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June 4, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Guatemala - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Guatemala.

This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Cha (ext. (5)8501).

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INTERNATIONAL MONETARY FUND

GUATEMALA

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984 Article IV Consultation with Guatemala

Approved by Eduardo Wiesner and Manuel Guitian

June 4, 1984

I. Introduction

The 1984 Article IV consultation discussions with Guatemala were held in Guatemala City during the period March 12-April 2, 1984.1/ The Guatemalan representatives included the Ministers of Finance, Economy, Agriculture, and Labor, the Secretary General of the National Planning Office, the President of the Bank of Guatemala, and senior officials of various ministries, the Bank of Guatemala, and several state enterprises. The staff representatives were C. Cha (Head-WHD), C. De Rosa, M. Hernandez, J. Martelino (all-WHD), G. Oliveros (EP-WHD), and T. Puri (Secretary-WHD).

The last Article IV consultation with Guatemala was completed on June 1, 1983 (EBM/83/77), and the current 16-month stand-by arrangement in an amount of SDR 114.75 million (106.3 percent of Guatemala's quota of SDR 108 million), was approved by the Executive Board on August 31, 1983 (EBS/83/163). To date, Guatemala has made four purchases under the arrangement totaling SDR 57.4 million; the fifth purchase of SDR 19.1 million, which is to become available on June 30, 1984, is conditional upon the completion of the mid-term review of the arrangement.

II. Background and Performance Under the Current Stand-By Arrangement

1. Background

Following nearly three decades of substantial economic growth and financial stability based on an expansion in agricultural exports and the development of light industry for domestic and Central American markets, the economic and financial position of Guatemala deteriorated sharply beginning in 1980. The growth in real GDP, which averaged 6 percent in the 1970s, decelerated in 1980-81 and turned negative in

1/ Guatemala has accepted the obligations of Article VIII, Sections 2, 3, and 4.

1982. The net international reserves of the Bank of Guatemala declined by more than US$300 million a year in the period 1980-82, and in addition Guatemala accumulated payments arrears of around US$290 million during 1982.

The deterioration in the economic and financial situation can be traced to a combination of factors. Political developments in Central America eroded private sector confidence with adverse effects on investment, trade, and capital inflows. At the same time, export performance was affected by the worldwide recession, which resulted in lower export volumes and a sharp decline in commodity prices. The negative impact of these factors on the balance of payments was exacerbated by expansionary domestic fiscal and monetary policies. During the period 1980-82 the overall deficit of the nonfinancial public sector rose to an average of 5 1/2 percent of GDP, compared with an average of about 1 percent in 1977-79, reflecting mainly a weakening of revenue performance and an increase in capital expenditures. The resulting expansion in credit to the public sector together with a rise in credit to the private sector outpaced the growth of the liabilities to the private sector, and thus produced a decline in international reserves.

In an attempt to forestall a further deterioration of the financial situation, in late 1981 the Guatemalan authorities framed an adjustment program which was supported by a one-year stand-by arrangement in the first credit tranche. Performance under the program fell short of expectations, in part because of an unexpected decline in exports and a suspension of normal foreign trade financing.1/ Although public expenditures were reduced, mainly through cutbacks in investment, there were some slippages in the fiscal performance due to a shortfall in revenues. The overall balance of payments deficit in 1982 amounted to US$316 million, including a large accumulation of external payments arrears, compared with the target of limiting the reserve loss to no more than US$50 million. Faced with a severe shortage of foreign exchange, exchange quotas for imports were introduced soon after the 1981-82 program expired in mid-November 1982.

The Guatemalan authorities prepared a new stabilization program for 1983-84, which is being supported by the current 16-month stand-by arrangement. The main objectives of the program were to achieve overall balance of payments equilibrium in 1983 and a small surplus in 1984, including a reduction in payments arrears of at least US$150 million over the program period and the liberalization of other exchange restrictions. These objectives were to be attained through a strengthening of the fiscal position, based on a tax reform and tight expenditure control, moderation in the expansion of bank credit together with the sterilization of the domestic counterpart of external payments arrears, and a normalization of financial relations with foreign creditors through an orderly reduction of the arrears.

1/ The performance is discussed in detail in EBS/83/76.

To ensure the success of the program, a comprehensive tax reform and a deposit scheme for external payments arrears were implemented prior to Board approval of the arrangement. The tax reform, which was designed to raise government revenues and improve the efficiency of the tax system in general, was introduced in July 1983. Its main feature was the replacement of the 3 percent stamp tax with a 10 percent value added tax (VAT). In addition, the tax reform included a change in selective excise taxes from a specific to an ad valorem basis, a simplification of the corporate income tax, a phased reduction of export taxes, and the elimination of the stamp tax on bank credit.1/ These measures were projected to yield net revenues of some Q 50 million in 1983 (1/2 percent of GDP) and Q 160 million in 1984 (1 1/2 percent of GDP), and thus were expected to reverse the steady decline in the ratio of taxes to GDP of recent years. It was projected that the increased revenues together with a policy of expenditure restraint would make it possible to reduce the deficit of the nonfinancial public sector from 4 1/2 percent of GDP in 1982 to 3 percent in 1984.

In order to verify the extent of outstanding arrears and to absorb excess liquidity in the banking system, in July 1983 the Bank of Guatemala required counterpart deposits in local currency equivalent to the full amount of the external arrears. These deposits, which amounted to nearly Q 290 million as of August 31, 1983,2/ have been sterilized in the Bank of Guatemala in exchange for five-year dollar-denominated stabilization bonds. The bonds may be redeemed before maturity, however, in accordance with the scheduled reduction in external arrears. The interest rate on these bonds is 6 percent per year, unless they are accepted by foreign creditors in settlement of the arrears, in which case the rate is 1 percentage point above LIBOR.

2. Performance under the current stand-by arrangement

Performance under the program during 1983 was mixed even though Guatemala observed all the quantitative performance criteria and thus was able to make all purchases as scheduled (Table 1). The financial outcome, particularly the balance of payments performance, was generally better than in the previous year and was broadly in line with the program targets, but there were slippages in the fiscal and monetary areas. Moreover, real GDP declined for the second consecutive year and, contrary to what was envisaged in the program, both investment and national savings continued to fall.

1/ Details of the tax reform are discussed in EBS/83/163, Appendix I.

