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***ANALYSIS OF GUATEMALA'S LEGAL AND REGULATORY FRAMEWORK
FOR TRADE AND INVESTMENT***

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SUMMARY OF RECOMMENDATIONS

Guatemala is a nation that has made substantial progress toward improving the climate for trade and investment. In recent years, the Government of Guatemala ("GOG") has implemented macroeconomic policies which, for the most part, have resulted in economic stability and expansion. To sustain the progress made to date and facilitate additional expansion, it is essential that obstacles to trade and investment in the existing legal and regulatory framework be identified and eliminated.

This report identifies obstacles in the legal and regulatory framework and classifies them according to the following criteria. Specific recommendations for the removal of each obstacle are also provided. Obstacles are classified according to the following criteria:

- Urgent** includes problems which require **immediate action** to prevent a **substantial decline in existing levels of trade and investment**.
- Priority** includes those legal and regulatory constraints which should be removed to provide the **greatest incremental benefit** to trade and investment in the country or which **will severely limit Guatemala's ability to expand trade and investment in the future**.
- Important** differs from Priority Category by degree, includes those constraints which will provide **substantial benefits** to the economy and/or which will **limit future expansion** of trade and investment.
- Valuable** constraints which **should be removed from the legal and regulatory framework to conform to modern legal principles**, but if continued will not markedly affect levels of trade and investment in the country.

In addition to the prioritized obstacles identified, the team identified several obstacles of a general or systemic nature and has listed those separately. All general obstacles are classified as priority. Specific manifestations of some of the general obstacles are discussed below in the Specific Obstacles and Recommendations Section.

This Summary of Recommendations is distillation from the body of the report and is intended to be used solely as a preliminary checklist. To gain a full understanding of the issues and recommendations one must read the body of the report.

I. SPECIFIC OBSTACLES AND RECOMMENDATIONS

URGENT

Protection of Workers' Rights

Guatemala's preferred trade status with the U.S. is threatened by failure to adequately protect internationally recognized workers' rights standards. Loss of GSP status would result in immediate and significant declines in exports, and a resulting drop in economic activity.

Specific Recommendations:

To comply with internationally recognized standards related to workers' rights Guatemala should:

1. Amend the Labor Code and Penal Code to conform to International Labor Organization ("ILO") Convention standards related to freedom of association and the right to organize, forced labor, minimum age, and minimum work conditions.
2. Establish strict inspection, investigation and enforcement standards to ensure compliance with the revised Code.
3. Improve the performance of the Labor Courts so that rights granted by law can be effectively enforced.
4. Accede to ILO Convention Nos. 148 and 155 and conform national health and safety laws to their standards.

PRIORITY

A. Protection of Intellectual Property Rights

Trade sanctions could be imposed on Guatemala under GSP/CBI legislation or Section 301 for failure to comply with international intellectual property standards, slowing the level of exports from the country. Even if sanctions are not imposed, weakness of intellectual property laws could deter incoming investment and technology transfer.

Specific Recommendations:

Patents

1. Accede to the Paris Convention.
2. Extend the period for protection of patents.
3. Eliminate use requirements.

Trademarks

1. Accede to the Paris Convention.
2. Provide for protection to become effective by registration or use.
3. Ensure protection of notorious trademarks.
4. Streamline registration requirements.

Copyright

1. Accede to the Berne Convention and the 1974 satellite transmission convention.
2. Amend the copyright law to extend protection to foreign and non-domiciled authors.
3. Extend copyright protection to software and semiconductor chip design.

B. Adherence to GATT Commitments

When Guatemala joined GATT, it subjected itself to applicable GATT rules. It also made a number of specific commitments with regard to reform of its trade regime, several of which carry time limits, and agreed to adhere (or initiate negotiations aimed at adhering) to additional agreements. The team found that Guatemalan officials lacked a detailed knowledge of what is required under these commitments, creating the possibility that Guatemala could fail to capture the full range of GATT benefits, or worse, be penalized, for failure to comply with its commitments. Adherence to these GATT commitments will drive many other changes in trade policy.

Specific Recommendations:

1. Conform Guatemalan law to GATT standards in the following areas:
 - a. Subsidies
 - b. Quantitative restrictions on imports and exports
 - c. Customs valuation procedures
 - d. Import licensing procedures
 - e. Product standards
 - f. Anti-dumping and countervailing duties
2. Initiate a training program for government officials on the requirements of GATT.
3. Develop a national GATT compliance plan.

C. Transparent Investment Processes

The availability of a transparent process for investment is the keystone of attracting foreign investment. Investors that are unable to obtain relevant information or to foresee their ability to navigate the approval process will quickly become discouraged and look to other locations.

Specific Recommendations:

1. Laws, regulations and interpretations related to investment should be compiled at one location and translated into English, and other target languages. A booklet should be prepared which summarizes general and sector specific legal requirements.
2. Continue efforts to establish the Ventanilla Unica para Inversionistas. The Ventanilla should include expedited (1) registration of foreign branches, (2) access to tax identification number, (3) access to work permits and visas for foreign workers (including approval of foreign technician percentages), (4) environmental review, (5) customs approval for importing and machinery necessary for the investment.

