PD-ABC-205

ISN 69540

UNCLASSIFIED

UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D. C. 20523

GUATEMALA

PROJECT PAPER

ECONOMIC STABILIZATION AND RECOVERY

FY 1990

AID/LAC/P-558

Project Number: 520-0385
Grant Number: 520-K-605

UNCLASSIFIED

CLASSIFICATION: UNCLASSIFIED

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

1. PAAD Number: 520-0385 520-K-605
2. Country: GUATEMALA
3. Category: CASH TRANSFER
4. Date: September 25, 1990
5. To: AA/LAC, James H. Michel
6. OYB Change Number: N/A
7. From: LAC/DR, Peter J. Bloom
8. OYB Increase: NONE
   To be taken from: ECONOMIC SUPPORT FUNDS (ESF)
9. Approval Requested for Commitment of: $ 50,000,000
10. Appropriation Budget Plan Code: LES090-35520-KG31;070-65-520-00-50-01
11. Type Funding: ☐ Loan ☒ Grant
12. Local Currency Arrangement: ☐ Informal ☒ Formal ☐ None
13. Estimated Delivery Period: FY 1990/1991
14. Transaction Eligibility Date:
15. Commodities Financed

16. Permitted Source		17. Estimated Source	
U.S. only		U.S.	
Limited F.W.		Industrialized Countries	
Free World		Local	
Cash	$50,000,000	Other	

18. Summary Description

The purpose of this $50 million cash transfer is to assist the Government of Guatemala (GOG) to stimulate growth through the maintenance of adequate macroeconomic policies, improvement of the efficiency of public sector activities, and initiation of selected sectoral reforms. The economic program commitments will be contained in a side-letter submitted by the GOG prior to the signing of the ESF grant agreement. The first disbursement will be based on the policy initiatives recently enacted by the GOG. Subsequent disbursements will be based upon evidence that the GOG has made satisfactory progress in implementing the fiscal, monetary, exchange and structural adjustment measures incorporated in its 1990 economic program.

Program funds will be deposited into a separate non-commingled, interest-bearing account in a U.S. bank, and will be disbursed to finance: 1) the servicing of non-military U.S. bilateral debt and debt to International Financial Institutions; and, (2) petroleum and its derivatives from A.I.D. Geographic Code 941 countries, the Netherlands Antilles and Curacao. The eligibility date for financing petroleum transactions is August 1, 1990. Following disbursement of the dollars, the GOG will deposit an equivalent amount of local currency in a special non-interest-bearing account in the Bank of Guatemala to be used to finance, in part, the GOG's Core Development Budget and the Mission's OE Trust Fund.

19. Clearances	Date
LAC/DP:BSchouten	9-18-90
LAC/CEN:LSimard	9/19/90
GC/LAC:TGeiger	9/19/90
PPC/EA:ECostello	9/19/90
ARA/ECP:CBryant	9/19/90
M/PFM/A:RBonnaffon	9/25/90
~~DAA/LAC:FSchieck~~	
SA/AA/LAC:KHarbert	

20. Action

☒ APPROVED ☐ DISAPPROVED

Authorized Signature: James H Michel

Date: 25 Sept. 1990

Title: ASSISTANT ADMINISTRATOR, LAC

Approval of Methods of Financing

This PAAD complies with current Agency guidance on methods of financing and has provided for adequate audit coverage in accordance with the Payment Verification Policy Implementation Guidance.

E. Cecile Adams, Controller, LAC

TABLE OF CONTENTS

I. INTRODUCTION

The $50 million Fiscal Year 1990 ESF cash transfer program proposed in this PAAD represents a continuation of the support for the Government of Guatemala's multi-year growth program, begun in 1988. As was described in last year's PAAD, the ESF program aims to support a macroeconomic program that permits steady and eventually self sustaining, long-term growth. A stable financial environment is a necessary, though not sufficient, condition to achieve that goal. Sectoral programs designed to remove the key structural constraints limiting the diffusion of the benefits of such growth to the poorest groups of society are required to win broad public support for the political and economic systems implied for a democratic society.

In the past two years, the sectoral program has focused principally on agriculture. Guatemala is an agricultural country, with some 25 percent of its GDP and half or more of its jobs generated in that sector. This year we expanded the sector-specific dialogue to include education, transportation and communications. As greater experience is gained in such sectoral programming, the Mission hopes to include other sectors, particularly health, in its policy dialogue with the Government.

While the program to be supported by ESF in 1990 has the same long-term objectives as the programs of the three previous years, it would be naive to overlook the influence that politics have in this year of presidential elections. As explained below, the Monetary Board was slow to react to a sharp deterioration in economic conditions during the first half of this year. However, the GOG has moved recently to address these issues. The Bank of Guatemala has been given authority to adopt corrective measures and a tight monetary program has been approved. It is expected that these effects will result in a sharp reduction in inflation and a return to a stable macroeconomic environment.

II. ECONOMIC DEVELOPMENTS DURING THE 1980s

A. Structure of the Economy

Guatemala is the largest Central American country in terms of both population and economic activity. The climate is varied and the wide distribution of soils allows cultivation of a variety of agricultural products, including coffee, tropical crops, fruits and vegetables. The country also has petroleum and nickel deposits and a substantial hydroelectric power potential. About half of the eight million people are descendants of the Maya civilization with only limited assimilation into the monetized economy. Only a fifth of the Indian population speak Spanish, the rest speaking some twenty-three different Indian languages. Economic integration has been made more difficult by the country's rugged topography and the scattered settlement pattern of the Indian population in the highlands.

During the 1960s and 1970s, Guatemala's economy enjoyed steady growth, reflecting prices for the country's export goods, the growth of exports within the Central American Common Market (CACM) and significant inflows of foreign resources. At the same time, prudent financial policies, including low fiscal deficits, moderate monetary expansion and flexible wage policies all contributed to low inflation rates, low external debt levels and maintenance of exchange rate stability.

B. Developments during the 1980s

1. Economic Deterioration: 1980-85

During the first half of the 1980s, Guatemala experienced serious financial and economic difficulties. Following several years of overall balance of payments surplus, the external position began to deteriorate. This worsening resulted from a variety of factors. Lower export prices for Guatemala's traditional exports combined with higher import prices resulted in a sharp deterioration of the country's terms of trade. Although the export structure had diversified throughout the period of the CACM, it was largely inspired by protectionist economic policy and hence was not in areas in which Guatemala produced efficiently. Moreover, the economic and political disruptions in Central America after 1979 adversely affected all regional trade and contributed to an erosion of confidence. Domestic investment levels fell abruptly and capital flight accelerated.

The negative impact of these external factors were compounded by expansionary fiscal and monetary policies, adopted to counteract the deteriorating external conditions. The overall deficit of the non-financial public sector rose from less than 1 percent of GDP during 1977-79 to an average of 5 1/2 percent during 1980-82. This increase reflected the combination of increased spending and the collapse of tax collections. Bank of Guatemala credit to the non-financial public sector expanded rapidly, outpacing the increased demand for financial holdings of the private sector. Given the open nature of the Guatemalan economy, the expansionary demand management policies produced a sharp reduction in the holdings of net international reserves of the Bank of Guatemala.

In both 1984 and 1985, the GOG undertook a series of measures aimed at addressing the deteriorating economic conditions. In November 1984 the GOG abandoned the fixed parity of the quetzal--maintained for over 60 years--and established a three-tier exchange rate system, comprising an official market, a banking market and an auction market. However, the GOG was unwilling to allow the free functioning of the system and the Bank of Guatemala intervened in the markets to cover imbalances. As a result, the exchange rate system generated significant losses of the Bank of Guatemala.

Fiscal discipline was enforced during these years, with the overall deficit of the non-financial public sector falling from some 3 percent of GDP in 1983-84 to about 1 1/2 percent in 1985. In 1985, the GOG sought to further strengthen the overall fiscal position through a comprehensive tax reform program. However, domestic opposition was severe and the GOG was forced to achieve an improvement in the fiscal accounts through a sharp curtailment of expenditures--particularly investment.

Despite the better fiscal performance, the net domestic assets of the Bank of Guatemala, continued to expand rapidly in 1984 and in 1985, mainly due to large exchange losses and high interest payments of the Bank of Guatemala. The improvement in the overall deficit of the non-financial public sector was more than overshadowed by the increase in the losses of the Bank of Guatemala, which increased from less than 1 percent of GDP in 1984 to 4 1/2 percent of GDP in 1985.

The expansion in the domestic monetary aggregates produced increased pressures on the domestic price level. After averaging less than 10 percent a year during the first five years of the decade, inflation in 1985 averaged over 30 percent. These conditions, together with the collapse of exports and the curtailment of public sector investment coincided with a sharp reduction in private sector investment. Regional instability and accelerating inflationary pressure resulted in a sharp loss of private sector confidence. As a result economic growth was negative each year during the period 1980-1985, reducing real GDP in 1985 to 6 percent below 1980 levels.

2. Stabilization and Economic Recovery: 1986-89

Upon taking office in 1986, the new Government sought to give greater importance to market forces in the determination of economic activities and reduce the role of the state. The GOG began by focusing on reducing the inflationary pressures and strengthening the fiscal and external situation. Measures initially adopted included (1) a radical simplification of the exchange rate system, (2) a temporary export tax, (3) reduction of exchange rate subsidies, (4) increases in the prices of petroleum products, agricultural inputs, pharmaceuticals and wheat, (5) tariff increases in telecommunications and water supply, (6) a major reduction in price controls, (7) monetary measures aimed at reducing the growth of the money supply, and (8) increases in the interest rates. The GOG also began to restructure customs administration, streamline export procedures, dropping all fiscal incentives to export to the CACM countries, and taking steps to lower industrial protection by reducing import tariffs on apparel and textiles.

The GOG also faced serious structural problems but was forced to address them only slowly during its period in power. Among the most pressing issues were low investment, and saving, heavy dependence on a few traditional exports and a severe dualism with wide disparities in income and social conditions.

The immediate impact of this stabilization program was positive and resulted in broad improvements in a number of areas. The decline in economic growth was halted and inflation decelerated sharply. The combined public sector deficit--including the losses of the Bank of Guatemala--was cut in half to 2 1/2 percent of GDP in 1986, primarily through a significant reduction in Bank of Guatemala losses, and then remained at about 3 1/2 percent in 1987-88.

Additional measures were adopted in both 1987 and 1988, aimed at consolidating the successful economic program initiated in 1986. That policy program was supported with resources from the ESF balance of payments program. Among the measures adopted were a major overhaul of the Guatemalan tax program (1987), opening of the "bolsa de valores" (bond market) to trade Guatemalan public and private sector financial instruments (1987), unification of all commodity trade into the regulated exchange market (1987), the unification and depreciation of the exchange rate (1988) and the subsequent adoption of a floating exchange rate (1989).