2/ For the purposes of the program, the amount of arrears outstanding as of August 31, 1983 was US$344 million. The difference between the amount of outstanding arrears and the stock of counterpart deposits is explained by the fact that the public sector was not required to make these deposits and that some counterpart deposits in respect of the foreign exchange requests prior to August 31, 1983 were made during the period September-December 1983.

Table 1. Guatemala: Performance Under Stand-By Arrangement

	Dec. 31, 1983		Mar. 31, 1984		April 30, 1984		May 11, 1984	
	Program 1/	Actual	Program 1/	Actual	Program 1/2/	Actual	Program 1/2/	Actual
	(In millions of quetzales)							
Net domestic assets of the monetary authority	724.1	705.6	719.1	712.6	714.1	729.1	714.1	713.1
Net indebtedness of the nonfinancial public sector with the domestic banking system	1,485.0	1,399.0	1,515.0	1,491.8	1,545.0	1,527.0	1,545.0	1,523.1
Outstanding balance of payments arrears	294.1	286.0	269.1	267.5	244.1	263.7	244.1	263.3
	(In millions of U.S. dollars)							
New foreign loans contracted by the public sector								
1-5 years maturity	150.0	6.0	150.0	26.0	150.0	26.0	150.0	26.0
1-10 years maturity	300.0	6.0	300.0	26.0	300.0	26.0	300.0	26.0

Sources: Bank of Guatemala; and EBS/83/163.

1/ Adjusted on the basis of actual payments arrears as of December 31, 1983.
2/ These limits are applicable through June 30, 1984.

Fiscal performance in 1983 was weaker than had been envisaged. Central government revenues declined for the third consecutive year, both in relation to GDP and in absolute terms, mainly as a result of a drop in tax revenues. Receipts from the VAT did not reach the amount projected because of a reduction in the tax rate from 10 percent to 7 percent and a significant increase in exemptions. These changes became effective October 1, 1983, largely in response to the concern of the business community over what they perceived to be the adverse effects of the new tax on economic activity and prices. To compensate for the loss in tax revenues, additional nontax receipts, a significant portion of which were nonrecurrent, were collected, and investment spending, particularly capital transfers to state enterprises, was reduced. On this basis, the overall government deficit was kept close to the program target. The financial situation of the rest of the public sector, which traditionally had registered small overall surpluses, deteriorated in 1983, mainly because of a decline in government transfers and significant cost overruns by the State Electricity Institute (INDE) in the construction of the hydroelectric project of Chixoy.

The overall public sector deficit amounted to Q 365 million (4 percent of GDP) in 1983, compared with a targeted deficit of Q 324 million (3 1/2 percent of GDP) in the program (Table 2). Although the larger deficit of the public sector was covered by domestic financing, the use of bank credit by the public sector was held below the program ceiling because of recourse by the Central Government and INDE to extraordinary nonbank financing of around Q 85 million. This financing included advance collections of the 1984 corporate income tax, bond placements outside the banking system, and an increase in INDE's pending bills to foreign suppliers.

The net domestic assets of the Monetary Authority were held within the program limits in 1983 as a result of the public sector's making use of nonbank financing as just described, and restraint in the expansion of credit to the rest of the banking system (Table 3). The growth in overall banking system credit was close to the program target as the lower than projected credit to the public sector was offset by an increase in credit to the private sector. The pace of the expansion of private credit reflected the lowering of lending rates, the need to finance the purchase of stabilization bonds for payments arrears, and the repercussions of the public sector's reliance on nonbank domestic financing. Although the growth of private financial assets with the banking system was as expected, the liquidity position of commercial banks became quite tight toward the end of the year because of credit restraint exercised by the Bank of Guatemala. The banks financed the increased demand for credit by the private sector by resorting to short-term foreign borrowing and by liquidating government bonds from their portfolio.

Table 2. Guatemala: Summary Operations of the Nonfinancial Public Sector

	1980	1981	1982	1983 Prog.	1983 Actual	1984 Prog.	1984 Proj.
	(In millions of quetzales)						
I. Central Government							
Revenue	748	742	731	749	704	900	682
Of which: Current	747	741	730	748	703	899	680
Tax	(686)	(659)	(633)	(648)	(552)	(812)	(520)
Nontax	(61)	(82)	(98)	(100)	(151)	(87)	(160)
Expenditure	1,117	1,380	1,142	1,094	1,033	1,203	1,090
Current	654	728	703	701	708	756	740
Capital	463	652	439	393	325	447	350 1/
Current account (deficit -)	93	13	27	47	-5	143	-60
Overall deficit = financing	-369	-638	-411	-345	-329	-303	-408
External financing	93	102	79	121	88	129	81 1/
Domestic financing	276	536	332	224	241	174	327
Banking system	(311)	(453)	(321)	(240)	(166)	(166)	(...)
Other	(-35)	(83)	(11)	(-16)	(75)	(8)	(...)
II. Nonfinancial Public Sector							
Revenue	965	983	1,008	1,042	973	1,223	991
Expenditure	1,315	1,601	1,415	1,366	1,338	1,510	1,418
Overall deficit = financing	-350	-618	-407	-324	-365	-287	-427
External financing	95	109	107	124	125	137	105
Domestic financing	255	509	300	200	240	150	322
	(As percent of GDP)						
Central Government deficit	-4.7	-7.4	-4.7	-3.7	-3.6	-3.0	-4.2
Revenue	9.5	8.6	8.4	8.1	7.8	9.0	7.1
Tax	(8.7)	(7.7)	(7.3)	(7.0)	(6.1)	(8.1)	(5.4)
Nontax	(0.8)	(0.9)	(1.1)	(1.1)	(1.7)	(0.9)	(1.7)
Expenditure	14.2	16.0	13.1	11.8	11.4	12.0	11.3
Current	(8.3)	(8.4)	(8.1)	(7.6)	(7.8)	(7.5)	(7.7)
Capital	(5.9)	(7.6)	(5.0)	(4.2)	(3.6)	(4.5)	(3.6)
Nonfinancial public sector deficit	-4.4	-7.2	-4.7	-3.5	-4.0	-2.9	-4.4
External financing	1.2	1.3	1.2	1.3	1.4	1.4	1.1
Domestic financing	3.2	5.9	3.5	2.2	2.6	1.5	3.3
Memorandum item							
Current account surplus of the nonfinancial public sector	2.2	1.1	1.3	1.5	0.8	2.5	0.2

Sources: Ministry of Finance; State Institute of Electricity (INDE); Bank of Guatemala; EBS/83/163; and Fund staff estimates.

