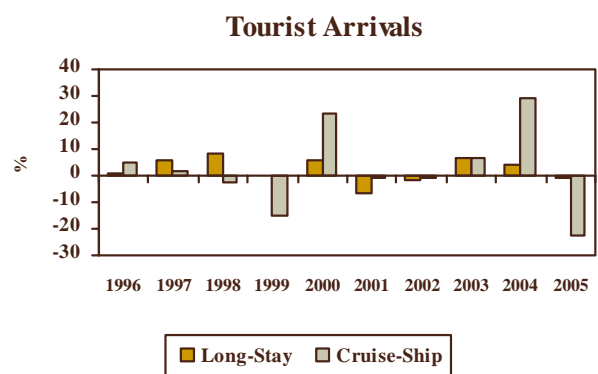
### Real Sector



Following two years of exceptional growth, averaging 8.1% real tourism value-added returned to trend, even though growth declined by an estimated 4.2% in 2005, with downturns recorded for both long-stay and cruise ship arrivals. During the first 11 months of 2005, the number of stay-over visitors declined by 1.1%, as a moderate expansion in the first three months of the review period was followed by a cumulative decline in the latter eight months. Reduced airlift capacity, the dampening effect of increasing oil prices and a weak summer period resulted in a fall-off in arrivals from the United Kingdom (6.5%), Canada (7.3%) and Europe (15.4%). In contrast, long-stay visitors

from CARICOM grew by 9.5%, largely on account of an influx of tourists from Trinidad and Tobago.

During the first 11 months of 2005, the number of cruise-ship passengers fell by 22.7%, after registering gains over the previous two years. Continued competitive pressure from ports located on the Northeastern and Southeastern coasts of the United States was partly responsible for the downturn in cruise arrivals. Additionally, higher fuel costs forced some cruise lines to offer shorter itineraries, leading to a reduction in the number of cruise ship calls to Barbados.



Owing to favourable weather conditions, sugar production for the 2005 crop season totalled an estimated 38,240 tonnes, or

3,880 tonnes more than the previous year's output. Non-sugar agriculture and fishing fell marginally as contractions in milk production and fish catches outweighed a moderate expansion in chicken output.

Total manufacturing output rose by an estimated 2.8%, slightly above the growth rate recorded in 2004. Beverage production expanded by approximately 10.0%, the result of continued foreign demand for rum. Boosted by the boom in construction, the production of non-metallic mineral products went up by a further 2.6%, after rising by 8.8% in 2004. Value-added in other manufacturing industries increased moderately. However, declines were registered in the processed foods and electronic components categories.

Construction activity led the non-traded sector performance, surging by 17.6%, well above the average outturn in the

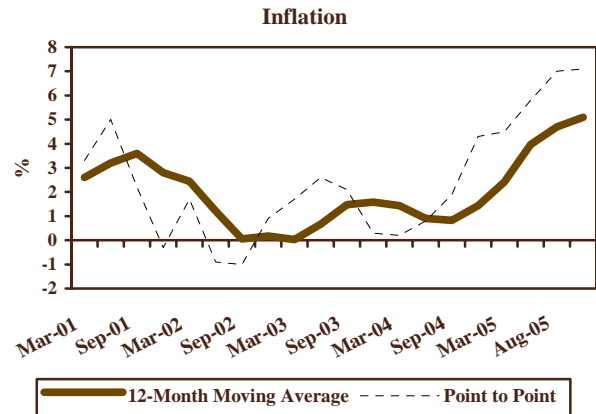
industry over the past five years. The continued growth in the construction industry was associated with increased investment in the tourism industry, Cricket World Cup (CWC) 2007 and various private and public real estate ventures, as well as commercial undertakings.

Boosted by relatively strong domestic demand, the wholesale and retail industry recorded growth of around 5.0%, while business and other services increased by about 4.6%. Output in mining and quarrying was up moderately, due to a rise in the quarrying component. Greater activity was also registered for electricity, gas and water, government services and transport, storage and communication, while yields for local oil production fell somewhat.

