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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/78

3:00 p.m., June 1, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	P.-C. Maganga-Moussavou, Temporary
	G. Ercel, Temporary
	P. D. Péroz, Temporary
	J. Delgadillo, Temporary
	J. C. Williams, Temporary
	S. R. Abiad, Temporary
	I. R. Panday, Temporary
	Y. Okubo, Temporary
	G. W. K. Pickering, Temporary
	H. Arias, Temporary
	G. Grosche
	W. Moerke, Temporary
	C. P. Caranicas
	V. K. S. Nair, Temporary
	S. El-Khouri, Temporary
J. J. Polak	T. de Vries
	K. G. Morrell
	O. Kabbaj
	J. A. K. Munthali, Temporary
M. Senior	
	A. Lindø
	C. Taylor
	Wang E.

L. Van Houtven, Secretary
L. Collier, Assistant

Also Present:
Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director. Legal Department: S. A. Silard. Western Hemisphere Department: M. E. Bonangelino, C. Cha, R. A. Elson. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, S. E. Conrado, P. Péterfalvy. Assistants to Executive Directors: M. Hull, J. G. Pedersen, E. Portas, M. Toro.

1. GUATEMALA - 1983 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting their consideration of the staff report for the 1983 Article IV consultation with Guatemala (SM/83/76, 5/11/83). They also had before them a report on recent economic developments in Guatemala (SM/83/71, 5/11/83).

Mr. Taylor commented that, when speaking earlier (EBM/83/77) about the elimination of exchange restrictions, he had been referring to the restrictions on current payments for imports, which were within the ambit of the Fund's responsibility. Under the circumstances, he believed that Mr. de Vries would agree that early action to phase down exchange restrictions would be desirable in the particular case of Guatemala.

Mr. de Vries said that he agreed with Mr. Taylor. He had contemplated a different strategy for a possible stand-by arrangement from that proposed in the staff paper. He believed it would be preferable to keep some of Guatemala's traditional policies intact. If the country had a relatively open trading system, it ought to be possible to bring prices in line, thereby abolishing import restrictions. There were two types of restrictions that were not easily distinguishable. Current account transactions should be as free as possible to help bring domestic prices into line with the exchange rate; on the other hand, in the current difficult political situation, other types of restrictions would be necessary to discourage capital flight. He encouraged the authorities to permit current transactions to flow in and out as freely as possible, but he favored limiting capital outflows.

The staff representative from the Western Hemisphere Department, answering questions raised at EBM/83/77, commented first on the role of fiscal policy. The main increase in revenues for 1983 was expected to come from measures that had already been taken. The Guatemalan authorities had officially announced that they intended to put into place the value-added tax, which would be enacted about mid-year. Although the timing was still under review, it was expected that it would affect revenue performance during the second semester of the year. Regarding overall revenue yields in 1983, it was expected that the Government would be able to reverse the trend that had been in evidence during the past two or three years by taking other measures, in addition to the value-added tax, that included the introduction of selective consumption duties, the conversion of selective excise taxes from a specific to an ad valorem basis, and an exit tax applied to travelers. The final element to bring in additional revenue was a new tax applied to the net worth of banks, which would substitute for the value-added tax that would not apply to the financial sector.

With regard to state enterprises, the staff representative continued, primary consideration and study by the authorities were aimed at the telecommunications enterprise and the electricity authority. Both were being reviewed carefully with World Bank staff in connection with possible loan programs affecting their operations, and a decision on possible tariff increases in those entities would be made during the course of the year. Profits of the telecommunications enterprise amounting to Q 10-12 billion would be transferred to the 1983 budget. That initial contribution was expected to be continued in future years by GUATEL, the most profitable enterprise in the public sector.

There had been a policy of consolidation pursued by the Guatemalan authorities in 1982-83 to revamp their public investment effort, the staff representative remarked. Their evaluations had resulted in the subsequent delay or elimination of large projects. Previously, such projects had been financed heavily with bank credit from the Central Bank, but in conjunction with the World Bank, institutional change was proceeding within the planning agency, and a new public investment program for the next four or five years was being developed. After the current decline and consolidation, it was expected that public investment would pick up and be in line with the newly established criteria.

