

Government of Guatemala
"Peace and Development for all"

CONSULTATIVE GROUP 2002

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PEACE AND DEVELOPMENT FOR ALL

Guatemala, December 19, 2001

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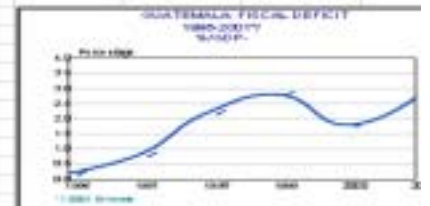
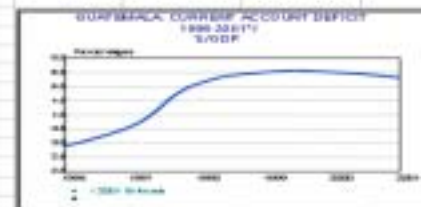
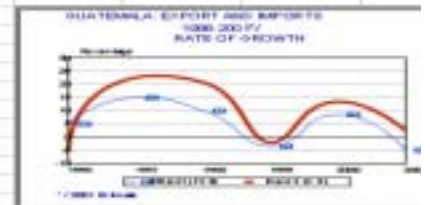
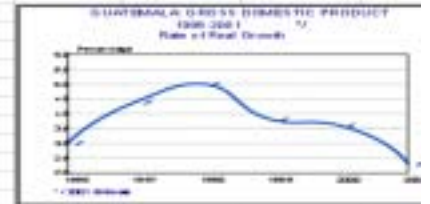
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TABLE 1

GUATEMALA
MAIN SOCIAL AND ECONOMIC INDICATORS
1998-2001

INCEPT	1998	1999	2000	2001e/
eracy (Calculate %) 1 /	31,7	29,8		
tal population (millions) 1 /	10,8	11,1	11,4	11,7
orking population (%) 1 /	33,6	31,5		
A. Annual Change				
ial GDP	5,0	3,8	3,6	2,3
ial GDP, by sector				
oods	4,3	3,2	2,3	0,8
ervices	5,5	4,3	4,6	3,4
consumption				
ivate	4,6	3,6	3,5	2,5
ublic	9,7	7,6	7,6	8,1
ross Fixed Capital Formation	17,4	5,8	-8,6	1,4
ivate	21,9	6,5	-4,3	-1,1
ublic	6,8	4,0	-20,4	9,6
ports in real terms	2,4	4,6	3,8	0,0
ports in real terms	24,5	0,7	6,1	0,2
II Percentage of GDP				
ublic Investment in Real Terms	3,5	3,5	2,7	2,9
ivate Investment in Real Terms	9,5	9,7	9,0	8,7
III Rate of Change				
ation (December to December)	7,5	4,9	5,08	4-6 2/
ternal sector				
ms of Trade	68,4	68,1	67,6	64,7
change rate a				
uetzales for dollar)	6,8	7,8	7,7	8,0 3/
dex of real exchange rate 4 /	96,5	85,8	87,1	88 2 5/
ternal Debt (In millions of US \$dollars)	2367,9	2631,3	2615,9	2516 6/
IV. Millions of Dollars				
urrent Account				
alance of Trade of Goods and Services	-997,2	-1015,8	-1049,0	-1110,1
ports FOB	-1702,5	-1730,7	-1917,2	-2080,7
ports CIF	2581,7	2492,8	2708,1	2574,5
apital Account	4650,9	4560,0	5171,1	5300,6
tal Balance	1239,8	890,5	1703,5	1480,1
oreign Exchange Reserve	242,6	-125,4	654,4	370,0
t means increase)	-242,6	125,4	-654,4	-370,0
V. Percentages				
ibt. Services/Exports of goods and Services	7,2	6,7	6,3	nd
urrent Account/GDP	-5,1	-5,5	-5,5	-5,3
VI. Rate of Variation				
oney and Credit				
it International Reserves	22,0	-9,3	53,7	30 8 5/
redits to Private Sector	27,3	14,0	9,7	12 - 14 2/
?	12,5	7,9	18,1	12 - 14 2/
VII. Percentages of GDP				
entral Government				
total revenue	10,5	11,1	11,1	11,0
total Expenditures	12,7	14,0	13,0	13,8
eficit or Surplus	-2,2	-2,8	-1,8	-2,7
ermal debt Outstanding(Mills of Quetzals)	6259,8	7807,1	8629,6	10520 0 5/
VIII. Annual Rates				
erage weighted interest rates				
ctive	18,1	20,6	20,1	18 1 7/
assive	6,2	9,8	10,0	7 8 7/



Source: Bank of Guatemala
Source: Instituto Nacional de Estadística (INEC) y Centro Latinoamericano y Caribeño de Demografía (CELADE)
Target 2001
December 11 2001 D
Base 1997
November 30 2001
October 31 2001
December 6 2001
End of 2001
not available

Source: Central Bank

I. INTRODUCTION

1. Since the Peace Agreements were signed in 1996, Guatemalans have been making great efforts to translate this extraordinary consensus into concrete actions to achieve by democratic means higher levels of security, prosperity and well-being. The signing of these Agreements, which put an end to one of the longest armed struggles of the Cold War, raised hopes that this fractured society could overcome some of its main structural and short-term problems within a reasonable period.
2. In January 2000, a new government drawn from the victorious opposition, came to power through peaceful elections. The new government adopted the Peace Agreements as the cornerstone of its administration. As President Alfonso Portillo said, "My government inherits the Peace Agreements. From 1986 until 1996, four different governments did the groundwork to end the civil war. The Peace Agreements are not the product of a single government, as it has been erroneously suggested. The Peace Agreements are a path to the future that Guatemalans have designed in order to have a just and inclusive society..." (Portillo, 2000, p. 17). President Portillo also publicly elevated the Peace Agreements to the category of state agreements.
3. It is in the interest of Guatemala's government to inform the international community about certain advances made toward fulfilling some basic conditions that were pending, as well as about its new plans and priorities. In fact, the upcoming meeting of the Consultative Group is perceived as an opportunity to carry out an in-depth discussion of these aspects. The Government's purpose is first, to urge the international community to continue supporting the implementation of the Peace Agreements and, second, to ensure that this support translates into better implementation of those pledges which have been made since the Consultative Group's first meeting in 1997.
4. This document puts forth the vision held by Guatemala's government regarding its main objective of continuing to fulfill the commitments outlined in the Peace Agreements. It also suggests the way in which it hopes the international community will continue to support these efforts. The document highlights achievements in the compliance of the Peace Agreements, such as increasing police effectiveness, housing and demobilization of both the Presidential and Vice-presidential staffs. Additionally, progress in monetary policy and tax reform stand out, but other achievements should also be recognized, such as improvements in strengthening the financial sector-- and in opening the economy, as well as in reforming labor regulations updating minimum salaries and benefits (salary bonuses) and the intellectual property law. In addition, a free trade agreement was signed with Mexico, the Dominican Republic and a partial agreement with Cuba, as well as advanced negotiations with Chile, Canada and Panama.

