



GUATEMALA

Supporting Poverty Reduction and Sustainable Development



Document presented to the members of the Consultative Group of Guatemala

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I. INTRODUCTION

- 1.1 Since the mid-1990s Guatemala has made considerable progress on a number of economic and social policy fronts. Its respectable average growth rate of around 4% has been fairly stable by Latin American standards. The country reined in the inflationary trends of the first part of that decade, the Peace Agreements were signed, and major strides were made toward consolidating democracy and advancing the national conciliation effort. Nevertheless, Guatemalans are still patently dissatisfied with the state of the economy, the exclusion of vulnerable groups still on the economic sidelines, and the governance and security situation in the country.
- 1.2 Even with the economy's reasonably strong performance, per capita income has risen only moderately (around 1.4%), even by Latin American standards, because the population is growing quickly. At this rate of economic growth it would take 58 years to double per capita income. The same goal could be accomplished in 22 years were the country to achieve sustained growth of 6%, the peace accord target. Accelerating and sustaining economic growth is a formidable challenge given Guatemala's low education and health indicators, meager aggregate investment rate (though public investment has been on the rise recently), and a saving rate that is among Latin America's lowest. Compounding these circumstances are continuing high fiscal deficits and external imbalances that threaten the Guatemalan economy's traditional stability.
- 1.3 Another serious problem is the vast number of people excluded by virtue of their social circumstances, ethnicity, or gender. Guatemala's income distribution is heavily concentrated in the wealthiest 20%. The concentration of employment income is one of the most skewed in Latin America. Two of every three people are subsisting on earnings of under two dollars a day—one of the highest poverty rates in the region. The ethnic and structural roots of these income-distribution problems are evident in the poverty rate for indigenous groups, which is higher still: four of every five indigenous people are poor. Guatemala also is one of the few countries in Latin America in which the education gap between high- and low-income groups not only has not narrowed significantly but is actually widening.
- 1.4 The December 1996 Peace Agreements brought to an end a long, brutal chapter of armed conflict and set the stage for Guatemala to rewrite its economic and social agenda to build a better, more inclusive, and more prosperous nation. Though the country is firmly embarked on that path there still are enormous challenges ahead. Greater economic growth is required to generate enough employment to absorb the growing population old enough to work. Despite Guatemala's resolute efforts to fulfill its peace accord pledges, additional measures are needed to achieve the targets. Perhaps the most important target is the one set for tax revenues, which

- should reach 12% of GDP by 2002. Tax revenues are still below the commitment levels (they represented only 5% of GDP in 2000) and are a crucial source of funds to carry through on the Peace Agreement commitments. In May 2000 the government, the private sector, and civil society worked out a “Fiscal Pact”, a historic consensus on principles and pledges relating primarily to such issues as balanced budgets, tax revenues, and public spending and borrowing. In July 2001, the Guatemalan congress approved a package of fiscal measures aimed at reaching a tax burden of 12% of GDP by 2002. These measures, however, will probably only raise the tax burden just slightly over 11% of the GDP by 2002.
- 1.5 The signing of the Peace Accords unleashed expectations of major changes. It also paved the way for the first meeting of the Consultative Group for Guatemala, which was chaired by the IDB and held at European Commission headquarters in Brussels in January 1997. At this meeting, the international donor community extended “offers” of aid exceeding US\$2 billion for 1997-2000 to help implement the peace process. In September of this same year, a follow-up meeting was held in Antigua, Guatemala. The international community reaffirmed its support for that process at the Group’s second meeting also chaired by the IDB in October 1998, again in Brussels. The preeminent issue on the agenda was the progress made on the Fiscal Pact and the need to achieve a tax-revenue target of 12% of GDP. Alfonso Portillo Cabrera, Guatemala’s president since early 2000, stated that implementation of the peace accord actions was a State policy, and underscored the importance of securing approval of principles and commitments for a Fiscal Pact.
 - 1.6 During the first two years of the Portillo administration some progress was made, particularly in macroeconomic terms. A coherent monetary policy helped to stabilize the Quetzal, international reserves increased and interest rates dropped. The Fiscal Pact was signed and fiscal measures were implemented in order to increase the tax burden. In terms of commerce, markets were opened, a free trade agreement was signed with Mexico and the Intellectual Property Rights Law was approved. A Labor Reform Law was also approved. In terms of finances, the government presented four important legislative packages to the Congress to pave the way for modernization, a measure that has not been taken in the last 30 years in Guatemala. As regards social policy, the Law of Human Development was approved and a Poverty Reduction Strategy has been prepared. The government has also promoted compliance with the Peace Agreements.
 - 1.7 The Inter-American Development Bank formulated a support strategy for Guatemala within the context of the peace agenda, and that prioritizes poverty reduction based on sustainable growth, social reforms and strengthening of governance. At the same time the Bank has been supporting Guatemalan authorities as they develop a Poverty Reduction Strategy (PRS), which is being presented to the International community in the Consultative Group meeting. During the first year of the Portillo administration, authorities began working on this strategy and tried to identify the poorest areas in the country. They then

formulated preliminary plans to meet these needs. The strategy is a document which is being continuously updated and broadened

- 1.8 The purpose of this document is to summarize the challenges to development in Guatemala and the resulting strategy of the Inter-American Development Bank for supporting Guatemala. The IDB support strategy is discussed at the conceptual level. The document also describes in some detail the dimensions of the Bank's loan portfolio in Guatemala and its future lending program to complement the efforts of the Government to reduce poverty and consolidate peace.
- 1.9 The Inter-American Development Bank welcomes the opportunity for a new meeting of the Consultative Group for Guatemala, assured that coordinated support of the donor community will decisively contribute to development in Guatemala.

