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Guatemala and the IMF

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IMF Executive Board Concludes 2005 Article IV Consultation with Guatemala

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On May 16, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Guatemala.[1]

Background

Guatemala has pursued macroeconomic stabilization successfully since the 1996 Peace Accords, although the goals of the Accords remain to be fully realized. Fiscal discipline has anchored the policy framework; international reserves have risen; and the banking system has been strengthened. Following three years of sluggish economic growth, activity improved somewhat in 2004, with real GDP rising by 2¾ percent, but consumer price inflation drifted upward to over 9 percent. Guatemala continues to suffer from widespread poverty; and, according to a 2002 World Bank survey, perceptions of corruption and weak integrity of some public institutions pose additional challenges.

The government that took office last year has adopted the Peace Accords as the platform for its policy agenda. The Accords embody a broad national consensus on economic, social, and security priorities. Reflecting this, the government's economic program rests on three main pillars: macroeconomic stability; financial sector restructuring; and structural reforms to boost growth and reduce poverty.

A key objective of the program is to keep the fiscal deficit below 2 percent of GDP. Within this framework, the government is seeking to mobilize additional fiscal resources to finance a significant increase in public investment and social spending.

Monetary policy is being geared to reducing inflation to the 4-6 percent range. The exchange system is flexible, but the central bank has intervened in the foreign exchange over the past year to contain the appreciation of the quetzal against the U.S. dollar. In January 2005 a rules-based mechanism for interventions was introduced.

The Guatemalan banking system has been strengthened in recent years. Prudential norms have been tightened and the offshore banks have been brought into the regulatory framework.

The government's structural reform program, *Vamos Guatemala*, is focused on promoting competitiveness, economic growth, and social progress. Steps have been taken to foster a business climate characterized by transparency, the rule of law, and good governance; a Commissioner for Competitiveness has been appointed; and implementation of Dominican Republic-Central American Free Trade Agreement (CAFTA-DR) is expected to help underpin the recovery. Social spending will be increased, with a redoubling of the development effort in municipalities with the highest incidence of poverty.

Executive Board Assessment

Executive Directors commended the Guatemalan authorities' efforts to maintain macroeconomic stability and pursue structural reforms. The public debt has been kept low, international reserves have been strengthened, and the financial system has been made more robust. At the same time, economic growth has been sluggish, poverty remains widespread, and the momentum in strengthening the tax effort has weakened, with consequent declines in social spending. More generally, the economic and social objectives of the 1996 Peace Accords remain to be achieved.

Against this background, Directors welcomed the authorities' renewed commitment to achieving the objectives of the Peace Accords. The government has set forth a comprehensive and ambitious reform agenda in the *Vamos Guatemala* plan. Directors considered that, to realize the growth dividends of the reform agenda, fiscal reform measures should be supported by prudent monetary policy to control inflation, while structural reforms should aim at increasing competitiveness and enhancing the investment climate. They welcomed the envisaged efforts to fight corruption and improve the transparency of government operations, which will help build trust in public institutions and partnership with the private sector, and solidify public acceptance and support for the reform agenda. Directors encouraged the authorities to continue their commendable efforts to promote a public dialogue and to garner the necessary ownership and consensus for faster implementation of the government's reform program.

Directors regretted the decline in the tax revenue-to-GDP ratio since 2002, which has set back the achievement of the Peace Accord goal of raising tax revenue to 12 percent of GDP. Additional revenues are needed to finance well-targeted social programs and pressing investment needs that are crucial for achieving the country's development priorities. Directors supported the ongoing work to strengthen tax administration, and welcomed the progress already evident in this area. However, they noted that strengthening tax revenues on a lasting basis will require congressional action on tax policy as well as some key tax administration measures. Directors underlined the importance of moving forward expeditiously with specification of measures aimed at strengthening revenues and improving the quality of the tax system, including by broadening the tax base and eliminating exemptions. They supported the government's active participation in efforts to strengthen cooperation on tax issues at the regional level.