5. The first part of the document describes the complex process of building peace. It briefly describes, first, some advances and setbacks experienced during the implementation of the Peace Agreements. Some recent measures adopted for implementing the Fiscal Pact are provided as an example. Second, it outlines the structural challenges facing Guatemala's society and economy. Emphasis is placed on the challenges for social policy and governance, in a society that has barely started to recover from the consequences of an armed conflict, which lasted more than thirty years.
6. The following section describes the main characteristics of the macroeconomic situation. It emphasizes the recent measures adopted by the government to stabilize the economy. In 1999, the economy entered into a situation of macroeconomic imbalance, which gave rise to high risks of inflation.
7. Another section describes the efforts undertaken to approach the goal, established in the Peace Agreements, of increasing the tax burden (ratio of taxes to GDP) to twelve percent of Gross Domestic Product (GDP). This achievement resulted from the Fiscal Pact, which was based on the Peace Agreements and it was started by the previous government (Fiscal Pact Preparation Commission, 1999).
8. In separate sections, the document also describes the essential features of monetary policy, several measures aimed at opening the economy and to strengthen the financial sector. Also described is the current status of international cooperation.
9. Within the framework of the Peace Agreements, the government has succeeded in maintaining macroeconomic stability, advancing tax reforms, encouraging the opening of the economy, and strengthening the financial sector. The results attained in these areas made viable the decision to convene a new Consultative Group Meeting. The purpose is to discuss the government's priorities with the international community.
10. One of the central messages that the government wants to convey to the international community, through the Consultative Group meeting, is that these results increase the possibility of advancing the human development objectives set out in the Peace Agreements, specifically, poverty reduction to strengthen democracy and to consolidate peace.
11. The second part of the document presents the government's opinion that, within the framework of the Peace Agreements, poverty reduction is one of the main challenges confronting economic and social policies in Guatemala.
12. The last section presents a summary of the strategy proposed by the government to reduce poverty. Followed by an annex with a list of the main projects and the level of financial support that each requires from the international community.

II. BUILDING PEACE

1. Compliance with the Peace Agreements

13. As expected, the process of implementing the Peace Agreements has not been linear. Periodic reports from the Verification Mission of the United Nations in Guatemala (MINUGUA) provide evidence of this. Significant advances have been made, but there has also been stagnation and even some setbacks (MINUGUA, 2001).
14. In order to prevent subjective evaluation, the bi-annual MINUGUA reports should be taken into account as analyses provided by a reliable witness, who constantly verifies that the Agreements are being observed. The bi-annual MINUGUA report constitutes a source of information for appraising compliance with the Agreements. For this reason, it will be distributed to the participants of the Consultative Group, as a reference document.
15. This explains why the government of Guatemala, having embraced the Peace Agreements as the cornerstone of its administration, has requested the Secretary General of the United Nations to extend the mandate of MINUGUA to continue monitoring the implementation of Peace Agreements.
16. The peace process in Guatemala is based on an ambitious set of commitments attained through arduous negotiations, actively facilitated by friendly governments and by international organizations. The very magnitude and depth of the commitments, sometimes, make partial actions appear as falling short of achieving the goals.
17. Since the Secretary for Peace will give a detailed presentation to the Consultative Group on the achievements of the Peace Agreements, it is sufficient here to mention a few examples of advances and setbacks for the purpose of illustrating the non-linear aspect of the peace process in Guatemala. Likewise, this description will highlight some cases in which international cooperation has made a significant difference toward carrying out the Agreements.
18. It must be remembered that implementing the Peace Agreements in Guatemala takes place in the context provided by a very young, but maturing democracy. The search for peace and security has always been of utmost importance to this democracy. Since the establishment of fundamental institutions in 1982 and the current period of civil governments started, in 1986, each elected government in Guatemala has been concerned with maintaining peace and security. However, since the advent of peace did not bring a corresponding increase in public safety and economic welfare, the clamor for these has not stopped, mainly because there still persist many features of a culture of violence and mistrust.
19. For example, during the preparations for the Brussels Consultative Group meeting in October 1998, there was a tragic event in April of that year: the assassination of Bishop Gerardi, who directed an inquiry into the loss of human lives during the armed conflict. The MINUGUA representative, who participated in that meeting of the Consultative Group, said that the assassination had “resuscitated the specter of political violence” (MINUGUA, 1998). Today, on the verge of a new Consultative

Group meeting, the courts have condemned and sentenced the criminals involved in that crime.

20. At the same time, Guatemalans have also realized that the arrival of peace has not meant a significant increase in prosperity. On the contrary, the economy has been stable since signing the agreements, but economic growth has been erratic and slow. For example, the increase in the Gross Domestic Product in 1997 was 4.4 percent. It increased to 5.0 percent in 1998 and then fell back to 3.6 percent and 3.3 percent in 1999 and 2000, respectively (Bank of Guatemala, 2000). Several projections estimate that this year the economy will grow barely 2 percent. With an average population growth of 3 percent, the consequent increases in earnings per capita since 1997 are paltry.
21. Other evidence that the economy has not generated greater activity can be found in productivity rates. It has been estimated that total productivity in Guatemala over the last two decades has barely increased (Edwards, 2000, p.55). In effect, productivity decreased 2.7 percent during the 80s and then barely increased 0.4 percent during the last decade. To this should be added the persistence of extremely high real interest rates and the need to increase the democratization of credit.
22. The most positive economic indicators of the last decade are the slowing of inflation. It sharply decreased from an average of 10 percent between 1991-1998 to 4.9 percent and 5.0 percent in 1999 and 2000, respectively. However, in this context of stabilization combined with slow growth, the citizens correctly perceive that sufficient prosperity has not arrived with peace, while wealth is concentrated among the highest percentile of the population, the same sector which proportionately absorbs less tax burden.
23. Many of the commitments contained in the Peace Agreements also had to be rescheduled, to keep them in force and also to accommodate this process of partial advances, with hopefully fewer setbacks in the future. In terms of public expenditures, however, the goals recommended by the Commission to Follow up the Implementation of the Peace Agreements have been surpassed each fiscal year since the Agreements were signed.

TABLE No.2
Budget Allocations Implemented in
Compliance with the Peace Agreements
1998-2001
(In millions of Quetzals)

Description	1995	1998		1999		2000		2001	
	Base Year	Goal	Actual	Goal	Actual	Goal	Actual	Goal	Completed a/
Total:	<u>2,706.3</u>	<u>5,036.2</u>	<u>5,849.9</u>	<u>6,138.1</u>	<u>7,167.7</u>	<u>7,214.5</u>	<u>7,437.3</u>	<u>7,910.4</u>	<u>4,975.6</u>
Health and Social Services.	750.4	1316.9	1382.1	1611.2	1931.9	1947.3	2003.2	2131.7	1289.0
Education, Science, Culture	1411.9	2577.7	2617.1	3144.0	3285.3	3663.9	3629.2	4010.2	2437.8
Housing	14.2	174.5	673.7	203.1	401.2	228.5	10.6	264.1	44.7
Internal Security	289.2	527.7	653.9	644.0	982.6	750.5	1092.4	820.7	716.9
Justice System	150.8	275.8	347.5	335.8	366.5	391.3	457.1	428.9	281.5
Attorney General's Office	89.8	163.6	175.6	200.0	200.2	233.0	244.8	254.8	205.7

a / Completed as of 7/31/2001

Source: Ministry of Finance

A. The Fiscal Pact

24. The commitment of the Peace Agreements to increase tax revenues to 12 percent of GDP, rescheduled for the year 2002, was accepted by the international community and became one of the necessary conditions for receiving more external assistance. Not meeting this objective in the past, together with other implementation difficulties, has impeded obtaining increases in foreign financing.

25. The commitment reached in the Fiscal Pact Preparatory Committee on how to meet the goal of raising tax revenues to 12 percent of GDP, relied on the active support of bilateral and multilateral agencies. The national debate, including different sectors of civil society was very intense and different positions were put forward in the media by diverse interest groups. One argument even held that the Peace Accord's requirement to increase the tax burden originated with some international organizations. However, it was rare to see that such an open debate was able to attain consensus in the form of the Fiscal Pact.