As a result of these policies real economic growth reached 3.7 percent in 1988 and 4.0 percent in 1989. At the same time, inflation steadily declined from almost 40 percent in 1986 to only 13 percent in 1989.

Notwithstanding the improvements in growth and inflation, the GOG confronted serious and tenacious difficulties with the external sector. In late 1988, the redemption of a significant quantity of public sector bonds, which the Central Bank did not offset with other operations, resulted in a sharp increase in the overall money supply which fueled a corresponding drop in international reserves of the

Bank of Guatemala. In 1989, the combination of a worsening financial position of the non-financial public sector and growing exchange losses of the Bank of Guatemala resulted in both an increase in the broad monetary aggregates and a further loss of international reserves. The impact of these developments was aggravated by a sharp drop in the international price of coffee, one of Guatemala's principal exports. Facing a loss in international reserves in excess of $ 135 million, the GOG temporarily strengthened its policy stance in the fall of 1989. A freely floating exchange rate was adopted and domestic interest rate controls were eliminated. In order to control the growth of monetary aggregates, the Junta Monetaria authorized the sale of open market instruments by the BOG. In late 1989 fiscal policy was tightened by increases in utility rates and gasoline prices.

III. THE GOG ECONOMIC PROGRAM

A. Introduction

Entering the 1990s, Guatemala must confront three broad development issues if growth is to be sustained over the medium term: maintenance of stable macroeconomic policies, improvements in public sector investment efficiency and implementation of key sectoral programs.

The first major issue is the maintenance of a stable macroeconomic framework. Most of the fundamental changes required to permit market determination of relative prices and rates of return, have been implemented. The price system, rather than government discretion, now plays the largest role in the distribution of scarce resources. However, policy instruments must be carefully managed and the GOG must maintain policies producing a stable absolute price level, and promoting domestic saving and private investment in order to sustain positive per capita growth.

The second major development issue is the improvement in the efficiency of public investment activities. Actions are necessary to strengthen planning, improve the quality of analysis and minimize the procedural bottlenecks to investment activities. Improving the quality of the public investment program must be achieved before much can be gained from increasing its absolute size.

Empirical evidence on the determinants of long-term economic growth suggests that improvements in human capital, better provision of social services and policies to address sectoral bottlenecks can contribute to the establishment of sustained economic growth. Accordingly, the third development issue facing the GOG is the improvement in the efficiency of sector-specific policies and elimination of distortions in the key sectors in Guatemala.

B. Recent Economic Development, January-June, 1990

Economic developments during the first half of 1990 were dominated by the expansionary monetary stance of the Bank of Guatemala (BOG). Given the shift to a floating exchange rate in late 1989, the results of the continued expansion in the net domestic assets of the BOG resulted in the combination of a depreciation of the exchange rate and an acceleration in inflation. Following a sharp drop in the net international reserve position of the BOG in January--reflecting payment of exchange rate guarantees provided to the private sector before November 1989--the BOG's net international reserve position remained largely unchanged for the rest of the period. The overall deficit of the Central Government--excluding BOG losses generated by quasi-fiscal operations--remained unchanged compared with last year at 0.4 percent of GDP. However, a reduction in Central Government revenue necessitated a corresponding reduction in overall Central Government expenditures and, in particular, in investment outlays.

Net domestic assets of the Bank of Guatemala increased by 23 percent during the first six months of the year compared with only 11.8 percent during the same period of 1989. This acceleration in net credit is explained almost exclusively by large BOG losses. During the first half of the year, BOG losses reached Q230 million or 0.8 percent of annual GDP. Those losses arose from the combination of subsidies for petroleum imports, exchange rate guaranties to exporters who had received partial advanced payments and, to a lesser degree, operational losses of the Bank itself. The increase in net domestic assets produced an increase in currency issue by 15.6 percent during the period compared with only 0.3 percent over the same period of 1989.

As the increase in currency issue far exceeded private sector demand for money, inflationary pressures accelerated. Twelve-month inflation jumped from 20.0 percent during the period ended December 1989 to 40 percent during the period ended June 1990. At the same time, private sector demand for dollars increased as the private sector shifted its quetzal-denominated assets into dollar-denominated assets.

First semester revenues of the Central Government increased by only 8 percent in 1990 compared with 1989. Tax revenues increased by 13 percent but that growth was offset by a slowdown in non-tax revenues arising from the elimination of the surcharge on petroleum sales. That surcharge was placed on gasoline sales to subsidize the price of diesel fuel and kerosene. Overall expenditures increased at the same pace as overall revenues. Expenditure control was maintained through the combination of the elimination of transfers to the state electricity company, INDE, and the tight wage and salary policy followed by the GOG. As a result the overall deficit of the Central Government remained at about 1/2 a percent of GDP in both periods.

Although the overall deficit of the Central Government was similar during the first six months of 1989 and 1990, the financing of the deficit was somewhat different. External resources this year were Q47 million (US$10 million) below 1989 levels and internal resources were correspondingly higher. However, the Central Government limited its access to Bank of Guatemala financing and, instead, sold public sector bonds to the private sector. In order to make such bonds attractive, effective interest rates (including discounts) of up to 36 percent were offered by the Ministry of Finance.

The impact of the expansionary monetary policy stance of the BOG was an increase in the demand for dollar holdings by the private sector. The initial impact was a depreciation of the freely floating exchange rate beginning in April. As a result, the Monetary Board in April restricted exchange rate fluctuations to a 5 percent band on either side of the previous week's exchange rate. Such administrative measures were not effective and the bands were eliminated the following month. However, the Monetary Board believed that the commercial banks were manipulating the floating exchange rate. Accordingly, on May 30, 1990, the floating exchange rate system was replaced with an auction market. Commercial banks now purchase dollars at the previous day's rate and sell the dollars to the Bank of Guatemala for a 0.5 percent commission. The Bank then offers the dollars in the auction market.

During June, the exchange rate determined in the auction market remained stable (Chart 1). However, the auction system awarded dollars first to individuals bidding at the average exchange rate of all bids rather than to those offering the highest bid. This mechanism weakened the link between the demand for dollars and the price of dollars because it provides an incentive to bid at the expected average rate for the day. As a result the official exchange rate began to appreciate moving from Q4.33 per U.S. dollar at the end of June to Q4.11 per U.S. dollars by mid August.

C. The Macroeconomic Program

1. The Economic Program for 1990

a. Real Economic Growth and Prices

Real GDP, after having increased by about 4 percent in both 1988 and 1989, is projected to increase by about 3 percent in 1990 (Table 1). Agriculture is projected to increase by 3.8 percent, based on the continued increase in the exports of both traditional and non-traditional crops. As in previous years, services are expected to increase at the fastest pace--with commerce, utilities and banking activities recording the strongest gains. The GOG economic team intends to hold 12-month inflation for 1990 to 30-35 percent. Given accumulated inflation of 27 percent for the first seven months, monthly inflation will have to be held to less than 1 percent for the remainder of the year. The policies required to ensure these results are detailed below.

b. Monetary Policy

Credit management during 1989 was severely handicapped by the public sector borrowing requirements, early redemption of the stabilization bonds and the exchange losses of the Bank of Guatemala. As described above, monetary policy continued to be expansionary during the first half of the year. The BOG has now adopted policies that should arrest that expansion. If such policies are maintained throughout the year, the inflation target can be achieved.

An important source of monetary expansion in 1989 and early 1990 was BOG losses. Such losses arose from the payment of interest on BOG bonds, exchange rate guarantee provided exporters who received partial payments and from the petroleum subsidy. Passive projections for 1990 indicated that such losses could increase from Q300 million in 1989 (25.5 percent of currency in circulation at the beginning of the period) to Q650 million (45 percent of currency in circulation at the beginning of the period) in 1990. As the resulting increase in currency issue would not be consistent with the inflation objective for 1990, the Junta Monetaria adopted the following measures:

(1) Increased the exchange rate used to import petroleum products, thus effectively eliminating the exchange rate subsidy.

(2) Authorized payment of the exchange rate guarantee to exporters in bonds rather than foreign exchange.

As a result, the losses of the BOG are now estimated at Q357 million (25 percent of currency in circulation at the beginning of the period). After June, such losses will be composed primarily of interest payments due on BOG bonds and on open market instruments.

To ease the implementation of monetary policy, during the remainder of the year, the Monetary Board authorized the Bank of Guatemala on July 10, 1990 to set interest rate levels on open market operations and to determine the amount of such instruments to be offered for sale. The Bank also established a monthly monetary program for 1990. For the first time, this program will be used to determine policy actions required to meet agreed-on monetary targets during the course of the year. At the same time, the Monetary Board began to unify reserve requirements. The large differentials that existed (41 percent as sight deposits and 13 percent as time and savings deposits) created as incentives for the banks to offer effective NOW accounts and counter BOG efforts to tighten monetary policy. The unification of reserve requirements will eliminate that incentive and strengthen the implementation of monetary policy.

The first step in the implementation of the monetary policy was an increase in the maximum maturity on open market instruments from three to six months and an increase in the maximum interest rate from 18 percent to 25 percent. However, the economic team believes that interest rates should be set by market forces. Accordingly, on July 23, the BOG began to auction open market instruments to the private sector. In the first auction, Q43 million in one-month bonds were sold to commercial banks. However, the BOG will begin shortly to sell bonds through the bond market ("bolsa de valores") to individuals.

Under the program, the net domestic assets of the BOG are projected to increase by 23 percent in 1990 compared with 50 percent in 1989 and 45 percent in 1988 (Table 2). Net international reserves of the BOG are projected to fall by 11 percent--see section 1d below--and high powered money is expected in increase by 13 percent. To meet this targeted growth in currency issue, the BOG will have to adopt a monetary policy that results in currency growth of about 1 percent a month for the remainder of the year.

During 1990, the BOG is expecting to sell about Q500 million in open market instruments to the private sector. Between January and July, the BOG sold approximately Q360 million both to commercial banks and to the nonfinancial private sector. The opening of the auction market for open market instruments will facilitate sales of such instruments and will help achieve the overall monetary targets established in the program.

c. Fiscal Policy

Discussions on fiscal policy during the first half of this year took place against the background of the deterioration in 1989. Tax collections were weakening and pressures to increase spending were mounting. Passive projections of the Central Government operations suggested that its overall deficit--excluding BOG losses--would increase from

3.8 percent of GDP in 1989 to 4.5 percent in 1990. Such a deficit is inconsistent with economic stability, given the limited financing options. Notwithstanding election year pressure, the Ministry of Finance announced the following revenue and expenditure measures to reduce the overall deficit:

- Reorganization of the Customs Department.
- Computerization of the income tax rolls.
- Administrative improvements in the collection of IVA.
- A hiring freeze for 1990.
- Restricting wage increases to an estimated 10 percent increase in the Central Government wage bill.
- Reduction in the subsidies for petroleum and transportation.
- A reduction in both the purchase of goods and services and a sharp restriction of investment program.
- A 20 percent increase in electricity prices.
- A 23 percent increase in gasoline prices.
- Approval by Congress of a 2 percent export tax which can be deducted from income tax obligations.