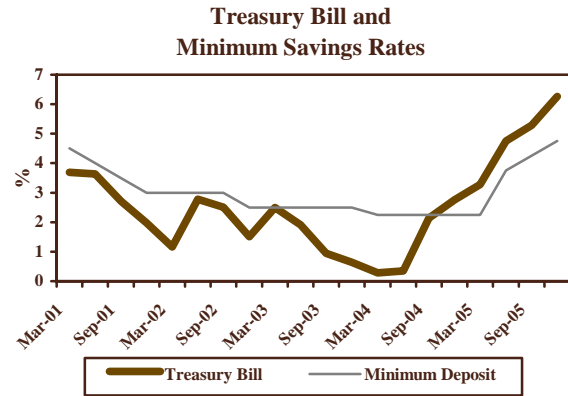
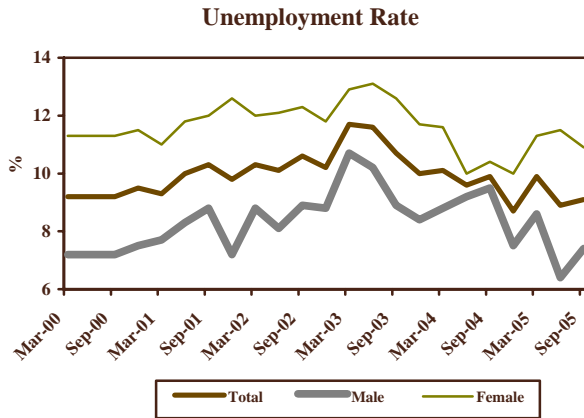
During the year, 428 new licences were issued to the international business and financial services sector; this was 67 more than those granted in 2004. Some 372

licences were granted to international business companies, an increase of 11 over the previous year. Forty-two licences were approved for societies with restricted liability, approximately 22 less than the amount permitted in 2004. Additionally, approval was granted for 14 new Exempt companies, 11 for exempt insurance and 3 for exempt management firms. No new licences were offered to offshore banks.

The twelve-month moving average rate of inflation at the end of September 2005 was estimated at 5.1%, compared to a rate of 0.8% one year prior, while the point-to-point figure was approximately 7.1%, compared to 1.9% at the end of September 2004. Prices in the food, housing and transportation categories recorded the highest increases. Following the persistent expansion in fuel import prices, the average price for transportation advanced by 5.7%, while the fuel and light index grew by 3.9%, in contrast to a decline of 6.7% reported in 2004.

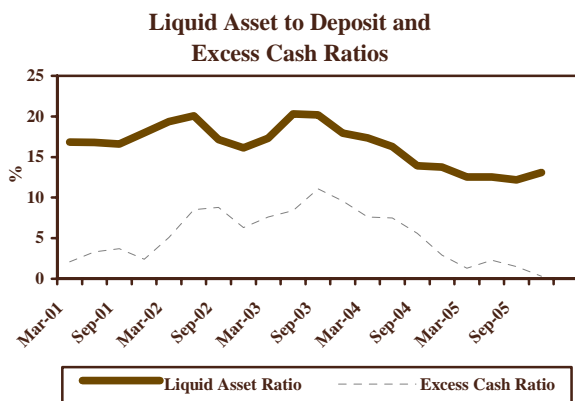


With the overall expansion in economic output, the average unemployment rate for the first three quarters fell by 0.8 percentage points to 9.1%. The male unemployment rate contracted by 1.8 percentage points to reach 7.4%, while the unemployment rate for females was estimated at 10.9%, compared to 10.7% during the same period one year earlier. Over 1,000 net new jobs were created, mainly in the general services, finance, insurance, and business and other services sectors.



### Financial Services Sector

Liquidity in the banking system continued to tighten over the review period. Commercial banks reduced their holdings of treasury bills and cash reserves, and the liquid assets ratio fell by 6.4 percentage points to reach 13.1% at the end of 2005.



Consequently, the three-month treasury bill rate rose from 2.76% at the end of 2004 to 6.26% at the end of December 2005.

