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# Guatemala's Trade Policy Reform: Analysis and Recommendations

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# EXECUTIVE SUMMARY AND CONCLUSIONS

Guatemala, jointly with the other countries of the Central American Common Market (CACM), has reversed its old policies of import substitution and protection and has embarked on trade liberalization and development of nontraditional exports. This radical policy shift is due to pressures from international financial institutions, and is also an integral part of deregulating the economy to stimulate efficient, dynamic development by the private sector in a competitive environment.

The Central American countries have jointly carried out a program of reducing external import tariffs, phasing out restrictive licensing, eliminating special exemptions from tariffs, and freeing intra-area trade from all restrictions. The countries have proposed adopting a common external tariff schedule.

To date, substantial progress has been achieved in reducing trade restrictions. However, much less has been done to improve the efficiency of the customs administration, provide the infrastructure in support of trade development, reform the exchange rate regime and other trade-related economic policies, and promote efficient investments that will help the private sector to survive and prosper while trade liberalization policies are being implemented.

An effective plan of action for the continuation of trade policy reform must be both economically sound as well as politically sustainable. Therefore, such a plan must take into account the unique political and market forces which currently characterize the Guatemalan import/export climate. Based on three important criteria — Guatemala commitments to the Central American Common Market, its existing politically influential private sector, and its desire to continue to protect some industries -- the Government of Guatemala ought to adopt a two phase approach to its on-going trade policy reform:

## PHASE I

In the short term, Phase I would promote two major policy changes that are both economically and politically viable.

- Adopt a two-tier tariff system.
    - 20 percent duty for some products in order to protect or to stimulate specific local industries; and
    - 5 percent duty for all other imports, including inputs essential for the protected industries.
- Remove existing exchange control and adopt a Mexican-type, pre-announced stable rate of very small devaluations.

**PHASE II**

In the medium term, as the region moves toward broader free trade agreements, Guatemala ought to seek a uniform tariff structure.

- Impose a single, uniform tariff rate of about 10 percent for all imports.

It should be clearly established that protection is a burden on consumers, the national budget, and the economy, and that protection inhibits export development. Protection will, therefore, be temporary to give some industries time to become competitive. The ultimate goal should be a single tariff system for Guatemala.

A uniform tariff rate does not discriminate against any particular Guatemalan product or business. A uniform rate also does not provide incentives for capital and other resources to move into less-efficient, higher-cost activities, unless the tariff rate is high enough to be protective. The other advantage of a uniform rate is that it minimizes opportunities for corruption at customs and greatly simplifies and reduces the cost of administering customs. An end to exchange controls and the adoption of regular pre-announced devaluations eliminate exchange speculation and holding of export proceeds abroad.

Another basic, underlying objective should be to move the Central American countries not only to reduce protection levels, but also to strengthen the ability of the local private sector to compete as trade is being further liberalized. The strategy to achieve this should include:

- Obtain private sector support for further trade liberalization through reforms of the exchange rate system;

- Improve the infrastructure that would attract foreign investment and further soften private sector resistance;

- Broaden the local financial market;

- Support industrial modernization; and

- Implement other steps designed to lower costs and improve Guatemala's ability to compete.

As a member of CACM, Guatemala should attempt to move all five countries to adopt these trade reforms. In the upcoming discussions under framework agreements with individual Central American countries, the United States should promote a region-wide strategy that supports Guatemala's initiative by adopting a common agenda with each country with respect to proposals for future tariff reform, exchange de-control, and a trade-supportive exchange rate system.

## IMPACT OF INDIVIDUAL TRADE BARRIERS

The intention of this study was to pinpoint and specify the areas where trade constraints should be reduced or removed. Each recommendation can be further developed into an agenda to work out a detailed work program for removal of trade constraints or distortions in the identified area.

A ranking of all major trade restraints according to their trade distortive effect is not completely clear at this time, because data are lacking for measuring the effective rate of protection and other forms of trade distortion. It is also not clear to what extent the tariff reform measures agreed to by the Central American countries will be carried out by January 1, 1993; whether a common external tariff will be adopted by all five countries; and whether the proposed tariff bands on some commodities will be adopted by all the countries and applied uniformly. It is not known yet which external tariff rate will apply to each individual customs classification and what tariff rates will govern imports previously under restrictive licensing.

Assuming the proposed trade policy reforms will be adopted in Guatemala on January 1, 1993, remaining trade restraints can be prioritized in order of severity based on the potential trade diversionary effects:

- Proposed maximum 20 percent tariff rate;
- Tariff bands on commodities;
- Unsatisfactory customs administration;
- Inadequate infrastructure and unreliable public services;
- Discriminatory health testing and similar potential indirect unfair trade practices;
- Exchange controls and an exchange rate unresponsive to foreign trade;
- Potential expansion of tariff rate dispersion from 5-20 percent to 0-20 percent;
- Financing constraints;
- Inadequate plant and company reforms; and
- "Basket" clauses in current tariff schedule.

## TARIFF STRUCTURE

All trade within Central America, except coffee, petroleum, sugar, and wheat, is now free from restrictions

Since 1986 Guatemala has reduced its maximum external tariff rate from 150 percent to 40 percent and its average rate from about 30 percent to 13 percent. On January 1, 1993, all five Central American countries are expected to change from the Brussels Nomenclature to the Harmonized Tariff System and adopt a four-tier common external tariff structure:

- 5 percent on imports of products that are not produced in Central America;
- 10 percent mostly on imports of capital goods, raw materials, and other inputs that compete against similar products produced in Central America;
- 15 percent on imports of finished products that do not require or do not merit protection and on imported components used in local production that compete with similar components produced in the Common Market area; and
- 20 percent on other imports — this is designed to protect local production.

## IMPORT LICENSE REQUIREMENTS

The list of products currently under restrictive export and import licensing and prohibitions will be further reduced by January 1, 1993. Licensing on exports designed to ensure adequate supplies and on imports to protect domestic producers will be removed. Import licenses will be converted to tariffs. Only relatively unimportant products (listed in the text) will remain under licensing for reasons of national security, protection of archeological treasures, ecology, or health restrictions related to imports from specific countries.

Licensing will be removed from imports of yellow corn, rice, sorghum, and soybeans, but the tariff rate will be raised from 5 to 20 percent and applied to a range of CIF prices related to the international price level. If the external price falls outside the established band of prices, the tariff applied will gradually rise to a maximum of 45 percent or fall to a minimum of 5 percent in order to keep the CIF price plus tariff within a narrow range. The intent is to insulate domestic producers of basic commodities from wide international price swings.

On January 1, 1993, all duty exemptions enjoyed by government officials, military, and some other privileged groups are to be abolished — this will not apply to specified charitable institutions, universities and cultural organizations, maquila, and nontraditional exporters (duty drawbacks). A 3 percent point surcharge, currently applied to all import tariffs, is to be eliminated.

## MAGNITUDE OF EXISTING TRADE DISTORTION

Trade distortions have been reduced by trade liberalization, particularly by the planned elimination of arbitrary restrictive import and export licensing and prohibitions on important products. However, neither the decline in trade distortions nor the remaining trade distortions can be measured because value added and other data for individual products needed to measure the effective rate of protection are not available. Also data to measure elasticities showing the response of imports to lower duties is not readily available by product classifications. Given time, however, this part of the analysis could be developed. The results would be distorted, however, by the influence of the relatively inflexible exchange rate on foreign trade over time.

A tariff of 20 percent against most imports that compete against domestic products will continue to restrict trade significantly. Even the lower duty levels will be sufficient to keep imports out in some cases. The duty increase from 0 to 10 percent on imports of gasoline and other petroleum products can prove sufficient to bar competition from imports of these products, except lubricants and jet fuel, from outside the region or it will raise the price level of petroleum products in the countries with a shortfall in locally refined products. Detailed evaluation of external and internal prices and costs would reveal other similar cases.

The greatest trade distortion will probably result from the planned increase in the basic tariff from 5 to 20 percent and application of a tariff band of up to 45 percent on basic grains that serve as important inputs for the Central American animal feed and agribusiness industry. The tariff increase will likely have a dual negative impact by reducing grain imports as well as exports of processed foods by the Central American industry now facing higher costs of commodity inputs.

The negative effects of the introduction of tariff bands and a higher base tariff on basic commodity imports will far outweigh the benefits mentioned earlier. The negatives are:

- Significant trade diversion;
- Reduced competitiveness for some nontraditional exporters;
- Divorce of domestic from international prices;
- Reintroduction of a form of government price control;
- Higher consumer prices of products important to the poor people;
- Excessive protection favoring producers of basic commodities relative to other industries;
- Reduced competition;
- Stimulating investments in less-efficient activities;
- Higher costs of inputs for the agribusiness industry;
- Possible extension of tariff bands to other imports, eroding the import liberalization program; and

- Contrary to basic concepts of open markets and a competitive free market economy.

Feed costs represent about 70 percent of the total cost of raising poultry. These costs can be expected to rise when the tariff for corn is raised from 5 to 20 percent and higher as international feed prices fall. Guatemala's poultry producers will not enjoy the lower feed costs from which their foreign competitors will benefit. The same problem may arise for producers of cereals and other food or feed products requiring inputs of rice, corn, soybeans, or sorghum.

Factors inhibiting and distorting trade include the failure to: reform customs; improve inland transportation, storage, and port facilities; and free the exchange rate system from restrictions.

It is clear that trade distortion can further be reduced by additional trade liberalization, by removal of nontariff trade barriers, and by trade-related economic policy reforms.

Central America cannot claim the status of a free trade area until all remaining restrictions on intra-area trade are removed. Free trade in petroleum products within the area would allow small local refineries in each country to optimize their operations with the result that petroleum products could be distributed at lower cost to consumers. If sugar could be sold by one Central American country to another in order to help fill its sugar quota in the United States, both Central American countries would gain.