On the basis of these measures, the overall deficit of the Central Government is projected by the Ministry to fall from 3.8 percent in 1989 to 2.2 percent of GDP in 1990 (Table 3). While total tax revenue is projected to fall from 7.9 percent of GDP to 7.2 percent, tax collections in the second half of the year, on an annualized basis, are projected to increase from 7.8 percent of GDP to 8.0 percent. The reduction in transfers from the major public sector enterprises and the elimination of revenues generated by the surcharge on petroleum sales (the "fondo compensatorio") will reduce non-tax revenues so that overall revenue of the Central Government is projected to reach only 8.1 percent of GDP. Austerity measures are expected to produce a cutback in expenditure from the 1989 level of 13.3 percent of GDP to 10.3 percent in 1990. A key factor in achieving this reduction is the limit on wage concessions to 10 percent for the year.

The monetary program prepared by the GOG should limit the growth of the BOG losses. Accordingly, the deficit of the combined public sector is projected to fall from 4.4 percent of GDP in 1989 to 2.9 percent in 1990 (see Table 3). Together with the overall reduction in the deficit of the combined public sector, internal financing of the deficit is expected to fall from almost 2 percent of GDP in 1989, to only 0.5 percent in 1990.

d. External Sector Policies

The shift to a market-determined exchange rate system may have been the single most important component of the GOG program. Such an exchange rate system increases the competitiveness of Guatemalan goods in international markets and controls pressures on the international reserve position of the banking system.

Those conditions were temporarily reversed in July and August when the auction mechanism produced a sharp (5 percent) appreciation in the exchange rate. As a result, foreign exchange sales to the commercial banks by the private sector virtually disappeared. In response, the Monetary Board authorized the use of a Dutch auction scheme on August 17 in which dollars are sold to the highest bidders. This shift had an immediate impact. The official exchange rate depreciated by almost 15 percent to Q4.53 per U.S. dollar on the first day and by an additional 11 percent to Q5.05 per U.S. dollar at the end of the first week of operation. Largely reflecting this measure, average purchases of foreign exchange increased from a daily average of less than $2 million during July to over $4 million immediately following the shift in the exchange system.

The freeing of the exchange rate was combined with a series of reforms aimed at facilitating international trade. A major reduction of tariff rates was approved. Tariff rates on all items were reduced from a range of 0-100 percent to only six rates: 2 percent, 5 percent, 7 percent, 17 percent, 27 percent and 37 percent. Also in March, the tax on exports was eliminated. Regulations authorizing the new free-trade zones and the export incentives law were finalized.

Based on the economic program for 1990, the GOG expects a sharp improvement in the overall balance of payments position of Guatemala. Continued export growth and restrained increases in imports are expected to contribute to an improved current account while net capital inflows are expected to slow only marginally between 1989 and 1990.

This condition will result in a reduction in the BOG's net international reserve position by $36 million in 1990 compared with a loss of $111 million in 1989 (Table 4). That loss reflects the combination of an increase in arrears by $18 million and the reduction in cash holdings of an equivalent amount. Some $123 million of gold will be sold at market prices to repay a loan secured with the BOG's gold in 1989. That repayment is composed of a reduction in the BOG's net international reserve position by $18 million--the gold export valued at $42.4 per ounce--and a valuation adjustment of $105. To meet the arrears target, total arrears will be reduced by $30 million in the second half of the year. The GOG presently is negotiating with both the IBRD and the IDB over an arrears reduction plan that could include additional disbursements in 1990. An arrears reduction plan with the IMF was successfully completed in June 1990.

According to GOG projections, the current account deficit of the balance of payments will fall from its 1989 level of $464 million to $387 million. In large part, this reduction reflects an improvement in Guatemala's trade balance, with exports increasing by 12 percent while overall import growth is restrained to 8 percent. While coffee prices are expected to remain weak, exports of cotton, sugar and cardamom are expected to increase traditional export levels. At the same time, the diversification and rapid growth of non-traditional exports is expected to continue.

The capital account of the balance of payments is projected to fall from $283 million in 1989 to $191 million in 1990. The bulk of the reduction reflects payment by the BOG of $123 million in loans secured with official gold. The combination of exchange rate and interest rate measures are expected to produce a slight increase in private sector capital repatriation.

2. The Medium Term Outlook

The GOG's medium-term projections are only indicative and seek to identify structural bottlenecks that must be addressed by the incoming government. The government's objective is to achieve sustained growth in output and employment within a context of stable prices. The GOG believes that real GDP growth can increase steadily to 5 percent by 1992. This growth will be based on the continued expansion and diversification of Guatemala's export structure. While traditional products will continue to play an important role, non-traditional exports will become increasingly important. The expansion of new varieties of export crops together with the expansion of small-scale manufacturing activities is projected to increase non-traditional exports--excluding exports to the rest of Central America--from 20 percent of total exports in 1989 to 31 percent in 1992.

This expansion of export activity is expected to be accompanied by improved efficiency of import use. With the exchange rate maintained at realistic levels, luxury imports and non-essential imports will be kept to a minimum. Therefore, it is projected that the current account of the balance of payments will improve from a deficit of $464 million in 1989 to $263 million in 1992.

This improvement in the external accounts of Guatemala require stable economic conditions. To ensure such conditions, the GOG projects a steady improvement in the overall deficit of the non-financial public sector. From 4.4 percent of GDP in 1989, the deficit of the combined public sector is expected to fall to only 2.3 percent in 1992. At the same time, financing for the deficit will increasingly consist of net foreign disbursements.

The measures adopted by the GOG are expected to have a marked acceleration in domestic savings mobilization. Domestic savings are projected to increase to 8.4 percent of GDP in 1990 from 8.0 the previous year. While domestic interest rates have been freed and the exchange rate is set by market forces, continued uncertainties related to the election year are likely to impede any rapid improvement in savings mobilization. However, as stable policies take hold and markets begin to function smoothly, savings are projected to increase at an accelerating pace. In part, such savings will be derived from capital repatriation. By 1992, indicative projections suggest that savings could reach almost 11 1/2 percent of GDP.

This increase in savings will offset the effects of an expected reduction in foreign savings. Rapid export growth together with the aforementioned rationalization of imports will reduce the current account deficit from 5.5 percent of GDP in 1990 to only 3.3 percent in 1992.

These conditions will allow Guatemala to achieve a sustainable, medium-term path, based on export performance and efficient use of available resources. The GOG is convinced that the adoption of appropriate policies will ensure such an outcome.

The measures adopted by the GOG since coming to power have substantially reduced the financing gap in the balance of payments. Export growth has accelerated and foreign investment has picked up. Indicative projections over the medium term suggest that the financing needs of Guatemala will fall only slowly (Table 5). Nevertheless, a significant change in the composition of the financing is expected. The international reserve losses will be eliminated as a principal source of financing as domestic savings mobilization accelerates. Such acceleration reflects the impact, over the medium term, of the policy to give greater freedom to market forces. In particular, the freeing of the interest rates and floating of the exchange rate eliminate significant impediments to private sector investment and the functioning of the financial markets.

D. Program to Improve Investment Efficiency

A principal goal of the GOG is to improve the efficiency of public sector investment. Both the GOG and the Mission recognize that decision-making within the government is technically complex and poorly organized. As a result, the investment budget had become little more than a wish-list of projects submitted by individual ministries. The objective of the Core Development Budget (CDB) is to establish an effective tool which strengthens the investment process. The CDB seeks to provide an analytical capacity and objective decision making criteria with which the line ministries and the Ministry of Finance can rationally distribute scarce resources.

To meet that objective, the Core Development Budget contains the top-priority investment projects of the GOG which receive special treatment by the Ministry of Finance. Funding for projects in the CDB was to be guaranteed, special attention was to be given by the Ministry of Finance and the funding mechanisms were streamlined. For example, payment orders (ordenes de pago y compra) were expected to be processed within one week rather than requiring several months for their processing.

The CDB has received strong support from both the Ministry of Finance and the line ministries. As a result of the special attention given by the Ministry of Finance to CDB projects, line ministries lobby to have their projects included in the CDB. Notwithstanding this support, some difficulties have arisen in the operation of the CDB. Between 1988 and 1989, preliminary information suggests that the execution rate remained unchanged at about 57 percent. As a substantial improvement in that performance was expected, the performance was a disappointment to both the GOG and the Mission.

The unchanged execution rate indicated unexpected design limitations. First, the CDB had been allowed to grow from 67 percent of the investment budget in 1988 to 72 percent in 1989. This size was far in excess of the 20 percent initially envisioned. By allowing such growth, the low execution rate masked a very respectable 48 percent increase in investment carried out within the CDB. This experience has taught all involved a number of important lessons.

Perhaps the most important lesson is that the optimism and commitment shown by the Ministry of Finance when selecting top-priority projects cannot cloud the serious limitations imposed by capacity constraints in the Ministries. Human resources were too weak to implement such a rapid increase in investment. The first lesson, therefore, is that the CDB must be streamlined. It cannot continue to represent almost 70 percent of the total investment budget but, instead, must represent truly an investment core.

A second restriction arises from limited monitoring of the investment projects. The Ministry of Finance does not yet have an information system which permits it to follow the execution of CDB projects but, rather, receives information on all investment projects. This problem is aggravated by weak links between the Ministry and the line ministries. As a result, we are, through the Fiscal Administration project, helping the Ministry of Finance to install a more streamlined information base. In addition, joint oversight committees have been established in both the Ministry of Finance and USAID. The MOF unit is composed of a number of units within the Ministry and has responsibility for CDB execution. The two teams meet monthly to review progress. Until an automated tracking system for investment can be put in place, it will be particularly important to keep the CDB small.

Third, the project selection by the Ministry of Finance had tended to focus more on the desirability of the proposed outcomes of projects to Guatemala over the medium term, rather than on project feasibility or readiness. As a result, a number of potentially worthwhile projects have been included in the CDB prematurely. The joint oversight committee will reinforce the project selection process, focusing on pre-investment analysis and project preparation. As part of this process, the Ministry will prepare and present a sample of the poorer performing projects to analyze the difficulties facing project managers.

Reflecting these lessons, we have reached agreement with the Ministry of Finance to sharply limit the size of the CDB. From Q728 million in 1989, the CDB has been reduced to Q366 million, an amount equivalent to about 40 percent of the overall investment budget. Negotiations on the 1991 CDB will seek even further reductions in the relative size of the CDB. Furthermore, the Mission has undertaken a financial review of the operations of the CDB. Preliminary data suggest the need for the Ministry to improve its own audit controls. Once the results of the review are available, the Ministry CDB oversight unit will work closely with the Mission's review team to eliminate any deficiencies in the financial controls of the CDB.