The staff's approach with regard to the exchange rate had been a cautious one, the staff representative commented. The issue was widely discussed in Guatemala and had been examined in the context of the consultation. The decision had been reached that the rate was essentially adequate at the moment, with weight given to four considerations. First, Guatemala had followed a tradition of financial discipline over the years, with a slight deviation in 1980-81 that had been corrected by the authorities. The fiscal policies being followed had a strong deflationary nature. The authorities were reducing the overall level of nominal expenditures in the Government--both on capital and current accounts--for the second year in succession. That policy, together with the efforts being made on the revenue side, would put the fiscal sector on a sound basis and reduce the large demand for credit of the past.

Second, the staff representative continued, great importance in the deliberations had been given to the use of the fiscal instrument, not only for stabilization purposes in domestic finance but also because of its potential effect on the balance of payments situation and, specifically, the export competitiveness position of Guatemala--the fiscal proxy. The effect of the value-added tax could be significant in terms of improving the competitive position of exports vis-à-vis the present tax system. The current outdated stamp tax, which had a cascading feature, did not permit any rebate to exporters. The value-added tax would probably feature a 10 per cent rebate on exports. On the other hand, the authorities were also taking measures to reduce some of the direct export taxes in order to aid the export sector. On the import side, selective consumption duties would be established, which would affect luxury imports primarily.

Third, a greater degree of flexibility in wages and prices prevailed in Guatemala than perhaps in other countries of the region, the staff representative remarked. There had been a substantial deceleration in the rate of price inflation in 1982, while official indices suggested that there had been no change at all. The Fund staff had not relied on that indicator on the advice of the technicians in the Government; nonetheless, the rate of price increase had been reduced by more than one-half, and there did not seem to be tremendous pressures on wages at present, which supported the idea of restoring competitiveness through price flexibility domestically.

The final consideration regarding the exchange rate was the possible degree of any possible overvaluation of the quetzal, the staff representative commented. There had been, in a quantitative sense, some degree of appreciation using a price proxy that was different from the official index in 1981 and 1982. It was not an exaggerated overvaluation and amounted to something on the order of 10 per cent, following a period where there had been a depreciation in real terms of the quetzal. No data had been collected systematically on the parallel market, but it appeared that the market had its origin in the establishment of exchange controls in 1980 and probably more important for certain kinds of transactions in invisibles than it was for trade transactions, such as tourist expenditures. There might be a demand for tourist exchange in the parallel market that would account for some of its depreciation.

Referring to the question of the Government's structural adjustment policies, the staff representative said that there were essentially three elements to be considered. First, the tax reform would affect a number of areas, including corporate income. The authorities were considering a unified national rate system for corporate income tax, instead of using the complicated schedule that was in effect at present. There were about four more elements in the tax system that would be inaugurated during 1983-84.

The second area of structural adjustment policy was the trade system, the staff representative remarked. The authorities in Guatemala, as well as in the rest of Central America, were reviewing the whole protective system and re-examining the effects of protection and tariff rates for imports. They were also re-evaluating the system of incentives, especially with regard to nontraditional exports. The major concern of the authorities was to develop programs to promote exports outside the region because of the problems that had occurred in regional trade. Those exports would have to play an increasingly important role in the future.

The third element was the public investment program, the staff representative continued. An institutional reform of the planning agency in the Government was under way, and the public investment program for the next four years was being redesigned. The program would continue to emphasize infrastructure: telecommunications, power, transport, housing, and agriculture.

