



• G U A T E M A L A •
Country Economic Review and Prospects



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Executive summary

Major steps to consolidate macroeconomic stability have been taken in the first semester of 2002. A Stand-By program has been agreed with the IMF that should ensure fiscal discipline, and cut the overall public deficit in half to 1.5 percent of GDP in 2002. In the financial sector, Congress approved major laws that will help to complete the cleaning up of the weak or failed banks. The laws will strengthen the Central Bank's autonomy, increase the independence of the Superintendency of Banks, and allow for new powers to supervise financial groups, including their offshore affiliates.

While some results on these two fronts have already been forthcoming, economic growth continued to be sluggish, at a rate probably close to 2 percent. Traditional exports have continued to be affected from poor commodity prices for sugar and coffee, while non-traditional exports have lost market shares, hampered by increasing costs, and an appreciated currency. Domestic demand has suffered from low consumer and investor confidence, as concerns for the security situation remained, civil society polarization increased, and few progress has been made towards the implementation of a reduction poverty strategy.

The economy is unlikely to gain much momentum in the second semester, as monetary policy will stay tight to tame higher than expected inflation, and terms of trade will remain unfavorable. For 2003, GDP growth could increase to about 3 percent if fiscal discipline is maintained, as monetary policy easing would induce a reduction in interest rates. The economy could also benefit from a likely settlement of the dispute with Belize, which could bring some aid

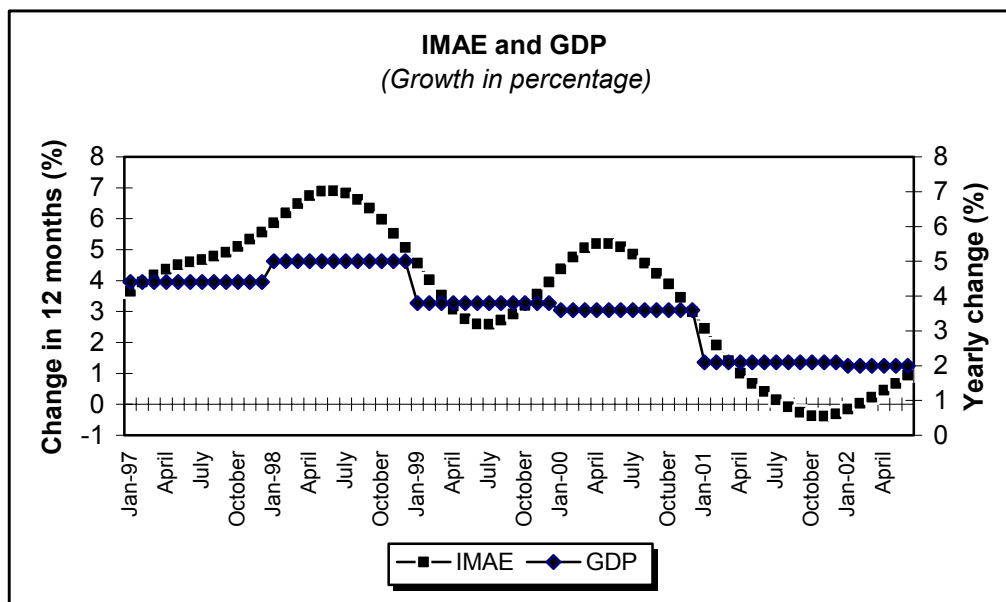
for the border areas, and of additional regional investment in anticipation of the possible conclusion of a free trade agreement with the US. However, for the economy to grow faster, consumer and investor confidence needs to be restored, and more efforts should be made to improve security, and to address impunity with a renewed determination. Success on these issues would also bring forth the external financing needed for the implementation of the pending commitments of the Peace Accords.

Recent Economic Developments

Economic growth remained poor in the first semester of 2002, as a slightly improved external demand was more than offset by historically low or worsening export prices, and a further loss in export competitiveness. The domestic economic situation continued to be affected by low consumer and investor confidence, as efforts to improve the confrontational relationship between the government and the private sector failed, the human rights situation worsened, and the security situation deteriorated. Conversely, significant progress was achieved towards ensuring macroeconomic stability, including a marked improvement in the fiscal situation and significant advances in the strengthening of the financial sector.