The sharp tightening of fiscal policy during the first half of 1990 has resulted in an extremely slow pace of investments. The Ministry of Finance also has restricted investment outlays to those financed with foreign disbursements. As the local currency generated from the ESF cash transfer is a major source of CDB financing, and the cash transfer has been delayed, execution of the CDB may not improve in 1990. The oversight units will give special attention to this issue over the course of the year.

E. Sectoral Programs

Economic growth has accelerated sharply in Guatemala since 1986, reflecting both an improvement in the country's terms of trade and the adoption of appropriate macroeconomic policies. Following almost five years of steady decline, real GDP growth averaged 3.7 percent during 1987-89, increasing real GDP above the previously obtained peak in 1981. Notwithstanding this performance, structural impediments have limited the impact that this growth has on the poorest segments of the population. Widespread poverty, high illiteracy rates, years of underinvestment in human capital and in infrastructure, and inappropriate policy sets have restricted the spreading of the benefits of growth. It is a key theme of the Mission's entire program to remove such constraints.

There exists little consensus on what defines a sector. For many, a sector comprises only producing or operating units in an economy that share a common function. However, this definition excludes a variety of areas that affect the development process. For that reason, the Mission has opted for a broader definition of sectors, including productive sectors (agriculture, industry, mining), infrastructural sectors (transport, energy) and social sectors (education, health, population). In this way, a broad range of constraints to the development process can be examined.

When the benefits of growth are not rapidly and broadly distributed, there is a presumption that markets may not be functioning properly. The objective of sector analysis is to identify such market failures and identify interventions that correct such failure. Markets may fail for a variety of reasons, including imperfect information, monopoly and increasing returns to scale. These conditions can create structural rigidities. Reversal of these conditions can lead to improvements in the distribution of the benefits of growth, and indeed to accelerating the pace of growth.

1. Agricultural Sector Strategy

Guatemalan agriculture accounts for 20 percent to 25 percent of GDP, two-thirds of the foreign exchange earnings and is a source of employment for six of every ten active workers. If agricultural inputs, product processing and agricultural-related finance are included, the contribution of agriculture to GDP increases to 40-50 percent of GDP, and employment levels reach almost 80 percent of active workers.

Performance of the agricultural sector was quite robust throughout the 1970s. Real agricultural production increased at an average annual rate of 6.3 percent, reflecting the growth of both traditional export crops--principally coffee, cotton, bananas and cardamom--and industrial use crops such as sugar. During the 1970s, export crops grew at an annual average rate of 9.1 percent and industrial use crops by 13.2 percent. The rapid growth was fueled by a combination of favorable terms of trade in international markets, low domestic inflation, stable real wages and a good investment climate.

The combination of poor economic policies and the deterioration of the country's external terms of trade sharply reduced economic growth during the first half of the 1980s. Average economic growth fell by 1.4 percent and inflation accelerated. However, the agricultural sector performed relatively well. Overall agricultural production fell by 0.6 percent, as external conditions reduced the production of export crops by 3.4 percent. On the other hand, both crops for internal consumption and industrial use crops grew by almost 3 percent each.

The aggregate figures for Guatemalan agricultural growth mask extreme differences within the sector. The sector is highly dualistic, composed of a commercial subsector and a subsistence subsector. The commercial subsector is composed of large farms producing the bulk of Guatemala's traditional exports. The farms in this subsector use modern production techniques and product quality tends to meet international standards. The subsistence subsector is comprised largely of small-scale farms. Production techniques are generally labor intensive and factor productivity is low. Until recently, the bulk of the crops produced in this sector were consumed by farm workers and no significant marketable surpluses were generated.

The popular view of subsistence agricultural systems is that traditional farmers are bound by cultural restrictions that limit their ability to improve their productivity. Such restrictions are attributed to religious beliefs, cultural patterns or language differences. However, in recent years, empirical evidence has been accumulated showing that this popular view is incorrect. Subsistence farmers have been found to be efficient and acting "rationally" in the sense that they maximize their incomes subject to a broad variety of constraints. While such farmers are risk averse and adopt new farming techniques at a slow and cautious pace, such behavior reflects responses to conditions largely out of their control. Three broad categories of constraints to traditional farmers can be identified: fixed and fragmented land holdings, poor infrastructure and the policies and regulations established by the government that impede the free functioning of the market.

a. Fixed and Fragmented Land Holdings

Over the medium run, the supply of arable land is fixed. In the coastal regions, land holdings are distributed in large plantations specializing in the production of the traditional export crops. In the Highlands, on the other hand, land holdings are small and the bulk of the production goes for basic grain. The fragmented nature of land prevents small-scale farmers from taking advantage of economies of scale and can make capital investments unprofitable.

The productivity of land holdings is further limited by a host of environmental conditions. Inappropriate use of water resources results in damaging soil erosion and intensive land use which drains the soil of important nutrients. In the absence of appropriate fertilizer and pesticide use, the productivity of arable land steadily declines.

b. Infrastructure

Guatemala has a well-developed system of primary and secondary roads but has a lack of tertiary and farm-to-market roads. This condition is aggravated by the tortuous terrain in the Highland. As a result, traditional agricultural sector is based on small-scale farming with low productivity. That productivity is further hampered by inadequate water supply and poor systems of irrigation. The volcanic soils of the region do not retain water and the sharply delineated dry season (January-April) limits crop production.

c. Prices and Regulations

If domestic prices do not accurately reflect relative factor scarcities in the economy, resources are not distributed in an optimal fashion. At the macroeconomic level. severe distortions existed when the present government took power in 1986. There were severe and binding price controls, an inappropriate exchange rate policy and a tariff structure that provided disincentives to agriculture production. Policy discussions with the GOG focused primarily on this area. The results of those discussions were summarized above.

At a sectoral level, there continue to exist remnants of the interventional policies followed by the previous government. Much of the remaining regulations and restrictions are aimed at ensuring adequate domestic supply of agricultural products but have actually impeded expansion of the agricultural sector. Restrictions on the import of key agricultural inputs have limited agriculture productivity growth over the past several years and restrictions on the export of basic grains proved to be a disincentive to grain production. Such regulations have benefited a small group of agriculturists, but their overall impact on agricultural productivity has been negative. At the same time, the GOG seeks to influence the prices of basic grains through the activities of INDECA.

The Mission recognizes that it cannot address all these constraints to agriculture production. Accordingly, the first priority of the Mission was to address the pricing distortions in Guatemalan agriculture. It was believed that the supply elasticity for individual crops is relatively high. Therefore, "getting the prices right" would provide a significant incentive for increased production. As part of the macroeconomic policy reform package, price controls were eliminated and the process of tariff reform was initiated. The exchange rate was first simplified and then unified. The change in the exchange rate regime was a key aspect for the stimulation of nontraditional agricultural growth and control of domestic demand policies ensured the appropriate macroeconomic environment for investment and diversification in the agricultural sector.

The Mission recognizes that correcting relative prices will not necessarily lead to major improvements in overall agricultural growth. The aggregate supply elasticity in agriculture is far lower than the supply elasticities of individual crops because resources used to increase the production of one crop will result in decreases in the production of others. The alternative, therefore, is to focus on measures aimed at improving factor productivity as the principal means of increasing farm output.

The objectives of the 1989 ESF program were aimed primarily at addressing the infrastructural constraints. Negotiations with the Ministry of Agriculture focused on investment activities and investment planning. This emphasis was adopted to take advantage of improvements in the Core Development Budget (CDB) which involved coordination of the Ministry of Finance and the Ministry of Agriculture. The strategy for the 1990 ESF program broadens the focus to include regulatory reform and improvement in infrastructure.

The macroeconomic reforms resulted in substantial improvements in the agricultural sector. Nontraditional exports increased by 24 percent in 1988 and by another 26 percent in 1989. The maintenance of an appropriate exchange rate and the reduction in tariff levels are expected to contribute to a 25 percent growth in such exports in 1990. Policy dialogue during 1990 has focused on regulatory improvement. The improvements achieved during 1990 include (1) the elimination of the prohibition of the export of basic grains, (2) the elimination of quotas on the imports of agricultural inputs, especially fertilizers, and (3) and the establishment of in-country testing for pesticide use.

As basic grains can now be exported, the agricultural sector can now begin to distribute resources to the most profitable activities. For example, the production of beans and basic grains has been inhibited because of the relatively small and stable demand for the products in local markets. As exports become a possibility, farmers can attempt to compete with neighboring countries. This competition will be aided by the availability of relatively cheaper agricultural inputs, reflecting the impact of the elimination of quotas. Finally, it is expected that early testing for pesticide use will reduce the amount of exports turned back at US ports for inappropriate pesticide concentrations.

Policy dialogue has also focused on the regulation and implementation of the Protected Areas Law, the Forestry Law and the Maya Biosphere Reserve Law. These laws are aimed at ensuring a sustainable pace of exploitation. Regulations concerning land use, use of pesticides and water management and forestry conservation are included in these areas.

Two additional issues continue to be discussed. The Mission has supported the extension of irrigation services to small-scale farms in the Highlands through DA-funded assistance. However, to increase the efficiency of such efforts, the Mission is seeking their transfer from public-sector administered units to user-controlled units. Some progress has been made. As part of the policy negotiations, a pilot project will be initiated this year. Further progress, however will depend on the outcome of the pilot unit. The Mission also has sought the restructuring of INDECA and a shift from direct intervention in the marketing of basic grains, to the provision of needed support services to improve the current marketing services. This second activity is consistent with the long-range objectives of reducing the role of the public sector in the provision of services. Unfortunately, progress in this area has been slow because of election-year uncertainties.

2. Education Sector Strategy

In 1989, Guatemala has an estimated population of 8.9 million inhabitants. In area, it is the third largest country in Central America, but the first in population and the second in population density. It is also the Central American country with the largest percentage of rural population (63 percent in 1985). The bulk of the rural population (73 percent) either do not speak Spanish or speak it as a second language. Twenty-three distinct Indian languages are spoken in the rural areas. The resulting difficulties in communication and integration have limited the rural population's access to the benefits of growth.

Education provides an opportunity to improve social conditions and accelerate economic growth. Recent economic studies have indicated that education levels in developing countries are positively correlated with economic growth, farmer productivity, health indicators, and are negatively correlated with fertility rates. While numerous theoretical issues remain to be clarified, the social return on investments in education have been shown to be high and, in some cases, higher than investments in more traditional development projects.