Directors noted that Guatemala continues to face serious problems of poverty and income distribution, with most of its social indicators falling below the averages for Latin America.
They accordingly welcomed plans to increase spending on social sectors from 2005, with a view to improving the quality of human capital, bolstering productivity growth, and alleviating social inequalities. Directors also called attention to the importance of improving the quality of public spending and strengthening public expenditure management. Key steps planned by the authorities include extending coverage of the Integrated Financial Management System to lower levels of government, and initiating a review of the long-term financial viability of the pension system.

Directors encouraged the central bank to focus on the goal of achieving low inflation. They agreed that the authorities should strengthen their flexible exchange rate regime, which remains appropriate for Guatemala. They recommended that foreign exchange market intervention be limited to smoothing excessive short-term volatility. Directors took note of the authorities' desire to prevent an abrupt appreciation of the quetzal, and welcomed the authorities' intention to pursue a broadly symmetrical intervention policy, also dampening excessive depreciation, as needed. At the same time, Directors considered that a strengthening of external competitiveness would be best achieved by actions to raise productivity, reduce infrastructure bottlenecks, and maintain a prudent fiscal policy. They supported the ongoing work aimed at adopting inflation targeting as the framework for monetary policy. Directors looked forward to further analysis of the implications of the sizable flows of private capital and remittances for monetary and exchange rate policies.

Directors welcomed the emphasis in the authorities' program on policies to increase growth, improve competitiveness, and foster a good business climate. This will require more open and competitive markets, the rule of law, and good governance. Directors were particularly encouraged by Guatemala's early ratification of the free trade agreement with the United States (CAFTA-DR), which will help Guatemala secure broad and stable market access to its main trading partner and provide an anchor for the implementation of growth-oriented institutional reforms. Such reforms should help attract new private investment and strengthen the position of the traded goods sector as Guatemala faces growing international competition, including from the recent expiry of quotas on world trade in textiles.

Directors were encouraged by the significant progress on financial sector reforms since the last consultation, in particular the steps taken to bring the offshore banks into the regulatory framework. They encouraged the authorities to address remaining vulnerabilities, including through steps to reduce bank lending to related parties, build general provisions, and deal with the persistent losses of the state mortgage bank (CHN), in line with the Financial Sector Assessment Program recommendations. Directors urged the authorities to persevere with implementation of anti-money laundering legislation and to update combatting-the-financing of terrorism legislation. The authorities were also encouraged to monitor closely any risks stemming from dollarization in the banking system.

Directors welcomed the steps taken by the authorities to strengthen macroeconomic statistics, including Guatemala's recent accession to the General Data Dissemination System. Further work is needed to address weaknesses in the national accounts, the balance of payments, and the data on non-budgetary fiscal transactions.

Directors considered that Guatemala's medium-term economic outlook is favorable under strong policies, albeit not without risks. The combination of low public debt, a strengthened banking system, a flexible exchange rate regime, and adequate international reserves provides considerable room for maneuver in dealing with adverse shocks.

Guatemala: Selected Economic and Financial Indicators

	2001	2002	2003	Prel. 2004	Proj. 2005
Real economy (percentage change)					
Real GDP	2.3	2.2	2.1	2.7	3.2
Consumer prices (end of period)	8.9	6.3	5.9	9.2	6.0
Public finances (percent of GDP)					
Consolidated public sector deficit	-2.3	-0.8	-2.0	-0.4	-1.7
Nonfinancial public sector debt (end of period)	17.1	15.5	17.1	18.0	17.8
Money and credit (end-year, percentage change)					
Credit to the private sector	12.5	6.1	7.3	16.2	11.2
Liabilities to the private sector	8.1	13.2	11.0	11.4	14.1
Interest rates (domestic currency time deposits)	11.3	9.6	6.7	6.9	...
External sector					
External current account balance (percent of GDP)	-6.0	-5.3	-4.2	-4.4	-4.4
Change in net international reserves (millions of U.S. dollars, increase -)	-499	23	-521	-581	-275
Gross international reserves (in months of next year imports of goods and services)	4.0	3.7	4.0	4.4	4.6
Terms of trade (percentage change)	-1.0	-2.5	-4.4	1.0	-0.5
Real effective exchange rate (end of period) 1/	3.2	8.3	-1.9	7.5	...

Sources: Bank of Guatemala; Ministry of Finance; and IMF Staff estimates and projections.
1/ End-period; a positive change indicates an appreciation.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.