II. POLITICAL AND SOCIO-ECONOMIC CONTEXT

A. The Peace Process

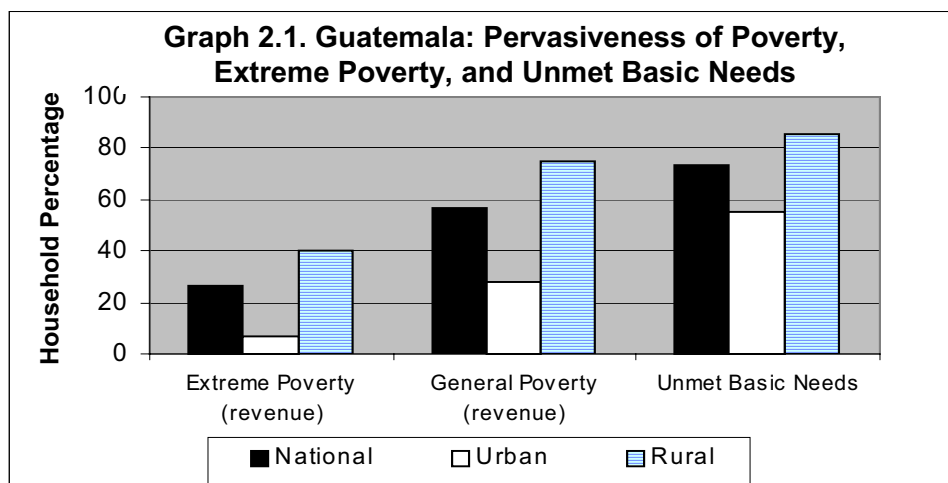
- 2.1 The Peace Agreements, signed in December 1996 by the Government of Guatemala and the guerrilla organizations (URNG), marked the end of a 36-year armed struggle that cost the lives of more than 100,000 people. The Agreements recognize that long-term peace requires fundamental changes in society and in the economy, and set out a comprehensive agenda to bring about this transformation. The agenda of commitments specifically includes a fundamental reform of the structure of government, of the justice system, of tax policy and the provision of social services. The parties agreed to an action plan calendarized until end-2000 and established a Commission for Accompanying the Peace Agreements (Comisión de Acompañamiento de los Acuerdos de Paz). The Commission must monitor the implementation of the more than 400 agreements that were reached.
- 2.2 Guatemala made considerable progress in the implementation of the Peace Agreements during the first year of peace, including the demobilization and reinsertion of war veterans and a downsizing of the armed forces. Also, programs were prepared to deal with the issues of housing, health care and bilingual education, and mechanisms were created to increase the participation of the indigenous population.
- 2.3 However, since the end of 1998, the reforms linked to the Peace Agreements began to lose some of their initial momentum. Opposition to constitutional changes halted the introduction of important commitments relating to indigenous

peoples. The reform program failed behind schedule to the point that it was necessary, at the end of 2000, for the Commission Accompanying the Peace Agreements to re-schedule execution of about 119 pending commitments.

- 2.4 Recent mobilization by numerous social organizations demanding that the Agreements be honored, demonstrates that society recognizes that their completion is necessary to overcome the obstacles to development in Guatemala. The approval of important tax measures in July 2001 and the strong will of the Government to encourage a wide-reaching dialogue with society over the following months, created favorable conditions for instilling new energy in the execution of the pending commitments contained in the Peace Agreements. The new Government elected in January 2000 gave its unwavering support from the beginning to the Agreements and emphatically reiterated this by signing a new calendarized action plan for the years 2000-2004.

B. Poverty in Guatemala

- 2.5 Guatemalan society is characterized by one of the highest poverty rates in the world. Regardless of the method used to quantify poverty (consumption, income, unmet basic needs), Guatemala's figures reveal it as one of the countries with the greatest incidence of poverty in Latin America. According to the latest measurements, based on the National Survey of Household Income and Expenditures 1998/99 (ENIGFAM), 66% of Guatemalans live in poverty. There are also significant differences in the geographical and ethnic distribution of poverty, with even greater concentrations among specific segments of the population.
- 2.6 Poverty in Guatemala is concentrated in the rural sector, where 60% of the population live. The incidence of poverty in rural areas, measured by consumption, impacts 76% of the population, however in urban areas it is not above 41%. For example, about 10% of the population of metropolitan Guatemala City is poor, whereas in the regions of the northwest (Huehuetenango and Quiché) and the north (Alta Verapaz and Baja Verapaz), more than 75% of people are poor.



2.7 In Guatemala, poverty affects a high percentage of the indigenous population disproportionately. According to income measurements based on figures from the ENIGFAM 98/99 survey, poverty among indigenous groups is estimated at 82%, which is far higher than the rate among non-indigenous people, calculated at 52%. On the basis of income, it is estimated that 40% of the indigenous population live in extreme poverty, compared to 15% of the non-indigenous population. Measured in terms of consumption, the indigenous population suffers from more than double the rate of extreme poverty than the non-indigenous population. Furthermore, the incidence of poverty among the indigenous population differs greatly from one area to another, varying from 32% in the metropolitan region to 88% in the northeastern region. Variations in extreme poverty are even more significant. Whereas 3% of the indigenous population in the metropolitan region live in extreme poverty, in the northern region the rate of extreme poverty rises to 56% of the population.

C. Economic Overview

2.8 Until 1997, Guatemala's macroeconomic framework remained stable thanks to the introduction of prudent fiscal and monetary policies. Meanwhile, the economy benefited from the effects of financial reform, flexible exchange rates, increasing trade liberalization and the privatization or opening to competition of a significant part of public utilities. During 1995-1997, economic growth reached an annual average of 4%, inflation was reduced to single-digit, the combined public sector deficit was kept below 1% of GDP, international reserves increased by almost half, exports grew by more than 50% and the deficit in the external current account balance stabilized at around 3.5% of GDP. However, taxation remained low, at 8.8% of GDP in 1997.