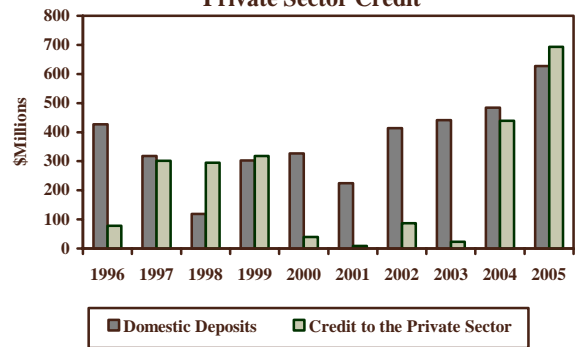
In an effort to encourage savings and stem the demand for credit, the Central Bank increased the minimum deposit rate on four occasions during 2005, raising it from 2.25% to 4.75%. In addition, the Bank rate – the interest rate commercial banks are charged on short-term loans from the Central Bank – was increased from 7.5% to 10.0% in July of 2005. However, a longer than anticipated adjustment lag and pre-existing contractual loan agreements meant that credit continued unabated. As a result, loans to the non-financial private sector expanded by an estimated 22.6% (\$693.4 million) over the review period, compared to a 16.7% (\$439.2 million) increase in

2004<sup>1</sup>. Robust growth in consumer instalment credit and the demand for mortgages resulted in an increase in personal lending of around 25.2% (\$376.8 million). Additionally, loans to private financial institutions rose by 30.5% (\$34.2 million) as a major insurance firm financed part of its acquisition activities, while credit to the distribution sector grew by 14.5%, largely owing to a loan issued to finance a takeover in the industry.

For the fourth consecutive year, double-digit growth was reported for domestic deposits which rose by \$560.2 million (10.7%) in 2005, following an increase of \$484.6 million (10.2%) in 2004. This expansion was predominantly attributed to a rise of \$240.0 million in private individual savings and growth of \$142.2 million in the deposits of statutory bodies.

<sup>1</sup> When extraordinary transactions are excluded, credit growth is basically the same as in 2004.

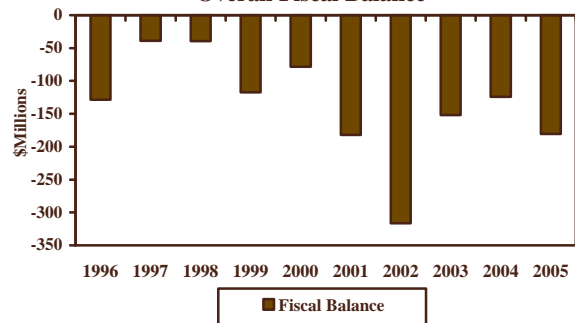
Changes in Domestic Deposits and Private Sector Credit



### Fiscal Sector

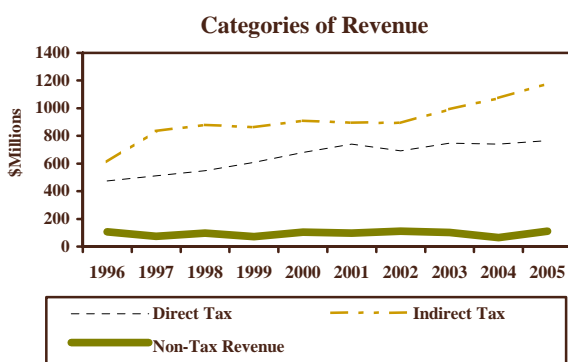
The fiscal deficit for calendar year 2005 was an estimated \$180.7 million, approximately 2.9% of GDP, compared to 2.2% of GDP for 2004, largely reflecting a pick-up in both current and capital expenditure.

Overall Fiscal Balance



Total revenue expanded by approximately 9.4% - up from 1.8% in the previous year - led primarily by a significant increase in indirect tax receipts. Value-added tax (VAT) collections were higher by 8.2%, compared to a rise of 9.9% in the