Unfortunately, statistics on the level of education in Guatemala are not reassuring. Within the region, Guatemala has the lowest primary school completion rate (50 percent) and it takes the greatest number of years to produce a 6th grade graduate (10.4 years). Approximately 62 percent of the primary school age group was enrolled in school in 1988. However, only 53 percent of the primary school aged group in the rural area of the country was enrolled.

These conditions have contributed to the low educational attainment levels in the Guatemalan adult population. Eighty-seven percent of the Guatemalan labor force over 15 years of age has not completed primary school. As a reflection of this low percentage, Guatemala has the second highest illiteracy rate in the Western hemisphere, after Haiti. Half of the individuals age 15 over older are illiterate. The picture is far worse for the indigenous population, where 73 percent of adult indigenous males are illiterate and 91 percent of adult indigenous women are illiterate.

The poor performance of the education system in Guatemala reflects the impact of two broad constraints: a weak institutional basis and an inefficient educational system. The principal institutional constraints include an over-centralized administration and a poorly managed administration. Delegation of responsibility for implementing education programs is centered in the capital and all important decisions are referred to the Ministry. The Ministry itself has poor planning, budgeting and management capabilities. As a result, decisions are made slowly and the impact of decisions are not felt in the field.

The second constraint restricting the provision of education is the inefficiency of the system. The long period of time required to produce a sixth-grade education was cited above. The extremely high repetition and dropout rates suggest that scarce resources--both human and capital--are being poorly utilized. This inefficiency results from a variety of causes. Low quality of teaching is a leading factor. Poor and inadequate supervision, inadequate in-service training, lack of achievement standards and minimal teaching supplies all contribute to this condition. In areas where children are monolingual in a Mayan language, the absence of a bilingual program can also result in poor attendance and large dropout rates.

In the past the Mission has sought to address these constraints through project interventions aimed at improving both the quality of education and the returns to education. However, it has become evident that fundamental policy changes must complement the Mission's project portfolio if substantial progress is to be achieved.

Such a policy focus is in its infancy. Although rapid progress has been achieved in the areas of both macroeconomic policy reform and agriculture policy reform, discussion on education policy only now is being initiated. Accordingly, the bulk of policy-oriented activities with the Ministry of Education has focused on joint identification of the key constraints and on identification of broad sectoral goals. Given the election year pressures, further progress is not expected this year.

The bulk of the policy issues raised by the Mission have focused on the administrative weaknesses of the Ministry of Education. The medium-term goals agreed on with the Ministry of Education include:

(1) An increase in budgetary resources given to education from 1.5 percent of GDP in 1989 to 3 percent of GDP by 1995;

(2) an increase in the proportion of educational expenditures applied to primary education; and

(3) an increase in the investment budget of the Ministry from 5 percent of expenditures in 1989 to 10 percent in 1995.

The Mission believes that the lack of resources available for primary education is a binding constraint. As policy negotiations become a more integral part of the relation between the Mission and the Ministry of Education, discussions will focus on decentralization and on increasing the supply of bilingual teachers (presently addressed through DA funded activities).

3. Transportation and Communications

Economic growth and development, particularly involving export expansion, are impossible without adequate transportation and communications services. Reflecting the prolonged constraints which have restricted public sector investment activities, both the transportation and communications services have deteriorated sharply in Guatemala over the last several years. The constraints arising from such deficiencies have now reached crises proportions. The Mission has engaged in an intensive analysis of the difficulties of this sector and preliminary discussions have already taken place. However, the GOG is facing a serious financial constraint which limits its ability to adequately respond to the limitations in the sector. Accordingly, the GOG has addressed this issue by opening provision of transportation and communication services to increased private investment and participation. Among the measures that have been adopted in 1990 are:

(1) Signing of a contract for the provision by the private sector of cellular telephone services.

(2) Privatization of storage and stevedore activities in Puerto Quetzal.

(3) Privatization of dock facilities services in Puerto Barrios.

(4) Privatization of grain storage facilities in Puerto Barrios.

(5) Authorization for private sector participation in storage facilities for exporters in the Aurora Airport in Guatemala City.

While these measures ameliorate some of the difficulties in the sector, considerable improvements are necessary. Negotiations will continue throughout the program period aimed at further privatizing services now in the hands of the GOG and improving the deteriorated infrastructure in this sector. Possible measures may include further privatization of airport facilities and the sales of some telephone services now provided exclusively by GUATEL to the private sector. In addition, progress of GUATEL's major investment program to improve service in areas where it is now wholly unacceptable will be monitored closely with the GOG.

IV PROGRAM DESCRIPTION FOR FY 1990

A. US Interests and the CDSS

The FY 1989 Guatemala CDSS describes the inequitable distribution of the country's considerable wealth. The low income of the majority of Guatemalans has been severely eroded in recent years, both by the regional recession and by the burst of inflation in 1985-86. The CDSS documents the impact of the economic crises and the difficulties of achieving improvements in living standards in the absence of a comprehensive stabilization plan.

The Report of the National Bipartisan Commission on Central America (NBCCA) identifies a clear need for a rapid build-up in economic assistance to Central America to address the dual problems of growth and equity. Nonetheless, before 1985 concerns about the lack of commitment of previous Guatemalan governments to addressing such problems resulted in assistance levels below those for neighboring countries. The return to a civilian government in 1986 led to the restoration of foreign assistance, including badly needed ESF support.

The proposed FY 1990 ESF program is consistent with NBCCA and Mission strategy for Guatemala, as most recently articulated in the 1991-92 Action Plan. The program will assist the government in undertaking policy reforms to stimulate growth through maintenance of adequate macroeconomic policies. The proposed sectoral emphasis--including reforms in the agricultural, education, transport and communication sectors--meets the CAI mandate to focus increasingly on sector growth programs. The development objectives of the strategy will be furthered through the financing of the Core Development Budget.

Economic stability and steady growth in real incomes, particularly of the country's least-advantaged groups, will give a strong boost to the institutionalization of democracy in Guatemala. In the near term, the ESF program will be directed to ensuring continued stability of the major macroeconomic variables. Given the election year pressures a steady hand in economic management is needed. The ESF program will assist that effort by increasing the supply of foreign exchange essential for inputs to production and by providing budget support to expand the level of services and infrastructure to the poor.

B. Policy Dialogue

The US Country Team has maintained close dialogue with the Government of Guatemala on economic policy issues since the negotiation of the FY 1986 ESF agreement. Beginning with the adoption of the economic package in June 1986, the Government of Guatemala has enacted measures to support its stabilization agenda and to stimulate private sector activities.

Discussions leading to the FY 1990 ESF agreement have centered on both the macroeconomic situation and on sector issues in agriculture, education, transport and communications. The US Country Team has worked consistently with the GOG to identify probable developments and help identify measures that needed to be put in place. The Mission has acted as a sounding board at the technical level and has helped the economic team strengthen its policy response to unexpected economic developments. As described above and as is summarized in the appendix, the GOG has enacted a series of measures in 1990. In addition projections of fiscal, monetary and external sectors have been developed which will be used by the US Country Team and the GOG to evaluate developments during the year and identify the magnitude of corrective actions necessary. The US Country Team has also worked together with the Ministry of Finance to strengthen the Core Development Budget. Revised operating instructions have now been developed and the Ministry has submitted a CDB for 1990.

As part of the final agreement, the GOG will submit the FY 1990 side letter containing a description of policies adopted thus far and the policies that remain to be enacted. Specifically, the side letter will contain:

(1) The monthly monetary projections described above, to include:
   - the reduction of the twelve-month inflation rate to 30-35 percent by December.
   - a 13 percent increase in high-powered money in 1990.
   - zero net credit to the non-financial public sector.
   - net international reserve position in conformance with monetary program levels.

(2) A commitment to joint tracking of progress made in the attainment of objectives laid out in the side letter. Among other emphases, this review process will ensure that no impediments to the free functioning of the exchange rate have been established. The principal indicator of the success of the exchange rate policy will be the maintenance of a spread between the official and parallel markets not exceeding 5 percent.

(3) A description of the objectives of economic policy in 1990 and a description of targets against which partial disbursements will be made.

(4) A best-efforts commitment to reduce arrearages to the International Financial Institutions and a pledge to stay out of non-accrual status with the IDB.

(5) Commitment to the structural reforms in the CDB.

C. Mechanism for Disbursement of ESF Dollars

Upon the GOG meeting all conditions precedent to the disbursement, USAID/Guatemala will request disbursement into a separate, interest-bearing account of the Government of Guatemala in the Federal Reserve Bank of New York. Evidence must be presented to support the establishment of a separate account for the dollar grant funds by providing the account number, name of the bank account and address of the bank to USAID/Guatemala. Once this information is provided along with evidence that all conditions precedent have been met, USAID/Guatemala will request that AID/Washington transfer $20 million into the Guatemalan separate account.

Withdrawals from the separate dollar account (including any interest earned) to finance imports of petroleum and its derivitives will be requested by the Bank of Guatemala (BOG) using the reimbursement basis presenting listings, together with copies of the required documentation, of eligible imports. Reimbursement procedures acceptable to USAID will be agreed upon with the Ministry of Finance prior to signature of the Agreement. August 1, 1990 may be established as the eligibility date for financing these purchases with ESF dollars. ESF dollars will also be used to directly pay non-military U.S. bilateral debt or IFI debt after the ESF Program Agreement is signed.

Before subsequent disbursements of $10 million and $20 million, staff of the GOG and AID will jointly evaluate progress made in achieving the goals and targets set forth in the side letter. Particular attention will be given to progress in reducing inflation, movement of the BOGs net international reserve position, maintenance of the policy of zero net credit to the nonfinancial public sector, the free functioning of the exchange rate auction, and status of the GOG with the IFIs. If difficulties are identificated, corrective actions will be negotiated and implemented before disbursement.

D. Accountability of ESF Dollars and Local Currencies

1. ESF Dollars

In previous years, USAID/Guatemala had an efficient system of managing the separate dollar account mandated by Congress. Once the noncommingled account for the ESF dollars had been established, the Bank of Guatemala (BOG) provided USAID with a list of completed foreign exchange transactions that fit the eligibility criteria contained in the ESF agreement. Only imported private sector productive inputs and Bank of Guatemala debt service payments were eligible. For every import transaction, the BOG provided copies of (1) a bank letter of credit, or other payment document to the supplier (2) the commercial invoice, (3) the bill of lading and (4) foreign exchange authorization. The Controllers Office reviewed the list, discarded obviously ineligible transactions, and authorized withdrawal of an amount equal to acceptable transactions, subject to a subsequent detailed review of the dollar separate account. The ESF U.S. Dollar separate account for FYs 1987 through 1989 have been reviewed by Peat Marwick, and the Mission has reports on all of these accounts. The reviews covered both the special account, including interest earned and withdrawals, and the documentation of the eligible imports, for compliance with the terms and conditions of the appropriate agreements.