- 2.9 The macroeconomic framework deteriorated in 1998-1999 as a result of an expansive fiscal and monetary policy. Public spending began to increase significantly, not only in the social sectors, which was in keeping with the conditions of the Peace Agreements, but also in other sectors. The decision was also made to massively increase spending early in 1999, in anticipation of year-end elections, but without a comparable increase in tax revenues. Meanwhile, the Central Bank continued its policy of reducing interest rates in a context of growing fiscal imbalance, implemented a program of bank reserve requirements reduction and began selling ever-greater amounts of foreign exchange reserves in order to alleviate the subsequent pressure on the quetzal. When the situation in the financial sector began to deteriorate with the bankruptcy of several important financial institutions that had granted excessive lending, the response was an erratic monetary policy, which generated a loss of confidence, with capital flight and massive losses of foreign exchange reserves. Faced with the threat of a financial crisis, fiscal and monetary policy finally became more restrictive in September 1999; however, the economic situation by then had deteriorated in all senses. At the end of 1999, the public sector deficit had increased to 2.9% of GDP, annual GDP growth had dropped to 3.6%, foreign exchange reserves had diminished, despite substantial revenue from privatizations, the exchange rate had dropped 29% in two years and the deficit in the current account balance had increased to 5.5% of GDP.
- 2.10 The new administration that took office in January 2000, announced that its priority would be to restore macroeconomic stability. In the first quarter, Congress approved a 10% reduction in public expenditures and the new monetary authorities introduced a monetary program based on open-market operations. At the same time, progress was made in fiscal matters, such as the signing of the Fiscal Pact in May of the same year, which contributed to a boost in confidence about the economy. International reserves increased by more than US\$ 650 million, the exchange rate stabilized and short-term market interest rates not only became less volatile, but also began to drop in the second half of the year. Unfortunately, the anticipated support from fiscal policy did not materialize in the second half. Only part of the fiscal measures agreed to in June in the Political Agreement for Funding Peace were introduced and uncertainty regarding fiscal sustainability began to grow. Private investment stalled and the economy, already affected by the rise in the oil prices and the drop in the price of coffee, began to decelerate. In the first half of 2001 the economic situation deteriorated even more with the slow-down in the main export markets and a further fall in the price of coffee. The fiscal situation was also greatly worsened by a 50% increase in Central Government spending during the first four months of the year. Finally, faced with fiscal losses, the authorities decided to introduce strong tax-related measures. In July 2001, Congress approved a tax package that included an increase in the value added tax (VAT), a reform of the tax code and stronger tax collection mechanisms. Meanwhile the finance sector's situation continued to be very shaky. During the first trimester, monetary authorities decided to intervene three insolvent banks, guarantee their deposits, and remove their owners and board of directors. At the same time, government authorities promoted a reform of

the finance sector's legal framework, through four important legislative packages to modernize this sector.

2.11 In the second half of 2001, the economic situation took a significant downturn because of the drought in the Central American region in July and August and above all due to the impact of the September 11th attacks. It is true that the drop in oil prices after the attacks and the cut in U.S. interest rates somewhat mitigated the impact on current accounts. However, the loss of tourist income, the drop in maquila exports and other non-traditional products, and the reduction in remittances all add up to a loss of between 50 and 100 million dollars for the rest of the year. A negative effect on capital accounts was also anticipated. Fortunately Guatemalan authorities seized the initiative by negotiating a "Stand-By" agreement with the IMF. They also reactivated the financial legislative packages in Congress, implemented the majority of fiscal measures approved in July and proposed alternative measures when the Constitutional Court upheld the alcohol and tobacco tax. These initiatives helped to successfully place \$325 million in Eurobonds in November. International reserves were also boosted by the final \$452 million payment of Telgua's privatization. In December, authorities implemented the new taxes on alcohol and tobacco and were hoping to get financial laws approved.

Table 2.1. Principal Macroeconomic Indicators for Guatemala, 1995-2001

Macroeconomic indicators	1989-94 average	1995	1996	1997	1998	1999	2000	2001 p ⁽¹⁾
GDP (% growth rate)	3.9	4.9	3.0	4.4	5.1	3.6	3.3	1.5
End of year inflation (% growth rate)	21.2	8.6	10.8	7.1	7.5	4.9	5.1	8.7
FOB exports (US\$ million)	1109	1991	2056	2391	2563	2494	2764	2682
CIF imports (US\$ million)	1865	3293	3146	3852	4651	4560	5171	5121
Current account balance (% of GDP)	-5.1	-3.9	-2.9	-3.5	-5.3	-5.6	-5.5	-4.8
Foreign debt (US\$ million)	2307	2107	2075	2135	2368	2631	2616	2799
Foreign debt service (% of exports of GNFS)	n.a.	13.9	10.7	16.1	14.0	13.2	18.7	21.5.
Net international reserves (months of imports)*	1.3	1.8	2.0	2.2	2.8	2.3	3.6	4.3
Fiscal indicators	1990	1995	1996	1997	1998	1999	2000	2001proj
Net tax burden (% of GDP)	6.9	7.9	8.7	8.8	8.7	9.3	9.5	9.7
Central Government balance (% of GDP, excluding grants)	-1.4	-0.6	-0.2	-0.5	-2.5	-3.4	-2.2	-2.8
Central Government Balance (% of GDP, including grants)	n.a.	-0.5	-0.1	-0.6	-2.4	-3.3	-2.0	-2.6
Combined Public Sector Balance (% of GDP)	-2.5	-0.9	-0.1	-0.6	-1.8	-2.9	-2.3	-3.0
Social expenditure (incl. Social security, in % of GDP)	3.6	4.3	4.2	5.3	5.8	6.1	5.9	5.9

*Months of imports of goods and services for the following year. Excludes claims on Nicaragua (\$146 million in 1999 and \$76 million in 2000).

⁽¹⁾ The Inter-American Development Bank's projections.

Sources: IMF, BANGUAT, MINFIN, IDB.

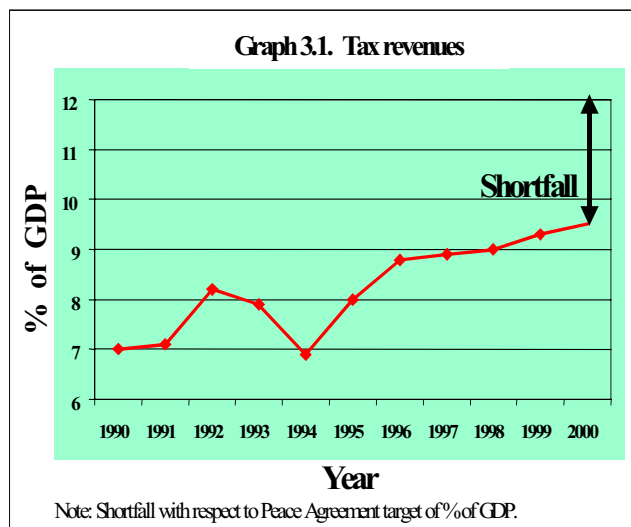
- 2.12 Based on an orderly economic program and a sound fiscal policy, Guatemala is aiming in 2001-2004 to overcome its main development challenges. These challenges, from the IDB perspective, are briefly discussed in the following section.