1/ Includes US$20 million of transfers to INDE for repair of Chixoy and thermal plants.

Table 3. Guatemala: Summary Operations of the Banking System

	1980	1981	1982	1983 Prog.1/	1983 Actual	1984 Prog.1/	1984 Proj.
			(In millions of quetzales)				
			I. Banking System				
Net foreign assets	364	23	-295	-295	-302	-284	-462
Net domestic assets	1,587	2,246	2,946	3,054	3,079	3,357	3,506
Credit to public sector	480	946	1,244	1,484	1,399	1,655	1,655
Central Government	(512)	(965)	(1,286)	(1,526)	(1,452)	(1,692)	(...)
Rest of public sector	(-32)	(-19)	(-42)	(-42)	(-53)	(-37)	(...)
Credit to private sector	1,278	1,435	1,537	1,686	1,740	1,804	1,890
Counterpart arrears	--	--	288	--	14	--	--
Other	-171	-135	-123	-116	-74	-102	-39
Medium- and long-term foreign liabilities	92	181	263	417	408	526	533
Liabilities to private sector	1,859	2,088	2,388	2,342	2,369	2,547	2,511
			II. Monetary Authority				
Net foreign assets	398	49	-267	-267	-236	-252	-396
Net official reserves	398	49	21	27	50	-58	...
Payments arrears	--	--	-288 1/	-294	-286	-194	...
Net domestic assets	18	387	702	722	706	755	896
Net credit to public sector	436	880	1,136	1,376	1,366	1,542	1,622
Net credit to banks	-135	-134	-318	-89	-146	-136	-115
Medium- and long-term foreign liabilities	-80	-165	-242	-386	-384	-489	-502
Counterpart arrears	--	--	288	--	14	--	--
Other	-203	-194	-162	-179	-144	-162	-109
Currency issue	416	436	435	455	470	503	500
			(Annual percentage change)				
Banking system							
Net domestic assets 2/	29.6	35.4	33.5	4.5	5.6	12.9	18.0
Net credit to public sector	196.3	97.1	31.5	19.3	12.5	11.5	18.3
Credit to private sector	22.5	12.3	7.1	9.7	13.2	7.0	8.6
Liabilities to private sector	9.8	12.3	14.4	-1.9	-0.8	8.8	6.0

Sources: Bank of Guatemala; and Fund staff estimates.

1/ As presented in EBS/83/163 and revised to reflect the downward adjustment of the outstanding arrears as of December 31, 1983.

2/ Changes as a proportion of the outstanding liabilities to the private sector at the beginning of the period.

The overall balance of payments registered a surplus of US$31 million in 1983 compared with a program target of equilibrium. This result reflected an improvement in the trade balance, large public sector borrowing abroad, and the above-mentioned short-term borrowing by commercial banks. The trade deficit was substantially smaller than had been projected as imports fell more than exports, owing to the general decline in economic activity, the depressed level of public investment, and the strict application of exchange restrictions prior to the start of the program with the Fund. Since the stabilization program began, there appears to have been some improvement in the sale of foreign exchange for imports under the quota system, but for the year as a whole a significant portion of the foreign exchange quotas remained unutilized.

The outstanding amount of payments arrears was reduced from US$344 million on August 31, 1983 to US$286 million on December 31, 1983, as was envisaged in the program. The amount of the new loans contracted by the public sector in the maturity range of one to ten years was well below the program limit. This outcome was explained in part by Guatemala's having advanced the contracting of nearly US$100 million of new loans contemplated in the program, just before the approval of the current stand-by arrangement in August 1983.

III. Report on the Discussions

Developments in the early months of 1984 and prospects for the remainder of the year indicate that, in the absence of corrective measures, the economic and financial situation is likely to deteriorate. As explained below, the fiscal situation may be expected to continue to be weak, and credit expansion of the banking system probably will accelerate because of the financing needs of the public sector and strong private sector credit demands. At the same time, the growth of the public's holdings of financial assets has also been weak. Because of this deterioration in the monetary and fiscal areas, the current account deficit in the balance of payments may rise notwithstanding some improvement in exports. Since projected inflows of official capital are now expected to be lower than had been envisaged in the original program, the overall balance of payments may be moving to a large deficit in 1984 (Table 4).

In these circumstances, the consultation discussions focused mainly on measures needed to bring Guatemala's performance back in line with the program for the remainder of the stand-by arrangement. The authorities reaffirmed their desire to adhere to the original program; nevertheless the mid-term review of the current stand-by arrangement could not be completed on schedule as the authorities needed additional time to develop the measures consistent with the achievement of the objectives of the program. The authorities' formulation of corrective measures

Table 4. Guatemala: Summary Balance of Payments

	1980	1981	1982	1983 Prog.	1983 Actual	1984 Prog.	1984 Proj.
	(In millions of U.S. dollars)						
Current account	-176	-573	-405	-297	-251	-302	-340
Trade balance	-78	-382	-218	-110	-43	-103	-85
Exports, f.o.b.	(1,520)	(1,291)	(1,170)	(1,140)	(1,092)	(1,215)	(1,170)
Imports, c.i.f.	(-1,598)	(-1,673)	(-1,388)	(-1,250)	(-1,135)	(-1,318)	(-1,255)
Services and transfers	-98	-191	-187	-187	-208	-199	-255
Capital account	-143	224	89	297	282	317	180
Private 1/	-273	-1	-226	13	-45	65	-55
Nonfinancial public sector	94	109	108	124	125	137	105 2/
Financial sector	36	116	207	160	202	115	130
Bank of Guatemala	(6)	(85)	(77)	(146)	(142)	(103)	(118)
Other banks 3/	(10)	(-4)	(8)	(10)	(41)	(10)	(7)
Other 4/	(20)	(35)	(122)	(4)	(19)	(2)	(5)
Overall balance (deficit -)	-319	-349	-316	--	31	15	-160
Net official reserves (increase -)	319	349	28	-6	-29	85	...
External payments arrears	--	--	288	6	-2	-100	...
	(In percent of GDP)						
Current account	-2.2	-6.7	-4.6	-3.2	-2.8	-3.0	-3.5
Capital account	-1.8	2.6	1.0	3.2	3.1	3.2	1.9
Private sector	(-3.5)	(--)	(-2.6)	(0.1)	(-0.5)	(0.6)	(-0.6)
Nonfinancial public sector	(1.2)	(1.3)	(1.2)	(1.4)	(1.4)	(1.4)	(1.1)
Financial sector	(0.5)	(1.3)	(2.4)	(1.7)	(2.2)	(1.2)	(1.4)

Sources: Bank of Guatemala; EBS/83/163; and Fund staff estimates.