26. At the first Consultative Group meeting in Brussels in 1997, the international community identified the low tax burden in Guatemala – one of the lowest in Latin America – as the main barrier to obtaining greater levels of international funding. In Brussels, the international community also accepted the goal laid out in the Peace

Agreements of raising the tax burden in Guatemala to 12 percent of GDP. Unfortunately, that goal had to be rescheduled, since it was not possible to meet that goal in the year 2000, as it had been originally planned.

27. The previous government must be given credit for having started the process known as the Fiscal Pact, a process that was accepted by the new government from the start. As President Portillo said, “we need to respect processes of consensus, such as the Fiscal Pact” (Portillo, 2000, p.16). For this reason the meeting of the Consultative Group, was postponed until the Guatemalan society showed their support for the Fiscal Pact, including the commitment of raising the tax burden to 12 percent of GDP in 2002, in this sense, the party in government represented in the legislature has made enormous efforts and progress.
28. Transforming consensus into the decision to put into effect the *Political Agreement to Finance Peace, Development and Democracy in Guatemala*, signed in June 2000 by representatives of society and the private sector, in the presence of the Follow-up Commission of the Peace Agreements, has been one of the most controversial matters that Guatemalans confronted in recent times. In some cases, it was necessary that legislation be passed almost exclusively by parliamentary majority, without the support of some of the original signatories of the Fiscal Pact.
29. The government decided to invite the international community to a Consultative Group meeting, since it is taking decisive steps towards the objective of raising the tax burden to obtain resources that make possible investment in land, housing, economic compensation for the displaced and uprooted, as well as in programs of health, education and poverty reduction. . Coming closer to the achievement of this goal is what allowed the Consultative Group to be convened. The purpose is to motivate the international community to support the government in the pursuit of its top priority of reducing poverty, which is essential for the achievement of a firm and lasting peace, to consolidate the rule of law and democracy in Guatemala.

B. Structural Challenges

30. There is agreement that besides maintaining macroeconomic stability, Guatemala needs to face the following fundamental challenges: first, fighting poverty, to increase the purchasing power of the majority of the population, to enhance social development both qualitatively and quantitatively, and, second, to improve governance. The agendas for economic policy, social policy and democratic governance that were approved at the beginning of this administration (Government of Guatemala, 2000 a, b, c), are consistent with a recent analysis of these issues by the Inter-American Development Bank (IDB, 2000).
31. If the objectives are limited to stabilization in a country like Guatemala, unfortunately old social inequalities will be perpetuated. There are powerful obstacles that have made it impossible, until now, for all Guatemalans to attain higher living standards. This is why macroeconomic stability and economic growth must be accompanied by deliberate efforts to accelerate social development.

32. The magnitude and depth of these important challenges pose difficult problems which the government of Guatemala has begun to confront. The central axis of these actions is found in poverty reduction.
33. Poverty in Guatemala is above the Latin American average. Moreover, poverty has a pernicious effect, which affects with greater severity the rural, female and indigenous population. This is why, in Guatemala, there will not be prosperity for everyone if there is only a stable, slow growing economy, it is necessary to purposefully reduce poverty. The government is implementing the strategy to reduce poverty which will be described below.

C. Governance

34. In addition to the challenges of macroeconomic stability and social development, Guatemala is also facing the challenge of qualitatively improving governance and safety.
35. To a large degree, the deficiencies of governance are a consequence of the armed confrontation that lasted more than three decades and whose scars have just begun to heal.
36. Despite the signing of the Peace Agreements, there are some segments of society where forms of interaction still prevail that correspond to a situation of armed conflict. However, one important advance has to be recognized, in Guatemala state terrorism is no longer an issue, as it was during the armed struggle..
37. From the beginning, the current government has undertaken to place in civilian hands those functions that were handled by military personnel during the conflict. For example, deliberate efforts have been made to put in the hands of civilians such activities as compiling information and advise to the Presidency of the Republic, as in the case of the Secretariat of Strategic Analysis (*SAE*), and the security of the President and the Vice-president or the Secretariat of Administration and Safety (*SAAS*),. as part of the on-going process of restructuring the military Presidential General Staff (*EMP*). In addition, military installations such as bases and outposts have been demobilized, and are now used for civilian purposes.
38. However, it is not only the consequences of the conflict, which negatively influence governance. Violence has become more intense and more visible. Even though state violence has disappeared, common crime and insecurity have increased, and the state institutions designed to prevent and control such violence have not adapted at the same rate.
39. There are multiple difficulties in adapting new public structures. This is generally due to the lack of resources for strengthening the state's capacity to guarantee safety, administer justice, and prevent and control violence. For example, even though important efforts have been made, there is still much to do to increase the effectiveness and efficiency of the National Civilian Police (PNC) and the administration of justice.

40. This is why horrific stories are frequently reported. Legacies of the civil war, they reveal a propensity to make justice directly, without waiting for the police to do their job. It has to be frankly recognized that governance is a challenge because human rights are precarious and the rule of law is often the exception. However, peace has created space for unprecedented levels of public debate on these issues.
41. To sum up, implementing the Peace Agreements in Guatemala has not evolved in a straight-forward way – it has been quite uneven. On the whole, implementing some of the commitments of the Peace Agreements, such as the Fiscal Pact, has been positive for strengthening democratic processes. But the population still waits for peace to be translated into greater safety and greater prosperity.
42. This is the context in which the government of Guatemala has decided to hold a Consultative Group meeting. The purpose is to assess with the international community how it can contribute to help translate the peace already achieved in Guatemala into the hoped-for and expected security and greater prosperity. To do that, it is necessary to look at the essential features of the current situation, especially the essential features of macroeconomic performance.

2. Recent Macroeconomic Evolution

43. At the end of 1999, Guatemala's economy was moving toward a recession. This was characterized by a slowdown in production, a deterioration of the foreign exchange rate, and increasing evidence of fragility in the banking sector. Moreover, international reserves were falling to unsustainable levels. For example, in October 1999, there was barely enough to finance two and a half months of imports, and the quetzal was devalued by almost 15 percent during the year. The effect of the unsustainable expansion that started in 1998, began to reveal itself in increasing deficits, which went from 0.1 percent in 1996 to 2.8 percent of GDP in 1999, with a corresponding rise in interest rates. This was the situation in which the new government found itself.
44. Since it came to office in 2000, the government of Guatemala has been conscious of the fact that without macroeconomic stability it is impossible to deal with other challenges. As the experience of the 80s shows, even though Guatemala did not suffer the hyperinflation of the other Latin American countries, neither social well-being nor good governance is possible in an inflationary environment.
45. This lesson has been learned by the government. The results of two years indicate that the government has maintained macroeconomic stability. It did this by applying a strict monetary policy to address adverse external circumstances, such as the decrease in prices of main exports and meteorological disasters. This provides the foundation to aim at a growth rate that will generate employment and that will, in turn, contribute to reducing poverty. The government agrees with and shares the aspiration stated by the President of the Inter-American Development Bank (Iglesias, 2000) that, in order to fight poverty, the Guatemalan economy needs to grow at an average rate of six percent. In this sense, it is essential the return of Guatemalan capital, which presently constitutes savings abroad.

46. What follows is a brief description of recent developments in Guatemala's economy, from the time that this government was inaugurated in January 2000, until the end of 2001. The description focuses on fiscal and monetary policies, but it also examines the opening of the economy and the strengthening of the financial sector, placing emphasis on the achievements as well as on the challenges still facing the government.

A. Monetary Policy

47. Given the serious foreign exchange and financial instabilities that were experienced throughout 1999, the new authorities at the Central Bank decided to adopt a set of measures in order to stabilize the exchange rate, preserve price stability and strengthen the financial system. Those measures had positive effects for 19 months because the exchange rate stabilized, and the monetary reserves increased to more than \$2.4 billion, as of November 30, 2001. Meanwhile, interest rates on open market operations were declining (Bank of Guatemala, 2001).