III. THE CHALLENGES TO DEVELOPMENT IN GUATEMALA

- 3.1 The drop in coffee and sugar prices and the recession in the United States, partially due to the September 11th terrorist attacks, will mean that economic growth in Guatemala for 2001 will drop to its lowest level in the last ten years. The effects of this international crisis, coupled with recent natural disasters in Central America, such as the recent drought, are now being felt in Guatemala. The result has been a marked increase in unemployment in the country and a major impact on the investment flow. The impact is most severe in rural areas where the drop in coffee prices has led to a drop in employment. In Guatemala, conditions of extreme poverty and famine have already been detected in 102 municipalities (33%). The government needs to design an economic reactivation policy and in order to do this it also needs a sustainable macroeconomic policy and rational fiscal policies to meet the demand for social spending and investment in human capital. At the same time Guatemala needs a strong, modernized financial sector. This would help make it possible to respond to the growing demands of small and medium producers by increasing their production and supporting diversification efforts. In addition, all of these actions need to be supported by a greater effort to improve citizen security, strengthen the justice system, and improve the country's overall governability.

A. Achieving Fiscal Sustainability

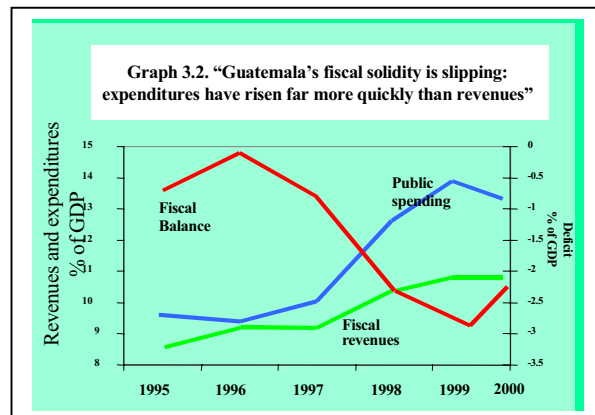
- 3.2 Guatemala must raise its level of tax revenues to finance the growing social investments, necessary for reducing poverty and consolidating peace. The net tax burden in Guatemala, despite constant growth from 7% of GDP in 1994 to 9.7 in 2001 (See Graph 3.1), continued to be the lowest in Latin America. This low tax burden makes it very difficult to finance



the Peace Agreements, which include the commitment (not fulfilled) to increase the net tax burden to 12% of GDP in 2000. Attempts in recent years to increase taxes or to improve their administration have failed or have resulted in insufficient gains in taxation, due in part to the strong opposition of interest groups, to lost legislative opportunities and to a weak taxpaying tradition. Given all this, the original goal of raising the tax burden to 12% of GDP was postponed until 2002.

3.3 The first significant attempt to change the taxpaying tradition was the preparation and signing of the Fiscal Pact in May 2000. Its ambitious agenda included not only revenues, but also spending (targets for social sectors), fiscal balance (average deficit of not higher than 1% of GDP), fiscal administration, debt management, the monitoring and auditing of fiscal procedures. A critical stage was the signing, in June 2000, of the Political Agreement for Funding Peace, which specified the tax measures to be taken to reach 12% of GDP in 2002, and which include an increase in the VAT. Some of these measures were implemented in June 2000², but faced with a deteriorating fiscal situation in the first months of 2001, Congress passed an important fiscal package³ in July, which included the increase in VAT to 12% specified in the Political Agreement, reforms to the tax code, and more aggressive legal sanctions on tax evasion. Opposition to these measures was strong (and included a successful appeal for constitutionality relief against the law to create a stamp tax on beverages and tobacco⁴). Nonetheless, a broad effort to increase taxes was necessary. It is difficult to determine what effect the legal changes will have on tax evasion or what impact would result from possible improvements in fiscal administration, but it is probable that additional measures will be needed to reach 12% of the GDP, a minimum condition for fiscal sustainability. In the medium term, fiscal soundness requires more ambitious fiscal efforts, as recognized by the Fiscal Pact.

3.4 Public spending dropped to 12.4% of the GDP in 2000, in an effort to recover control of the macroeconomic situation. (See Graph 3.2). However, public spending levels rose again in 2001 to 13.8% of the GDP. Up until 2000, trends in spending mostly



² The measures included: increasing the maximum income tax rate from 25% to 31%, broadening the VAT base to include customs taxes and eliminating certain exemptions.

³ The other measures approved in July 2001 include: an increase in the IEMA tax (tax on commercial companies and agro-businesses) from 1.25% to 2.25% of sales, or from 2.5% to 3.5% of net assets; a 100% increase in the tax on sea and air traffic; a tripling of the tax on bunker (except for electrical plants), and a new stamp tax on cigarettes and drinks.

⁴ In order to offset the loss in fiscal revenues owing to the elimination of the stamp-tax law, new taxes were enacted in November, which went into effect in December 2001. These new taxes were set in dollars, and applied to beverages and tobacco.

reflected the will of the authorities to honor the commitments included in the Peace Agreements, which require a 50% increase in public expenditure (in terms of % of GDP) between 1995 and 2000 in the **health, education, justice, and public security** sectors, with spending on **housing** several times higher than previous levels. In addition to these commitments, most of which were quantitatively met (with the notable exception of housing), there was also a significant increase in investment in physical infrastructure. In 2001 public spending increased significantly in quantitative terms. Nonetheless, comparable progress has not been made in qualitative terms or in terms of transparency. This has generated intense opposition to the fiscal package proposed by the government. Conscious of this need, the authorities are trying to increase transparency by broadening the SIAF (*Sistema Integrado de Administración Financiera* - Integrated Financial Management System), and to increase the efficiency of investment with the introduction of a National Public Investment System (*Sistema Nacional de Inversión Pública* - SNIP), so as to make it possible to select investment projects more appropriately. The authorities also organized a broad based dialogue for the fourth quarter of 2001 and the first quarter of 2002, addressing pending aspects of the Fiscal Pact. This dialogue seeks to change public opinion on the need for these fiscal measures.