Central American countries should not continue different external tariff rates on some consumer products listed in Part III of the tariff code (such as cars, petroleum, alcohol). Guatemala plans to phase in these tariffs within the 5 to 20 percent rate structure that will be applied to the bulk of the tariff structure. All Central American countries should eliminate exceptions and should adopt identical external tariff rates so that developing countries will not be tempted to use the country with the lowest duty as entry point to supply the entire Central American market.

To offset the competitive pressure from imports of finished products due to reduced duties, the influential local private sector is advocating zero tariff rates on inputs in order to be able to better compete. A widening of the tariff rate structure would, however, raise again the effective rate of protection and should be resisted. The private sector should push the government to remove infrastructure bottlenecks to improve efficiency and to lower the costs of operation rather than search for new ways to enhance protection.

The proposed tariff band and tariff increase on imports of some agricultural commodities introduces price controls aimed at distorting and diminishing foreign trade, thus making some important parts of the Central American food processing industry noncompetitive.

The maintenance of four different tariff rates leaves opportunities for arbitrary decisions and corruption at customs and contributes to inefficiency and trade distortions. The aim should be to move to a simple two-tier tariff system: 5 percent on imported inputs and 20 percent on finished products.

The ultimate goal for Central America should be a single tariff rate of around 10 percent on all products. It would be simple and cheap to administer and would greatly reduce the scope for corruption at customs.

## THE GUATEMALAN PRIVATE SECTOR

Private sector organizations in Guatemala and all of Central America are very influential on trade policy issues. They are usually consulted by their government before a change in tariffs is finalized. Many private local companies in Guatemala do not favor trade liberalization and feel that trade reform has gone too far and too fast. The Government of Guatemala has stressed its commitment, as a member of the Central American Common Market, to the collective decision to start trade reform under pressure from international financial institutions.

The excessive part of protection was essentially eliminated when tariffs were reduced to the maximum current 30 percent level. Further reductions will adversely affect more companies and create a resistance to further cuts. Governments should try to gain private sector support for more trade liberalization in the future. This can be accomplished by making infrastructure investments and introducing trade-related economic policy reforms that will reduce private company operating costs and help them become more efficient to confront competition and survive and prosper from trade liberalization.

It can be argued that trade liberalization, by and large, has moved as fast and as far as is currently acceptable politically and that a pause is in order before more liberalization is attempted. In the meantime, however, greater efforts should be made to remove nontariff obstacles, including sweeping reforms of the customs administration of Guatemala. Diverse indirect trade barriers should be reduced or phased out before lower tariff barriers cause the private sector to search for other forms of protection and hence oppose removal of indirect means of protection.

The type of problem exemplified by low-cost imports of chicken legs from the United States could occur in other industries. To protect domestic chicken producers from U.S. competition, the government has started to resort to onerous health testing requirements clearly intended to restrict imports, because these tests are confined only to imports, in fact, only to chicken leg imports from the United States. Guatemala is clearly violating GATT regulations regarding the nondiscriminatory application of health tests.

Guatemala should establish health and phytosanitary testing and certification requirements, but they should be science-based, transparent, and applied regularly, systematically, and nondiscriminatorily to imports as well as domestic products. A panel composed of producers, exporters, and importers in diverse industries could be permanently appointed with final authority to settle disputes relating to unfair trade practices.

## CUSTOMS OPERATION

An inefficient, corrupt customs operation can raise costs, discourage foreign trade and cause sizable revenue losses for the government. A series of recommendations to reform customs procedures and to reduce the practice of under-invoicing is presented in the next chapter and discussed in the main body of this report. The intent is to make customs procedures more efficient and to reduce red tape, corruption, and evasion of tariff and tax payments. Foreign consultants have made some notable progress introducing computerized reporting systems, but more work needs to be done, based on a clear, strong commitment to customs reforms at the highest political levels.

By lowering costs of operations, trade-related economic policy reforms are essential in creating the environment that will enable the local private sector to become more efficient and competitive and to face reduced protection and increased competition from imports. These economic policy reforms include privatization of some public services, infrastructure development, reduced public sector deficits, removal of exchange control, and an exchange rate system that does not become a substitute for tariff protection, but also does not impair the competitiveness of Guatemala's exporters and domestic producers. A Mexican-style, controlled rate of devaluation that is pre-announced and very gradual would offset domestic cost increases caused by inflation. Such a devaluation strategy would eliminate exchange controls, and would end speculation, uncertainty, rationing, auctions, the Ventanilla Unica, and holding export proceeds illegally abroad.

Trade liberalization will not translate into dynamic import and export development unless private companies re-structure and modernize their operations, replace obsolete equipment, and train and upgrade their work force. Technical assistance and financing can help many smaller and medium-sized firms not only to survive trade liberalization, but also to develop exports as a means to improve economies of scale and reduce unit costs of operation. The private sector should take the initiative to develop and carry out programs of industrial modernization that are an essential complement to tariff and nontariff trade and customs reforms and to changes in trade-related economic policies.

## RECOMMENDATIONS

Following are more specific recommendations for tariff reform, nontariff reforms, trade-related economic policy reforms, and private sector adjustment.

### TARIFF REFORM

1. Guatemala should carry out all future tariff reform in concert with the rest of Central America, including Costa Rica and Nicaragua, in order not to jeopardize subregional integration and preparation for an eventual free trade agreement with the United States.

2. Total free trade should be established within Central America for the following product categories: coffee, petroleum, sugar, and wheat. All restrictions on intra-area trade for these products should be removed, including all price controls and supports, subsidies, and incentives, and harmonize tax treatment in these product categories.

3. Equal external tariff rates should be established in all Central American countries by phasing out all exceptions for individual countries and by incorporating Part III product classifications into the unified Parts I and II of the proposed Harmonized Tariff System.

4. Pressures should be resisted from private sector groups to establish duty free imports of inputs to produce finished goods that compete against imports, because a 0 percent tariff confined to these inputs would raise again the effective rate of protection.

5. The introduction of tariff bands, that is, flexible tariff rates, against imports of yellow corn, rice, sorghum, and soybeans should be accepted as only a temporary measure replacing restrictive import licensing banned by GATT. Tariff bands are a device to protect local producers from wide swings in international prices. The increase in the basic tariff from 5 to 20 percent and the long lags built into the adjustment mechanism make the system rather insensitive to competitive market forces that will negatively affect the local food processing industry. The tariff bands should be removed as soon as feasible and the 20 percent tariff lowered again in order not to discourage nontraditional exports.

6. Wide differences in tariff rates for so-called "basket" classifications (*los demas* and *otros*) from those of defined products should be avoided in the new tariff schedule because they present opportunities for arbitrary decisions and bribes at customs.

7. An effort should be started to collect the data needed to calculate the effective rate of protection for highly protected industries in order to be able to accurately point out the extent of trade distortion under the tariff structure in force after January 1, 1993 and thus push for further trade liberalization. The likely industry candidates would be basic commodities, food processing, apparel, and textiles.

8. The next phase of external tariff liberalization should aim at reducing the four-tier to a two-tier tariff rate structure: a higher tariff to provide temporary, moderate protection and a lower tariff for all other imports.

9. The basic policy objective should be to move away from import restraints to export development by emphasizing production and marketing efficiency rather than direct or indirect protection.

10. The ultimate goal of import liberalization should be a uniform, single external tariff rate for all imports by the five Central American countries.

11. The governments should work closely with all local private sector organizations to gain their support for further trade liberalization by devising programs for wide ranging trade-related reforms that will enable local companies to survive and to benefit from trade liberalization and eventual free trade.

12. To fully benefit, trade reform has to be accompanied by:

    a) Removal of diverse nontariff trade obstacles, including sweeping reforms of customs administration;

    b) Trade-related economic policy reforms, including changes in the exchange rate system;

    c) Programs of financially supported specialization and thorough modernization at industry, company, and plant levels to achieve economies of scale and a competitive marketing mentality.

13. Central America should pursue a free trade agreement with Mexico, possibly together with Colombia and Venezuela (G-3 countries), because it will:

    a) Further liberalize trade and stimulate private sector efficiency and;

    b) Encourage customs reforms and infrastructure development.

14. Guatemala or Central America as a whole should invite local private sector cooperation to develop carefully its agenda for discussions with the United States Trade Representative under the terms of the Framework Agreement. Topics should include:

    a) Removal of the type of U.S. trade barriers to Central American exports that Central America has already removed;

    b) The impact of Mexico's entry into NAFTA on the CBI and GSP benefits for Central America;

c) Technical assistance and financing to set up effective health and phytosanitary testing procedures and facilities nd certification of domestic and imported products on a nondiscriminatory, transparent, scientific basis.

## NONTARIFF REFORMS

1. The Government of Guatemala's program and plans to eliminate or phase out export and import licensing and prohibitions on all important products appears sound and no changes can be recommended. Remaining restrictions relate to national security, health, ecology, and archeological treasures.

2. Incentives for producers of nontraditional exports should be re-examined as to whether they create an excessive competitive advantage in the United States and other foreign markets to an increasing number of Guatemalan exporters that do not export one of Guatemala's few traditional basic commodities. It should be analyzed whether a 10-year complete tax holiday is too long, whether duties should be clearly limited to drawbacks related to exports, and whether tax incentives should be offered only to pioneering companies that develop exports of a product never before exported or given all exporters of processed products and agricultural goods, other than coffee, sugar, cotton, and bananas.

3. Programs for removing nontariff trade restraints should be implemented before further duty reductions will cause local private sector groups to search for effective substitutes for tariff protection.