With regard to the strategy of programming in countries such as Guatemala, the staff had found that they faced tremendous problems of liquidity, the staff representative remarked. A withdrawal of private savings had taken place, mainly in 1979-80, and more recently there had been a withdrawal of external credit and external lines of credit on which the region had depended critically in the past. Another source of the illiquidity was the countries' buildup of a large number of nonliquid claims against other members in the region, which had traditionally been a strong outlet for exports and a source of foreign exchange earnings. Those countries looked to the Fund to replace some of the sources of liquidity that were no longer available. In general, the staff had advised the authorities to maintain a flexible posture on the interest rate, especially in light of recent developments in the world financial markets. For example, in connection with the previous stand-by arrangement, Guatemala had raised interest rate ceilings substantially in late 1981. It was important that the instrument of ceilings on interest rates be maintained flexibly, reviewed, and adjusted in light of developments in domestic prices, foreign financial markets, and balance of payments trends.

The authorities of those countries had been advised to maintain credit policy on a restrained basis, the staff representative continued. Capital flight had been extensive in the region, perhaps supported by the credit policy. The supply of credit should be adjusted to the prospects for real growth and activity in the economy, which at present were depressed for a number of exogenous reasons.

The importance of a tight expenditure policy in the fiscal area, especially on current expenditures, had been stressed, in order to reduce the deterioration in the current account position of the Government, which had its counterpart in increased reliance on central bank resources, the staff representative noted. A country like Guatemala should increase its access to external financing from international financial agencies, because it had a relatively favorable external debt position at present and had potential substantial access to agencies such as the World Bank and the Inter-American Development Bank. The Government was moving in the direction of relying increasingly on external financing of its investment program, so as to change the mix of financing of the overall deficit in the public sector.

The authorities had been encouraged to return freedom to the current account transactions, the staff representative from the Western Hemisphere Department continued. Guatemala, like the other countries in the region, continued to maintain capital controls, which the staff considered justifiable in the circumstances. The staff had advocated a policy whereby, even if there were notional limits on current transactions and an extensive review process of requests for foreign exchange, bona fide transactions would be allowed where they could be duly authenticated and justified. On the question of import quotas, the movement away from direct quantitative restrictions toward an instrument based more on the price mechanism had been encouraged. The result would benefit the revenue situation of the Government. The program strategy also emphasized the need to eliminate arrears as quickly as possible, in the hope of re-establishing the external credit position of countries like Guatemala vis-à-vis the financial world. Guatemala was in the process of instituting a local deposit requirement that would verify the true extent of payments arrears in the economy. Once the estimate of arrears had been established, agreement on a schedule for their orderly reduction and cancellation in as brief a period as possible would follow.

Mr. Senior thanked Directors for their interest and their comments, which would be highly valued by his authorities. The Guatemalan authorities had been negotiating a new program with the Fund, to be supported under a new stand-by arrangement for a period until the end of 1984. The stand-by arrangement would be a logical follow-up to the first credit tranche arrangement that had ended in 1982. There was now basic agreement between the staff and the authorities concerning the overall framework of the program for 1984, and a mission was currently in Guatemala to complete the full details of the program.

Guatemala's previous arrangement with the Fund in the first credit tranche had gone substantially beyond what was usually required for similar stand-by arrangements, Mr. Senior commented. As was usual in first credit tranche arrangements, the program with Guatemala had not included phasing of drawings, but it had contained intermediate targets for key variables instead of the usual targets for the end of the program period only. At the same time, conditionality associated with the arrangement had been somewhat stiffer than usual. The authorities had been virtually in full compliance with the program, even under more adverse circumstances than originally expected, which underscored their commitment to adjustment. In the event, the program had turned out to be much more restrictive than intended, as output and exports had declined substantially, and unemployment had increased accordingly.

It should not be surprising that the authorities were preoccupied with the need for reactivating economic activity, or at least with arresting its further deterioration, Mr. Senior said. In that regard, the staff's projections for the current year was that output would again decrease by about 2.5 per cent. Under those circumstances, the authorities, although fully committed to adjustment, were understandably concerned that such adjustment must principally rest on policy instuments that did not adversely affect output and employment. In other words, they wanted to be especially selective regarding policy instruments, so as to minimize the cost of adjustment and not to exacerbate inflationary pressures and labor stability. Only in such a context did the authorities consider that fiscal discipline could be maintained, thus assuring the success of the program.