B. Modernizing the Financial Sector

- 3.5 Modernizing the financial sector is one of the main challenges for achieving economic stability in Guatemala. The current banking system is characterized by maturity mismatches, a heavy concentration of lending within related business groups, loss provisions too low for banks' nonperforming-loan totals, and capital bases barely above the required standard. The system's regulatory framework is incomplete and permissive, and there is no regulation at all of the securities market. The existence of a vast and busy informal sector (finance corporations and offshore banks) associated with regulated institutions makes the system less than transparent and complicates analyses of its situation.
- 3.6 Guatemala's financial sector fell into serious trouble in November 1998 when three major coffee exporters went bankrupt. What confidence remained in the system's solidity slipped further in early 1999 with the closure of another 10 financial institutions. The quetzal lost value, interest rates were very volatile, and monetary policy was inconsistent. The quality of bank loan portfolios deteriorated sharply: the ratio of past-due and delinquent loans to total loans outstanding increased 50% (from 7.9% in October 1998 to 12% in mid-2000, slipping back to 9.5% in late March 2001)⁵. This vulnerability became clear in the first quarter of 2001 when, as a result of nonfulfillment of commitments with

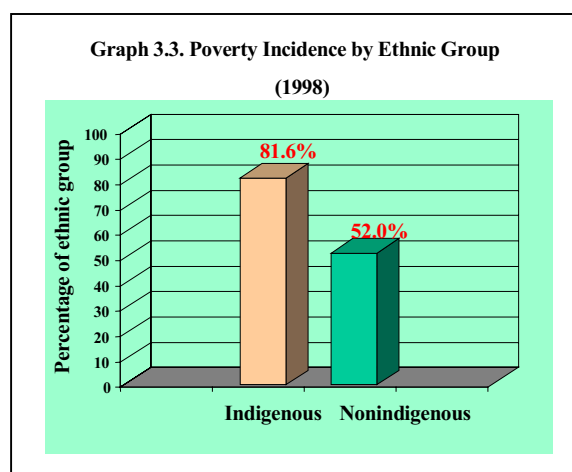
⁵ Figures for July 2001 excluded the rates corresponding to the Banks taken over during the first quarter of 2001.

BANGUAT, three banks were declared insolvent and taken over. The total cost of the takeover is estimated at US\$325 million.

- 3.7 The Government of Guatemala, conscious of these challenges, initiated a wide-ranging set of reforms in the financial sector. At the end of 2000, the Unrestricted Foreign Exchange Transition Act was passed, allowing for free trading and contracting in foreign exchange, and creating an Institutional Foreign Exchange Market and Currency Exchange Houses. Furthermore, four laws fundamental for modernizing the financial sector are awaiting legislative approval: a) the Banks and Financial Groups Act, aimed at rationalizing the legal framework in which these entities operate; b) the Bank Supervision Act, which sets out to strengthen the functional independence and supervisory capacity of the Superintendency of Banks; c) the Banco de Guatemala Act, which will define more precisely the objectives of the Central Bank and will give greater autonomy to actions by BANGUAT; and, d) the Currency Act, which establishes the norms applicable to monetary exchange and the movement of capital. The Guatemalan Congress is expected to pass these four laws in December 2001.

C. Reducing Poverty and Investing in Human Capital

- 3.8 Guatemala faces the great challenge of reducing the poverty that affects significant parts of the population, excluding them from the benefits of development. Public expenditure in social sectors has been increased significantly, from 4.3% of GDP in 1995 to 7.0% of GDP in 2000. However, poverty rates continue to be considerably higher than in other Latin American countries. In fact, 66% of Guatemalans live in

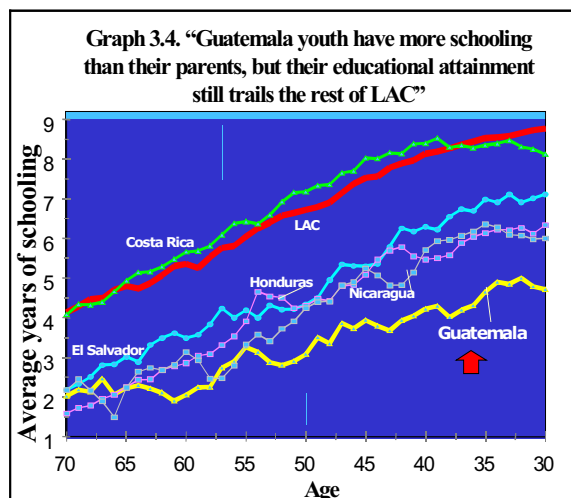


poverty. Poverty in Guatemala is concentrated in rural areas, where 60% of the population lives, and most seriously affects the most vulnerable social groups, such as the indigenous peoples. The poverty rate stands at 76% in rural areas: among indigenous groups it is almost 82%, while 52% of non-indigenous rural people are fall into that category (see Graph 3.3). Social exclusion is also gender-biased. (Adult illiteracy affects 41% of women, compared with 26% of men; maternal mortality is at more than double the Central American average).

- 3.9 The rural poor face intense exclusion from the benefits of development. Households with unmet basic needs are two to three times more common in rural

areas than in urban ones. This situation also exists in more developed departments such as the Department of Guatemala, where 18% of urban homes are overcrowded, as compared with 34% of rural homes in the same department. There is also a great bias in income distribution, with the richest 20% of the population receiving 60% of total income and the poorest 20% receiving only 3.7%.

3.10 In contrast to the poverty indicators, investment in human capital in Guatemala is still insufficient, although it has risen significantly, mostly in education. The number of children who receive a **primary education**, expressed as a percentage of the total child population, rose from 33% in 1995 to 48% in 1998 (see Graph 3.4). However, there is an increasing gap between the situation of the young in



Guatemala and those in Latin America as a whole. Credit must be given to the Ministry of Education for progress in two key areas: (a) a new model for providing educational services and improvements in coverage, retention and quality; this includes the extension of primary education in rural areas with large indigenous populations; and (b) the enactment of educational reform, within the framework of the Peace Agreements. However, there is still much to do in order to improve human capital indicators.