1/ Includes errors and omissions.
2/ Includes $20 million of loans to be contracted for Chixoy and thermal plants repairs.
3/ Includes short-term capital.
4/ Includes SDR allocations and contributions to nonmonetary international organizations.

would be affected by the timing of the elections for a Constituent Assembly to be held on July 1, 1984; presidential elections are expected to take place sometime in the first half of 1985.

In the discussions the staff was mindful of the importance expressed by Executive Directors in the summing up of the 1983 Article IV consultations about the critical role of the tax reform in the Government's stabilization program, and their concern over the need for a more flexible interest rate policy and an early elimination of exchange restrictions.

1. Fiscal policy

The program envisaged that the deficit of the nonfinancial public sector would not exceed 3 percent of GDP (about Q 290 million) in 1984. The staff estimated that in the absence of corrective measures the potential deficit might reach as much as 5 1/2 percent of GDP (around Q 520 million), mainly because of further significant slippages in revenue performance and because of financial difficulties in INDE. Government revenues for 1984 are estimated at Q 680 million, or Q 220 million lower than what had been projected in the program. This shortfall is due mainly to lower VAT collections (Q 160 million is now projected as the yield compared with Q 370 million in the program). According to the estimates of the Ministry of Finance, potential revenue from the VAT was reduced by one half as a result of the changes of last October. In addition, revenue collections have been affected by administrative deficiencies. Finally, damages to a tunnel of the Chixoy hydroelectric project last December are expected to involve additional outlays by INDE.

The authorities acknowledged the seriousness of the fiscal problems in 1984, but they believe the unexpected widening of the fiscal gap could be dealt with by a combination of expenditure cuts and revenue improvements. Government expenditures were to be reduced to below budgeted levels through a tight control over current spending (yielding savings of Q 50 million) and a further reduction in investment outlays (yielding savings of Q 90-110 million). According to the authorities, additional revenues of about Q 70-90 million could be raised through better tax administration and the collection of extraordinary revenues, such as past due obligations from coffee exporters.

The authorities indicated that they were in the process of revising INDE's budget with a view to reducing substantially both current and capital expenditures. The authorities have initiated discussions with the IDB and several foreign suppliers for loans of around US$20 million to finance the cost of repairs for the Chixoy tunnel and the temporary operation of the thermal plants until the Chixoy project is completed.

The staff welcomed the authorities' intention to reduce current expenditures. However, the staff questioned the feasibility of limiting current expenditure to the extent proposed by the authorities as this would seem to freeze all noninterest expenditures, including wages and salaries which had not been raised since 1982. The staff also asked whether it was advisable to reduce public investment further.

As regards the revenue proposals of the authorities, the staff expressed doubts whether the measures in question would produce the amount indicated by the authorities. Furthermore, the measures were of a kind that would result in only temporary effects. The staff proposed, therefore, that actions be undertaken to close the fiscal gap through measures such as an increase in the base and rate of the VAT and the introduction of selective consumption taxes.

The staff also suggested to the authorities that the tariffs of INDE and GUATEL (State Telecommunication Enterprise) be raised to strengthen the financial position of those enterprises, particularly since the tariffs of these enterprises had not been adjusted for several years.1/

2. Monetary policy

The authorities were aware that the performance of financial savings recently had been weak while bank credit to the private sector had grown quite strongly. Moreover, potentially large credit demands by the public sector and certain financially troubled lending institutions, as well as large interest payments on foreign obligations by the Bank of Guatemala, threatened to add to the pressures on the monetary authorities in 1984. Several commercial banks and a state-owned financial intermediary (CORFINA) have recently been facing serious financial difficulties as a result of unprofitable ventures. These institutions have signaled their need for additional financial assistance from the Bank of Guatemala. Credit to the public sector in the first four months of 1984 increased by Q 125 million, some three fourths of the increase planned for the year as a whole.

In reviewing monetary developments, the authorities said they recognized that interest rates should be managed more flexibly so that they might play a role in encouraging financial savings while restraining the demand for credit. Thus, the authorities are considering the possibility of allowing commercial banks to introduce variable interest rates.2/ The staff proposed, as an interim measure, an increase in the ceilings on interest rates of around 3 percentage points on loans and deposits, in order to permit the deposit rates to increase to

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1/ GUATEL's telephone tariffs were raised in April by an average of about 5 percent, but were rolled back soon after because of public pressures.

2/ In a related move, the authorities raised the legal ceiling on interest rates on government bonds from 9 percent to 13 percent at the end of last year. However, the actual interest rates on government bonds have not yet been changed and remain at 5 percent for the banks and 8 percent for all others.

levels that are positive in real terms and closer to those prevailing in international markets.1/ However, the authorities stated that they would require more time to study the effect of these changes before making a decision.

As regards credit policy, the staff stressed that in order to comply with the overall credit targets of the program it would be essential that the rate of credit expansion be reduced, both to the public and private sectors. The authorities agreed that the Bank of Guatemala's net credit to financial institutions should be strictly limited, and that short-term foreign borrowing by commercial banks should be brought under control. The possibility of requiring importers to make larger deposits for opening letters of credit with the commercial banks also was explored.

3. External policy

a. Balance of payments prospects for 1984

The Guatemalan authorities said that the external position was still weak because the recent improvement had reflected in large part a compression of imports brought about by the application of a comprehensive exchange quota system. The authorities reaffirmed their intention to work to achieve the balance of payments surplus that had been targeted in the program, but they expressed concern about the difficulties of achieving that goal.

Notwithstanding the signs of a recovery of exports, there was a fear that the balance of payments would weaken in 1984, because of a resumption of the growth of imports, rising interest payments, and lower capital inflows. Exports, which had declined for the last three years, are now projected to increase by 7 percent in 1984, on the strength of higher international prices for the major export commodities and a recovery in banana production. However, imports are projected to rise at an even faster rate, owing to a general recovery of economic activity and the additional oil imports occasioned by delays in the completion of the Chixoy hydroelectric project. At the same time, official interest payments are projected to rise because of the heavy commercial borrowing abroad in the last few years and because of interest payments on external payments arrears. Because capital inflows may be lower than projected in the program, the staff emphasized the need for strong fiscal and monetary measures to reduce the current account deficit and to strengthen the capital account.