4. Sweeping reforms in the customs administration are needed to reduce corrupt practices, arbitrariness, and discrimination, and to improve efficiency and transparency in customs procedures. The following are some reforms deemed desirable:

   a) A national debate on corrupt practices at customs should be encouraged until a clear-cut commitment for sweeping reforms is elicited at the highest political levels in Guatemala.

   b) The profession of customs officials should be upgraded to a civil service career program with promotion to the highest level based on merit alone. Political appointments at customs should be phased out.

   c) A computerized regular schedule of frequent rotations of all customs officials to different customs posts should be introduced in order to reduce loyalty relationships from developing between customs officials and regular importers.

   d) Compensation scales and retirement programs for customs officials should be improved.

e) An ongoing technical training program should be developed to upgrade the technical capacity of customs officials.

f) The investment budget for customs should be increased to improve facilities and installations and to install computers and other modern equipment and materials.

g) An effective system of fines and dismissals for corrupt practices should be implemented.

h) The experiences of customs administrations in other countries should be studied in developing specific reform programs.

5. An analysis division should be created at customs and/or the Banco de Guatemala to ferret out corrupt practices and under-invoicing of imports or exports designed to minimize payments of tariffs and taxes or avoid return of foreign exchange proceeds. A bonus system, in addition to salary, could be established for analysts based on the number and value of irregular invoices they uncover.

   a) The experience in other countries in preventing under-invoicing could be evaluated.

   b) Information on imports from Guatemala recorded by other countries could be solicited.

   c) A system of up-dated international price guidelines for price determination could gradually be built up for more and more products and used to compare and to challenge prices recorded on invoices and permits by exporters and importers.

   d) A free exchange market and a single tariff should be pursued as the most effective way to reduce under-invoicing and corruption at customs.

6. Following the example of "Ventanilla Unica," all paperwork required of an importer should be concentrated at one location. To further speed up processing, all import forms should be tested as to their essentiality and all of those eliminated that prove not to be essential or that duplicate information.

7. A study should be undertaken of the efficiency and feasibility of moving all inland customs warehouses and services to the entry locations of imports in order to eliminate loss of in-bond shipments in transit from entry points to inland customs warehouses. In 1990 alone, about 1,800 such shipments disappeared en route, according to a reliable Guatemalan customs source.

8. Guatemala should consider setting up a nondiscriminatory, transparent system of product testing and certification that is clearly defined and science-based. The system should be based on sanitary and phytosanitary standards. It should be applied equally to domestic as

well as imported products with the intent to protect the population, not to restrict trade. Existing GATT guidelines should be adopted.

9. Establishing and administering the rules of origin of products will be needed when a preferential or free trade agreement is concluded with Mexico and other countries. The simplest rule to administer is one of declaring a Mexican import of national origin if the transformation (value added) there of raw materials or components from third countries is sufficient to place the final product into a different tariff classification.

10. Countervailing duties to offset anti-dumping practices should be established against imports clearly subsidized or exported at prices below those in the exporting country.

11. Disputes relating to unfair trade practices or countervailing duties could be settled by a panel of importers, exporters and producers from diverse industries with final authority to arrive at a settlement.

## TRADE-RELATED ECONOMIC POLICY REFORMS

1. Trade-related economic policy reforms should be implemented in support of trade reforms and to enable the private sector to confront more effectively increased competition from imports when protective barriers are reduced and to benefit from future free trade agreements.

2. Local private sector associations should develop workshops designed to identify specific government economic policies that contribute to the high costs of operations of their member companies and to formulate workable proposals for further economic policy reforms.

3. Some major reforms that need to accompany trade reform relate to reliable telecommunications, postal service, and electricity; an efficient, low-cost internal transport system; adequate storage capacity and modern port and airport facilities; a credit system geared to satisfy the needs of the private sector; improving technical education of the work force; and an open door for technology transfers.

4. Privatization of port facilities and other state enterprises in a way that also stimulates competition, rewards improvements in efficiency, and passes cost savings to clients could help advance efficient trade development.

5. Government revenue should not be pre-empted by public payroll and fringe benefits, deficits of state companies, and debt service, with little left for infrastructure investments.

6. Government deficits should not pre-empt local capital markets and drive up local interest rates.

7. New capital sources should be created for trade-related investments by considering the feasibility, among other issues, of eliminating all exchange controls and establishing a pre-announced rate of devaluation; by raising tax disincentives for real estate investments; by exempting re-invested corporate earnings from income taxes; and by creating a privately run social security system, similar to Chile's.

8. Exchange controls are an arbitrary, discriminatory measure equivalent to restrictive import licensing and should be abolished. Loss of foreign exchange and capital flight are usually the result of uncertainty about misguided economic policies, and not a consequence of remittance freedom.

9. Guatemala should re-examine its exchange rate system as to whether it helps to stimulate efficient trade development and preserves balance of payments equilibrium in the light of significant import liberalization.

10. A controlled, Mexican-style weekly devaluation rate of about 1 centavo per dollar announced for 12 months in advance would eliminate uncertainty and speculation about a possible devaluation. Coupled with an end of exchange controls, rationing, and auctions, such a devaluation rate would greatly eliminate the incentive by exporters to keep exchange proceeds illegally abroad. This revised system, applied with a continued anti-inflationary monetary and fiscal policy, would gradually eliminate any over-valuation of the exchange rate and act as an incentive for developing nontraditional exports. It would help local companies to absorb the competitive pressure from imports resulting from tariff reductions. If inflation and the trade balance improve, the rate of devaluation can be slowed down after 12 months; if the reverse trends materialize in 1992, the controlled rate of devaluation needs to be accelerated the next year.

## PRIVATE SECTOR ADJUSTMENT

1. Restraints for trade development also exist within the private sector, within the local firms themselves. These restraints need to be removed to forestall a future backlash against trade liberalization in favor of a return to protectionism.

2. Many local businesses, faced with competition from imports, need to consider major reforms within their own firms in order to survive and prosper from trade liberalization in future years. They may need to change outmoded management styles; invest in training and upgrading their work force; search for lower-cost supply sources; upgrade and increase the budget for marketing and export promotion; improve product quality, design, and packaging; study competitors' strategies and changing consumer tastes; improve the financial strength of the company; and develop a quick response capability to new competitive inroads.

3. Local private firms and industries need to speed up programs of modernization and replace obsolete plant and equipment in step with progressive trade liberalization.

4. Local business associations could prepare industry-wide financing proposals and present them, with government support, to international financial institutions.

5. Faced with competition from imports, companies should review their operating strategies, whether to specialize in fewer lines and produce also for exporting in order to reduce unit costs through economies of scale, whether to give up production and switch to imports supplying the domestic distribution network, or whether to seek a foreign partner who can offer technology, capital, or markets abroad.

6. A great deal can be done to remove trade restraints even for small and medium-sized Guatemalan companies and overcome diseconomies of scale:

    a) Companies in the same industries in different Central American countries could form joint regional export marketing or trading companies.

    b) Guatemalan companies in the same industry producing complementary or differentiated products could form "export committees" following the Chilean model and develop joint sales catalogues and finance jointly a salesman abroad, advertising and market research, and other marketing efforts.

    c) An inexpensive, on-going training program can be set up for commercial attaches at Guatemalan embassies abroad to efficiently collect regularly relevant market intelligence, relay it speedily to appropriate private sector organizations at home, promote actively Guatemalan products abroad, inform appropriate Guatemalan firms of relevant future dates of trade fairs and public tender offers, and compile and update a local directory for arranging contacts for visiting Guatemalan businesses. The database and information system available at U.S. embassies can serve as useful guides.

7. The local private sector must benefit for trade liberalization to last and eventually to lead to free trade agreements.

# GUATEMALA'S TRADE POLICY REFORM: ANALYSIS

## OBJECTIVES

The objectives of this project are to:

- Evaluate trade policy reforms implemented or planned by Guatemala;
- Analyze tariff and nontariff barriers to trade and their impact in distorting trade; and
- Develop specific recommendations for an appropriate strategy to further advance reforms of Guatemala's policies toward eventual free trade.

## REASONS FOR TRADE REFORM

Since 1986, Guatemala embarked upon several fundamental changes in its foreign trade policies in support of its overall economic development process. Historically, a few traditional commodity exports paid for a wide range of consumer goods imports. During the 1960s and 1970s, Guatemala encouraged internal industrial development with a policy of import substitution on a subregional basis as member of the Central American Common Market (CACM).

The Central American integration movement stagnated due to political dissention and after the easy targets of import substitution had been reached. The world energy crisis and the Latin American external debt crisis fully revealed misguided policies of protectionism, state controls, and nationalism that stifled investments, exports, and economic development.

It came to be recognized that high import tariffs:

- Decreased consumption of imports;
- Reduced the trade deficit;
- Raised domestic prices;
- Increased production in protected industries;
- Provided a stimulus to prefer selling in the domestic market; and
- Created a disincentive to expand exports, in other words, an anti-export bias.

Protection against competition from imports created incentives for shifting resources into less efficient, high cost, noncompetitive production sectors. Imposition of high levels of protection allowed domestic price levels to rise, which created an incentive to produce for the domestic market because it became more profitable than exporting.

High tariff levels also acted in limiting the trade deficit by taxing imports. This artificial improvement in the trade balance enabled the maintenance of an overvalued exchange rate which inflated local costs of production measured in dollars and thus discouraged development of nontraditional exports, while depressing also the profitability of traditional exports.

High levels of protection in Guatemala diverted investments into the food and beverage; textiles, apparel, and shoes; rubber products; plastics; paper; soaps and cleaning products; and other simple chemicals industries.