48. Regarding inflation, the available indicators show an evolution that exceeds the target set out in the approved policy-- that the inflation rate should not exceed 4 percent to 6 percent. The authorities remain watchful and will adopt necessary measures to keep inflation within one digit and close to the prestablished range .

49. The Monetary Board is also working on modernizing the process for executing monetary instruments. Monitoring and tracking monetary, exchange rate and financial indicators now complement traditional instruments of financial analysis.

50. A debate about macroeconomic policy was also underway. Some observers (Edwards 2000, p.17) claimed that there was a risk when practicing what the former Deputy Managing Director of the International Monetary Fund calls an "impossible trinity" (Fischer, 2000, p.3). According to these observers, experience shows that to maintain a fixed or stable exchange rate, with free capital movements and a monetary policy that supports independent domestic objectives, will lead to a point where one of those elements must yield.

51. However, until now, the main challenge has come from the lack of consistent support on the part of fiscal policy in the attempt to maintain macroeconomic stability. This situation has begun to change with the adoption of the Fiscal Pact and the Political Agreement to Finance Peace, Development and Democracy..

52. In any case, the coordination between monetary policy and fiscal policy must continue to maintain macroeconomic stability. For this purpose, it is especially important that fiscal policy does not pursue expansive objectives while monetary policy adopts restrictive objectives.

53. To consolidate fiscal discipline, the government is searching an agreement on an economic program with the International Monetary Fund (IMF). This will help to maintain macroeconomic stability and consequently strengthen international standing,

while decreasing country risk in the international financial markets. These elements are also essential for accelerating economic growth and poverty reduction.

B. Fiscal policy

54. At the end of 1999, the global public sector deficit, including the Central Bank, was 3 percent of GDP. As evidence of fiscal responsibility, in 2000, the deficit decreased to 2.5 percent of GDP..
55. After the Ministry of Finance reviewed the budget, the government arrived at the conclusion, at the beginning of 2000, that the amount of the approved budget might jeopardize the objectives of stability and growth. At the initiative of the President of the Republic, the Congress of the Republic passed Law No. 9-2000 and cut the approved budget by 10 percent, or Q2.2 billion.
56. At that same time, the government decided to conclude the process leading to the Fiscal Pact, which had been started by the previous government. The main purpose was that negotiations among different organizations representing society be initiated as soon as possible, so that the Congress could be presented with a set of concrete measures aimed at meeting the rescheduled goal of raising tax revenue to 12 percent of GDP, as set out in the Peace Agreements.
57. In June 2000, more than 130 social organizations and representatives of the business sector, in front of the Follow-up Commission and MINUGUA subscribed the Political Agreement for Financing Peace, Development and Democracy (*Acuerdo Político para el Financiamiento de la Paz, el Desarrollo y la Democracia*). This agreement contains measures for strengthening the administration of the tax system and increasing tax revenues, both of which are necessary for meeting the goal of raising the tax burden.
58. One part of the measures proposed in the Political Agreement to Finance Peace, Development and Democracy was presented by the Ministry of Finance to the Congress, which passed Law 44-2000, taking effect on July 1, 2000. This law, for the Abolition of Privileges and Fiscal Benefits, Increasing the Tax Base, and Tax Regularization, modifies the taxes levied on airplane tickets, vehicular air traffic departures. This law also introduced more progressive income tax rates.
59. Later, in July of this year, Congress passed six more laws, containing some of the reforms outlined in the Fiscal Pac Political Agreement to Finance Peace, Development and Democracy. These laws, motivated political actions among different sectors and contain reforms to the tax code, the criminal code, and the criminal process code, as well as laws against tax evasion and contraband. They also modify the value-added tax, stamp tax, commercial and agricultural business tax, and change import taxes on vehicles, ships, planes, crude oil, and petroleum products. Additionally, social compensation was approved for all salaried persons, from the private and the public sector.

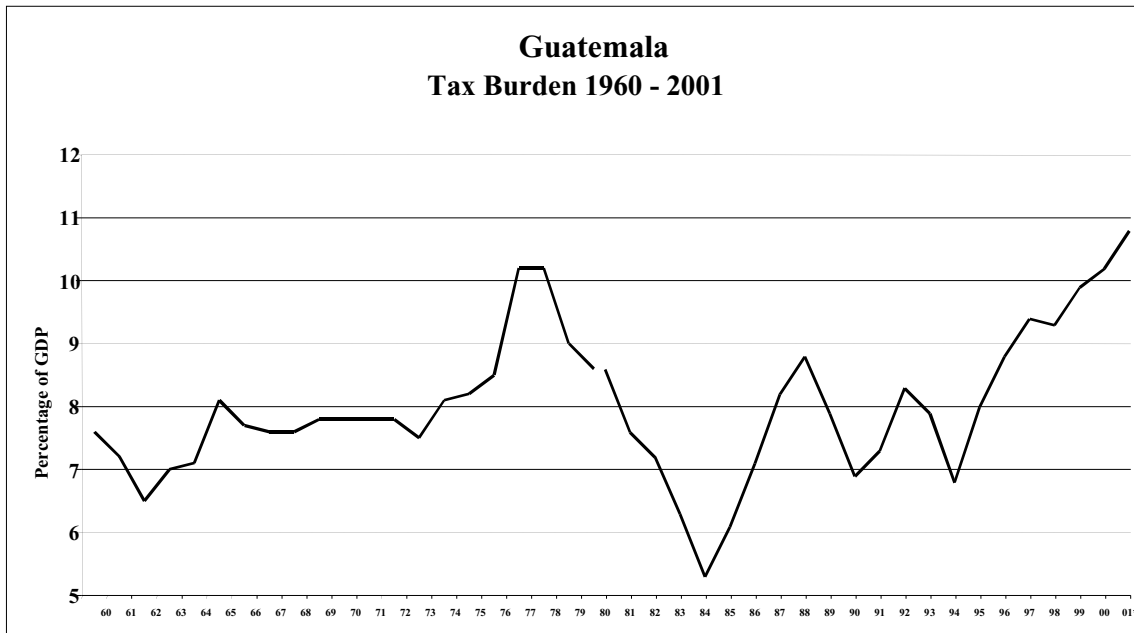
60. It is estimated that these measures will raise tax revenues by at least 0.9 percent of GDP, for fiscal year 2001. During the previous budget year the tax burden was 9.9 percent, therefore, the goal of reaching a tax burden of 12 percent by fiscal year 2002 is closer to realization. Recently, the Congress of the Republic approved five new taxes which confirm the trend to increase the tax burden that the government has been putting in practice.

TABLE No. 3
Net Tax Revenues of the Central Government
Impact of New Tax Measure in 2002
- As Percentage of GDP -

Measure	2002
Value Added Tax (Net)	0.66
(+) Tate increase from 10% to 12% (Gross).	0.78
(-) Tax Credit Refunds.	0.12
Taxo n Comercial, Agricultural , and Livestock Businesses	0.25
(+) Rate Increase of one percentage point (Gross)	0.34
(-) Income Tax Credit	0.08
Vehicular Traffic Tax	0.00
Implementing Tax for Air and Sea Traffic	0.00
Tax on Distribution of Petroleum and Derived Products	0.03
Increase of fuel oil (Bunker C).	0.03
Import Duties	0.01
Reduction in the discount given on the tasable base of imported, Used, five or six year-old cars from 60% to 50%.	0.01
Measure in Specific Taxes to the Consumption	0.39
Beverdges	0.32
Tobacco	0.07
Total Net Impact in 2002	1.3
<i>Net Taxes Burden Befote Reforms</i>	9.2
<i>Net Taxes Burden UIT Reforms</i>	10.6
<i>Nominal PIB (in Millions of Quetzals)</i>	176,957.5

Source: Ministry of Finance

61. These measures represent an extraordinary event in the fiscal history of the country. Over the last forty years, the tax burden exceeded 10 percent of GDP only in 1977 and 1978, then it went back to single-digit levels, where it has remained until now. In contrast with other tax measures adopted in the past, this time, the agreement was subject to intense debate among different social organizations..