1/ At present, the effective rates on time deposits vary from 5 to 8 1/2 percent, while the interest rate ceiling on deposits is set at 9 percent. The current ceiling on lending rates is 12 percent.

b. Exchange restrictions

The current stand-by arrangement provides for a significant liberalization of exchange restrictions, including a reduction of external payments arrears in an amount of US$50 million during the period September-December 1983 and US$100 million in 1984; the extension of a bona fide clause by January 15, 1984 to all invisible payments with the exception of nonbusiness travel abroad; and a liberalization before the expiration of the stand-by arrangement of the remaining restrictions, namely the exchange quotas for imports and the restrictions on nonbusiness travel abroad.

(1) Arrears

The outstanding external payments arrears, which amounted to an estimated US$288 million at the end of 1982, increased to US$344 million by August 31, 1983. In accordance with the program, external payments arrears were reduced by US$58 million during the period September-December 1983 and the authorities reiterated their commitment to reduce the outstanding amount of such arrears by a further US$100 million in 1984. The authorities intend to meet the scheduled reduction in 1984 by the redemption of stablilization bonds at the rate of around US$25 million per quarter.

(2) Restrictions on invisible payments

The authorities introduced at the end of February 1984 exceptions to the existing limits on requests for foreign exchange for the following invisible transactions that would be permitted in duly authenticated cases (i.e., bona fide clause): (1) expenditures for students abroad; (2) family remittances; (3) remittances of domestic earnings to Guatemalan residents abroad; and (4) remittances of foreign workers' earnings in Guatemala. With these changes, the only exchange restrictions remaining on invisible payments other than arrears pertain to nonbusiness travel abroad. The authorities consider the limits on nonbusiness travel as transitional arrangements which would be eliminated, together with the exchange quota system for imports, as the balance of payments improved.

(3) Foreign exchange quotas for imports

The authorities recognized the distortions created by the existing foreign exchange quota system for imports as well as its adverse impact on nontraditional exports and on economic recovery in general. They emphasized the temporary nature of the quota system and reaffirmed their intention to eliminate the system when the balance of payments situation of the country strengthened. Although the stand-by program provided for a review of the existing exchange restrictions by the end of May 1984 with a view to their elimination before the expiration of the program, the authorities felt that they were not yet in a position to commit themselves to a specific schedule for the elimination of such restrictions as demand management policies, particularly in the fiscal area, had not yet been elaborated fully. The authorities said that the establishment of suitable domestic financial policies had to precede the liberalization of the quota system in order to avoid a further deterioration of the balance of payments.

The staff expressed concern over the fact that import licenses, as well as foreign exchange sales for imports, were significantly below the amounts established under the quota system. The authorities attributed the underutilization of import quotas to administrative deficiencies in the implementation of the quota system, the weakness of economic activity, and the absence of a correspondence between quarterly quota allocations and the actual timing of imports. According to the authorities, some of these imports were probably being handled through the unofficial parallel market or through importers' own payment arrangements. They estimated that as much as one fifth of total imports was being channeled through the parallel market in which the quetzal is at a discount of some 25 percent in relation to the official rate.

The authorities emphasized that they intended to maintain the existing parity of Q 1 per U.S. dollar and were not contemplating the legalization of the parallel market. They were aware of the fact that the real effective exchange rate of the quetzal had appreciated by about 15 percent in the last three years, but they noted that this appreciation was due mainly to the recent strength of the U.S. dollar and that the maintenance of the existing parity was essential to internal financial discipline (Chart 1). The authorities also pointed to a number of fiscal measures which they have established to enhance the competitiveness of exports. These included the substitution of the VAT for the stamp tax (which permits the rebate of domestic taxes on exports), the gradual elimination of taxes on traditional exports, the implementation of a system of tax credit certificates (CAT) for nontraditional exports to third markets, and the extension of the existing import duty exemptions and income tax concessions. The authorities considered that these measures, combined with prudent financial management, would be adequate to keep Guatemalan exports competitive in international markets.

c. Medium-term outlook

Although there was some improvement in the balance of payments last year, the external position of Guatemala remains weak as evidenced by the need to resort to restrictions. Moreover, debt service payments in the coming years are projected to rise sharply, while the course of the economy remains uncertain. In this situation, there will be a need for further adjustments to strengthen the balance of payments.