In November 1989, the GOG changed the exchange rate system. Reflecting the policy of reducing the role of the public sector in the distribution of scarce resources and giving greater freedom to market forces, the BOG shifted to the commercial banks the responsibility of establishing the exchange rate and the purchase and sales of foreign exchange. In keeping with the desire of the GOG to reduce the size of the bureaucracy and reduce capital controls, the information received by the BOG was also sharply reduced. Under the new system, commercial banks are required to submit only summary statistics to the BOG. Commercial banks, in turn, hold import documents only until the transaction is completed. As a result, neither the BOG nor the commercial banks can provide the information previously available.

Under these conditions, the Mission proposes that, for the FY 1990 ESF agreement, withdrawal by the BOG from the noncommingled account be authorized upon presentation to USAID/Guatemala of documentation showing petroleum imports and for the direct payment of non-military U.S. bilateral debt and debt service payments to international financial institutions. In the former case the Controller's Office will review the documentation and authorize withdrawal of ESF dollars from the noncommingled account in an amount equal to or less than the amount of petroleum imported.

Eligible petroleum imports will come from AID Geographic Code 941 countries plus Netherlands, Antillas and Curacao. The use of ESF dollars to pay for petroleum imports will ensure that the shortages in the supply of key productive inputs to the private sector not jeopardize the growth rate expected in 1990.

The formal financial assessment of the capability of the Bank of Guatemala to effectively carry out its responsibilities under the ESF Cash Transfer Program, as required by the new guidance contained in State 194322 (6/15/90) will be postponed until the new documentation system is installed.

2. ESF and Local Currencies

USAID has established a Mission Order for local currency management (No. 19-7) which is now fully in place. Our system works as follows. Within 10 working days following disbursements by AID/W of ESF grant dollars, the Government of Guatemala deposits the equivalent amount of quetzales into the special account. The rate of exchange will be the highest rate that, at the time of the quetzal deposit, is not unlawful in Guatemala.

The Division of External Finance (DFEF) of the Ministry of Finance is responsible for coordinating requests by public sector agencies for use of the funds in budgeted activities. In FY 1988 and beyond, the Technical Budget Office of the Ministry of Finance participates in this process through the establishment of the Core Development Budget. All financial transactions are the responsibility of the Bank of Guatemala and the National Treasury.

The Core Development Budget framework for management of local currency identified by the GOG with ESF works as follows:

a. The Guatemalan government determines its highest priority development investments for the upcoming budget year. These investments form the Core Development Budget. USAID is participating in the development of methods used by the GOG in the prioritization process, through provision of technical assistance in investment project evaluation.

b. The GOG submits the Core Development Budget to USAID for approval. Mission approval is based on two elements: (1) that the CDB was prepared using sound budgetary principles, and (2) that it does not contain military and other expenditures prohibited under U.S. foreign assistance legislation. Through the FY 1989 Fiscal Administration

Project, USAID/Guatemala is providing assistance to the Ministry of Finance to improve the budgetary process, particularly for capital budgeting.

c. Once the CDB is approved, ESF local currencies may be disbursed to finance any activity it contains.

d. The Ministry of Finance submits quarterly reports to USAID which show flow of funds from the special account into the CDB. The Controller's Office performs in-house monitoring to assure the GOG check registers, cash reconciliations, budget decrees and related correspondence adhere to the provisions of the ESF agreement regarding use of funds and documentation.

e. Primary responsibility for audit of the CDB rests with the Guatemalan Controller General Office. USAID retains full audit and document inspection rights.

Price Waterhouse has completed an assessment of the technical assistance needs of the Controller General's Office. The USAID Controller's Office will work with the GOG Controller General to implement the recommendations contained in the report.

This system for local currency management conforms fully to AID/W guidance on use of local currency for general budget support. The guidance requires that documentation must exist demonstrating that the local currency was transferred from the special account to the appropriate development budget account of the host country. Adoption of this system has substantially decreased the Mission LC management and paperwork burden over our previous system of project-by-project approval.

For USAID trust funds in quetzales, the full amount for OE, technical support and audit accounts must be transferred by the GOG to the U.S. Disbursing Officer's interest-bearing account in the Bank of America in Guatemala City after receipt of the U.S. dollar disbursement by the Guatemalan Government.

For local currency programs with the private sector under the FY 1987 ESF agreement, subagreements provide for audits to be carried out by private accounting firms contracted by USAID. USAID financial reviews of non-D.A. project activities are financed from the audit trust fund established for use by the Mission with local currency under ESF agreements. IQC's with two local affiliates of U.S. accounting firms have been signed for this purpose. Price Waterhouse was contracted in January 1990 to perform a financial management review of the GOG administrative programming, accounting and internal control systems established to comply with its implementation, financial administration and monitoring/reporting responsibilities under the local currency programs. This also included a follow-up on recommendations made during the review performed in FY 1989 together with a in-depth review of the documentation and circumstances surrounding the programming and disbursement of the ESF local currency funds under the agreement for FYs 1988 and 1989. The Mission has received the draft report which is being reviewed.

APPENDIX A

Summary of the FY 1990 ESF Program

As described in Part III, the GOG has already adopted a series of measures during 1990 aimed at addressing the economic slippages that occurred in late 1989 and the first quarter of this year. These measures, adopted in conjunction with the on-going policy dialogue between the USG and the GOG, include:

Fiscal Policy

1. The reduction of subsidies to public sector entities.
2. More than 20 percent increase in gasoline and diesel prices.
3. Increase in electricity rates by 20 percent and water rates by 100 percent.
4. Reorganization of the Customs Office of the Ministry of Finance.
5. Establishment of a hiring freeze for the public sector.
6. Announcement of a limit on wage increases to Q100 per worker, to be paid in three tranches during the year.
7. Computarization of income tax rolls.
8. Administrative improvements in collection of IVA.
9. Approval by Congress of 2 percent export tax, which can be deducted from income tax obligations.

Monetary Policy

1. Establishment of a zero net increase in Bank of Guatemala credit to the non-financial public sector during 1990.
2. Authorization by the Monetary Board to the BOG to implement an independent monetary program.
3. Approved of a monthly monetary program.
4. Adopted an auction system for the Bank of Guatemala open market instruments, allowing market forces to set the interest rate.

5. Approved a staged unification of reserve requirements. While this measure was designed to avoid any impact on a broad monetary aggregates, it will facilitate implementation of the BOG's monetary program.

External Sector

1. Reduction of tariff levels on 80 percent of Guatemala import items from a maximum of 100 percent to a maximum of 37 percent.

2. Elimination of the exchange rate band which impeded the free functioning of the exchange rate market.

3. Elimination of the exchange rate subsidy for petroleum prices.

4. Shifted the present auction market to Dutch auction.

Transport Sector

1. Authorization of private sector activity in publicly-owned ports.

2. Privatization of storage and stevedore activities in Puerto Quetzal.

3. Privatization of deck facilities in Puerto Barrios.

4. Privatization of grain storage facilities in Puerto Barrios.

Communications Sector

1. Approval of private sector provision of cellular plans.

Agricultural Sector

1. Eliminate import quotas on agricultural imports.

2. Eliminate prohibitions on the export of basic grains.

3. Establishment of in-country testing for pesticide use.

In addition, the GOG will make the following commitments:

1. Use open market instruments to achieve a sharp reduction in inflation.

2. Reverse the loss of the BOG net international reserves.

3. Not interfer with the market determination of the exchange rate.

Tranching Strategy

The first tranche of $20 million will be disbursed after the GOG provides a side letter describing their policies and after signing the Grant Agreement with the GOG. Disbursement will be made based on the policy modifications introduced thus far in the year and the implementation of the economic program begun in July 1990. As a result of that program, inflationary pressures have subsided, the official exchange rate has depreciated sharply and foreign capital inflows have increased nine-fold.

The Mission is proposing two subsequent disbursements of $10 million and $20 million, respectively. The GOG will be permitted to request two additional disbursements at approximately six week intervals. Each disbursement will be contingent upon agreement between the USAID staff and the GOG on the progress in achieving the economic goals set forth in the side letter. A monthly monetary program has been approved by the Bank of Guatemala (BOG). The GOG will follow monetary policies that result in a reduction in twelve-month inflation from 50 percent in July to 30-35 percent in December. Present projections indicate that twelve-month inflation should fall to 42 percent by October and 33 percent by December. The monetary program expected to achieve these results contemplates an increase in high powered money by 13 percent during 1990. To meet this target, the BOG will have to adopt a monetary policy that results in an average monthly increase in high powered money of about 1 percent. Preliminary information indicates that the BOG overperformed on this target in July and August. The monetary developments also will be examined to ensure that the BOG has maintained its policy of zero net credit to the nonfinancial public sector and that the net international reserves position of the BOG--including the stock of external arrears--conforms with the programmed levels.

Each review also will include an examination of the broad economic developments that have occurred since the last disbursement and the extent to which the goals of maintaining stable macroeconomic conditions is being meet. If unforseen developments not explicitly included in the side letter have jeopardized the overall objectives of the program, USAID staff and the GOG will jointly negotiate additional policy measures to ensure that the objectives of the program are reached. The review will also examine developments in the exchange markets to ensure that no impediments to the free functioning of market forces have been established. The principal indicator of the success of the exchange rate policy will be the maintenance of a spread not exceeding 5 percent between the exchange rates in the official and the parallel markets.

APPENDIX B

Performance Under the FY 1989 ESF Program

The $69.5 million ESF balance of payments grant was obligated in August 1989. The program supported a comprehensive reform package implemented by the GOG. Among the major macroeconomic components of that package were:

1. A shift from a fixed exchange rate system to a crawling peg system wherein the exchange rate was adjusted automatically according to a real effective exchange rate calculation (i.e. in line with the differential between the real exchange rate in Guatemala and in Guatemala's principal trading partners).

2. An initial devaluation of the official exchange rate from Q2.70 per US dollar to Q2.78 per US dollar.

3. The complete liberalization of domestic interest rates.

4. Authorization for the Bank of Guatemala to undertake open market operations.

5. Approval of three new financial institutions, including a branch of an international bank.

6. Enactment of a pro-export free zone law and presentation to Congress an export promotion law; and

7. Privatization of AVIATECA.

In addition to these measures, the GOG initiated a series of sectoral policies, including

1. Commitment to execute 70 percent of the investment budget of the Ministry of Agriculture (MAGA).

2. Presentation by MAGA of a unified budget incorporating the diverse entities operating in the agricultural sector. This unified budget permitted improved monitoring and evaluation of diverse activities carried out in Guatemala.

3. Preparation by MAGA of an analysis of irrigation needs.

4. Reorganization of BANDESA. A new president was appointed along with two new deputy directors. A significant reassignment of BANDESA's personnel also was begun at mid-year.