The growth of the monthly index of economic activity (IMAE), which was mostly negative in the second semester of 2001, turned slightly positive in the first semester of 2002, but was still below 1 percent in June on a year-to-year basis. Such a low rate is in part the result of a poor export performance, in particular for non-traditional goods, in part the reflection of tepid domestic conditions.

Graph 1



According to customs data, non-traditional exports¹ to Central America declined by just 3 percent, but non-traditional exports to the rest of the world plunged by about 30 percent in the first six months of 2002, leaving total non-traditional exports 13 percent lower than in the first semester of 2001. External trade figures are often revised, sometimes dramatically, however such a large decline is backed by similar data from another source², and by anecdotal evidence from the exporters association. Such a decrease is happening after an already large decline in 2001, suggesting a loss of competitiveness. The exchange rate has appreciated in real terms by 14 percent since early 2000, and is mentioned as a major factor by exporters, in particular as it has also appreciated relatively to neighboring Central American countries. Other factors include labor costs, which have been rising much faster than

domestic prices³, higher security costs, and in some cases lack of financing.

Traditional exports fared relatively better with a 3 percent decline. Sugar export proceeds rose 9 percent, as a 22 percent increase in volume in the wake of a record harvest was partially offset by an 11 percent decline in export prices. International sugar prices since 1997 have declined about 50 percent but sugar production costs are very competitive in Guatemala due to favorable natural conditions, and sugar production remains profitable even at present low prices. Such is not the case for coffee producers, as prices remain close to historic lows. Current prices are below average production costs, and many farmers are switching to alternative crops, in particular maize and bananas in lowland areas. In the highlands, where quality is better, producers are attempting to attract premium prices through internet auction, or various marketing methods. Coffee exports

¹ Traditional exports are defined as sugar, banana, coffee, cardamom, and oil. Non-traditional exports includes everything else.

² The “Balanza Cambiaria” from the “Mercado Institucional de Divisas” shows a 25 percent total export decline for the period January-July 2002, compared to the same period in 2001.

³ Since 1999, the minimum wage has increased by 38 percent, while the consumer prices have increased by 20 percent.

receipts declined by 33 percent, reflecting mostly a decline in volume. Banana exports were affected by repeated labor disputes at the main container port in July, but had been up 6 percent in volume, and 2 percent in value in the first semester. A consistent success story since 1998 has been cardamom exports, which had tripled to about US\$100 million in 2001, mostly due to higher prices. Despite economic uncertainty in its main market, the Middle East, exports were rising again by 38 percent in the first half of 2002, led this time by higher volumes.

Tourism revenues, which grew 16 percent in 2001 despite September 11, is another bright spot in the export picture. Although slowed down after the terrorist attacks, the growth rate is expected to be 8 percent in 2002. Part of the recent growth reflects an increase in home trips for immigrants, mainly from the community living in the US that has swelled in the last decade, as well as rising tourism from neighboring countries. According to the latest official data, remittances have been almost doubling, but it is in part the result of a methodology change⁴.

Imports were boosted by the continuing strength of the quetzal, and grew 14 percent according to customs data. However, this growth's significance is also in doubt⁵. Capital goods imports were particularly buoyant, suggesting businesses were prepared to boost production, although business surveys during the semester were showing low expectations for a recovery.

Regarding production for the domestic market, the same business surveys have been suggesting a flat profile, consistent with the actual data compiled in the IMAE. Most negative in the surveys was the

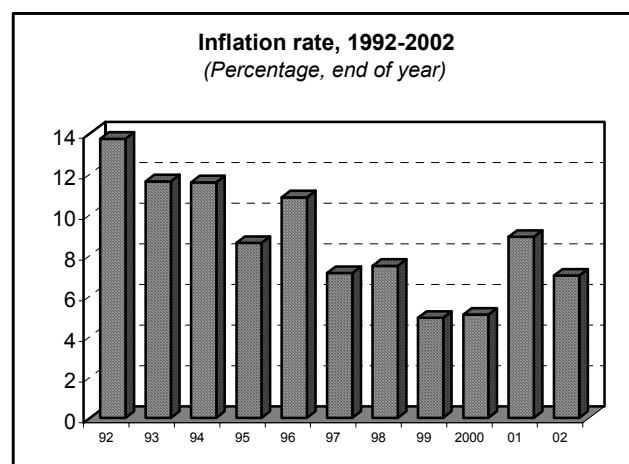
⁴ Previously, only transfers made through Western Union were recorded. Data for transfers through commercial banks are now available and recorded.