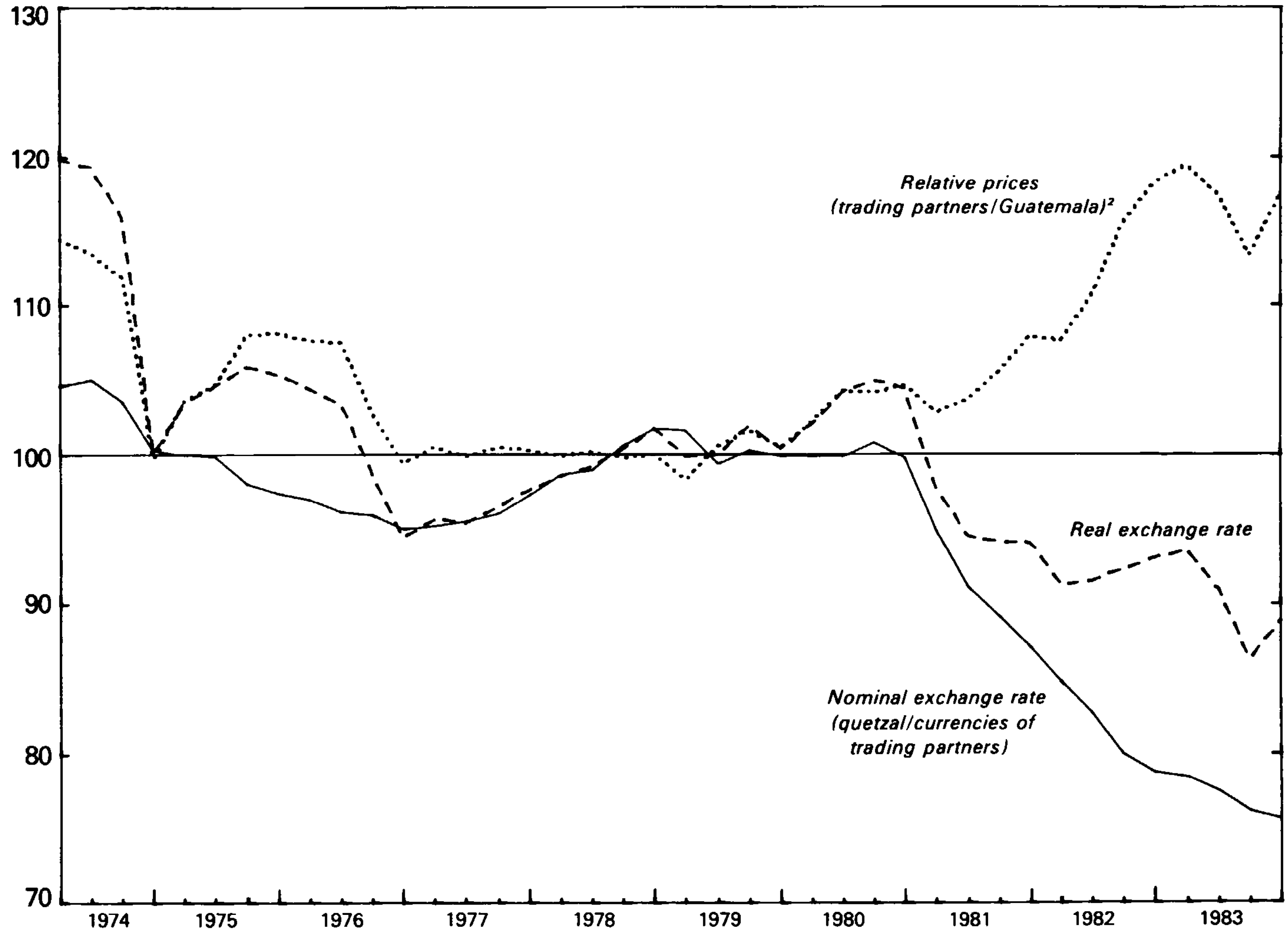
Although any projections over the medium term have to be viewed as quite tentative in the light of the political uncertainties in the Central American region, the authorities considered it appropriate for purposes of this exercise to assume a moderate recovery in the growth

CHART 1

GUATEMALA

EFFECTIVE EXCHANGE RATE, 1974-83[1]

(1978 = 100)



Sources: IMF, *International Financial Statistics;* and Fund staff estimates.

[1]In Guatemalan quetzales per unit of foreign currency. A rise (fall) in the index reflects a depreciation (appreciation) of the quetzal. The index is based on trade weights for 1980 representing over 90 percent of trade with partner countries.

[2]Relative prices were measured by consumer price indices.

rate of real GDP, to a rate slightly higher than the rate of increase of population of 3 percent a year. Assuming that capital inflows were at their historical rate of about 3 1/2 percent of GDP 1/ and taking into account the need for an improvement in the net foreign reserve position, a sustainable balance of payments position would require that the current account deficit be limited to 3 percent of GDP (Table 5). Consistent with these objectives and given that imports might be expected to rise with the recovery of the economy, exports would need to grow at an average annual rate of 11 percent over the next five years. The authorities agreed with the staff that, while a prudent financial policy should continue to be a major feature in future adjustment efforts, export promotion policies will have to play a vital role in order to achieve the objectives of strengthening the balance of payments and bringing the economy to a sustainable growth path.

In this connection, the authorities made reference to a number of measures, in addition to the fiscal incentives for export promotion discussed in the previous section, which were being developed. Among these were the creation of a free zone (Maquila), and the negotiation of various preferential tariff agreements with several countries offering tariff concessions similar to those extended by the United States under its Caribbean Basin Initiative. Also, discussions were underway with U.S. investors for the development of nontraditional agricultural exports. The authorities said that these efforts should be assisted by the current economic recovery of the major industrial trading partners, which should result in greater demand and higher prices for Guatemala's exports. Notwithstanding the need to pursue vigorously the promotion of nontraditional exports, it was agreed that efforts also should concentrate on normalizing and fostering increased trade within the CACM region, given the importance of such trade at present, as well as its potential for future expansion.

The projections for the medium term show relatively large, although declining, official capital inflows, and raised the question whether the debt service burden would not be encumbered unduly. Guatemala's outstanding external public debt at the end of 1983 amounted to US$1.6 billion, and while the debt burden generally has been manageable, the debt profile had deteriorated because of an increasing recourse to commercial borrowing. Furthermore, there has been an accumulation of external payments arrears which have to be settled in the near future. As a result, the debt service ratio was projected to rise from 12 1/2 percent in 1983 to 38 percent by 1986, before declining to 20 percent by 1989. The sharp increase in the debt service payments through 1986 was due mainly to large principal repayments on the commercial loans recently contracted with short maturities and balloon repayment terms, as well as the planned reduction of external payments arrears. Interest payments as a percent of exports of goods and services are

1/ The projections on the net inflows of capital over the next five years provide for a gradual recovery of private capital inflows and assumes that they will reach 2 percent of GDP by 1989.

Table 5. Guatemala: Medium-Term Outlook

	1983	1984	1985	1986	1987	1988	1989
	(In millions of U.S. dollars)						
1. Balance of payments							
Current account	-251	-340	-283	-346	-384	-426	-473
Of which: exports of goods and services	1,205	1,300	1,446	1,613	1,755	1,962	2,193
imports of goods and services	-1,487	-1,679	-1,781	-2,017	-2,241	-2,530	-2,840
Capital account	282	180	335	403	448	498	552
Overall balance (deficit, -)	31	-160	52	57	64	72	79
2. External debt 1/							
Outstanding debt	1,600	1,907	2,221	2,544	2,864	3,149	3,386
Debt service							
Total 2/	150	349	473	610	406	437	436
Amortization	77	226	326	452	241	261	259
Interest	73	123	147	158	165	176	177
Excluding IMF	143	339	409	546	379	413	422
Amortization	77	226	278	404	228	249	253
Interest	66	113	131	142	151	164	169
Excluding IMF and arrears	141	219	299	457	379	413	422
Amortization	75	126	178	318	228	249	253
Interest	66	93	121	139	151	164	169
	(As percent of GDP)						
Current account	-2.8	-3.5	-2.7	-3.0	-3.0	-3.0	-3.0
Capital account	3.1	1.9	3.2	3.5	3.5	3.5	3.5
Outstanding debt	17.7	19.8	21.2	22.1	22.4	22.2	21.5
	(As percent of exports of goods and services)						
Debt service							
Total	12.4	27.8	32.7	37.8	23.1	22.3	19.9
Excluding IMF	11.9	26.1	28.3	33.8	21.6	21.0	19.2
Excluding IMF and arrears	11.7	16.8	20.7	28.3	21.6	21.0	19.2

Sources: Bank of Guatemala; IBRD/DRS; and Fund staff estimates.