GRAPH No. 1

Source: Ministry of Finance

62. A rejection exists among some sectors, within which can be found higher income groups, to the increased tax burden, arguing that greater transparency is required in public expenditures..
63. Therefore, to increase transparency in public expenditures, a comprehensive reform of the public finances is underway. This covers revenue and public expenditures, budget preparation, accounting and financial registers, procurement procedures, and secure, transparent payment procedures. These are the goals of the Integrated Financial Administration System (SIAF), which is supported by the World Bank and the United Nations Development Program (UNDP) and is already functioning in the executive branch. The government supports the extension of the system to the municipalities, to the judicial and legislative branches, and to autonomous and decentralized entities, as well as to government contractors suppliers
64. For the same purpose of transparency and in accordance with the stipulations of the Fiscal Pact, the government has established the National Public Investment System (SNIP), in order to achieve greater efficiency and transparency in the allocation of public investment resources.
65. Finally, in order to improve tax collection and enable taxpayers to meet their obligations in an honest and efficient way, the Tax Administration Authority (SAT) is combating tax and customs fraud, as well as broadening the tax base in order to increase tax collection.

66. Based on this year's results to date, in terms of economic stabilization and achieving fiscal goals, the government made the decision to hold a Consultative Group meeting. It believes that at this meeting the tax issue will no longer be the main obstacle, as it was at previous Consultative Group meetings, therefore allowing for productive discussions with the international community on topics of greater importance, such as poverty reduction.
67. It is clear that as long as threats to macroeconomic stability continued, it was difficult to take on other, longer-term objectives. Now that these threats are under control, the government hopes that the international community will support its intention to implement a strategy to reduce poverty. This is the most important challenge to social and economic policies in Guatemala.

C. Opening the Economy

68. From the beginning, the government has encouraged the liberalization of the economy in order to increase domestic competition and international competitiveness. Opening the economy has favorable repercussions for all consumers, because it keeps domestic prices low and it stimulates efficiency among domestic suppliers.
69. This objective has been pursued on three main fronts. First, regulations to restrict the entry of certain products that confront monopolistic or oligopolistic restrictions have been relaxed such as sugar, cement, dairy products, fertilizers, chicken, wheat flour, beer and steel. Second, trade negotiations have been intensified to sign free trade agreements with other partners. For example, the governments of Central America have completed negotiations for a free trade agreement with the Dominican Republic, and with Mexico. Finally, legislation has been approved to reform the labor code and the intellectual property law has been modernized. In both cases, these laws were necessary to preserve the preferential access of Guatemalan exports to the U.S. market.

D. The Financial Sector

70. Regarding the strengthening of the financial sector, the Monetary Board has assisted commercial banks that were experiencing difficulties. To protect the integrity and confidence in the banking system, in February and March of 2001, the Monetary Board took over three relatively small commercial banks that held about 5 percent of bank deposits, as well as the liquidation of two finance companies. The Monetary Board also approved the liquidation of the three banks it had taken over.
71. However, there is consensus in the government that the financial sector needs a thorough reform, to reduce its vulnerability and its linkages, by giving the public sector the tools necessary to shore it up in case of emergency. For this reason Congress is involved in an intense process of approval of legislation to strengthen the Central Bank, banking laws, and bank supervision.
72. To complement these required reforms, negotiations have begun with the Inter-American Development Bank and the World Bank to obtain loans to support banking

reform. Given the importance this reform has for preserving macroeconomic stability, obtaining a favorable decision on these loans for the financial sector is one of the government's main priorities.

73. Possibilities have improved for a favorable response, since until now obtaining a loan for the financial sector had been hindered by the absence of banking law reform and by not meeting fiscal goals, which are also essential for maintaining macroeconomic stability.

3. International Cooperation

74. The international community has always been involved in the peace process. Immediately after signing the Peace Agreements, the first Consultative Group meeting on Guatemala was held in Brussels on January 21-22, 1997 (Government of Guatemala, 1997a). At that time, the international community offered to support the peace process in Guatemala, and some of that support has been translated into concrete actions and projects. However, as with implementing the Peace Agreements, there have been obstacles and difficulties that have prevented the fulfillment of some of the pledges made by the international community.
75. This situation was later discussed, at two Consultative Group meetings and one Follow-up meeting. The most recent Consultative Group meeting was convened as a result of the natural disaster known as Hurricane Mitch, which devastated the Central American Isthmus in 1998 (Government of Guatemala, 1999). Another Consultative Group meeting was held before that in Brussels, in October 1998 (Government of Guatemala, 1998) and the Follow-up meeting was held in Antigua, Guatemala on September 9-10, 1997 (Government of Guatemala 1997b).
76. It has already been stated that the international community's support was immediate at the first Consultative Group meeting in Brussels in 1997. At that meeting, in response to the Guatemalan government's presentations, the international community made pledges that amounted to US\$ 1.9 billion. At the next Consultative Group meeting, this figure increased to US\$ 2.3 billion. Since that time, these figures have been used as a basis for measuring the extent to which the international community has met these pledges.
77. In contrast to the situation at the beginning of the 90's, net transfers of reimbursable resources became positive after the Consultative Group meeting in Brussels in 1997. For example, net transfers of resources were negative by US\$ 36.79 million in 1995 and US\$ 65.61 million in 1996. In contrast, positive transfers started to be registered in 1997 with US\$ 9.20 million, US\$ 180.91 million in 1998 and US\$ 186.98 million in 1999.

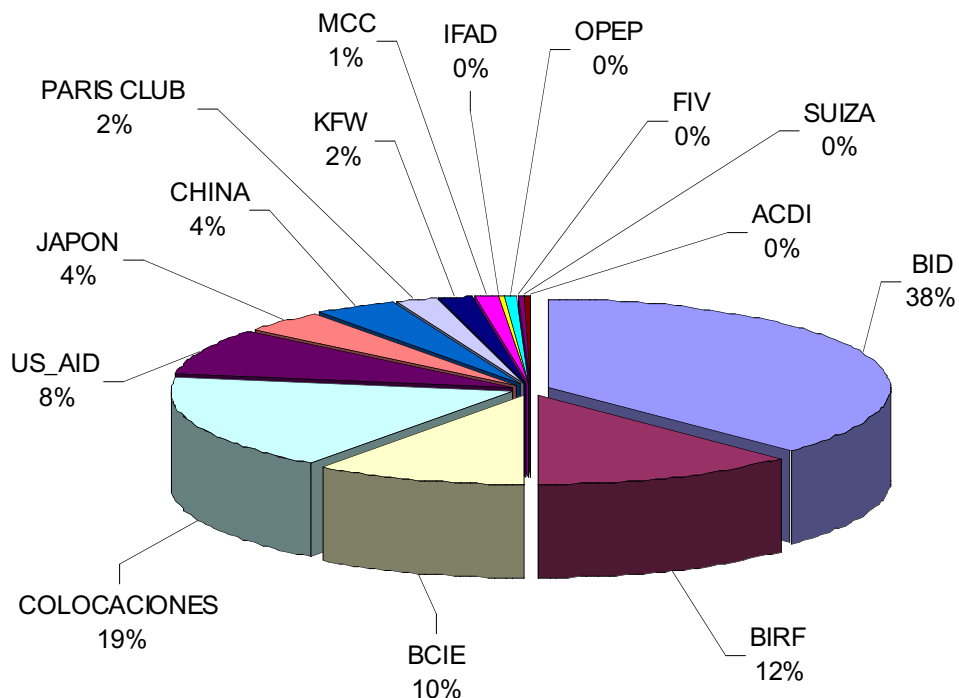
TABLE No. 4
Guatemala: Net Transfers of External Debt
(In millions of US \$)