⁵ A new automatic data registration system for imports based on the import taxes software has been implemented in July 2001 and upgraded in June 2002, increasing substantially the level of recorded imports, and rendering growth rates for 2001 and 2002 largely meaningless.

level of consumer and business confidence in the economy. Major concerns that affected confidence were continuous corruption allegations, a perceived deterioration in human rights⁶, and the renewed deterioration of security for both household and businesses, that is constantly increasing consumer as well as business costs.

Inflation has remained around 9 percent during the semester, largely above its target level of 4-6 percent set in the monetary program, while core inflation was just a bit lower at 8.4 percent in July. Although inflation is set to decline by about 1 percent in August as the one-off effect of the rise in value added tax in August 2001 will fade, such a level is a disappointment, in particular in the current context of low domestic demand and currency appreciation.

Graph 2



Commercial bank interest rates have eased regularly since the beginning of the year, and at the end of August, average lending rates had declined 135 basis points to 16.5 percent, while deposit rates had declined 115 basis points to 7.3 percent. At this level, real deposit rates have become negative, but deposits in domestic currency remain more attractive than deposits in

⁶ Report of the UN Representative on Human Rights Defenders, May 2002.

dollar, and even more so with the domestic currency appreciation. For lending rates, the decline reflects increasing competition from dollar interest rates, which have become legally and widely available in the country since May 2001.

Economic Policies

After the spending excesses of the first semester of 2001, and the widening fiscal deficit that ensued, the authorities decided to return to fiscal discipline. They signed a Stand-By agreement in April by the IMF, in which they commit themselves to halve the overall public sector fiscal deficit to 1.5 percent of GDP in 2002. For the central government, the deficit is to be reduced to 1.3 percent of GDP.

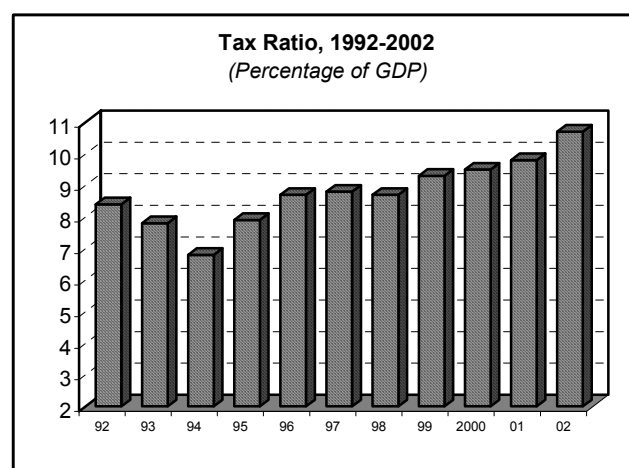
On the revenue side, the administration has been struggling to advance towards the target of 12 percent of GDP for the tax ratio, a commitment agreed in the 1996 Peace Accords, initially to be met in 2000. In July 2001, Congress approved reforms to the tax and penal codes aimed at strengthening the tax administration, and a tax package which included an increase in the VAT rate from 10 percent to 12 percent. The implementation of the VAT increase was followed by widespread public demonstrations and a national strike, and the government decided not to raise taxes⁷ further until the end of this administration in November 2003. The Stand-By agreement settles for a tax ratio target of 10.7 percent of GDP for 2002, an increase of about 1 percent of GDP compared to 2001. Most of this increase is the result of the tax package⁸, which

⁷ Except in case tax collections were to fall below the amount envisaged in the Stand-By agreement

⁸ In addition to the VAT rate increase implemented in August, the package included a rise in the rate of the IEMA - a minimum tax that is deductible from the income tax - from 1.25 percent to 2.25 percent on enterprise sales, or 2.5 percent to 3.5 percent on enterprise assets, whichever is lower, implemented in the last quarter of 2001. Other tax measures included a 100 percent tax increase on ship and aircraft circulation, a tripling of the taxation on fuel oil (except for power plants) and, in November 2001, a 230 percent increase in the excise on cigarettes.

implementation was completed in January 2002 with the reestablishment of a 10 percent custom duty on gasoline and, in February, with an increase in excise taxes⁹. As of June 2002, tax revenues had increased by 24 percent, led by a 38 percent increase in direct taxes and a 25 percent increase in VAT revenues, and the quarterly targets had been met.