5. Development of a tropical forest action plan. A working group was formed with the active participation of the Vice-President of the Republic. A forestry law, developed with aid technical assistance, was submitted to Congress.

The GOG recognized that the successful implementation of its program required the maintenance of stable macroeconomic policies. To complement its policy package, therefore, the GOG sought to limit the overall deficit of the nonfinancial public sector to no more than 2 1/2 percent of GDP and to adopt a monetary policy that limited the loss of Bank of Guatemala net international reserves to no more than $30 million (excluding the proposed World Bank export promotion loan of $30 million).

The GOG faced increasing difficulties implementing this policy package. Faced with larger-than-expected losses of the Bank of Guatemala, continued pressures arising from the servicing of its domestic debt, and financing needs of the nonfinancial public sector, the net international reserves losses continued unabated throughout most of the second half of the year. Although the BOG had the authority to sterilize the increases in the money supply with open market instruments, lack of familiarity with the new instrument resulted in important lags in the use of such instrument. However, the GOG completely freed the exchange rate system in November. While this measure permitted an increase of some $30 million in international reserves during November-December, the Bank of Guatemala suffered a loss of $110 million during 1989.

The results of the freeing of the domestic interest rate system also were delayed. The banking cartel effectively restricted competition among banks. The continued increase in domestic liquidity also prevented the anticipated increase in domestic interest rates. As a result, the balance of payments was not strengthened by a significant increase in private sector capital repatriation until the freeing the the exchange rate in November.

The combination of continued slowdown in the collection of tax revenue, expenditure pressures and Bank of Guatemala losses increased the combined deficit from 3.7 percent of GDP in 1988 to 4.4 percent in 1989.

SUMMARY ACCOUNTS OF THE MONETARY AUTHORITIES
(IN MILLIONS OF QUETZALES)

	Q2.7 = US$1			Q4.35 = US$1	
	1987	1988	1989	1989	1990
NET INTERNATIONAL RESERVES	118	(161)	(457)	(736)	(893)
NET DOMESTIC ASSETS	888	1,337	1,928	2,207	2,549
PUBLIC SECTOR	931	1,002	1,099	1,099	600
NET CREDIT TO BANKS	(471)	(600)	(668)	(668)	(719)
CREDIT	121	157	162	162	181
DEPOSITS	(592)	(757)	(830)	(830)	(900)
MEDIUM- AND LONG- TERM FOREIGN LIABILITIES	(1,065)	(1,056)	(951)	(1,532)	(1,658)
BOG LOSSES	1,380	1,758	2,114	2,114	2,471
OTHER 1/	113	233	334	1,194	1,855
CURRENCY ISSUE	1,006	1,176	1,471	1,471	1,656

SOURCES: BANK OF GUATEMALA; AND AID STAFF ESTIMATES.

1/ INCLUDES STABILIZATION BONDS, EXCHANGE VALUATION AND OTHER NET ASSETS.

SUMMARY ACCOUNTS OF THE MONETARY AUTHORITIES
(In percentage change) 1/

	1988	1989	1990
Net international reserves	-27.7	-25.2	-10.6
Net domestic assets	44.6	50.3	23.2
Public Sector	7.1	8.2	-33.9
Net Credit to Banks	-12.8	-5.8	-3.5
Credit	3.6	0.4	1.3
Deposits	-16.4	-6.2	-4.8
Medium- and long- term foreign Liabilities	0.9	8.9	-8.6
BOG losses 2/	37.6	30.3	24.3
Other 3/	11.9	8.6	44.9
Currency issue	16.9	25.1	12.6

Source: Table 6.

1/ With respect to liabilities to the private sector at the beginning of the period.
2/ Excludes operational losses.
3/ Includes stabilization bonds, exchange valuation and operational losses.

BALANCE OF PAYMENTS
(IN MILLIONS OF US DOLLARS)

	1988	1989	1990	PROJECTED 1991	PROJECTED 1992
CURRENT ACCOUNT	(544)	(464)	(387)	(316)	(263)
TRADE ACCOUNT	(484)	(509)	(501)	(382)	(316)
EXPORTS, FOB	1,073	1,146	1,279	1,525	1,756
IMPORTS, CIF	(1,557)	(1,655)	(1,780)	(1,907)	(2,072)
SERVICES, NET	(158)	(112)	(57)	(114)	(122)
PRIVATE TRANSFER	98	157	171	180	175
CAPITAL ACCOUNT	288	283	191	276	223
OFFICIAL TRANSFER	0	40	25	25	20
NONFINANCIAL PUBLIC SECTOR	90	64	40	49	32
BANK OF GUATEMALA	(52)	(8) 1/	(95) 2/	0	0
DIRECT FOREIGN INVESTMENT	96	91	97	105	105
PRIVATE SECTOR	155	116	124	97	61
EXCEPTIONAL FINANCING	152	70	160	40	40
BOP SUPPORT GRANT	75	70	55	40	40
REFINANCING	77	0	0	0	0
VALUATION ADJUSTMENT	0	0	105	0	0
OVERALL BALANCE (- LOSS)	(104)	(111)	(36)	0	0
CHANGE IN ARREARS	(32)	21	18	0	0
NET INTERNATIONAL RESERVES (- INCREASE)	136	90 1/	18	0	0

SOURCES: BANK OF GUATEMALA; AND AID STAFF ESTIMATES.

1/ EXCLUDES $65 MILLION IN REFINANCED INTEREST PAYMENTS BY NICARAGUA.

BOP

2/ INCLUDES PAYMENT OF $123 MILLION TO MOCATA FOR GOLD SWAP.

BALANCE OF PAYMENTS GAP 1)
(In millions of US dollars)

	1988	1989	Projected 1990	1991	1992
Requirements	2182	2263	2339	2644	2822
Imports	1557	1655	1780	1907	2072
Factor services	357	433	378	490	502
Amortization 2)	268	175	181	247	248
Receipts	1518	1734	1874	2211	2442
Exports	1073	1146	1279	1525	1756
Non-factor services	199	301	303	376	381
Foreign investment	96	91	97	105	110
Transfers	149	196	195	205	195
Private	98	156	171	180	175
Official	51	40	25	25	20
Gap	664	529	465	433	380
Private capital	155	116	124	97	61
Official borrowing	254	231	250	296	279
Change NIR (+ incr.)	103	111	36	0	0
Rescheduling	77	0	0	0	0
ESF transfer	75	70	55	40	40

Sources: Bank of Guatemala; and AID staff estimates.

1) Totals may not add due to rounding.
2) Includes gold revaluation.

GAP
08/28/90
09:23

Check	0	2	0	0	0
ESF/gap	0.113	0.131	0.118	0.092	0.105
Private/gap	0.233	0.219	0.267	0.224	0.161

Selected Economic Indicators

	1988	1989	Projected 1990	1991	1992
			Percentage change		
Real GDP	3.7	4.0	3.0	4.5	5.0
Consumer prices					
Annual average	11.2	13.0	33.0	.15.0	10.0
End of year	11.0	20.2	30.0	10.0	10.0
			Percent of GDP		
Gross domestic investment	13.3	13.5	13.9	14.5	14.6
Public 1/	2.4	1.6	1.1	1.4	1.5
Private	10.9	11.9	12.8	13.1	13.1
Gross savings	13.3	13.5	13.9	14.5	14.6
External savings 2/	6.9	5.5	5.5	4.2	3.3
Domestic savings	6.4	8.0	8.4	10.3	11.3

Sources: Bank of Guatemala; and AID staff estimates.

1/ General Government only; excludes capital transfers.
2/ In 1990, excludes gold transaction.

	1989	1990	1991	1992
GDP (Q millions)	23635.9	31582.7	37953.8	43836.6
GDP (US$ millions)	8441.0	7260.0	7590.0	7970.0

OPERATIONS OF THE NONFINANCIAL PUBLIC SECTOR
(IN PERCENT OF GDP)

				PROJECTED		
	1987	1988	EST. 1989	1990	1991	1992
				A. CENTRAL GOVERMENT		
REVENUES	9.4	10.1	9.5	8.1	8.2	8.3
TAX REVENUE	8.2	8.8	7.9	7.2	7.2	7.4
OTHER REVENUE	1.2	1.3	1.6	0.9	1.0	0.9
EXPENDITURE	11.8	12.9	13.3	10.3	10.7	10.8
CURRENT	9.7	10.5	10.6	8.4	7.3	7.7
CAPITAL	2.1	2.4	2.6	1.9	3.4	3.1
SURPLUS OR DEFICIT	-2.4	-2.7	-3.8	-2.2	-2.5	-2.5
SURPLUS OR DEFICIT	1.0	0.8	0.7	0.5	0.4	0.3
BOG LOSSES	-2.1	-1.7	-1.3	-1.1	-0.2	-0.1
OVERALL SURPLUS OR DEFICIT (-)	-3.5	-3.7	-4.4	-2.9	-2.3	-2.3
FINANCING	3.5	3.7	4.4	2.9	2.3	2.3
EXTERNAL FINANCING (NET)	0.3	0.7	0.6	0.5	0.8	0.9
FOREIGN ASSISTANCE	1.1	1.1	0.8	0.7	0.5	0.4
BOG LOSSES	2.1	1.7	1.3	1.1	0.2	0.1
DOMESTIC FINANCING	0.0	0.2	1.8	0.5	0.8	0.9
BANKING SYSTEM (NET) *	-1.1	-0.1	1.2	0.5	0.0	0.0
CHANGE IN ARREARS	0.1	0.0	0.0	0.0	0.0	0.0
CHANGE IN FLOATING DEBT	0.9	0.3	1.2	0.0	0.0	0.0
OTHER	0.0	0.0	-0.7	0.0	0.0	0.0

SOURCE: TABLE 7.

GDP	17711.1	20544.9	23635.9	31582.1	37953.7886	43836.6259

41

OPERATIONS OF THE NONFINANCIAL PUBLIC SECTOR
(IN MILLIONS OF QUETZALES)

	1987	1988	EST. 1989	PROJECTED 1990	1991	1992
				A. CENTRAL GOVERMENT		
REVENUES	1,660	2,082	2,239	2,550	3,099	3,632
TAX REVENUE	1,448	1,810	1,863	2,268.	2,734	3,244
OTHER REVENUE	212	272	376	282	365	388
EXPENDITURE	2,093	2,643	3,136	3,258	4,056	4,731
CURRENT	1,715	2,160	2,511	2,660	2,762	3,379
CAPITAL	378	483	625	598	1,294	1,352
SURPLUS OR DEFICIT	(433)	(561)	(897)	(708)	(957)	(1,099)
				B. REST OF PUBLIC SECTOR		
SURPLUS OR DEFICIT	184	164	154	150	150	150
BOG LOSSES	(378)	(356)	(300)	(357)	(78)	(50)
				C. COMBINED PUBLIC SECTOR		
OVERALL SURPLUS OR DEFICIT (-)	(627)	(753)	(1,043)	(915)	(885)	(999)
FINANCING	627	753	1,043	915	885	999
EXTERNAL FINANCING (NET)	55	142	130	172	293	399
FOREIGN ASSISTANCE	199	217	195	215	192	16[illegible]
BOG LOSSES	378	356	300	357	78	50
DOMESTIC FINANCING	(5)	38	418	171	322	381
BANKING SYSTEM (NET) *	(187)	(15)	288	172	NA	NA
CHANGE IN ARREARS	21	(7)	8	0	NA	NA
CHANGE IN FLOATING DEBT	154	67	288	0	NA	NA
OTHER	7	(7)	(166)	(1)	NA	NA

SOURCE: MINISTRY OF FINANCE; AND AID STAFF ESTIMATES.