Guatemala joined the rest of Latin America during the 1980s in efforts to overcome the external debt crisis and to reactivate the economy by emphasizing export promotion, deregulation, and an open door to foreign investment. These changes are supported by the influential private sector in Guatemala. Foreign trade reform, particularly import liberalization, has now become a key aspect of economic policy reforms designed to establish a market-driven economy. Essentially five major factors have been responsible for the recent change from emphasis on protection to trade liberalization:

- Failure of subregional import substitution within CACM to promote sustainable economic development;
- Realization that emphasis on protection against imports discourages export growth;
- Demand for dollars to meet expanded external debt service required export promotion, not import substitution;
- Pressures from international financial institutions and other credit sources abroad to start import liberalization and exchange reforms; and
- Requirements for trade reforms for establishing a free market economy.

Entry into GATT by Guatemala (July 1991) and by other Central American countries triggered further irreversible commitments to trade liberalization, including removal of import licensing and prohibitions on several important products.

## TARIFF REFORMS

On January 1, 1986, under pressure from the IMF, World Bank, and other external sources, the Central American governments jointly embarked on a broad program of subregional trade liberalization which has not yet been concluded:

- All specific import duties were abolished or converted to ad valorem duties.

- Tariff classifications were simplified and changed to the Brussels Nomenclature System.

- The 30 percent tariff surcharge and export taxes were eliminated and many ad valorem tariffs reduced.

- All restrictions were eliminated on trade within CACM except on coffee, sugar, wheat flour, and petroleum products.

- It was agreed to work toward a common external tariff on Parts I and II of the tariff schedule, which comprised 95 percent of all tariff classifications.

- The tariff rates for individual products were varied mostly according to whether the imports are deemed essential inputs into the production process of final consumption articles, whether they are capital goods or components not produced or not competing with local products or whether they are "luxury" items.

- The rates on the remaining tariff classifications in Part III of the common tariff schedule were left for each country freely to establish. Part III includes vehicles, petroleum, alcohol, weapons, jewelry, and other "luxury" items.

The highest duty levels were assigned to "luxury" items and finished products that compete with domestic goods; the lowest duties went to raw materials, components, and finished products that do not compete with local production. A strong element of protection remained in Guatemala after 1986.

Since 1986, successive tariff reductions have lowered the maximum rate from 150 to 30 percent (Parts I and II of the tariff schedule) and to 40 percent (Part III).

## TARIFF STRUCTURE

In five years, Guatemala's main tariff structure changed as follows:

| DUTY LEVELS (% AD VALOREM) | NUMBER OF PART I/II CLASSIFICATIONS | % OF TOTAL 1992 | % OF TOTAL 1987 |
|---|---|---|---|
| 0 - 5 | | | 7 |
| 5 | 868 | 48 | |
| 6 - 10 | | | 40 |
| 10 | 232 | 13 | |
| 11 - 20 | | | 8 |
| 20 | 353 | 20 | |
| 21 - 30 | | | 11 |
| 30 | 335 | 19 | |
| 31 - 40 | | | 12 |
| Above 40 | — | — | 22 |
| TOTAL | 1,788 | 100 | 100 |

The current average rate of these tariff classifications has been lowered to 13 percent. Government revenue from import tariffs is about $160 million per year.

Part III of the schedule was reduced from a maximum 150 percent (liquor) to a maximum 40 percent (cars). Petroleum imports remained the only group free of duties.

The dispersion of the tariff rates narrowed in recent years. Wide differences in tariffs between finished products and imported inputs have remained, however, and so has the effective rate of protection. Tariff rates are generally lower for agricultural than for industrial products.

A comparison of the current tariff rate structure with that of five years ago reveals that:

- Tariffs above 30 percent in Parts I and II have been moved mostly into the 20 percent and 30 percent categories; and

- Tariff levels below 10 percent have been mostly consolidated into the 5 percent category.

The removal of excessive protection at the highest duty levels can be considered the biggest step in the tariff reform of the recent past. Removal of excess protection does not seriously threaten most local businesses. Additionally, the bulk of the duty levels has been lowered somewhat — from a range of 6-10 percent down to 5 percent. Some individual duties have been raised in the process of tariff reform. Often the high duties on finished products were lowered relatively more than the low duties on the corresponding inputs or raw materials. Essentially, 60 percent of all duties are at low or moderate levels and 40 percent at the higher, protective levels.

The Guatemalan tariff structure during the past three years clearly differentiates between finished products and raw materials. This difference is documented for individual industries as follows (average tariff rates):

| INDUSTRIES | FINISHED PRODUCTS | | | RAW MATERIALS | | |
|---|---|---|---|---|---|---|
| | 1989 | 1990 | 1992 | 1989 | 1990 | 1992 |
| Textiles | 49 | 40 | 30 | 20 | 16 | 12 |
| Apparel | 69 | 40 | 30 | 33 | 28 | 15 |
| Shoes | 84 | 40 | 30 | 37 | 26 | 15 |
| Paper | 29 | 20 | 24 | 9 | 7 | 5 |
| Paints | 30 | 30 | 20 | 4 | 7 | 5 |
| Pesticides | 10 | 9 | 12 | 11 | 10 | 6 |
| Pharmaceuticals | 14 | 7 | 5 | 9 | 10 | 6 |
| Soaps | 50 | 30 | 20 | 14 | 12 | 5 |

Average tariff levels for agricultural product groups are currently as follows:

5% Grains, Beans
8% Meats, Seeds
10% Fish, Dairy, Fats and Oils
14% Beverages
15% Hides, Live Animals
20% Fruits, Vegetables, Flour, Cocoa, Sugar Products
30% Processed Foods

The highest current duties of 40 percent are on imports of cars, station wagons, and vans, classified in Part III of the tariff schedule. Buses, jeeps, trucks, and parts enter at duties ranging from 5 to 35 percent. Problems have arisen with respect to determining the CIF values for calculating these duties. Most cars enter Guatemala fully assembled and some are driven to the point of embarkation or border crossing.

A computerized list of CIF prices for cars based upon the U.S. red and blue books has been established for vehicles imported by individuals. Dealers rejected this arrangement, and for them the ex-factory prices are now the basis for calculating the CIF value of vehicles imported for resale. The importers have to present an invoice with the ex-factory price authenticated by the consulate.

For used cars, a 20 percent discount of the original list price applies after the first year and 10 percent for each additional year up to a maximum 60 percent. It has now been proposed to limit these discounts to the 30 percent level. The chassis number on used cars defines the make of the car for determining the list price for CIF valuation.

## FUTURE TARIFF REFORMS

Central American economic integration has been strengthened with the decision of Honduras to re-enter the Central American Common Market; with the electoral defeat of the Sandinistas in Nicaragua; and with the proposed formation of a customs union among Guatemala, El Salvador, and Honduras. In this customs union, imports from third countries will be able to cross the border into another member country without again paying duties. Furthermore, customs revenues collected by each member country are to be pooled and divided in some way among the countries in the customs union. In essence, the objective of the customs union is to revitalize and advance regional integration. The agreement to form the customs union has been signed, but it may take more than a year to implement it.

All five Central American countries are committed to subregional free trade, a common external tariff, and elimination or harmonization of nontariff barriers. The Central American countries have decided to change from the Brussels Nomenclature to the Harmonized Tariff system on January 1, 1993, and to further consolidate the tariffs in Parts I and II of the tariff schedule from 5 to 30 percent to a range of 5 to 20 percent. Guatemala will do this by executive decree, but changes in Part III of the tariff require approval by Congress.

Guatemala, together with the other four Central American countries, plans to adopt a four-tier tariff structure by January 1, 1993:

- 5 percent on imports of products that are not produced in Central America;

- 10 percent mostly on imports of capital goods, raw materials, and other inputs that compete with similar products produced in Central America;

- 15 percent on imports of finished products that do not require or do not merit protection and on imported components used in local production that compete with similar components produced in the Common Market area; and

- 20 percent on other imports — this is designed to protect domestic production.

Customs procedures would be greatly simplified and corruption practices at customs reduced if Guatemala were to move to a two-tier tariff schedule rather than maintain the multi-level tariff schedule.

The following industries in Guatemala currently have a preponderance of 30 percent duties which will have to be lowered to at least the 20 percent level by January 1, 1993:

| | |
|---|---|
| Seafood | Thread |
| Fruits | Textiles |
| Wines | Apparel |
| Beer | Gloves |
| Tobacco | Shoes |
| Leather Products | Hats |
| Metal Tubing | Vases |
| Carton and other Paper Products | Ceramic Products |
| Cloth | Costume Jewelry |
| Belts | |

Part III of the tariff schedule continues to be left up to each country to adjust. Guatemala has decided, however, to integrate Part III into the rate schedule of Parts I and II.

Imports of crude oil for the Texaco refinery and electricity are to be raised from a 0 to a 5 percent duty. The tariff on petroleum products will be raised from 0 to 10 percent. Duties of imports of fire engines and ambulances are to be lowered from 15 to 5 percent. Liquor, weapons, watches, pearls, and vehicles, currently assessed mostly a 40 percent duty, will be lowered to 20 percent.

**FLEXIBLE TARIFF FOR BASIC AGRICULTURAL IMPORTS**

In July, Guatemala expects to follow El Salvador and Honduras in introducing a flexible tariff range rather than a fixed rate for imports of yellow corn, rice, sorghum, and soybeans. The basic tariff rate will be raised from 5 to 20 percent. A range for the CIF reference price will be determined based upon past prices at the U.S. Gulf of Mexico. If the future international price moves below the established reference price range, then the actual duty applied will be increased up to 45 percent; if the price drops below the reference price range, the duty will be reduced down to a minimum 5 percent. The result will be a CIF price plus duty to the importer that will fluctuate within a narrower range than international price levels and afford domestic producers effective protection.