ITEM	1995	1996	1997	1998	1999	2000	2001
Disbursements	115.10	139.40	174.49	348.80	381.40	200.75	67.38
Debt Service	151.89	205.01	165.29	167.89	194.42	218.77	128.71
Net Transfers	-36.79	-65.61	9.20	180.91	186.98	-18.02	-61.33

Source: Ministry of Public Finance

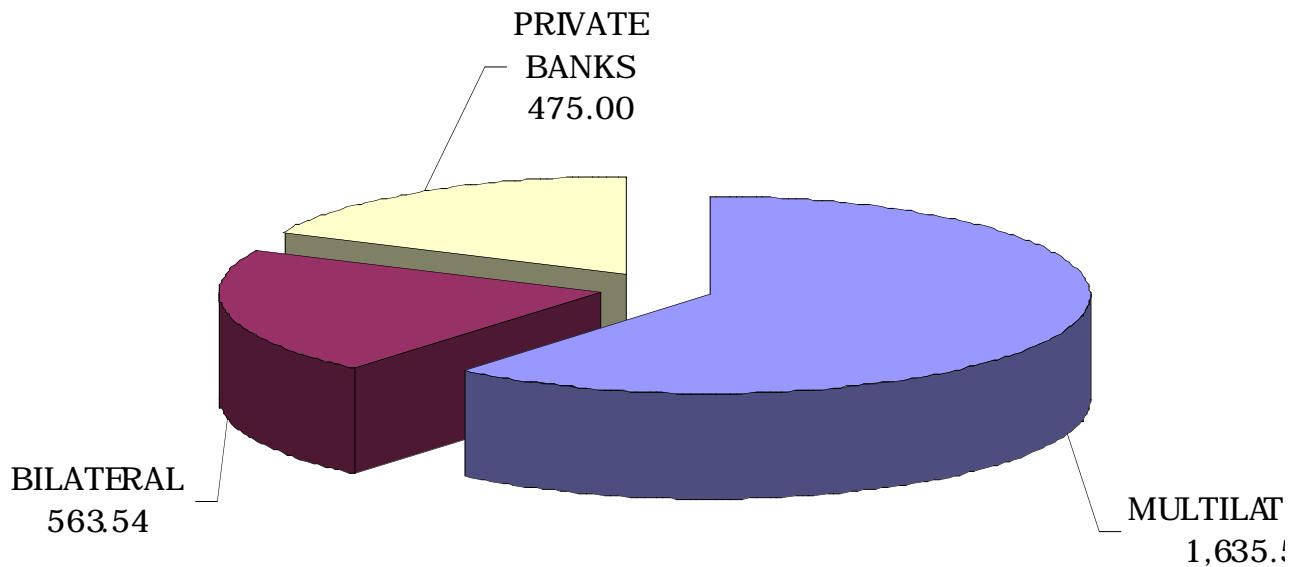
78. As of 2000, this tendency was reversed, indicating that it is necessary to make greater efforts to increase the amount and the efficiency in the disbursement of external assistance. By itself, this fully justifies holding the upcoming Consultative Group meeting.
79. However, in order to provide a complete picture, it is also necessary to include the non-reimbursable resources that the international community has donated since the signing of the Peace Agreements. In the last four years, these donations have amounted to about US\$670 million.
80. Financing sources have also been diversified considerably. The most recent data available reveals that nearly 41.5 percent of all reimbursable resources loaned to Guatemala are from the IDB. The World Bank and the Central American Bank for Economic Integration (CABEI) follow with 13.7 percent and 12.2 percent, respectively. Among bilateral reimbursable financing sources, the United States stands out with 10.1 percent, followed by Japan and the Republic of China, with about 5 percent each.

GRAPH 2
GUATEMALA: COMPOSITION OF OUTSTANDING EXTERNAL
DEBT BY CREDITOR
AS OF 31/12/2001
(PERCENTAGES)



Source: Ministry of Finance

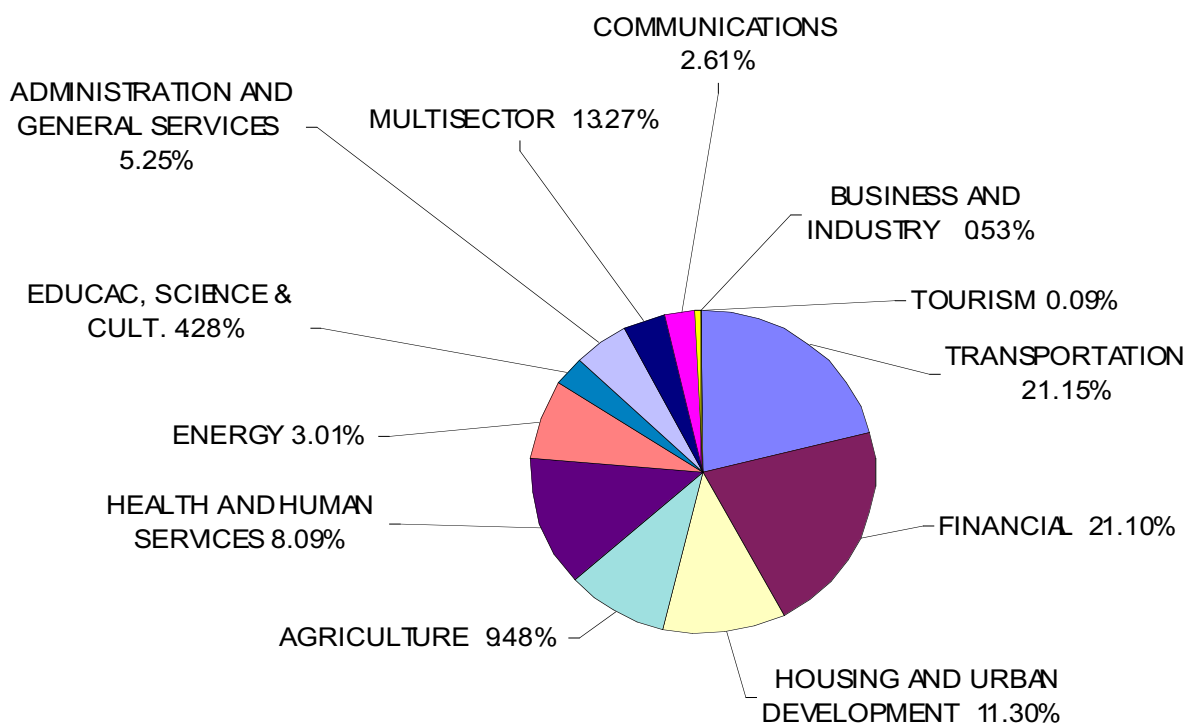
GRAPH 3
GUATEMALA: COMPOSITION OF OUTSTANDING EXTERNAL
DEBT BY SOURCE
AS OF 31/12/2001
(MILLIONS OF US \$)



Source: Ministry of Finance

81. Finally, almost 27 percent of foreign reimbursable funds have been allocated to infrastructure – transport, energy and communications. Social sectors – education, health, and housing – have received almost 24 percent of all foreign reimbursable financing. To a certain degree, this reflects the previous government’s priorities. This government proposes to change the distribution, placing priority on social sectors, as part of the poverty reduction strategy.