*) INCLUDES SALES OF BONDS TO THE PRIVATE SECTOR.

3(A)2 - NONPROJECT ASSISTANCE CHECKLIST

The criteria listed in Part A are applicable generally to FAA funds, and should be used irrespective of the program's funding source. In Part B a distinction is made between the criteria applicable to Economic Support Fund assistance and the criteria applicable to Development Assistance. Selection of the criteria will depend on the funding source for the program.

CROSS REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? HAS STANDARD ITEM CHECKLIST BEEN REVIEWED?

A. GENERAL CRITERIA FOR NONPROJECT ASSISTANCE

1. FY 1990 Appropriations Act Sec. 523; FAA Sec. 634A. Describe how authorization and appropriations committees of Senate and House have been or will be notified concerning the project.

   CN submitted July 27, 1990; expired August 11, 1990.

2. FAA Sec. 611(a)(2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?

   N/A.

3. FAA Sec. 209. Is assistance more efficiently and effectively provided through regional or multilateral organizations? If so, why is assistance not so provided? Information and conclusions on whether assistance will encourage developing countries to cooperate in regional development programs.

   No.

4. FAA Sec. 601(a). Information and conclusions on whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.

Financing of petroleum imports and debt servicing will result in (a), (b), and (d). Policy reforms will continue to have positive effects in each area.

5. FAA Sec. 601(b). Information and conclusions on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).

Shift to a more market-determined economy will result in increased U.S. trade and investment in Guatemala.

6. FAA Sec. 121(d). If assistance is being furnished under the Sahel Development Program, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of A.I.D. funds?

N/A.

B. FUNDING CRITERIA FOR NONPROJECT ASSISTANCE

1. Nonproject Criteria for Economic Support Fund

a. FAA Sec. 531(a). Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of Part I of the FAA?

Yes.

b. FAA Sec. 531(e). Will assistance under this chapter be used for military or paramilitary activities?

No.

c. FAA Sec. 531(d). Will ESF funds made available for commodity import programs or other program assistance be used to generate local currencies? If so, will at least 50 percent of such local currencies be available to support activities consistent with the objectives of FAA sections 103 through 106?

Yes.

d. FAA Sec. 609. If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made?

N/A.

e. FY 1990 Appropriations Act, Title II, under heading "Economic Support Fund," and Sec. 592. If assistance is in the form of a cash transfer: (a) Are all such cash payments to be maintained by the country in a separate account and not to be commingled with any other funds? (b) Will all local currencies that may be generated with funds provided as a cash transfer to such a country also be deposited in a special account, and has A.I.D. entered into an agreement with that government setting forth the amount of the local currencies to be generated, the terms and conditions under which they are to be used, and the responsibilities of A.I.D. and that government to monitor and account for deposits and disbursements? (c) Will all such local currencies also be used in accordance with FAA Section 609, which requires such local currencies to be made available to the U.S. government as the U.S. determines necessary for the requirements of the U.S. Government, and which requires the remainder to be used for programs agreed to by the U.S. Government to carry out the purposes for which new funds authorized by the FAA would themselves be available? (d) Has Congress received prior notification providing in detail how the funds will be used, including the U.S. interests that will be served by the assistance, and, as appropriate, the economic policy reforms that will be promoted by the cash transfer assistance?

Yes

2. <u>Nonproject Criteria for Development Assistance</u>

N/A - ESF FUNDED

a. <u>FAA Secs. 102(a), 111, 113, 281(a)</u>. Extent to which activity will: (1) effectively involve the poor in development, by expanding access to economy at local level, increasing labor-intensive production and the use of appropriate technology, spreading investment out from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (2) help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local governmental institutions; (3) support the self-help efforts of developing countries; (4) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (5) utilize and encourage regional cooperation by developing countries?

Reforms and improved balance of payments status will have positive effects on an economy-wide basis.

b. <u>FAA Secs. 103, 103A, 104, 105, 106, 120-21</u>. Is assistance being made available (include only applicable paragraph which corresponds to source of funds used; if more than one fund source is used for assistance, include relevant paragraph for each fund source):

N/A.

(1) [103] for agriculture, rural development or nutrition; if so (a) extent to which activity is specifically designed to increase productivity and income of rural poor; [103A] if for agricultural research, account shall be taken of the needs of small farmers, and extensive use of field testing to adapt basic research to local conditions shall be made; (b) extent to which assistance is used in coordination with efforts carried out

46

under Sec. 104 to help improve nutrition of the people of developing countries through encouragement of increased production of crops with greater nutritional value; improvement of planning, research, and education with respect to nutrition, particularly with reference to improvement and expanded use of indigenously produced foodstuffs; and the undertaking of pilot or demonstration programs explicitly addressing the problem of malnutrition of poor and vulnerable people; and (c) extent to which activity increases national food security by improving food policies and management and by strengthening national food reserves, with particular concern for the needs of the poor, through measures encouraging domestic production, building national food reserves, expanding available storage facilities, reducing post harvest food losses, and improving food distribution.

(2) [104] for population planning under Sec. 104(b) or health under Sec. 104(c); if so, extent to which activity emphasizes low-cost, integrated delivery systems for health, nutrition and family planning for the poorest people, with particular attention to the needs of mothers and young children, using paramedical and auxiliary medical personnel, clinics and health posts, commercial distribution systems, and other modes of community outreach.

(3) [105] for education, public administration, or human resources development; if so, (a) extent to which activity strengthens nonformal education, makes formal education more relevant, especially for rural families and urban poor, and strengthens management capability of institutions enabling the poor to participate in development; and (b) extent to which assistance provides advanced education

and training of people of developing countries in such disciplines as are required for planning and implementation of public and private development activities.

(4) [106] for energy, private voluntary organizations, and selected development problems; if so, extent activity is:

(i)(a) concerned with data collection and analysis, the training of skilled personnel, research on and development of suitable energy sources, and pilot projects to test new methods of energy production; and (b) facilitative of research on and development and use of small-scale, decentralized, renewable energy sources for rural areas, emphasizing development of energy resources which are environmentally acceptable and require minimum capital investment;

(ii) concerned with technical cooperation and development, especially with U.S. private and voluntary, or regional and international development, organizations;

(iii) research into, and evaluation of, economic development processes and techniques;

(iv) reconstruction after natural or manmade disaster and programs of disaster preparedness;

(v) for special development problems, and to enable proper utilization of infrastructure and related projects funded with earlier U.S. assistance;

(vi) for urban development, especially small, labor-intensive enterprises, marketing systems for small producers, and financial or other institutions to help urban poor participate in economic and social development.

(5) [120-21] for the Sahelian region; if so, (a) extent to which there is international coordination in planning and implementation; participation and support by African countries and organizations in determining development priorities; and a long-term, multidonor development plan which calls for equitable burden-sharing with other donors; (b) has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of projects funds (dollars or local currency generated therefrom)?

DRAFTER:GC/LP:EHonnold:3/20/90:2169J

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

LAC-IEE-90-57

ENVIRONMENTAL THRESHOLD DECISION

Project Location	:	Guatemala
Project Title	:	ESF Cash Transfer Program
Project Number	:	520-0385
Funding	:	$50 million
Life of Project	:	One Year, FY 1990
IEE Prepared by	:	Alfred Nakatsuma USAID/Guatemala
Recommended Threshold Decision	:	Negative Determination
Bureau Threshold Decision	:	Concur with Recommendation
Comments	:	Negative Determination subject to condition being place in appropriate documents that local currency associated with this program not be used to finance the purchase, use, or importation of pesticides, or construction work which would have a major environmental impact.
Copy to	:	Terrence Brown, Director USAID/Guatemala
Copy to	:	REMS Environmental Advisor, ROCAP/San Jose
Copy to	:	Alfred Nakatsuma USAID/Gualtemals
Copy to	:	David Hoelscher USAID/Guatemala
Copy to	:	Mark Silverman LAC/DR/CEN
Copy to	:	IEE File

James S. Hester Date SEP 13 1990

James S. Hester
Chief Environmental Officer
Bureau for Latin America
and the Caribbean

50

Initial Environmental Examination

Project Location : Guatemala

Project Title : ESF Cash Transfer Program

Funding : $50,000,000

Project Description

The funds under this Program will be made available to the Government of Guatemala (GOG) in direct support of its economic program. Funds from this program will provide, as in the FY 1986, 1987, 1988 and 1989 Programs, immediate balance of payments support to Guatemala and the allocation of urgently needed foreign exchange for a) the purchase of essential imports from the U.S. for the productive private sector; b) petroleum imports; and c) payment of non-military debt served obligations to International Financial Institutions and the USG. Availability of funds under this program is contingent upon compliance with the conditions to be mutually agreed upon between the GOG and A.I.D. on the 1990 economic program.

In all cases, funds made available will be programmed through the Guatemalan Ministry of Finance and Central Bank which have overall responsibility for determining the subsequent use of funds. All local currency associated with the program, with the exception of an estimated US Dols. 5 million for USAID-managed operating expenses, technical support and audit trust funds, will be disbursed as general budget support to the Government of Guatemala's Core Development Budget in accordance with the general parameters established in FY 1988's Core Development Budget mechanism. Under the latter, USAID neither programs nor approves the specific uses of local currency funds.

Environmental Impact

The proposed program qualifies for a categorical exclusion according to Section 216.2(C)(2) of 22 CFR as one in which "AID does not have knowledge of, or control over, and the objective of AID in furnishing assistance does not require, either prior to approval of financing or prior to implementation of specific activities. Knowledge of or control over, the details of the specific activities that have an effect on the physical and natural environment for which financing is provided by AID."

Recommendation

Based on the A.I.D. regulation discussed above, the Mission recommends that the ESF Cash Transfer Program for FY 1990 be given a Categorical Exclusion determination requiring no further environmental review.

Concurrence: ______________________
Terrence Brown
Mission Director

9/13/90
Date

2623R

Approvals: ANakatsuma ______ 9/10
DBoyd ______
DAdams ______
SWingert ______