Assuming the reference price ranges from 90 to 110, then the 20 percent duty will be applied if the CIF import price stays within that range. Importers will pay a CIF price plus duty of between 108 and 132. If the international price falls to 80, then importers will pay a 35 percent duty in order to pay a total minimum CIF price plus duty of 108.

In this way, Guatemala expects to insulate imports of basic agricultural commodities from international price fluctuations and stabilize the imported price (CIF plus tariff) of these commodities. This measure will act like price supports in introducing greater certainty of prices and profits for farmers as inducement to cultivate crops. The danger is that protection in the guise of stabilization may encourage inefficient production and higher consumer prices.

The introduction of tariff bands designed to control and neutralize price competition should be opposed and rejected on those grounds and also that this form of governmental price control is contrary to the free market concepts the Guatemalan government committed to establish when it abolished price controls and subsidies and liberalized imports. The concept of tariff "bands" may also violate GATT rules.

Tariff "bands" promote higher domestic consumer prices and discourage nontraditional export development. The important Guatemalan food processing industry using these basic inputs will not benefit from future international price declines of these commodities. Their competitors abroad, however, will have a competitive edge from international price declines. If basic commodity prices rise in international markets, food processors abroad have the option to absorb some of these increases in their margins if there is intense competition. Guatemalan food processors will have an incentive to confine themselves to supplying mainly the domestic market in the future due to the government-dictated divorce of their supply prices from international price levels. There is the uncertainty that the tariff bands will suddenly be given up by the government.

## IMPORT/EXPORT LICENSING AND PROHIBITIONS

The proposed tariff "bands" on the four basic commodity imports are designed to replace restrictive licensing requirements. Guatemala currently maintains import licensing requirements on 15 product groups.

Licensing requirements and prohibitions to import or export were established to protect:

- National security;
- Archeological treasures;
- Ecology;
- Health; and
- Domestic producers.

The technical personnel at the Ministry of Economy recently analyzed the old laws on licensing with a view to identifying which products could be eliminated from the list of prohibitions or licensing requirement. Private sector groups were consulted before a definite recommendation was formulated.

After Guatemala joined GATT in July 1991, it committed to eliminate licensing requirements within three years or present acceptable alternatives for basic grains, beans, flour, apples, pears, grapes, and fats.

The Ministry of Economy has recommended that for national security the following imports remain under licensing:

- Radio transmitters and other transmission equipment;
- Camouflage cloth similar to that used by the military;
- Ammunition;
- Explosives;
- Potassium chlorate; and
- Nitrate fertilizer.

The Ministry of Economy has recommended eliminating import licensing on the following:

- Natural rubber seeds and synthetic rubber;
- Kenaf seeds;
- Powdered milk;
- Fruit pulp; and
- Cotton seed

The importation of 21 product groups remains prohibited. The prohibition of imports of wheat flour and wheat is to be lifted, but subjected to the maximum duty prevailing three years from now under a commitment to GATT. Domestic wheat production is of low quality, declining, and noncompetitive, and farmers are moving into other, more profitable crops.

The Economy Ministry recommends ending import bans on:

- Christmas trees;
- Firecrackers;
- Cocoa; and
- Fats.

The importation of bees is prohibited from countries where African killer bees exist. Imports of wild and domestic animals are prohibited from countries with reported hoof-and-mouth disease and other exotic diseases. Importation of sands is prohibited from countries where coffee rust disease is prevalent. Other prohibited imports are:

- Weapons (except with license from the Ministry of Defense);
- Flower bulbs and roots (disease control);
- Coffee (disease control);
- Cyclamates (cancer risk);
- White phosphorus (security risk);
- Fruits and flowers from Mexico (disease control);
- Firecrackers;
- Used tires (disease control);

- Marijuana and opium (health control);
- Biological products for veterinary use (from countries with animal diseases);
- Salt (noniodine); and
- Seeds.

Export prohibition is currently applied to 10 product groups, half of which are being recommended by the Economy Ministry to be removed from the list of prohibitions:

- Coffee pulp (no demand abroad);
- Citronella (adequate domestic supplies);
- Orchid plants and bulbs (if cultivated in hot houses);
- Discoureaceous and amaryllidaceous plant roots (adequate supplies); and
- Citron tea (adequate supplies).

The Ministry recommends maintaining export prohibition on:

- Turtles;
- Blood plasma;
- Articles of archeological or historical value;
- Tree ferns grown in their natural habitat; and
- Food products or beverages containing cyclamates (cancer risks).

Restrictive export licenses are still imposed on 24 product groups, half of which are now recommended to be removed from licensing:

- Cotton (protecting supplies for local textile industry are no longer needed);
- Animal feedstock (adequate domestic supplies are available);
- Sugar (adequate domestic supplies);
- Cocoa (adequate domestic supplies); and

- Fresh, refrigerated, and frozen meats (adequate local supplies);
- Oxen used in transportation (superseded by trucks);
- Molasses (relationship domestic consumption to exports can be controlled in other ways);
- Margarine and other vegetable oils (adequate supplies; but licensing to remain for supplies financed by PL-480 funds);
- Wicker and rods (no private sector pressure to continue licensing);
- Shrimp (export companies are under licenses);
- Edible vegetable oils (adequate supplies, but licensing for production financed with PL-480 funds); and
- Sesame seeds (small domestic demand).

Export licensing on the remaining half of the product groups is recommended by the Economy Ministry to be retained:

- Live wild animals (to protect local species);
- Chicken meat and eggs (to ensure adequate domestic supplies); and
- Raw cattle hides (inadequate domestic supplies and international prices deemed high);
- Wild birds and plants (to protect local species)
- Live cattle (deemed politically sensitive to remove licensing);
- Treated cattle and horse hides (inadequate domestic supplies and international prices very high);
- Scrap metal (to ensure adequate domestic supplies);
- Paper for recycling (ensure adequate domestic supplies);
- Basic grains (ensure domestic supplies, but major study needed);
- Cotton seed cakes for cattle feed (ensure adequate supplies);

- Wood (ensure adequate supplies); and
- Cotton seed (ensure adequate supplies)

## SURTAX AND VALUE ADDED TAX

All export taxes have been eliminated. The 7 percent value added tax is applied on the full CIF value of imports, but not on exports. The tax on domestic products is applied on the added value component at each stage of production and marketing, so that the application of the tax on imported products is comparable to domestic products.

A 3 percent surtax is applied on the CIF value of imports in addition to the tariff. Thus, the tariff on an imported product, for example, is 5 percent plus 3 percent surtax, totalling 8 percent, or 20 percent plus 3 percent, totalling 23 percent. This surtax, which was to have been phased out but was retained in full, is scheduled for elimination when the Harmonized Tariff of 5 percent to 20 percent is adopted.

At that time, duty exemptions on imports by government officials and military are also to be eliminated. This proposed step has apparently caused some resistance.

## EXPORT PROMOTION

All other duty exemptions are to be eliminated when the proposed new tariff schedule goes into effect. The only duty exemptions remaining will be those established:

- By the constitution for universities and cultural organizations;
- For some (not all) charitable organizations, such as CARE and CARITAS;
- For diplomats;
- For agricultural cooperatives;
- By the law promoting development of new and renewable sources of energy;
- By the law establishing Free Trade Zones; and
- By the law promoting maquiladora and nontraditional export development.

Under the export incentive legislation, producers enjoy a 10-year corporate income tax holiday and duty exemptions on imports of machinery, equipment, components, and raw materials involved with re-exporting, in the case of maquilas and free trade zone operations or exporting of nontraditional products.

A proposal to enter into a free trade agreement with Mexico calls for a review of this incentive legislation in the future. It would be appropriate now to undertake a review of these remaining major export incentives with a view to whether or not they offer exporters from Guatemala an artificial, excessive competitive advantage in the U.S. and other foreign markets and the extent to which this incentive law discriminates unfairly against Guatemala's traditional exporters. One should examine the question of separating maquiladora from nontraditional exporters and also producers of nontraditional exports from mere marketers of these products. One should also examine separating new from merely nontraditional exports in awarding long tax holidays and duty drawbacks or exemptions.

A case can be made for shortening tax holidays for agricultural and manufacturing industries that do not face the long start-up and development periods of petroleum and mining companies. Some countries in Latin America have distinguished between a company being the pioneer in developing a new export that had never been exported before from that country and other exporters of nontraditional products that have been developed in the country already for some time and are already exported by others in the country. One can question whether one additional producer of mushrooms added to 10 existing exporters of mushrooms makes a comparable innovative effort as, say, the first exporter of some vegetable or vehicle part never before exported from Guatemala. Incentives could also be limited according to the value added produced by the exporter.

## PROTECTION LEVELS

During the past six years, Guatemala has progressed substantially in liberalizing trade. Export taxes and many export incentives and subsidies have been eliminated and the level of import tariffs reduced and made more uniform. Half of all tariff classifications are now at the low level of 5 percent. In the near future, tariffs of 30 percent in the most protected industries will be reduced further, duty free privileges further curtailed, and about half of all import and export licensing and prohibitions eliminated or phased out within three years. Licensing will thus be eliminated on all important products where domestic producers were protected.

The largest moves have been in reducing the highest levels of import tariffs from a maximum 100 percent and 150 percent down to the current rate of 30 percent and 40 percent. This drop in tariffs, however, has not seriously reduced effective protection for most firms, because protection was excessive at these previous very high levels. A study done by SIECA indicates, for example, that a reduction in tariffs from a range of 20 to 40 percent down to 10 to 20 percent would eliminate effective protection in the Guatemalan paper and tire industries, reduce effective protection somewhat for apparel and shoes, but not affect the protection in the textile industry. Pesticides, chemicals, and pharmaceuticals have not had high levels of tariffs in the past, and the planned decrease in maximum levels from 30 to 20 percent is not expected to affect these industries appreciably.