GRAPH 4
GUATEMALA: ALLOCATION OF EXTERNAL RESOURCES
BY ECONOMIC SECTOR - IN PERCENTAGES
AS OF 7/31/2001



Source: Ministry of Finance

82. It must be recognized, however, that there have been difficulties in executing the financial pledges made by the international community at previous Consultative Group meetings. These difficulties have contributed to the fact that disbursements, resulting from the Consultative Group meetings held since 1997, have come to a little more than half the amount originally pledged.

83. The country's difficulties with implementation are well-known, such as the insufficient absorptive capacity, insufficient matching funds, or certain institutional weaknesses, which affect the implementation of projects funded by foreign resources. However, so far, the main obstacle to increasing external assistance in Guatemala has been the failure to implement the fiscal commitments to raise tax revenues.

84. These difficulties described above, confronted by the execution of projects, have not disappeared. The government intends, in response to the renewed support that it hopes to receive from the international community, to eliminate many of these obstacles, which appear at several levels of the administration. To achieve this, as agreed in the Fiscal Pact, the National Public Investments System (*SNIP*) proposes to

undertake a multi-year program for public investment. One of its purposes is to prevent public investment from falling below 4 percent of GDP between 2001 and 2004 (SEGEPLAN 2001). As mentioned, this system also intends to improve transparency in public investment.

III. PRIORITIES AND PROJECTS

1. Framework of the Peace Agreements

85. The objectives stated in the Peace Agreements provide a frame of reference for managing the government's priorities. This frame of reference is made up of four areas: a) resettlement, incorporation and reconciliation, b) integral human development, c) sustainable productive development, and d) modernizing the democratic state, including building participatory capacities and coordinating different areas of society. Moreover, three aspects traverse these areas and must be incorporated in a substantive way: indigenous peoples' rights, gender concerns, and social participation.
86. As evidence of the government's intention to focus on these priorities, more than 3 billion Quetzals, equal to about 2 percent of GDP, have been allocated in the fiscal year 2002 budget, under public investments for the social sectors. This amount will be dedicated to education, health, social security, housing, and community services. Moreover, in the framework of the Peace Agreements, the Follow-up Commission has proposed that budget allocations be approved for Fiscal Year 2002, amounting to almost 2.35 billion Quetzals, for expenditures related to human rights, public safety and the administration of justice. These budget allocations provide some of the matching funds required by the different projects which will be presented to the international community for financial support during the Consultative Group Meeting.

TABLE 5
Guatemala: Central Government Expenses
By Function: 2000– 2002
(In Millions of Quetzals)

Description	2000	Close* 2001	Projected Budget 2002
Total	19,801.2	23,545.2	26,049.1
General Services	3,142.4	3,159.2	3,121.1
National Security	1,092.4	1,580.6	1,530.4
Defense	1,085.5	1,215.7	1,029.8
Social Sectors	8,733.6	11,228.9	12,305.3
Operations	6,256.7	8,213.8	9,001.1
Capital	2,476.9	3,015.1	3,304.2
Education	3,078.9	4,023.3	4,093.5
Health	1,671.0	2,437.5	2,239.7
Safety and Social Well-being	1,524.1	1,694.0	1,744.0
Housing and Community Services	1,473.2	1,785.5	2,700.2
Social Funds	986.3	1,288.5	1,527.9
Education	550.2	708.5	912.6
Health	332.2	364.4	399.8
Other costs related to Social Funds	103.8	215.6	215.6
Economic Sectors	3,224.0	3,235.4	4,272.0
Agriculture	464.6	656.8	876.9
Transportation and Communication	2,059.8	2,343.6	3,062.4
Electricity	436.5	39.5	28.8
Other 1/	263.1	195.6	303.9
Other	2,523.3	3,125.3	3,790.5
Amortizations	692.4	906.7	2,522.2
Interest, Commissions and Other	1,830.9	2,218.5	1,268.3
PERCENTAGE OF GDP			
Total	13.43	14.57	14.61
General Services	2.13	1.96	1.75
National Security	0.74	0.98	0.86
Defense	0.74	0.75	0.58
Social Sectors	5.92	6.95	6.90
Operations	4.24	5.08	5.05
Capital	1.68	1.87	1.85
Education	2.09	2.49	2.30
Health	1.13	1.51	1.26
Safety and Social Well-being	1.03	1.05	0.98
Housing and Community Services	1.00	1.11	1.51
Social Funds	0.67	0.80	0.86
Education	0.37	0.44	0.51
Health	0.23	0.23	0.22
Other costs related to Social Funds	0.07	0.13	0.12
Economic Sectors	2.19	2.00	2.40
Agriculture	0.32	0.41	0.49
Transportation and Communication	1.40	1.45	1.72
Electricity	0.30	0.02	0.02
Other 1/	0.18	0.12	0.17
Other	1.71	1.93	2.13
Amortizations	0.47	0.56	1.41
Interest, Commissions, Other	1.24	1.37	0.71
<i>GDP at Current Prices</i>	<i>147,476.9</i>	<i>161,562.8</i>	<i>178,273.4</i>

* Estimate

1/ includes industry, commerce, tourism, and others derived from petroleum and mining

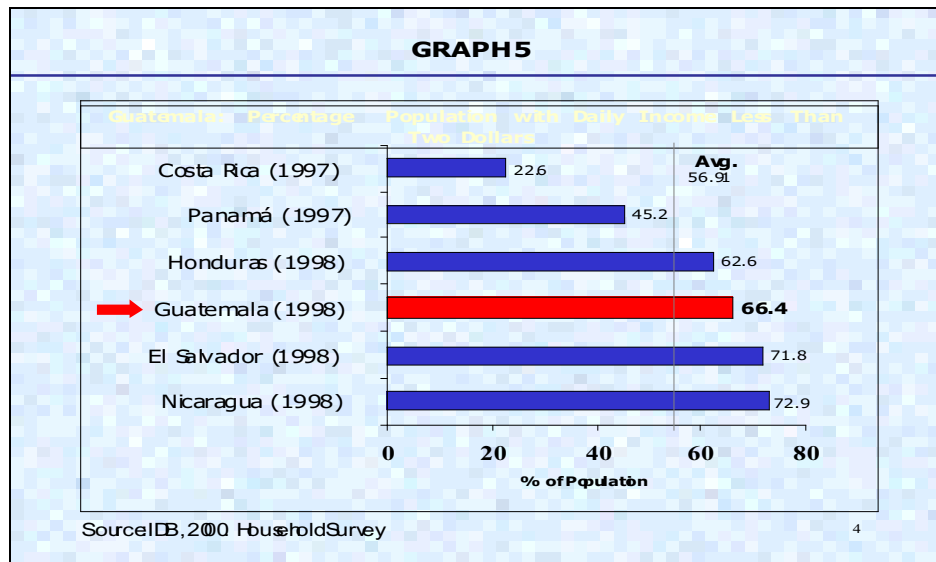
SOURCE: Ministry of Finance

87. Within the framework of these same priorities, the government has decided to implement a strategy to reduce poverty. For the first time, a map of poverty by municipality is available and the government has decided to confront with determination this obstacle to peace and democracy. This decision is based on the conviction that the measures adopted will make a decisive contribution to the implementation of the Peace Agreements.