3.11 Budget expenditures in the **Health** sector have grown in terms of GDP in recent years, surpassing the goal established in the Peace Agreements. However, there are persistent problems of poor health care coverage in rural areas, due to a high concentration of the budget in the department of Guatemala and an imbalance in spending that favors curative health care, to the detriment of preventative health care.

3.12 It is expected that the modernization process being implemented by the government will generate conditions to overcome these deficiencies. The modernization process is showing significant progress, such as the new Health Code that became effective in 1998 and the introduction of a new health care model known as the "Integrated Health Care System" (*Sistema Integrado de Atención en Salud - SIAS*). The new Health Code effectively recognizes the participation of civil society in the design and implementation of health policy, while encouraging the de-concentration and decentralization of health care programs and services.

D. Improving the Conditions for Governance

- 3.13 The **institutions** and the **State institutional apparatus generally** are greatly in need of improvement. Despite the rapid progress of democracy, much remains to be done to achieve three fundamental objectives: (a) **representation**, meaning that the interest of all groups must be taken into account; (b) **control over public institutions**, which requires politicians and civil servants to pursue collective, not private, interests; and (c) **participation**, requiring expeditious, transparent mechanisms whereby a balance can be struck among the various interests in the society as a whole.
- 3.14 Advances toward these goals will help correct problems of exclusion, corruption and administrative inefficiency. Guatemalans' formal **participation in the political process** has traditionally been among the weakest in Latin America: a very high percentage of Guatemalans believe that voting accomplishes nothing. The electoral rules strongly favor private interests rather than political parties, with which very few people feel any sense of identification.
- 3.15 On the other hand, Guatemalan society faces severe **public security** problems, including assaults, robberies, and kidnappings. Similarly, domestic violence against women and children is widespread, affecting 36% of women who live with a man. Youth gangs are another source of concern. One telling indicator of the degree of insecurity felt by the population is the increase in the number of firearm permits issued each year, which increased from 16,000 in 1995 to more than double that number in 1998. The large number of private security agents is also revealing —17,000 registered, 6,000 unregistered— employed by 132 security firms. Government spending on domestic security is 22% higher than the Peace Agreement target. A National Civil Police Force has been created, with new ground rules and principles, reflecting the tenets of the peace accords, and more than 10,000 officers have been trained. However, much work remains in order to consolidate the rule of law among the citizenry, increase the political participation of civil society and guarantee public security.
- 3.16 The challenges to development in Guatemala, mentioned in the preceding paragraphs are the analytic basis on which the IDB proposes a medium-term support strategy. Within this strategy there is ample room for complementary support from the international donor community.

IV. IDB STRATEGY FOR GUATEMALA

A. A Support Strategy for Reducing Poverty through Sustainable Economic Development

4.1 IDB strategy in Guatemala for 2001-2003 fits into the framework of the Peace Agreements, the main goal being poverty reduction. In order to reach this goal, the Bank is concentrating its efforts along three strategic lines:

- a. **Promoting sustainable economic growth and competitiveness:** Poverty can be reduced only if accelerated and sustainable economic growth is achieved. It would take Guatemala 58 years to double the year 2001's per capita income if growth continued at a rate of 4%, and 22 years if GDP growth could be kept at 6% annually. Such growth requires a stable fiscal context with increased sources of tax revenue to sustain increased social spending. A solid and reliable financial sector is also necessary to increase investment levels and encourage productive sectors. An essential requirement for achieving fiscal stability compatible with the development strategy of the IDB in Guatemala was the signing of the Fiscal Pact in May 2000 and additional measures approved in July 2001.
- b. **Supporting fairness, social protection and the development of human capital:** The Bank's strategy gives priority to the reduction of poverty by addressing its main originating factors: (i) limited access to opportunities resulting from practices of social exclusion and very limited productive assets; (ii) vulnerability to adverse events; (iii) lack of means of providing social protection to the most vulnerable groups; and (iv) lack of a concerted strategy for combating poverty. At present, the Bank supports Guatemala by means of initiatives and lines of action related to poverty reduction, community development, social investment, housing programs and natural disaster emergency programs, extension and improvement of social services (health care, rural aqueducts, educational reform), modernization of the State (program for improving living-standards measurement surveys) and the development of productive sectors.
- c. **Strengthening the modernization of the State and Governance:** the Bank's strategy for 2001-2003 takes into consideration the need to strengthen the mechanisms of democratic participation by supporting the introduction of reforms to the electoral system and the strengthening of the institutional capabilities of the Electoral Supreme Tribunal. The Bank will also back selective institutional reforms in the executive, legislative and judicial branches. The IDB will as well support the process of decentralization and municipal development. Finally, the Bank's strategy will help efforts to develop a national program of *civic coexistence* focused on preventing violence, on rehabilitation of young people, and on community participation; all of this based on peaceful conflict-resolution mediation mechanisms.

- 4.2 The IDB strategy also coincides with the strategic guidelines of the Regional Programming Paper for Central America (RP-CA), which consist of: (i) sustainable development and the prevention and mitigation of natural disasters; (ii) human development; (iii) institutional concerns involving the distribution of the benefits of integration; and (iv) the strengthening of regional bodies. The Bank's strategy for Guatemala reinforces the objectives of the regional strategic priorities.
- 4.3 The matrix on the following page summarizes the strategy proposed by the Bank. It provides an overview of the various areas of priority that comprise the action plan, and show how they complement the main goal of the strategy, which is poverty reduction.