Most industries still feel protected after tariffs were reduced to a maximum of 30 percent. An indication of this is that more firms apparently felt affected when import duties at 0 to 5 percent were raised to the 5 percent level. The Camara de Industria, which represents private industries in Guatemala, proposed duty levels of 0 to 40 percent for Guatemala.

When maximum duties on finished products are lowered from 30 to 20 percent, more firms will encounter competitive pressures from imports and more may then want to be compensated for a drop in the level of protection by advocating a drop in the 5 percent duty on imported inputs to 0 percent.

Companies claim they will be at a competitive disadvantage in a future free trade agreement with Mexico, because Mexico maintains 0 percent tariffs on a wide range of imported inputs. This competitive disadvantage can be minimized if Guatemala negotiates and applies appropriate rules of origin testing on imports from Mexico. Actually, only 7 percent of tariff classifications had duties ranging from 0 percent to 5 percent in 1987.

In the process of trade liberalization, import tariffs on finished products were often reduced more than those on imported components or raw materials. Some of these were even increased. This means that companies found the cost of imported inputs to have risen or reduced only marginally while competition from imports of finished products was intensifying with each round of tariff reductions. The influential private sector throughout Central America could succeed in pressuring the governments to adopt a 0 percent tariff level for essential imported inputs for locally produced finished products that compete against imports enjoying substantial duty reductions.

The government, although strongly influenced by the private sector, is committed to Central American integration and the proposed customs union with El Salvador and Honduras. Guatemala is, therefore, unlikely to fail to fulfill its commitment of shrinking further the tariff rate structure to a range of 5 percent to 20 percent. A 0 percent level could, however, be added next year.

In many cases, a tariff rate of 20 percent still offers ample protection. Chile reduced its tariff level to a uniform across-the-board 11 percent and its private sector is prospering. Mexico's average level of duties has been reduced to 7 percent, compared to Guatemala's 11 percent after the proposed reduction, and Mexico's foreign trade has become more dynamic than previously. The trade-weighted average tariff in the United States is only about 4 percent.

As tariffs are being reduced in Guatemala and restrictive licensing curtailed, more companies will encounter increased competition from imports. They will then seek ways to become more efficient. Some will specialize and concentrate production in their lowest cost lines. Some may even give up production and convert to importing and distributing these imports in their own distribution network. Pressures for devaluation may increase. Many firms may fight competitive pressures from imports through nontariff trade barriers. The type of controversy currently raised by imports of chicken legs from the United States could recur in other industries.

Consumer preference in the United States for other chicken parts resulted in an oversupply of chicken legs, thus depressing the market price in the United States for chicken legs to 11 to 14 cents per pound. At this low FOB price, it became highly profitable to export chicken legs to Guatemala where the demand is dynamic and the price for poultry is around 50 cents per pound. Guatemala keeps poultry exports restricted by licensing to ensure adequate supplies for the domestic market. Inadequate domestic supplies and the high cost of feedstock in Guatemala plus the excess supply situation of chicken legs in the United States are responsible for the wide price disparity which would not be bridged even if the highest current duty level were applied. Guatemala has charged the United States with dumping practices in order to be able to restrict imports under GATT rules. U.S. exporters, however, are apparently not selling below domestic price levels. Guatemala has also started to introduce onerous health inspections with the intent to restrict imports. It wants each cargo of imported chicken legs to be inspected for salmonella disease, traces of which can probably be found in all raw chickens. Domestic production or other food imports are not subjected to similar health testing.

As further reductions in tariff levels generate competitive pressures from imports on Guatemalan producers in more industries, the incentive to employ administrative and other diverse nontariff trade restrictions will increase. A wide scope for such unfair practices is currently available in Guatemala, although some improvements are being implemented.

It is strongly recommended to identify nontariff trade restraints and to develop strategies for their early removal before influential elements in the local private sector recognize increasing benefits from preserving these forms of indirect trade restraint. Before competitive pressures from imports intensify further, progress should be achieved in introducing customs procedures, health regulations, product certification, rules of origin, and definitions of tariff classifications that are transparent, automatic, nondiscriminatory, and do not lend themselves to corrupt practices.

## POLITICAL CONSTRAINTS ON TRADE LIBERALIZATION

By and large, the influential local private sector does not support trade liberalization that reduces the effective rate of protection.

There exist some differences of opinion on this point, particularly from member companies in GEXPRONT that are exclusively exporting. Some companies producing for the local market represented in the Camara de Industria fear the effects of a further reduction in duties to 20 percent or below, a phase out of restrictive licensing on agricultural products, and the increase in minimum duty levels on components and raw materials. They would prefer duties ranging from 0 to 40 percent.

Effective pressures from the IMF and World Bank, however, generated subregional commitments to trade liberalization. The Guatemalan government can point to this commitment as a CACM member in rejecting private sector opposition to trade liberalization. For the same reason, the government can also reject external pressures for trade reforms beyond the range of commitments already made at the subregional level.

Therefore, Guatemala would not, at this time, accept a proposal to move to a uniform tariff rate structure of, say, 10 percent. A realistic approach to promote is that Guatemala and the other Central American countries abandon the four-tier tariff structure as soon as possible and adopt a dual rate of 5 percent and 20 percent, resist pressure for 0 percent tariffs on inputs, and concentrate on reducing nontariff barriers to trade. After reforms of nontariff trade barriers have caught up with the advance achieved in reducing tariffs, efforts could be resumed for a further reduction in the dispersion of tariff rates toward an eventual uniform rate. This effort has to be made at the regional level possibly as part of preparing Central America for a free trade agreement with the United States or with NAFTA. Ideally, tariff reforms should be carried out concurrently with other trade-related reforms so that the benefits from tariff reductions are not offset by failure to carry out other reforms.

In the current tariff structure, there are many so-called "basket" classifications that lend themselves to arbitrary decisions at customs, inviting bribes. Various milk products, for example, carry a duty of 5 percent, but then there is a classification of "the rest" (*los demas*) with a tariff of 20 percent. Similar "basket" classifications at much higher tariff levels prevail in most industries. Some extreme cases have one classification of *los demas* next to "others" (*otros*), each with widely different duty levels. Presumably only the customs officials can decide whether a product should fall under *otros* or *los demas*.

## EFFECTIVE RATES OF PROTECTION

The tariff structure cannot be analyzed completely at this time, because it will change in the near term, but the final changes for individual customs classifications and industries are not yet known.

Effective rates of protection cannot be calculated at this time because the necessary data are not available. The value added for individual products at domestic as well as international prices needs to be calculated to arrive at the effective rate of protection. Ex-factory domestic prices are needed as well as the prices of individual domestic and imported inputs into the production process and their relative weight in the total value added of each product. Private companies decline to furnish usable data due to fear of tax consequences.

Calculations were made last year for 10 basic agricultural commodities, where calculations are relatively simple and information was provided. It took three people, three months (two man-months) to complete this task.

The methodology for computing the effective rate of protection is known. The effective rate of protection is measured by:

$$Ej = \frac{Vj - Wj}{Wj}$$

Where, $Vj$ = value added at domestic prices
$Wj$ = value added at international prices

Value added at domestic prices is measured by

$$Vj = Pjf\,(1 + Tj) - Fij * Pij\,(1 + Ti)$$

Where, $Pjf$ = CIF price
$Tj$ = Import duty of the finished product
$Fij$ = Coefficient of input
$Pij$ = CIF price or domestic price of input
$Ti$ = import duty of input

Value added at international prices is measured by:

$$Wj = Pjf - Fij * Pij$$

The excess level of protection, which does not affect the local private sector if it is removed, is measured by the difference between the actual and the implicit tariff rate:

$$Tj - Ii$$

The implied tariff rate is measured by:

$$Ii = \frac{Pd - Pjf}{Pjf}$$

Where, $Ii$ = implied tariff rate
$Pd$ = domestic ex-factory price

Effective protection measures the margin gained from the process of protected domestic production and the process if the product were sold at international price levels and all inputs acquired also at international prices. In reality, the level of effective protection is influenced not only by the differences in nominal prices of inputs and finished products resulting from tariffs, but also by the rate of exchange, interest rates, export incentives, subsidies, licensing, transport costs, and diseconomies of scale. If all negative and positive distortions in the domestic price level are netted out and aggregated and compared to the international price level, then effective protection measures the coefficient of the aggregate net subsidy in the economy.

## UNIFORM TARIFF RATE

The effective level of protection would be significantly lower with a uniform tariff level rather than one where imported inputs are taxed at lower levels or enter duty free while the finished domestic product enjoys protection against imports. At this time, however, it is extremely unlikely that Guatemala would abandon its subregional commitments and consider adopting a uniform tariff level. It is also very unlikely that it would start advocating that Central America as a whole adopt a uniform tariff rate in view of pressures from its own private sector to promote a 0 percent tariff for some imported inputs.

One can argue, however, for a uniform tariff rate as the eventual goal for Central American countries. A uniform rate has many advantages aside from reducing protection of inefficient producers and ending discrimination among exporters. A uniform tariff rate would be very easy and inexpensive to administer and would largely eliminate corrupt practices in the customs administration. It is a neutral tariff that does not discriminate among different industries or products and, therefore, lets the price mechanism operate more freely.

Duties tend to reduce the incentive to concentrate production in the more productive activities. Dispersion of duty rates causes resources and investments to move into the more protected, less productive activities. The efficiency of the economy suffers when this happens.

Tariffs produce not only an anti-import but also an anti-export bias by artificially creating incentives to produce for the local market. Also, products become less competitive in international markets.