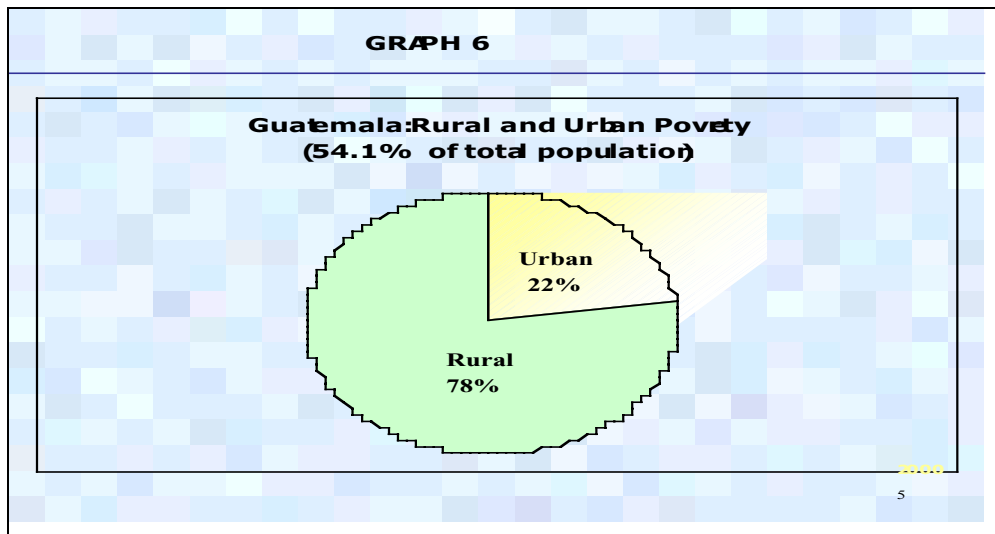
2. Poverty Reduction

88. Economic stability, fiscal adjustment, economic liberalization and strengthening the financial sector have been the main achievements of this government in its first two years. However, there still are important challenges, since there are structural shortcomings in the Guatemalan economy that require priority attention. Among them, the incidence of poverty stands out as the most urgent and most complex task, if peace and democracy are to be built on solid and definitive foundations.

89. Quantitatively, Guatemala has one of the highest incidences of poverty in the region, with almost two thirds of the population living below the poverty line.



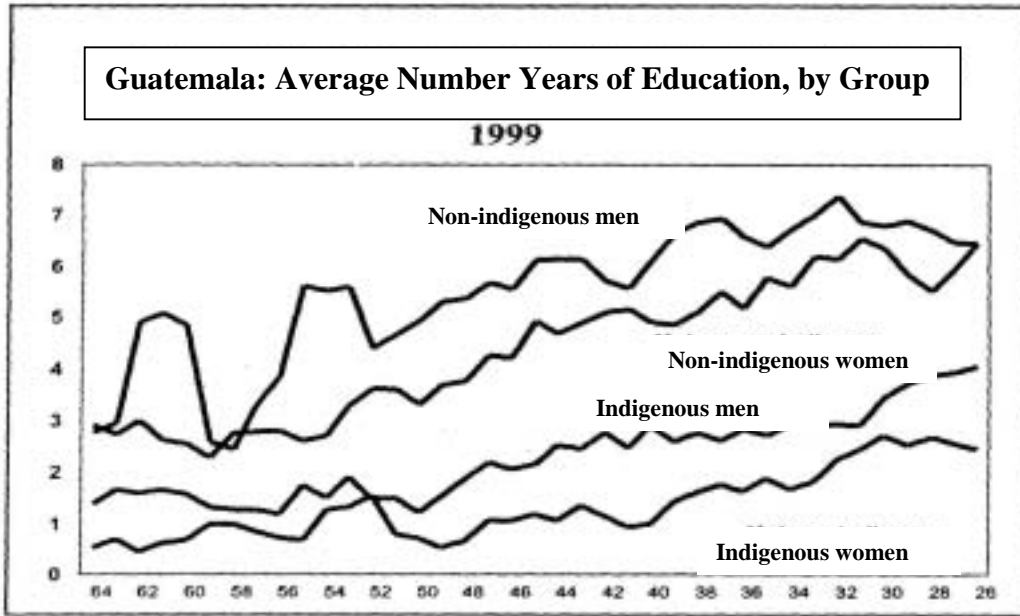
90. In order to be effective, poverty reduction programs in Guatemala must focus on the rural population, which is mostly indigenous. The largest concentrations of poverty are found in rural areas. Three fourths of those who live in rural areas are poor, compared to one fourth of those living in urban areas. This means that public programs need to concentrate mostly on the rural population.



Source: SEGEPLAN, *The Drama of Poverty in Guatemala*

91. However, in a multicultural, multi-ethnic and multilingual society such as Guatemala, the incidence of poverty has a tendency to affect indigenous people more than non-indigenous people. For example, nearly 75 percent of indigenous population is poor, while the number is 40 percent for non-indigenous population (SEGEPLAN 2001b).
92. Poverty in Guatemala also has a gender bias. For example, while indigenous men on average complete three years of schooling, indigenous women barely accomplish two years. Therefore, to be effective, poverty reduction programs must focus primarily on the rural, indigenous population, and emphatically target women.

GRAPH 7



Source: Inter-American Development Bank

Source: Inter-American Development Bank

93. These are only some main indicators of poverty. They reveal the quantitative and qualitative magnitude of the work that must be done. First, it is clear that implementing a strategy to reduce poverty in Guatemala significantly goes beyond the timeframe available to this government. However, the government does have the goal of making poverty reduction the main focus of its administration during its remaining years. Its intention is to lay the bases so that the objective of reducing poverty is incorporated into the responsibilities of future governments.
94. Secondly, in contrast with other precedents, the government has decided to design and execute a poverty reduction strategy convinced that this is one of the basic structural challenges facing Guatemalan society. The strategy has not been designed in order to comply with international requirements of debt reduction. This means that financing for the poverty reduction strategy will rely fundamentally on domestic resources, through reallocation of budgetary resources, more efficiency in the tax system, and streamlined public expenditures.
95. Third, it is clear that since the incidence of poverty is highest among the female, rural, indigenous population, programs and projects of poverty reduction must be designed in such a way as to have greater impact among these segments of the population. The elements of the strategy for poverty reduction are briefly summarized below. A more detailed description will be distributed as a separate document at the Consultative Group meeting (SEGEPLAN 2001a).
96. There are three central pillars in the proposed poverty reduction strategy. First, there must be balanced, economic growth at an average annual rate of not less than 4 percent. This is the most direct method of creating jobs that are adequately remunerated. Second, there must be investment in human capital, targeting poor people, mainly in the areas of food security, education, (pre-school and primary school), and health (emphasizing prevention and primary care). Finally, there needs to be investment in physical capital, especially for the construction of basic infrastructure, such as sewage systems, potable water systems, local roads, rural electricity, as well as access to land in support of rural development.
97. At the same time, the poverty reduction strategy identifies three transversal themes which should be included in all proposed actions. First, multicultural and intercultural factors, second, gender equity, and third, reduction of vulnerability to natural disasters.
98. The strategy covers the period from 2002 to 2005 and it assumes that macroeconomic stability will prevail during this time and that limitations on public expenditure will continue. In this context of macroeconomic austerity, what is available is the increase in tax revenues and the reallocation of public expenditures, especially through the social funds that already exist.
99. The Annex I of this document contains an inventory of projects amounting to US\$3,145 million in support of activities required for the continued implementation of the Peace Agreements and for initiating the execution of the Poverty Reduction Strategy. Based upon the Government's commitment to maintain the public investment above 4 percent of GDP during the period 2001-2004, it has allocated US\$986 million of counterpart resources to finance the counterpart funds for the

projects identified in Annex I. Consequently, the Government estimates a financing gap of more than US\$2,100 million.

100. In conclusion, be effective the consolidation of the peace process and the poverty reduction strategy need to have the support of the international community. Large amounts of fresh resources must be channeled to support the peace process and poverty reduction. Only in this way, premature struggles over scarce resources will be avoided - struggles that could jeopardize peace and development for all.

List of Projects (Annex I)

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