MATRIX 4.1 GUATEMALA. STRATEGY SUMMARY

Poverty reduction

Growth, stability, and competitiveness

Fiscal strengthening, including Fiscal Pact implementation

Support for production sectors, particularly agriculture, microenterprise and small and mid-sized enterprise, tourism

Modernize/strengthen factors markets and infrastructure

Modernize financial sector. Support regional integration

Improve institutional framework for environmental protection and make environmental policy more effective

Equity, social protection, and human capital development

Strengthen compliance with peace agreements and monitor achievement of their targets

Support for health and education reforms

Support for child development and literacy

Strengthening of institutional framework for housing sector

Programs targeted to the poorest: social safety net

Support for local management capacity

Modernization of the State and governance

Strengthening of democracy

Modernization of government: Executive and Legislative Branches, justice system

Support for decentralization and municipal development

Enhancement of citizen security

B. IDB Action in Guatemala

1. Financing the Priorities of Development

a) Loans and Technical Cooperation Approved in 1999-2001:

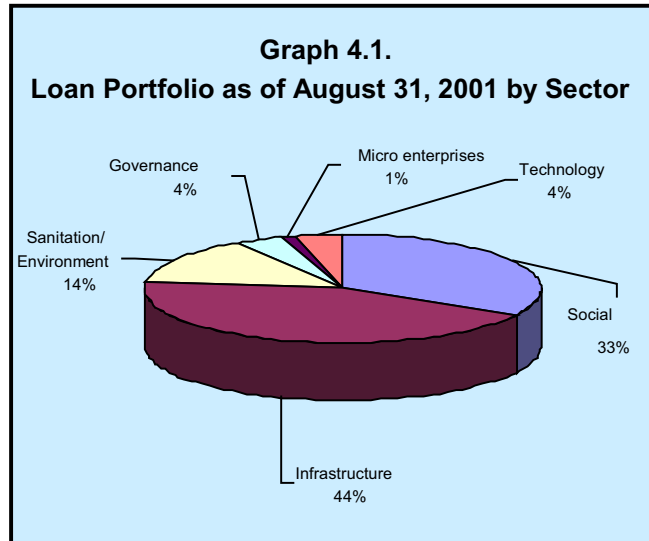
- 4.4 **Loans.** In the period of 1999-2001 the Bank approved seven loans totaling US\$ US\$266.5 million: In 1999: Program for Improving Health Care Services II, Recovery and Modernization of Roadways II, Municipal Development Program, and Technological Development Program. Although the Bank did not approve loan operations for Guatemala in 2000, three projects have been approved so far in 2001: Support for Foreign Trade (US\$ 5 million), Support for Educational Reform II (US\$ 22 million), and Sustainable Management of the Lempa River Basin (US\$ 4.5 million) as part of the Trifinio project. Two loans were also approved in order to facilitate preparation for the Program for Fighting Urban Poverty and for Foreign Trade operations.
- 4.5 **Technical Cooperation Grants:** In the period of 1999-2001, the Bank has approved a total of 27 technical cooperation grants totaling approximately US\$12.8 million. These operations include 14 regular operations financed by the Fund for Special Operations, 8 operations financed by Trust funds, and 5 operations financed by the Multilateral Investment Fund (MIF).

b) Current Loans Portfolio:

- 4.6 The IDB loan portfolio in Guatemala is comprised by 29 loans that finance 26 projects for a total of US\$ 955.8 million. Out of this total, US\$ 509.8 million (more than 50% of the entire portfolio) had been disbursed as of November 30, 2001, though this in fact amounts to more than 70% if measured in terms of the portfolio actually in execution (7 approved operations are still pending legislative ratification and/or contract signing). 80% of the projects are classified as having a satisfactory level of execution. An action plan has been implemented for the single project classified as having little chance of reaching its development objectives, the Sustainable Development Program for the Petén (973/OC and 974/OC-GU),. That action plan has been approved by the authorities with a view towards improving its execution. A table summarizing the loan portfolio of IDB projects, grouped into strategic areas, is included as Annex I.
- 4.7 In addition to the aforementioned loans, the Bank's loan portfolio in Guatemala also includes five small projects for US\$ 2.4 million, and 72 technical cooperation grants for US\$ 33.5 million (including 14 MIF operations for US\$ 15 million).
- 4.8 The Bank's portfolio in Guatemala is relatively young (73% of the total has been approved within the last five years), and the projects that make up the current portfolio now being executed were prepared on the basis of priorities defined in

previous strategies with multifaceted objectives, such as: i) inclusion of the poor, indigenous and rural population; ii) broadened and improved social services; iii) modernization of the State; and iv) development of the productive private sector. The table in Annex I demonstrates how the current projects contribute to achieving the overall objectives of the Bank's current strategy.

4.9 As indicated in Annex I, 53% of the loan portfolio is aimed at supporting the goal of sustainable growth and increased competitiveness. However, from a traditional, sectorial point of view (Graph 4.1), it can be seen that social programs represent 33% of the portfolio and that environmental content amounts to 14%; the trend is for the relative weight of these two types of programs to increase within the loan portfolio.



c) Disbursements:

4.10 During the 1996-1999 period the Bank made a series of increasing disbursements, providing Guatemala with significant positive net cash flows. In 2000, as a result of the portfolio's cycle of maturity, changes in personnel and the non-initiation of the last approved loans, disbursements were reduced by almost 70% compared to the previous year, which led to a negative net flow of US\$ 24 million. It is believed that in 2001 disbursements will rise again, returning to a positive net flow.

2. Future Operations

4.11 **Possible Operations for 2001-2003:** The IDB's possible inventory of projects to be financed in Guatemala during the period of 2001-2003 consists initially of 25 loan operations amounting to a total of US\$ 972 million and 19 technical cooperation grants in the amount of US\$ 7.3 million. This tentative program is balanced in its distribution—in terms of numbers of operations—among the three prioritized areas for strategic intervention presented in the previous section. Table 4.1 shows the relationship between each of these operations (loans and technical cooperation) and the strategy areas identified by the Bank in Guatemala.