Diseconomies of scale of production, high internal transport costs, high cost of credit, obsolete technology, an untrained work force and low productivity, an overvalued exchange rate, and similar issues should not be accepted as excuses for maintaining protection, because they perpetuate inefficient production. They are the result of misguided economic policies and should be dealt with through government reforms rather than be compensated by protective tariffs.

## NONTARIFF TRADE RESTRAINTS

Nontariff trade restraints need to be removed so that local companies will be able to benefit from trade liberalization and support it. While tariff reforms, jointly conceived by the Central American countries, have progressed substantially, little attention has been paid to nontariff trade restrictions and to trade-related economic policy reforms. Tariff reform needs to be tied to industrial reconversion, infrastructure improvements, privatization, exchange rate and credit reform, anti-monopoly regulation, and further decontrols and elimination of subsidies to encourage an environment where efficient, modernizing businesses can meet competition from imports and successfully develop exports. If local companies cannot benefit from trade liberalization, they will seek to offset the competitive pressures stemming from lower tariff protection by indirect or nontariff restraints on imports.

Nontariff trade constraints will gain significance as tariffs are being reduced, and also as free trade agreements are concluded with Mexico and other countries.

## CUSTOMS PROCEDURES

Aside from tariff reform aimed at reducing the levels of protection that encourage the growth of noncompetitive industries, future trade negotiations should emphasize how to improve transparency and efficiency and less arbitrariness, corrupt practices, and discrimination in the administration and procedures of customs clearance. The administration of customs can be used effectively to restrain foreign trade.

Frequent changes in top management at customs in Guatemala make it difficult to plan and to carry out necessary reforms. Reform measures are interrupted and stalled by frequent management changes. There is no solid organizational structure at customs. Personnel is not professional, well trained, nor adequately compensated. There are many incentives and opportunities for corruption, but little effective control over customs personnel. There is a great shortage of funds for maintaining and modernizing installations, equipment, and facilities and little new investment is being undertaken.

A project, SIDUNEA, sponsored by UNCTAD, started to install new equipment which ended up as an effort to improve the collection of external trade statistics. Last year, SIDUNEA was re-oriented to concentrate on introducing an improved system of customs procedures. Computers are to be installed in at least seven customs locations. The SIDUNEA project is to end this year.

Peat-Marwick's on-going technical assistance program in customs started in January 1990. It has a dual objective:

- Improve the customs administration; and
- Computerize customs procedures.

The problem of establishing CIF values for imported cars, mentioned earlier, was solved under this program.

A computer system has been installed for registering all individual Guatemalan customs agents and documenting their financial situation and daily activities at customs. It is designed to track the imports and invoices handled by each agent in order to be able to hold him responsible if an irregularity occurs with a shipment passed through customs by him.

A similar computerized control system has been installed for all individual trucking companies handling imports, their owners, and the truck drivers. This is to able to better trace the disappearance of containers and shipments entering the country and in transit in bond to one of the privately owned warehouses in the country (*almacenes de deposito*) where imports are stored and processed by customs located in these bonded warehouses.

The computer system in place also records each shipment entering and leaving a customs location, its value, tariff assessment, and other charges. The system allows tracing the activities per customs location, and even per individual customs official, to measure productivity and to set targets for tariff revenue collection for individual officials. The system compares actual performance against the target.

A computer system has now also been developed that will establish a rotation schedule for each customs official. It has been started in Guatemala City, but can be expanded to the rest of the country. It has been found that customs officials have been kept for years in one place and have come to identify more with their regular importers and their merchandise than to act in the government's interest as revenue collectors.

A computerized inventory system at each customs location has been installed to accurately account for goods stored at customs as well as the length of time and reasons for storage.

All paperwork relating to daily customs problems ends up at the centralized office of the customs general secretary. The large volume of paperwork created delays and confusion. A computerized system now controls, sorts, and distributes the flow of paperwork for more specialized, efficient handling.

Improvements in three areas are planned for the near term:

- Computerized control of bonded containers in transit from entry points to the customs located at warehouse centers scattered at different locations in the country. Better control can verify early if shipments arrived and trace disappearances. In 1990 alone, about 1,800 shipments disappeared before reaching customs for clearance. Improved controls last year reduced disappearance to less than 600 containers. The estimated revenue loss for the government as a result of these disappearance is about $40 million per year.

- A data bank of international prices to better determine the correct CIF value of imports in three industries: chemicals, textiles, and household appliances. This measure will be designed to control under-invoicing designed to evade tariff and tax payments. A private sector source estimates that under-invoicing in foreign trade in Guatemala could be up to 40 percent at times.

- A control system to register accurately and promptly all shipments entering and leaving maquila factories in order to trace smuggling from maquila plants into Guatemala without paying duties.

Government revenues from customs are estimated to reach $320 million, including the value added tax, if these measures are adopted and enforced, taking into account the proposed lower tariff rates. Customs will then contribute about 30 percent to total government tax revenues. The government could recover millions of dollars in additional revenues with an intensive program to set up international price guidelines for determining CIF and FOB values of exports and imports. This can be done with communication and cooperation with customs in the United States and other countries.

All of these improvements planned or carried out represent less than half of what still should be done to install efficient customs operations capable of dealing with the growing trade volume and complexities expected from further trade liberalization and free trade agreements.

Guatemala's customs officials cannot work efficiently because they lack proper and up-to-date manuals and materials and modern equipment. Installations are not being maintained adequately because of lack of funds. There is no research capability in customs and no planning or analysis department. There is no on-going technical training program or career development at customs. The top customs position apparently is not a career post, but a political appointment. This investment has to be recovered. Pay scales at customs are very low and an inducement for corrupt practices.

There is little technical capacity and no organization for administering rules of origin procedures, effective, consistent health testing of products, certification, labelling, and packaging standards, or consistent product classification.

The customs classification in many instances in vague and subject to different definitions and interpretations. "Basket" clauses labelled *otros* or *los demas* or both of these vague classifications in one product category offer customs officials frequent opportunities to be arbitrary in deciding under which classification a product falls. Importers sometimes find part of their expected profits evaporating when their product is classified in a category of a higher tariff than expected. Negotiations and a special compensation can then lead to re-classification of the imported product. It is possible to obtain an advance ruling from customs which tariff is applicable to a given import, but to ensure certainty one has to send in a sample and complete, detailed description, otherwise something could still be found when the imports enter to cause a dispute over classification. The procedure applied by U.S. customs in providing a standard, efficient way of final, guaranteed pre-classification of an import could be studied for possible adoption in Guatemala.

Imported whiskey and other products widely sold at low prices in Guatemala City indicate large-scale smuggling of many consumer goods in the upper tariff range.

Guatemala also has a customs dispute settlement commission composed of private and public representatives. It takes, however, six months of time and expense to settle a given dispute over product classification. It usually is more economical and efficient to bribe a customs official to change the classification of an import.

The Guatemalan and other Central American governments are moving ahead with tariff and trade reforms and changes and plan to implement a free trade agreement with Mexico without taking adequately into account the capacity of their customs organization to administer these changes.

The reforms introduced thus far and others planned require strong government commitment and backing at the highest levels in order not to be abandoned in the future, but to prevail and progress further. Without top government backing, special interest groups will work to erode the effectiveness of these reforms and block the introduction of new ones in the future.

## UNDER-INVOICING

Under-invoicing is widely used in Guatemala to reduce payment of duties and other taxes in the case of imports and to keep foreign exchange abroad as a hedge against devaluation risks. Under-invoicing is also used to show lower profits from exports as part of widespread corporate income tax evasion. Under-invoicing is successful because no effective preventive controls or confiscatory fines are being implemented.

No systematic export or import price verification system exists that would aim to minimize under-invoicing. Only if a very substantial disparity from going market prices is detected will an export price be challenged.

A computerized information system that collects and updates international prices and price ranges for more and more products should be developed, possibly for use by customs regionally throughout Central America. The experience in customs of other countries could be studied and proven methods copied. The use of ex-factory prices and those in the red and blue book in the United States for determining the CIF value of car imports, mentioned earlier, is an example that this can be implemented for some products. The use of tariff bands to stabilize import prices for some basic agricultural commodities will also entail up-to-date information on international price changes. To employ foreign price guidelines for determining CIF and FOB prices for tariff assessments will certainly increase the incidence of disputes and require reform of the dispute settlement mechanism to handle and increase volume of complaints efficiently, equitably, and speedily.

Further liberalizing the exchange market or adopting the Mexican system of announcing the daily or weekly schedule of very slow devaluations a year in advance would reduce the incentive for speculation and hedging. It would not eliminate the desire to show lower profits from exports for tax purposes.

At the Central Bank and at customs, an analysis division of invoices, prices, CIF and FOB values could be created that should be able to save the government millions of dollars a year in foreign exchange, tariff, and tax revenues. The compensation of these officials could consist of a base salary and a bonus related to the number and value of irregularities processed.

Currently, the Statistical Department on Foreign Trade at the Central Bank compiles monthly foreign trade data. The library at the Central Bank keeps statistics on the volume and value by tariff classification. Data are compiled from invoices received from customs and copies of exports permits issued by the Ventanilla Unica office. Exporters normally have 45 days from the date export permits are issued to deliver the foreign exchange. This can be done at commercial banks which deliver copies of the receipts issued to the Statistical Department. The value of foreign exchange delivered, as shown on the receipt, is compared to the original export permit issued by the Ventanilla Unica. Discrepancies result because one permit sometimes covers several shipments at different points in time or several permits are used for one shipment. If an exporter ships beyond the 45-day deadline or changes quantities or prices of goods shipped from what is shown on the export permit, then he has to justify this discrepancy.

