

BUFF/ED/23/57

May 10, 2023

**Statement by Mr. Guerra and Ms. Lankester Campos on Guatemala
Executive Board Meeting
May 15, 2023**

On behalf of our Guatemalan authorities, we would like to thank Ms. Oliva and her team for their open and constructive discussions during the mission, their proactive engagement, valuable analysis, and comprehensive report. Our authorities broadly share staff's assessment.

It has been proven that political cycles must be considered when analyzing the economy, given the effect political forces may have on it. Notwithstanding, Guatemala has proven its resilience during presidential elections. Our authorities have no doubt that this will be the case in the presidential elections on June 25th. The public and private sectors have been working on a first-time initiative aimed at ensuring the continuity of policies they have implemented to unlock longstanding structural vulnerabilities. The initiative is also addressing issues such as social inclusion, poverty, informality, and infrastructure gaps, all of which are key to boosting Guatemala's economic potential and enhancing resilience. The initiative builds on the program "Guatemala no se detiene (Guatemala moving forward)," a key accord between the public and private sectors to improve the country's economic, social, and environmental performance. In fact, they consider this Article IV consultation to be of particular importance to support this initiative, as well as the recent significant improvements in sovereign credit risk ratings from the main credit agencies.

Economic stance

Over the last two decades, Guatemala has built a strong economy, resilient to external and domestic shocks with ample buffers and reinforced by both a prudent fiscal stance and a credible monetary policy framework.

After a strong growth recovery of 8 percent in 2021, the economy grew 4.1 percent in 2022, and Banguat expects a 3.5 percent growth rate for this year, its potential level of growth. For 2024, the authorities envisage a stable macroeconomic framework, which is in line with the latest figures of short-term economic indicators, including the Monthly Index of Economic Activity, the Confidence Index of Economic Activity, and the high growth of family remittances.

Recently, S&P and Fitch improved Guatemala's sovereign debt rating from BB- to BB stable, considering its economy's strengths, such as its solid external position, the moderate level of debt to GDP, and its prudent monetary policy.

As mentioned before, the authorities recognize the importance of addressing structural challenges. In fact, to lower informality, two increases to minimum wages were approved, along with regulations to facilitate partial-time hiring. Also, efforts have been directed towards electronic invoicing, digitalizing public sector procedures, and further implementing the Tax Simplification, Update, and Incorporation Law. To improve the business climate, key laws were recently approved: the leasing and insolvency laws, the law to encourage foreign investment, and the Free Zones Act.

Similarly, to reduce infrastructure gaps, specific initiatives serve as examples: the first PPP *Autopista Escuintla-Puerto Quetzal* (Escuintla-Quetzal port Highway) should start in 2023, and investment spending increased in infrastructure for the health sector.

On monetary and exchange rate policy

In the last monetary policy meeting, on April 26th, the Monetary Board decided to increase the monetary policy interest rate by 25 b.p., from 4.75 percent to 5 percent, as part of a gradual strategy to bring inflation down without significantly harming economic activity. The decision was made with a data-dependent and forward-looking approach. Inflation has decreased significantly in the past two months, from 9.92 percent in February to 8.32 percent in April. Going forward, there is still uncertainty around inflation developments and risks from a challenging external environment; therefore, Banguat will act cautiously, continue to monitor inflation developments closely, and communicate clearly and transparently on the need for keeping a restrictive monetary policy stance until inflation is robustly close to target. The authorities expect inflation to return to the upper limit of the target band (4.0 percent \pm 1 p.p.) by the end of 2023 and be at the midpoint of the band by 2024.

Authorities concur that greater exchange rate (FX) flexibility can help absorb external shocks and are committed to further improvements in the communication framework. Still, they assess that temporary measures have helped to maintain exchange rate expectations more

stable while avoiding abrupt capital outflows or reductions in external foreign currency financing. Overall, they consider that the approach towards greater flexibility should be gradual so as not to hinder a competitive and transparent foreign exchange market. Also, given the current account results and outlook, no significant misalignment with fundamentals is considered to be present. They expect the current account surplus to close in about two years, owing to higher imports and further moderation in the remittances' rate of growth.

Since the mid-2010s, Banguat has accumulated large buffers in the form of international reserves, which are assessed to be adequate in the current environment of protracted high uncertainty. Finally, Banguat is evaluating possible strategies to recapitalize the central bank, but further discussion would have to take place with the new administration.

On fiscal policy

The authorities remain fully committed to ensuring long-standing fiscal stability and debt sustainability, as well as maintaining their good debt servicing track record. Guatemala has remained among those with the lowest shares of debt to GDP in the Latin American region and has made progress on customs, tax administration enforcement, and digitalization. In fact, the deficit has been below the anchor for two consecutive years, and tax revenue reached an all-time high of 12.0 percent of GDP in 2022. Our authorities are aware that this result is still very low compared with Guatemala's peers.

In that context, authorities concur that more progress is required on the revenue side, keeping on strengthening the capacity of the tax administration and gradually broadening the tax base to gain fiscal space to foster growth and reduce poverty over the medium term. They consider that broadening the tax base is the right strategy to increase the tax burden, at least in the medium term.

The 2023 budget, approved by Congress in November 2022, envisages an overall deficit of three percent of GDP and a decline in total expenditure of 0.5 percent of GDP. Nonetheless, social spending will be higher in 2023 as part of the authorities' efforts to support the most vulnerable. The authorities acknowledge that their current MT Framework could be improved to be better anchored to close infrastructure and social gaps.

Public debt continues to be on a decreasing path, and it is expected to remain sustainable at 29.4 percent of GDP with high probability and moderate sovereign risk. The 2022 ratio of 29.4 estimated by staff includes pending debt balances against the social security institute, IGSS, of about 0.2 percent of GDP. Yet, the Ministry of Finance does not recognize the debt claimed by IGSS, and some judicial processes are in court for resolution.

Even when the authorities recognize that it will be the new administration in charge of building upon the progress made, they are committed to working on the PIMA/Climate-PIMA evaluation during the first half of June with the IMF team as a first step to identify the main steps moving forward on streamlining processes. As they believe its results could enhance their public investment framework and its resilience to climate events.

On the financial sector

The authorities consider the banking sector to be sound, and the overall financial system remains resilient. Despite the challenges posed by the pandemic and current circumstances, bank credit to the private sector grew by 20 percent in domestic currency in 2022, financed by the growth in customer deposits, which represented nearly 90 percent of the total bank's liabilities at the end of December 2022.

The banking system maintains soundness with solvency ratios well above the regulatory levels, capital ratios (16.5 percent) well above the regulatory minimum capital adequacy ratio (10 percent), nonperforming loans reported at 1.3 percent, and sound profitability with returns on assets at 2.3 percent and returns on equity above 24 percent. Also, the liquidity of the banking system remains adequate, with short-term and MT liquidity ratios estimated at 20 percent and 48 percent, respectively.

Going forward, authorities agree on the importance of the approval of the Banking and Financial Groups Law Reform and the approval and implementation of the AML/CFT Law that addresses gaps and aligns Guatemala's regime with the FATF standards. The latter is critical to achieving a positive outcome on the next AML/CFT evaluation, to be conducted by the FATF in 2027.

Finally, the Guatemalan authorities remain committed to strengthening structural reforms in fiscal transparency and governance, benefiting from the discussion of a Fund's technical assistance. Also, significant efforts are directed towards strengthening data availability and quality. Endeavors to improve the business climate, address labor market informality, and strengthen resilience to climate change will continue until this presidential period while working on synergies for the agenda to continue amid the governmental change.