Table 4.1. Inventory of Possible IDB Projects by Strategic Area, 2001-2003				
Strategic Area	Loans Program		Technical Cooperation Program	
	Number and Name	Amount (Mill.)	Number and Name	Amount (Mill.)
Economic Growth, Stability and Competitiveness	GU0119: Financial Sector II	200.0	TC0105017 Support of Tax Reform	0.36
	GU0126: Rural Electrification (PER)	95.0	TC0104006 Support of Fiscal Pact	0.15
	GU0154: Global Micro-credit II	20.0	TC9911124 Urban Transportation GIC	0.15
	GU0133: Program for Sustainability of Priority River Basins	40.0	TC0012055 Labor Market Program	0.15
	GU0066: Lake Amatitlán Cleanup	20.0	TC0104001 Natural Disasters AGA/GIS	0.15
	GU0149: Upper River Lempa- Trifinio Management	4.5	TC0003025 Strengthening of Electricity Regulation Agency	1.50
	GU0150: Rural Potable Water Program	50.0	TC0006010 Guatemala City. Private Sector Sewage Service	0.60
	GU0152: VMCE ⁶ Inst. Reinforcement	5.0		
	GU0158: Labor Market	10.0		
	TOTAL	444.5	TOTAL	3.06
Fairness, Social Protection and Human Capital Development	GU0157: Social Protection Program	30.0	TC0108010 Dialogue & Citizen Participation	0.15
	GU0131: ARE II Educational Reform	22.0	TC0001028 Program for Improving Measurements of Living Standards	0.64
	GU S/N: ARE III Educational Reform	40.0	TC0104003 PRSP Preparation	0.75
	GU0153: Supplement. Housing Program	20.0	TC0102039 Promotion of Indigenous Culture	0.20
	GU0155: Neighborhood Upgrading in Marginal Urban Areas	60.0	TC0010039 Pilot Program: Social Management	0.08
			TC0101040 Indigenous Women in Democracy	0.04
	GU S/N: Social Benefits Program	100.0		
	GU0159: Literacy Program: Stage I	10.0		
	GU S/N: Literacy Program. Stage II	30.0		
TOTAL	312.0	TOTAL	1.86	
Modernization of the State and Governance	GU0143: Program for Modernizing Congress	12.0	TC9802449 Reinforcement of Superintendency of Banks	1.20
	GU 0165: Supreme Electoral Tribunal	6.0	TC0108015 Support and Follow-up with Consulting Group	0.15
	GU S/N: Modernization of the State	40.0	TC0106015 Public Security	0.15
	GU 0163: Public Safety and Civic Coexistence	30.0	TC0103009 Participatory Municipal Training	0.08
	GU0134: Municipal Development II	41.0	TC0012029 Role of Women in the Maintenance of Democracy: Stage II	0.75
	GU 0164 Reinforcement of the National Procurement System	6.5	TC0103049 Municipal Strengthening	0.07
	TOTAL	135.5	TOTAL	2.40
GRAND TOTAL	892.0	GRAND TOTAL	7.32	

4.12 In the preparation of this Tentative Operational Program, consideration was given not only to national and sectorial priorities, but also to the country's financial absorptive capacity (the share of the net flows of the Bank's operations within the country's overall net foreign debt flow), the share of counterpart fund

⁶ *Viceministerio de Integración y Comercio Exterior* ["Office of the Deputy Minister of Integration and Foreign Trade"]

requirements of the Bank operations within the national budget, political consensus, and the institutional capacity of executing agencies.

- 4.13 It must be noted that the extent of financing the Bank will provide depends upon the successful introduction of the tax measures necessary for reaching the goal of a 12% tax burden in terms of GDP by the year 2002, as agreed upon in the Peace Agreements. Otherwise, the Bank, in collaboration with government authorities, would have to agree to a smaller lending program. The dimensions of such a scenario of new loans would then be proportional to the fiscal efforts demonstrated by the country.
- 4.14 It is worth noting that all the Bank's operations will continue, either through their general focus or their specific components, to support the reduction of the social exclusion of the poor, indigenous and rural populations. In particular, the Bank's lending program proposes action to reduce poverty and to back the commitments to the indigenous peoples established in the Peace Agreements through the financing of various programs. Above all, investments will be proposed to reinforce and improve the quality of bilingual education through the Educational Reform Program II. Initiatives aimed at recovering, protecting, maintaining and restoring indigenous cultural heritage will also be supported. Also, through the Program for Fighting Urban Poverty, attention will be given to the indigenous population in the marginal suburban areas of metropolitan Guatemala, through improvements in basic infrastructure, participatory processes, and income-generating activities.
- 4.15 On the whole, the IDB's support strategy and specific actions in Guatemala have a conceptual focus consistent with the challenges of development and the priorities of the Government which emphasize implementation of the Peace Agreements and the Poverty Reduction Strategy. There is a great need for the support and concerted action of the donor community in the pursuit of these objectives.

Annex I. Summary of Current Portfolio of IDB Loans

(As of November 30, 2001)

STRATEGIC OBJECTIVES	<i>PROGRAMS</i>	<i>AMOUNT APPROVED</i>	%	DISBURSED	%
Sustainable Economic Growth and Competitiveness	Renovation and Modernization of Roadways I	150.0		150.0	
	Renovation and Modernization of Roadways II	150.0		19.6	
	Sectorial Program for Infrastructure and Investment	7.7		6.5	
	Emergencies caused by Natural Disasters	40.0		38.1	
	Manag. and Conservation of the Chixoy River Basin	14.4		14.3	
	Environmental Program: Guatemala Metropolitan Area	34.8		0.0	
	Sustainable Development Program for the Petén	19.8		2.5	
	National Micro-enterprises Program	10.0		8.6	
	Program for Reconversion of Agricultural Production	33.0		2.8	
	Pre-Investment for Peace Program	8.0		2.6	
	Program for Strengthening Foreign Trade	5.0		0.0	
	Technological Development Program	10.7		0.0	
	Management Program for Lempa River Basin	4.5		0.0	
	Rural Aqueducts Program	32.8		29.1	
		520.7	54	274.1	54
Support of Fairness, Social Protection and Development of Human Capital	Community Development Program for Peace	50.0		43.3	
	Program in Support of Educational Reform I	15.4		13.4	
	ARE [Educational Reform Support] II	22.0		0.0	
	Social Investment Fund	42.3		41.8	
	Housing Program	60.0		53.1	
	FIS-PRORIENTE Program	90.0		27.2	
	Improvement of Health Care Services I	13.6		13.5	
	Improvement of Health Care Services II	55.4		0.0	
		348.7	36	192.3	38
Reinforcement, Modernization of the State and Governance	Reinforcement of Customs System	1.4		1.2	
	Program in Support of Justice System	25.0		6.9	
	Municipal Development Program II	40.5		35.3	
	Development of Municipal Sector	19.5		0.0	
		86.4	10	43.4	8
TOTAL		955.8	100	509.8	100