## VENTANILLA UNICA

The creation of the Ventanilla Unica office in 1987 for exporting represents a successful example of reducing red tape and improving efficiency in foreign trade. As part of the effort to promote nontraditional exports, the Association of Nontraditional Exporters (GEXPRONT)[1] suggested creating the Ventanilla Unica.

As the first step, all paperwork and offices dealing with export procedures were centralized in one office. The second step was to analyze all forms and applications as to their essentiality for the exporting process and to eliminate all excess red tape and procedures. In this way, the average time required to obtain an export permit was reduced from about 20 days to little more than two hours.

All necessary certifications, test results, and other documentation must be attached to the application for an export permit by the exporters before Ventanilla Unica will start processing his request. It checks quantities, prices, the customs classification, and other information shown on the documentation. When the United States rejected imports of cabbage from Guatemala due to health-impairing pesticides used, a laboratory was designated in Guatemala to test such products for the type of pesticides used. A certificate that the proposed export has passed the test has to be attached to the export application sent to Ventanilla Unica. If a product does not meet the health test, Ventanilla Unica would alert the U.S. Department of Agriculture about the possibility of unauthorized exports.

Ventanilla Unica could be an effective organization — it has the necessary dedication and enthusiasm — to take on the added responsibility to check for under-invoicing practices. It would need improved computer capability, an analysis division, and collection of international price data. The FOB price approved by the Ventanilla Unica would show on the export permit, a copy of which is sent to the Central Bank, where the receipt arrives showing the foreign exchange delivered by the exporter to the commercial bank. This division of reporting

[1] Gremial de Exportadores de Productos No Tradicionales.

responsibility and reconciling information at different institutions could reduce the scope for corruption in this case.

According to the manager, it costs only about $100,000 per year to operate the Ventanilla Unica. If a nominal fee of 10 quetzales were charged for processing each export permit, Ventanilla Unica would be self-supporting.

A Ventanilla Unica for imports would be more difficult to create because of the much more complex and greater number, variety, and dispersion of imports and associated regulations. Import procedures, however, could be consolidated and red tape greatly reduced, following the example of what was achieved in exporting. A Ventanilla Unica for imports could be created at each customs location.

The efforts should be directed to reducing, simplifying, standardizing, streamlining, and computerizing all documentation required for imports and to facilitate, clearly define, make transparent and more stable, and automate all customs procedures.

## REGISTRATION, CERTIFICATION, TESTING REQUIREMENTS

Among the diverse nontariff trade restraints is the discriminatory application of registration, certification, or testing requirements of imported products with intent to restrict their importation. A costly lengthy or delayed approval process without clear justification can sometimes be employed, involving red tape and payment of fees, and at times bribes to speed up or by-pass this process.

GATT has been developing and improving technical standards for product registration and phytosanitary (plant cleanliness) regulation, which Guatemala should consider when setting up a regular system of registration and testing. Currently, it does not exist for imports and only for those exports which need to pass U.S. health test standards.

Testing requirements, registration, and certification should not be employed with intent to restrict imports. A panel of professional experts should be appointed to set up the rules and procedures for standards and testing of products. Nondiscriminatory, clearly defined requirements should be established for product registration, certification, and testing equally for domestic as well as imported products.

Science-based health and safety standards should be applied without discrimination to all domestic and imported products. Countries can establish different standards and need not insist on reciprocal treatment, but their standard should be applied without discriminating against imports. It should be designed to protect the health or safety of the country's own people regardless of whether the products are imported or produced domestically.

The existing prohibition against the domestic use of harmful pesticides has proven difficult to police effectively. Some agricultural exports to the United States, therefore, did not meet stringent U.S. health standards and were rejected. The Guatemalan government has now established testing requirements for these exports to the United States that have proven effective in meeting U.S. health standards.

In the case of chicken leg imports, the government wants to introduce stringent health testing requirements that will effectively bar chicken leg imports from the United States. These new testing requirements are discriminatory because they are not being applied to domestic chicken production.

**RULES OF ORIGIN**

The setting up and administration of rules of origin of imported products is not necessary for Guatemala when the Central American countries establish free trade within the area and a common external tariff.

This situation changes, however, when Guatemala or all of Central America concludes a free trade or other preferential trade agreement with Mexico, the United States, or some other country. Rules of origin need to be applied to imports to prevent that exporters in third countries from circumventing the normally applicable duties in Guatemala by shipping, for example, through Mexico and thus benefitting from the preferential duty treatment accorded Mexico under the free trade agreement.

It is often very difficult to effectively police rules of origin of imports, and customs that are not efficient will generally have difficulties in determining the origin of raw materials and components of imports. Attempting to implement an advanced system would probably open the door to new opportunities for corruption. At this stage, it would be difficult in many cases to determine the share of components and raw materials of a product imported from Mexico that are not of Mexican origin.

It is recommended that Guatemala establish common rules of origin for imports from all Central American countries, best in conjunction with the start of negotiations of a free trade agreement with Mexico in order to arrive at rules that will have immediate practical application.

The simplest rule of origin would be as follows: an import from Mexico would meet the national origin test and quality for preferred duty status if in the process of transformation the added value places the product into a different tariff classification than the raw materials and components that might have been imported by Mexico from third countries. Imports of agricultural products or raw materials from Mexico may still be difficult to trace as to their national origin. As tariffs on imports from third countries are decreased further, the incentive to circumvent the rules of origin via Mexico will also diminish.

## ANTI-DUMPING, COUNTERVAILING DUTIES, DISPUTE SETTLEMENT

Central America should establish a regional anti-dumping law and countervailing duties because other countries maintain subsidies and engage in price manipulations in order to gain unfair trade advantages.

Criteria should be carefully developed and clearly defined that would identify dumping practices and invoke countervailing duties. These criteria should be consistent with GATT regulations.

A Central American panel composed of importers and producers from diverse industries could be created and given final authority to settle disputes relating to dumping practices, countervailing duties, and other unfair trade practices. Governments do not necessarily have to be represented on such a panel.

## DEVALUATIONS

Exchange control is a form of rationing the supply of foreign currencies and it can be used by the government arbitrarily to decide who gets it and who does not. Exchange controls can, therefore, be applied similar to or in place of restrictive import licensing.

Devaluation of the currency can be decided and decreed by the government. Devaluation raises the prices of imports in local currency and lowers the prices of exports in dollar terms. Devaluation, therefore, can be used to restrict imports, similar to raising tariff levels, and to stimulate exports comparable to export subsidies. Governments sometimes resort to devaluation of their currency relative to the U.S. dollar to improve their trade balance at the cost of their trading partners.

Countries devaluate their currency also for other reasons. A common motive is to compensate for inflationary cost increases that occur as a result of government budget deficits or other imbalances or controls in the economy.

The objective of trade liberalization is to permit market forces to determine the flow of trade and the supply of goods. This objective will be undermined if governments maintain exchange controls and manipulate the exchange rate in order to influence the trade balance.

Governments should be encouraged to introduce reforms that would establish greater budgetary stability, thus removing a prime cause for inflationary pressure that give rise to manipulation and controls of the exchange rate. Budget deficits can also cause real interest rates to rise attracting inflows of foreign exchange rate which decrease the real exchange rate, thereby retarding the development of nontraditional exports.

Guatemala's exchange control does not work efficiently, because it permits exporters to evade controls and leave abroad a sizable proportion of export proceeds. Repatriation of foreign exchange probably declines in times of perceived higher risks of devaluation and thus contributes to the pressures for devaluation. In June 1992, for example, demand at the weekly auctions was at times as much as $30 million, but supply of foreign exchange only $8 million.

Promotion of nontraditional exports require an exchange rate that is sufficiently flexible to offset inflationary cost increase and thus keep exports competitive abroad.

As tariffs are being reduced, it becomes necessary to re-assess Guatemala's current system of controlled exchange supplies fed into an auction system with the intent of maintaining a stable exchange rate. When high tariffs restricted imports, an overvalued exchange could be maintained without causing a growing trade deficit. As tariffs are reduced and offer less protection against imports, an overvalued exchange rate increasingly contributes to the growth of the trade deficit.

A Mexican-type, gradual rate of devaluation system that is pre-announced and controlled would seem to serve better Guatemala's current dual trade objective of import liberalization and nontraditional export promotion. A devaluation of, for example, 1 cent per week (10 percent over the next 12 months) could be announced in advance and rigidly maintained by the announced price at which the Central Bank is willing to purchase and sell foreign exchange. Otherwise the exchange market could be left free to the commercial banks.

This move, coupled with an end of exchange control, would end the uncertainty and speculation and retention of export proceeds abroad that produces instability in the exchange market and forces governments into sudden, major devaluation with severe inflationary consequences and capital flight.

A creeping 10 percent annual devaluation would keep the parity of the quetzal stable if domestic inflation proves to be around 14 percent and U.S. inflation about 4 percent.

If Guatemala's trade deficit and rate of inflation decline during the next 12 months, then the government could afford to slow down the pre-announced rate of devaluation for the following 12 months. Devaluation could be slowed to, say, 1 cent every 10 days instead of every seven. Annual devaluation would be 6.5 percent, domestic inflation 11 percent, and U.S. inflation possibly 4.5 percent. If the trade deficit and inflation increase, Guatemala should then announce a slight acceleration in the creeping rate of devaluation.

After Guatemala has brought its trade and budget into reasonable balance and annual inflation well below 10 percent per year, it could then eliminate pre-announcing a rigid rate of devaluation, but the Central Bank should continue to intervene, as is being done in the advanced countries, to prevent any serious and prolonged instability in the balance of payments.

Guatemala's exchange rate needs to be sufficiently flexible to offset inflationary cost increases that would erode the competitiveness of nontraditional exports and the ability of sound local companies to compete against imports free from protection.

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