Graph 3



On the spending side, government expenditures, which had risen by 1 percent of GDP to 13.4 percent of GDP in 2001, are limited by the agreement to 12.8 percent of GDP in 2002. To that effect, mechanisms of expenditure control to correct the 2001 overruns have been put in place¹⁰. The control will be facilitated by the inclusion of the social funds in the Integrated Financial Management System (SIAF). The adjustment is to fall on current expenditure, while

⁹ The rise is 125 percent for soft drinks, 100 percent for wine, 22 percent for beer, and 11 percent for liquors.

¹⁰ The mechanisms include the following actions: set specific quarterly expenditure ceilings for each ministry, forbid increases in budgetary appropriations (ampliación presupuestal) except in specific circumstances, forbid offsetting savings in expenditure other than in the wage bill with additional spending in other categories, freeze general wages, including bonuses to the civil service, prohibit the increase in the number of civil servants except in health, education, and security sectors, ensure that all government investment will be included in the budget and be subject to the review of the National System of Public Investment (SNIP) and to the prior certification of available financing by the Ministry of Finance.

capital outlays would remain at the same level of GDP. The government is also committed to protect social expenditure to the minimum level of at least 5 percent of GDP. As of June 2002, the administration had complied with the conditions for expenditures set up in the agreement, and in particular expenditures in the first semester were at or below targets, with total expenditures declining by about 4 percent.

In the last few years, targets have been set for public spending in education, health, justice, security, housing and military expenditures, as required by the Peace Accords. Most of the targets have been met in 2001 and seem likely to be met again in 2002, in particular in the social sectors. Last year exceptions were housing and the military¹¹ and, according to preliminary figures, this situation seems to be continuing this year.

One important issue regarding public expenditures have been the level of transparency, as allegations of corruption and embezzlement from public officials have accumulated. A series of anti-corruption initiatives before and commitments at the Group Consultative meeting in February 2002, led to a brief renewal of optimism, as a dialogue with civil society groups seemed to be possible. However, despite some follow-up, the results have been disappointing, as progress in prosecuting cases has been modest. In March the government proposed to establish an anti-corruption forum, but civil society and private sector groups declined to participate.

The exchange rate has appreciated in nominal terms by 2.6 percent since January 2002. In real terms, the inter-annual appreciation has amounted to 6.2 percent in August, a major headache for exporters, who at times claim for Central Bank

intervention. However, Central Bank abstained to buy dollars, as it has been its policy not to intervene in the foreign exchange market, except to smooth out sudden variations. The free float policy, which has been enforced since early 2001, is now part of the Stand-By agreement. The appreciation is somewhat surprising due to low export revenues, and a high current account deficit. Anecdotal evidence has surfaced that increasingly banks in El Salvador are lending in dollar to Guatemalans at more attractive rates than the ones offered in dollar domestically, flows that are not recorded in the official credit to the private sector data. Similarly, capital inflows from El Salvador are said to be attracted by higher dollar deposits rates. More generally, increasing credibility of the monetary authorities since 2000 is having a supportive effect on the exchange rate.

Monetary policy in recent years has been targeting money supply¹² through the use of open market operations. For 2002, the monetary program set a 4-6 percent range for inflation and an 8-10 percent range for the growth of money supply, in line with nominal GDP growth. In the first semester money supply remained mostly within the range, although tended to be closer to the upper limit in the second quarter. At the end of June however, accumulated inflation since January had already reached 3.8 percent, suggesting that the currency issue range may have been set at too high a level. In addition, other indicative indicators monitored by the Central Bank have been exceeding their target range. The growth in M2 reached 13 percent versus a 9-11 percent target and credit to the private sector was 14.6 percent higher versus a 10-12 percent target¹³. After currency issue exceeded its range in July and accumulated inflation reached 5.3 percent, the authorities decided to increase open market paper operations, while moving the

¹¹ In May, Minugua (Misión de Naciones Unidas para Guatemala, the UN body in charge of monitoring the implementation of the 1996 Peace Accords) expressed concern at military overspending in 2000-2001.

¹² The money supply aggregate targeted is the sum of net foreign exchange reserves and net domestic assets of the Central Bank.