1/ Medium- and long-term external public debt; includes IMF, but excludes the amount of outstanding bonds issued in respect of arrears.

2/ Includes repayment of arrears.

expected to increase from 6 percent in 1983 to about 8-10 percent over the next five years. The staff suggested, therefore, that caution should be exercised in the contracting of debt, particularly as regards the terms of new foreign loans. Furthermore, foreign borrowing should be used mostly for the development of projects with a high foreign exchange earning potential in order to ensure that the debt servicing burden in future years would not come under serious pressure.

IV. Staff Appraisal

Following the coffee boom years of the mid-1970s, Guatemala's economic and financial situation began to weaken and this was followed by a serious deterioration in 1980-82. The balance of payments deficit amounted to more than US$300 million in each of these years, including the accumulation of large external payments arrears in 1982. Moreover, exchange restrictions were intensified toward the end of 1982 by the introduction of a comprehensive exchange quota system for imports. The deterioration in the balance of payments was accompanied by a general weakening of the economy; output stopped growing in 1981 and fell in 1982, reflecting large drops in domestic investment and foreign demand.

To arrest the deterioration of the economic and financial situation, the Guatemalan authorities framed a stabilization program in mid-1983 which was supported by a 16-month stand-by arrangement which runs through the end of 1984. The main objectives of the program are to strengthen the balance of payments and to liberalize exchange restrictions through an improvement in the fiscal position, a moderation in bank credit expansion, and the orderly reduction of payments arrears. The overall balance of payments improved somewhat last year and arrears have been reduced since the beginning of the program in August 1983; the improvement in the balance of payments was in part the result of restraints over imports and increased short-term borrowing by commercial banks. Although the overall fiscal position weakened, the ceilings on bank credit to the nonfinancial public sector were observed in 1983, partly because the public sector made heavy use of nonbank domestic financing.

Developments in the early months of this year suggest that the balance of payments is likely to deteriorate in 1984. Thus, in the absence of decisive adjustment measures, it seems that Guatemala will not be attaining the objectives of the stand-by arrangement for 1984.

In the fiscal field, the major area of concern is the Government's revenue performance, which the authorities have said they would strengthen mainly through improved tax collections, including a reduction in tax arrears. The staff recognizes the merit of the proposed measures, but it has serious doubts to whether they would generate resources sufficient to cover the unfinanced fiscal gap in prospect for 1984. More importantly, the staff feels that the kinds of revenue measures needed are those that would strengthen the fiscal position on a sustainable basis. In particular, under the present circumstances, the staff would urge the authorities to adopt permanent tax measures that would eliminate the revenue losses that are resulting from the changes in the original VAT arrangement. The staff notes that the authorities have made substantial efforts to hold down current expenditures in the last two years, and it welcomes the authorities' intention to continue this policy in 1984. The sharp decline in capital expenditures in the last two years reflected the scaling down of several large investment projects and the shifting of investment priorities to small-scale projects with a high socio-economic impact. In view of the weakness of investment, however, the staff would caution the authorities that further cuts in investment might jeopardize the prospects for economic recovery. The staff recommends, therefore, that the fiscal strategy over the medium term concentrate on raising revenue and increasing public saving, in order to be in a position to finance needed investment.

The staff is concerned about the recent deterioration in the financial position of several state enterprises, particularly INDE. Although the staff concurs with the authorities' decision to cut expenditures of these enterprises to cope with their financial difficulties, it would be advisable that these cuts be accompanied by upward adjustments in tariffs to strengthen the savings performance of the enterprises.

In the monetary area, the growth of the private sector's holdings of financial assets recently has been weak, while credit to the private sector has been expanding rapidly. In view of the potentially large demand for credit by the public sector and by some financially troubled lending institutions, the management of credit policy in 1984 will be difficult. In order to ensure achievement of the targeted increase in net international reserves, there is an urgent need to encourage the private sector to hold more financial assets, while restraining credit expansion to fit to the growth of such holdings and balance of payments aims. Therefore, the staff would agree with the authorities' decision to limit credit expansion by the Bank of Guatemala to financial institutions to stay within the original projections of the program.

To ensure effective monetary management, the staff believes that interest rates should be allowed to play a more important role in the financial sector. The recent increase in interest rate ceilings on government bonds and the possibility of allowing the use of variable interest rates by the commercial banks are encouraging signs of flexibility. Consistent with these measures, and taking into account the recent increase in interest rates in international markets, the staff also believes that interest rate ceilings on bank deposits and loans should be raised, thereby permitting market forces to play a more important role in determining the appropriate level of interest rates. In addition, the short-term foreign borrowing by the commercial banks, which increased sharply last year, should be kept under strict control so as not to undermine the efforts to restrain credit expansion.

Appropriate fiscal and monetary measures would strengthen the balance of payments and thus would facilitate the early liberalization of the exchange system. Apart from the adverse effects on resource allocation, exchange restrictions hamper the recovery of economic activity, particularly in the manufacturing sector, and constitute a barrier to sound investment decisions by the private sector. The staff notes that the decision of the authorities to maintain the existing parity of the Guatemalan quetzal with the U.S. dollar calls for the pursuit of demand and incomes policies consistent with restraint over costs and prices.

The staff welcomes the recent liberalization of certain exchange restrictions, namely, the orderly reduction of the outstanding external payments arrears and the application of a bona fide clause with respect to limits on several invisible transactions. The staff would urge the authorities to eliminate the remaining restrictions as soon as possible. However, in the absence of a well-defined set of financial policies which would permit the development of a specific timetable for the elimination of these restrictions, approval for the retention of the remaining exchange restrictions is not proposed. The staff would hope that Guatemala soon will be in a position to adopt the measures that would enable it to continue to have access to Fund resources.