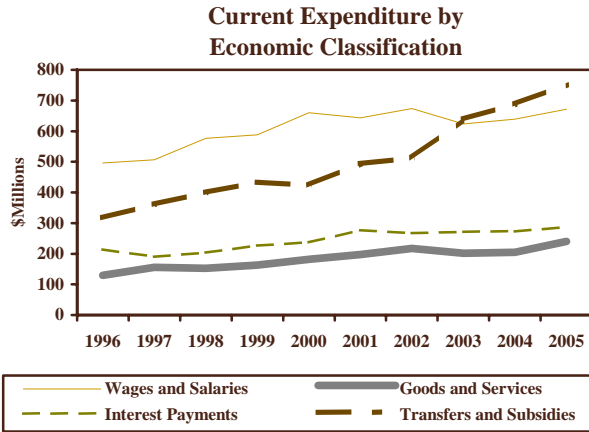
preceding year when real economic activity expanded at a faster rate. Import duties advanced by 5.8%, relative to 17.8% one year earlier, largely reflecting the slowdown in import growth. Moreover, excise tax collections went up by 22.8%, due in part to an increase in excise taxes on various categories of motor vehicles implemented in September 2005. With the imposition of a 3% cess tax on imported goods from outside the CARICOM region, as well as an increase in the environmental levy on all imported used vehicles, miscellaneous indirect tax receipts rose by approximately 7.8%, in contrast to a decline of 8.0% in 2004.



Direct tax collections grew by 3.4% during the review period, after a marginal contraction in 2004. Corporate tax revenue surged by 13.3% on account of

higher levels of tax takings from the international business and financial services sector. Several companies in that sector were re-categorised in 2005 and paid taxes for the first time. Property tax receipts also grew by 8.9%, following a 15.0% expansion one year ago, on account of the revaluation exercise, greater compliance and an increase in the tax base. Conversely, personal tax earnings contracted by 6.4% owing to an increase in tax allowances as well as a cut in the marginal income tax rate.

Total expenditure of the central government rose by 11.6% over the review period, compared to marginal growth one year prior. Higher spending on wages and salaries, goods and services and transfers and subsidies facilitated an 8.1% (\$91.7 million) upswing in current expenditure.



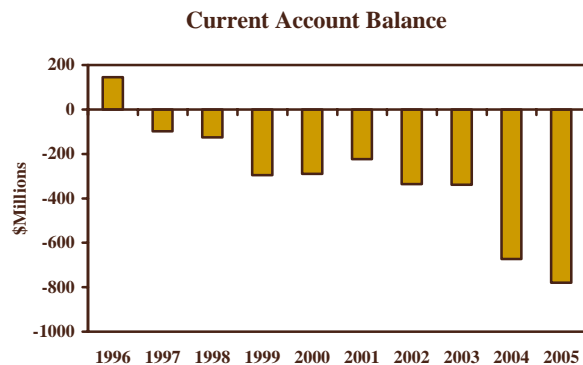
In particular, outlays on wages and salaries rose by 5.1%, compared with 2.5% a year earlier, due mainly to negotiated increases in salaries and wages as well as the upward revision of salaries related to the public sector job evaluation exercise. Interest payments expanded moderately, by 5.4%, as higher domestic interest disbursements offset a reduction in external interest outlays. As a result of increased spending on infrastructure on account of CWC 2007, capital expenditure also picked up during 2005, expanding by 9.9%.

The fiscal deficit was financed from both domestic and foreign sources. With regard to foreign financing, the main injection

was \$245.2 million from a bond issue on the international market in December, 2005. Government was a net depositor at the Central Bank, while the National Insurance Service and private non-bank entities provided additional funds to cover some of Government's operations.

### **External Sector**

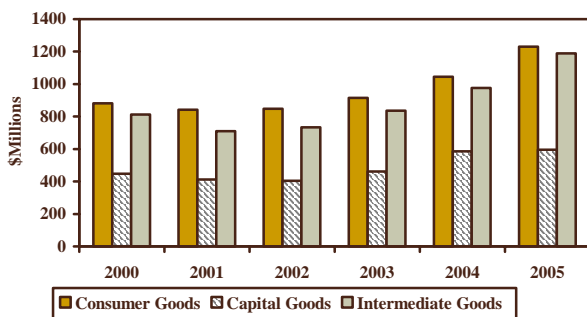
At the end of 2005, the current account deficit was provisionally estimated at \$778.9 million (12.6% of GDP), a deterioration of \$105.5 million from the figure reported one year ago. Continued expansion in retained imports and a decline in tourism receipts offset a significant rise in domestic exports during the year.