¹³ Figures at end-August 2002.

inflation band up to 5-7 percent for the end of 2002.

At end-August, open market paper operations had increased by about 17 percent. Fortunately, the average interest rate on open market operations, which had declined from 24 percent in January 2000 to about 10 percent in January 2002, remained at this relatively low level in the first semester, containing the cost of monetary policy. This level reflects the rather high liquidity in the financial system together with the lack of otherwise more attractive lending opportunities for the banking sector, and should limit Central Bank losses to 0.8 percent of GDP in 2002.

Efforts continued to clean up the financial sector. The first bankruptcies of financial institutions occurred in late 1998, but it was only in 2001 that the authorities opted for decisive action. They took over three medium-sized banks, while providing additional credit lines to guarantee their deposits, and increased the capital requirement ratios. Already, several indicators have improved, at least at the sector level. The proportion of non-performing loans¹⁴ in the banks' portfolio¹⁵ declined from 11.1 percent in July 2001 to 9 percent in July 2002, and the capital to assets ratio improved from 8.7 percent to 9.2 percent.

In January 2002, a new Banking Law was approved, which improved the prudential regulatory framework, set up a new framework for the resolution of insolvent banks, and included the supervision of offshore activities, as well onshore activities not previously supervised. The new law provides the authority to transfer assets of non viable banks to other banks with limited judicial intervention, and removes bank secrecy to lending operations. After difficult negotiations between the majority and the opposition, Congress finally approved in May the rest of a

package of sweeping financial reforms, supported by a US\$200 million loan from the Inter-American Development Bank, and a US\$150 million loan from the World Bank. As a result, new laws regulating the Superintendency of Banks, the Central Bank, and monetary arrangements, entered into force in June. Altogether, the laws approved in 2002 bring the financial sector up to international standards, in particular in terms of reporting requirements, supervision of financial groups, including offshore entities, lending to related parties, money laundering, and enforcement capacity. Their approval provide a legal framework for the modernization of financial institutions, enhance the autonomy of the Central Bank, the independence of the Superintendency of Banks, and provide for the re-capitalization of the Central Bank.

As part of the Stand-By agreement, a program of on-site inspections of commercial banks has been scheduled, which should have been completed by the end of August. However, the inspection program, which could lead to the determination of additional insolvent banks, had inspected only about two thirds of them in early September.

As regards trade policy, a totally new agenda has been defined by the US proposal to negotiate a Free Trade Agreement with Central American countries, acting as one negotiating side. Such an ambitious proposal, which could accelerate enormously integration within Central America, as well as between these countries and the US entails a series of challenges that just begin to be grasped in Guatemala, where a public debate on the issues involved is now developing.

In the area of privatization, almost all the government participation in the largest enterprises has already been divested. The government plans to sell in the second semester of 2002 the

¹⁴ Defined in the Super-intendency classification, as loans "in mora" or "vencida"

¹⁵ Portfolio of all banks, except the 3 banks intervened in 2001.

remaining shares¹⁶ in the power company (EEGSA), energy distribution companies (DEEGSA and DEOGSA) and the national airline.

The government unveiled an economic action plan for 2002-2004 in June. The plan aims at reactivating the economy through large infrastructure projects and the granting of concessions to private companies to expand, modernize, and operate airports, ports and other facilities. The total package calls for investment of US\$2.5 billion, almost all from private investors. However the plan was met with a lack of enthusiasm by the domestic private sector, and given the international and domestic investment climate, it will be difficult to attract foreign investors in the short-term.

Outlook

Major efforts have been made in the first part of 2002 to reduce the public deficit and strengthen public finances, and to build a sound legal and regulatory framework for the financial sector. The results achieved so far provide a high level of macroeconomic stability in the short term. For stable macroeconomic conditions to be guaranteed next year, it is imperative that the Stand-By agreement be extended by another 12 months, as pressure will build for more public spending ahead of the November 2003 elections. The full implementation of the financial reforms is also necessary, including strengthened independence and re-capitalization of the Central Bank. With this framework in place, the probability of a macroeconomic crisis, such as the one the authorities had to confront in the run-up of the last elections in 1999, will be greatly reduced.