With regard to the current exchange rate policy in Guatemala, Mr. Senior noted, there seemed to be no conclusive evidence that the fall in exports that had taken place in the past two years had been due to a loss in competitiveness. Table 17 of SM/82/198 indicated that the planted area and the volume of production for such traditional important export commodities as coffee, sugarcane, and bananas had remained stable or even increased. The fall in exports for some of those items had been mainly due to the introduction of export quotas--for coffee and sugar--or falling international prices, or both. This also showed that the planted area for the production of cotton had fallen substantially. Cotton was sensitive to political uncertainty; it was an annual crop, and the substantial variation in the planted area of cotton in the present circumstances of the Central American region was not surprising. Also contributing significantly to the decline in exports was the decrease in those products, mainly industrial, that were exported to the other Central American countries, as Guatemala was traditionally the largest exporter to the rest of the region. Given the depressed level of economic activity in those countries, as well as their current payments difficulties, those exports had fallen significantly. It was therefore evident that the decline in exports was in great part explained by those factors and not necessarily by exchange rate considerations.

Some Directors had mentioned the appearance of a parallel exchange market, Mr. Senior recalled. Under present circumstances of regional political uncertainty, it was not surprising that there would be significant pressures for capital flight. The present exchange control regime in Guatemala did not allow speculative capital movements, and the appearance of the parallel market reflected the demand for foreign exchange for such capital movements. The speculative demand in no way reflected the equilibrium exchange rate that underlying market forces indicated. He believed that Mr. de Vries's comments in that regard were appropriate.

In conclusion, he reiterated that the Guatemalan authorities shared the concern of those Directors who had mentioned external payments arrears, Mr. Senior stated. In the program being agreed with the Fund, one of the main objectives would be to substantially reduce those arrears. The pace of reduction, however, would be constrained by other important considerations, such as the amount of additional financing obtained, rescheduling arrangements with commercial creditors, and the objectives established for the balance of payments in the program. The authorities were determined to reduce those arrears as fast as possible.

The Chairman made the following summing up:

> Executive Directors were in general agreement with the thrust of the staff appraisal contained in the report for the 1983 Article IV consultation with Guatemala. Noting the significant deterioration in the economic and financial position of Guatemala and the uncertainty in the region in recent years, Directors commended the adjustment efforts initiated by the Government last year in the context of a first credit tranche stand-by arrangement, and recognized the important role that fiscal policy was playing in the Government's stabilization program.
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> Directors noted specifically the measures taken to reduce government expenditures in 1982 and 1983 and expressed support for the Government's program of tax reform. It was pointed out that the substitution of a value-added tax for the existing sales tax, together with other contemplated reforms, should

improve the efficiency of the tax system as well as the competitiveness of exports. The review of pricing policies in parastatal enterprises was welcomed.

Directors welcomed the intention of the authorities to pursue a restrictive monetary policy, consistent with the objective of overall balance of payments equilibrium, and noted that this policy stance would be facilitated by the anticipated improvement in the Government's fiscal position and by the policy of wage restraint that the authorities intend to implement.

Directors stressed that the authorities should adopt a more flexible posture on interest rate policy, which would be governed by developments in the balance of payments, foreign financial markets, and domestic price movements.

Directors expressed support for the Guatemalan Government's intention to eliminate exchange restrictions on current transactions as soon as possible. Significant early progress in reducing external arrears was considered an essential element of the Government's stabilization program. The importance of the long and strong tradition of exchange rate parity with the U.S. dollar was noted. However, in the circumstances of major external imbalance and uncertainty prevailing now, the importance of giving due consideration to the role of the exchange rate in the Government's stabilization effort was also discussed. In contemplating future use of Fund resources, several Directors stressed the importance of satisfactory policy understandings in the field of exchange restrictions.

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

APPROVED: October 19, 1983

LEO VAN HOUTVEN
Secretary