Growth in retained imports slowed to

approximately 15.6% in 2005 from 17.8% one year earlier. Higher prices for fuel resulted in an estimated 21.6% expansion in intermediate goods imports, compared to 17.0% in 2004. Consumer goods imports rose by around 17.8%, or 3.7 percentage points above the figure recorded a year ago. Imports of capital goods were up by about 1.7%, compared to a notable expansion observed in the previous year when higher machinery imports resulted from increased imports by a utility company and the launch of two new telecommunication firms.

Retained Imports

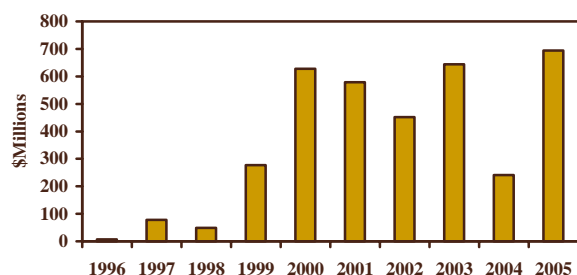


Domestic exports rose by 17.4%, more than triple the growth rate registered in 2004. A 17.6% increase was recorded in the food and beverages category, principally because of higher rum exports.

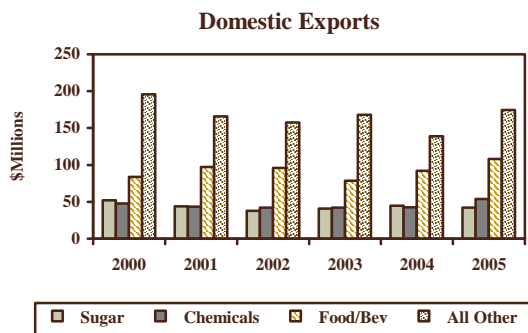
Growth of 27.3% and 25.4%, respectively, was recorded for exports of chemicals and miscellaneous goods. However, sugar receipts fell by 6.3% (\$2.8 million) on account of unfavourable exchange rates and higher freight charges relative to the previous year. Travel earnings decreased slightly by 0.4% - in contrast to the rise of 2.3% in 2004 - primarily reflecting the estimated 1.1% decline in long-stay tourist arrivals and the approximate 22.7% drop in cruise passenger arrivals.

Boosted by a turn around in net private capital inflows, and proceeds to the government from external borrowing, the capital and financial account for 2005 was estimated at \$694.2 million, more than twice the surplus recorded one year prior.

Capital and Financial Account



Net long term public capital inflows totalled \$145.4 million, as Government benefited from the proceeds of a \$250.0 million bond issue on the external capital market. Additionally, net private sector inflows amounted to \$483.1 million on account of higher proceeds for real estate projects and lower amortisation payments by the private sector.



### Outlook for 2006

In 2006, economic activity is expected to grow between 4.0% and 4.5% on the strength of the non-traded sectors and a rebound in tourism. Construction, transport, storage and communications and business and other services are projected to drive the non-traded sector growth, owing to both private and public projects associated with Cricket World

Cup (CWC) 2007. Traded sector activity is forecasted to turn around due to a pick-up in the tourism industry and an improved performance in non-sugar agriculture and fishing. The average rate of unemployment for 2006 is likely to remain below 10% and the 12-month moving average rate of inflation should be lower than that of 2005 as the increase in oil prices is expected to be less steep in 2006.

In line with the continued expansion in the non-traded sectors, retained imports are likely to post strong growth in 2006. However, the increase in the cess tax to 6% should constrain the rate of import growth to below the level posted in 2005. The external current account balance is projected to improve to around 11.1% of nominal GDP. A rise in travel credits is expected on account of a better tourism performance and domestic exports should benefit from the establishment of the Export Promotion and Marketing Fund.

Despite a stronger current account position, the NIR is projected to decline because of lower capital and financial inflows.

A deterioration in the fiscal position of the Central Government is anticipated in 2006; the increase in capital expenditure occasioned by activities surrounding CWC 2007 and the rise in current expenditure as a result of higher spending on wages and salaries and transfers and subsidies are expected to outstrip any growth in receipts.

Monetary measures implemented by the Central Bank in 2005 are likely to slow the growth of commercial bank credit in 2006. However the expansion in loans could still outpace the accumulation in domestic deposits. Consequently, liquidity in the banking system may yet tighten further.

**January 30, 2006**