For 2002 as a whole, it is likely that, barring a major external shock, the main fiscal objectives of the Stand-By agreement will be met, in particular

the tax ratio will rise to 10.7 percent of GDP, and the central government deficit will decline to 1.3 percent of GDP. Inflation is likely to be at 7 percent at the end of the year, close to the upper range of the adjusted target range, if monetary policy continue to be tight as announced in July. Regarding the balance of payments, the current account deficit is likely to record a decline from 5.9 percent in 2001 to 4.8 percent for 2002. However, this improvement is in part the consequence of an impressive increase in workers remittances, which is itself largely due to changes in registration methodology, and is therefore difficult to interpret. Foreign exchange reserves are likely to meet their target, even though they will decline by about US\$210 million¹⁷.

Economic growth is unlikely to accelerate significantly in the second semester, and GDP growth will be about 2 percent in 2002. On the external side, the prospects for a rebound in non-traditional exports are limited, and traditional exports are suffering from low prices, which are unlikely to recover in the short term. In the meantime, oil prices are creeping higher in the third quarter, contributing further to the deterioration of the terms of trade. The most buoyant foreign exchange earners have become tourism and workers remittances, which may continue to be dynamic, but further growth acceleration in these sectors is unlikely.

On the domestic side, one major missing ingredient for stimulating demand is confidence. After the Consultative Group meeting in February, which had raised hope, the confidence-building dialogue between the administration and civil society did not materialize, and polarization between the government and the private sector, as well as with the opposition, has been increasing.

¹⁷ The decline in foreign reserves includes US\$180 million, temporarily deposited after the Eurobond issue at the end of 2001, and earmarked to pay short-term debt in 2002. Net of temporary deposit, the net international reserves decrease is US\$30 million.

¹⁶ About 14 percent of the total.

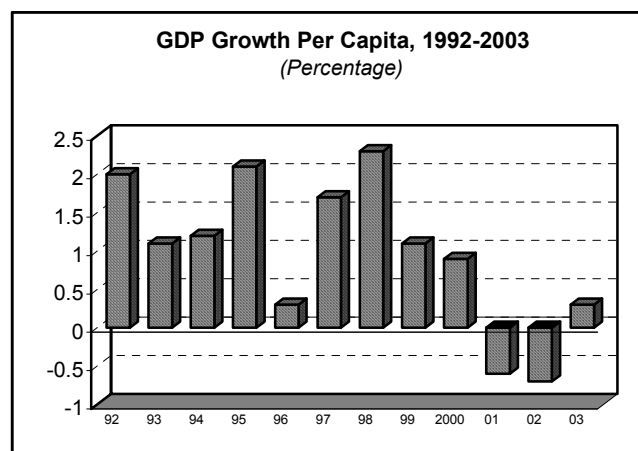
Assuming an improved external environment and the renewal of the Stand-By agreement, GDP growth could accelerate to about 3 percent in 2003, as the economy would benefit from continued macroeconomic stability. Continued reduction in the public deficit would translate into a more accommodating monetary stance, allowing for a reduction in interest rates which will boost domestic consumption as well as investment, and for some currency depreciation, which will lift exports.

Additionally, two positive developments could help. The first one is the likely settlement of the century-old dispute between Guatemala and Belize. Once the proposals¹⁸ are approved by simultaneous referendums in both countries, the UK and other donors may offer development grants of up to US\$100 million to be shared by the two countries.

The second is related to the expected progress in the negotiations of the Free Trade Agreement between the US and Central America. Although domestic divisions have somewhat overshadowed the importance of the topic this year, the private sector is becoming increasingly aware of the transformation that such an agreement would entail. Efforts to improve competitiveness and preparations for new export opportunities are likely to result in a progressive increase in domestic and intra-regional investment, with some initial but modest effect in 2003.

However, to achieve a 3 percent GDP growth rate is not satisfactory, and results in almost no growth in the GDP per capita. Guatemala, which did grow at an average 4.2 rate in the second half of the 1990's, needs to achieve growth rates well above 5 percent, and for that confidence is required. For both consumer and investor confidence to be restored, more efforts should be made to improve security, and to address impunity with a renewed determination. Success on these issues would also bring forth the external financing needed for the implementation of the pending commitments of the Peace Accords.

Graph 4



¹⁸ Proposals for a final border settlement have been presented in September by the OAS-appointed facilitators to both governments, which are likely to endorse it. However, the proposals are then submitted to approval by referendum in each country.