It is recommended that the next Article IV consultation with Guatemala be held on the standard 12-month cycle.

Guatemala - Fund Relations
(As of April 30, 1984)

(Amounts in millions of SDRs, unless otherwise indicated)

I. Membership Status

(a) Date of membership: December 1945
(b) Status: Article VIII

(A) Financial Relations

II. General Department

			Millions of SDRs	Percent of Quota
(a) Quota: SDR 108 million				
(b) Total Fund holdings of quetzales:			261.0	241.6
(c) Fund credit:	Total		153.0	141.6
	of which:	Cr. Tr.	(41.7)	(38.6)
		CFF	(76.5)	(70.8)
		EAR	(34.8)	(32.2)
(d) Reserve tranche position			--	--
(e) Current Operation Budget			--	--

III. Current Stand-by Arrangement and Special Facilities

(a) Current stand-by arrangement
- (i) Duration: August 31, 1983 to December 31, 1984
- (ii) Amount: SDR 114.75 million
- (iii) Utilization: SDR 57.38 million
- (iv) Undrawn balance: SDR 57.37 million

(b) Previous stand-by arrangement
- (i) Duration: November 13, 1981 to November 12, 1982
- (ii) Amount: SDR 19.10 million
- (iii) Utilization: SDR 19.10 million
- (iv) Undrawn balance: --

(c) Special facilities
Compensatory financing: SDR 76.5 million, approved by the Executive Board on November 13, 1981 and purchased on November 18, 1981.

IV. SDR Department

		Percent of allocation
(a) Net cumulative allocation:	SDR 27.7	
(b) Holdings:	0.1	0.3
(c) Current Designation Plan:	--	--

V. Administered Accounts

(a) Trust Fund Loans	
(i) Disbursed	--
(ii) Outstanding	--
(b) SFF Subsidy Account	
(i) Donations)	--
(ii) Loans) to Fund	--
(iii) Payments by Fund	--

VI. Overdue Obligations to the Fund

(a) General Department:	Repurchases	--
	Charges	--
(b) SDR Department:	Charges	--
(c) Trust Fund:	(i) Repayments	--
	(ii) Interest	--

B. Nonfinancial Relations

VII. Exchange rate arrangement: All transactions take place at the fixed exchange rate of US$1 per quetzal.

VIII. Last Article IV Consultation: February-March 1983, completed by the Executive Board on June 1, 1983 (EBM/83/77). This consultation was conducted after a 19-month cycle.

IX. Technical Assistance: None.

X. Resident Representative/Advisor: None.

Guatemala: Selected Economic and Financial Indicators

	1981	1982	1983 SB Prog.	1983 Actual	1984 SB Prog.	1984 Proj.
	(Annual percent changes, unless otherwise specified)					
National income and prices						
GDP at constant prices	0.6	-3.5	-2.3	-2.8	1.0	0.8
GDP deflator	8.6	5.1	7.0	6.6	7.2	5.4
Consumer prices (annual average)	11.4	5.0	7.0	6.4	7.0	6.0 1/
External sector (on the basis of U.S. dollars)						
Exports, f.o.b.	-15.0	-9.4	-5.0	-6.7	6.6	7.2
Imports, c.i.f.	4.7	-17.1	-9.9	-18.2	5.4	10.6
Non-oil imports, c.i.f.	3.1	-16.2	-8.3	-19.5	10.8	10.3
Export volume	-6.7	-3.3	-7.5	-11.4	3.5	1.1
Import volume	1.5	-14.5	-11.4	-16.2	1.1	9.0
Terms of trade (deterioration -)	-11.8	-3.3	1.0	8.0	-1.2	4.6
Nominal effective exchange rate (depreciation -)	12.4	8.8	...	5.3	...	...
Real effective exchange rate (depreciation -)	9.0	0.3	...	6.8	...	...
Government budget						
Revenue and grants	-0.8	-1.5	2.5	-3.7	20.2	-3.1
Total expenditure	23.5	-17.2	-4.2	-9.5	10.0	5.5
Money and credit						
Domestic credit 2/3/	35.4	33.5 4/	4.5	5.6	12.9	18.0
Public sector	(25.1)	(14.3)	(10.1)	(6.5)	(7.1)	(10.8)
Private sector	(8.4)	(4.9)	(6.2)	(8.5)	(5.0)	(5.9)
Money and quasi-money (M2)2/	12.8	15.1	-2.0 5/	-1.4	8.8	6.0
Velocity (GDP relative to M2)2/	4.4	3.9	4.2	4.1	4.2	4.1
Interest rate (average maximum rate on time deposits)	10.0	12.7	9.0	9.0	9.0	9.0
	(As percent of GDP)					
Overall public sector deficit	7.2	4.7	3.5	4.0	2.9	4.4
Central government savings	0.2	0.3	0.5	-0.1	1.4	-0.6
Central government budget deficit	7.4	4.7	3.7	3.6	3.0	4.2
Domestic financing	(6.1)	(3.6)	(2.4)	(2.7)	(1.7)	(3.4)
Foreign financing	(1.3)	(1.1)	(1.3)	(1.0)	(1.3)	(0.8)
Gross domestic investment	17.0	14.3	14.3	10.7	15.9	10.7
Gross national savings	10.3	9.7	11.1	7.9	12.9	7.2
Current account deficit (balance of payments)	6.7	4.6	3.2	2.8	3.0	3.5
Public external debt, inclusive of use of Fund credit	12.1	15.1	17.8	17.7	19.7	19.8
	(As percent of exports of goods and services)					
Debt service 6/	6.1	8.2	12.6	11.7	15.8	16.8
Interest payments 6/	2.9	3.9	6.3	5.5	7.5	7.2
	(In millions of U.S. dollars)					
Overall balance of payments	-349	-316	--	31	15	-160
Gross official reserves (months of imports, c.i.f.)	2.1	2.1	2.3	3.2	2.4	...
Payments arrears	--	288	294	286	194	...

Sources: Bank of Guatemala; and Fund staff estimates.

1/ Target set by the authorities.
2/ Figures for 1982, 1983 and 1984 are adjusted to reflect revised estimates of payments arrears as of December 31, 1982.
3/ Changes as a proportion of liabilities to the private sector at beginning of the period.
4/ Including the counterpart of payments arrears.
5/ Excluding the counterpart of payments arrears.
6/ Medium- and long-term debt. Excludes IMF and redemption of stabilization bonds.