D. Access to Commercial Financing

Commercial financing is unavailable to large numbers of Guatemalan businesses with excellent production capabilities. Improving the financial system to make commercial financing available would unleash dormant entrepreneurial opportunities and permit expansion of existing businesses.

Specific Recommendations:

1. Enhance and expand legal protections associated with security interests, including improved real property registry, expansion of freedom of contract, secured leases, and expedited enforcement procedures.
2. Prohibit the use of bearer shares.
3. Expand and improve regulation of the pagarese and the securities market generally.
4. Improve judicial foreclosure and other legal procedures.

E. Closed and Partially-Closed Sectors

Guatemala can provide a broader opportunity for trade and investment by opening closed and partially-closed sectors to the foreign and domestic investors. In the case of state-owned operations, the opening could reduce public capital outlays required for expansion and improvement of the national infrastructure, while improving the physical environment for further expansion of trade and investment.

Specific Recommendations:

1. Eliminate sectoral restrictions in the transportation, insurance, banking, housing and professional services sectors.
2. Eliminate equity requirements in the airline, transportation, radio and television, forestry and mining sectors.
3. Consider privatizing certain state-owned industries, with appropriate safeguards.

F. Effective Dispute Resolution

The Guatemalan judicial system as it presently operates fails to provide the level of legal protection required to ensure a timely and predictable resolution to commercial disputes (see General Obstacles section). There is a critical need for alternative mechanisms, such as arbitration, through which investors can resolve disputes in a predictable and timely fashion without resorting to the courts.

Specific Recommendation:

Adoption of a special arbitration law (modeled on the UNCITRAL model law) for international commercial arbitrations.

G. Investment Stabilization

A stable investment environment lessens the risks to investors. Guatemala would be wise to take all necessary steps to provide maximum investment stability.

Specific Recommendations:

1. Continue the process of qualifying for MIGA.
2. Negotiate bilateral investment treaties with the U.S. and other key countries.

H. Financial Systems

The creation of a financial sector which efficiently delivers a broad range of services is a critical element of an attractive trade and investment climate.

Specific Recommendations:

1. Adopt modern banking laws which will authorize and regulate participation by banks and others in a broad range of financial services.
2. Establish a National Securities Commission and adopt a securities law.
3. Consider modifying the Economic Compensation Law to create a pension system for workers. Permit the establishment of pension funds and provide them regulated access to the securities and other financial markets.

I. Customs

- a. Reduce the fiscal reliance on customs by implementing broader based taxes.
- b. Assist customs with training and support to implement the Harmonized Tariff System.
- c. Establish sound and effective valuation procedures.

IMPORTANT

A. Real Property Limitations

1. Permit foreigners to access property located near territorial borders, beaches and waterfronts through long term leases or other means.
2. Eliminate the 7% IVA tax from real property transfers.

B. Commercial and Corporate Operations

1. Eliminate the requirement that commercial contracts be written in the Spanish language.
2. Adopt the U.N. Convention on the International Sale of Goods.
3. Eliminate the existing agency law (at a minimum rescind Article 8).
4. Provide parity treatment for foreign branches.
5. Eliminate requirements that corporate books be kept in Spanish and Quetzales.
6. Eliminate guaranteed dividends to holders of preferred stock.
7. Establish more specific regulations regarding mergers.
8. Eliminate closing requirements for local branches.

C. Bankruptcy

1. Review the existing law and update for current and future business conditions.
2. Expedite judicial proceedings.

D. Foreign Workers

Expand percentages of foreign workers permitted by the Labor Code to provide maximum flexibility for attracting new investors from diverse sectors.

E. Procurement

Adopt a transparent process for procurement, based on the model GATT procurement code.

F. Technology Transfer

Eliminate limitations on the deductibility of royalty payments

G. Maquila Operations

Clarify the distinctions between categories authorized by existing law.

H. Expropriation

Clarify valuation and procedural problems with the existing provisions of the law.

VALUABLE

Other trade and investment recommendations found throughout the report and not discussed here would be valuable in facilitating increased trade and investment in Guatemala.

II. GENERAL OBSTACLES TO TRADE AND INVESTMENT

Several areas of general concern exist which were not squarely within the Scope of Work. These represent general, systemic obstacles which permeate the Guatemalan legal system, and the process of law reform. Specific, limited manifestations of these constraints were encountered in several areas of the study. To the extent possible, those have been incorporated into the report.

These general obstacles constitute priority barriers to trade and investment and their elimination is fundamental to improvement of the overall legal and regulatory climate in Guatemala. This discussion represents a preliminary scoping out of the obstacles and identifies some possible recommendations for further action.

A. Legal Infrastructure/Judicial Institutions

Repeatedly, and in many different contexts of the analysis, the team encountered areas where the law on the books and the law in practice were completely distinct. For example, labor laws contain minimum wage and age provisions but it was apparent from our study that there are many underage persons working for less than minimum wage. According to many, this gulf between the written and the practiced (enforced) law is mainly a problem of an ineffective judicial system (a right that cannot be enforced is not a right).

One apparent cause of the problem is procedural in nature - litigants have access to numerous procedural mechanisms which can be used to delay a proceeding. Other problems may relate specifically to civil legal systems where injunctions are not favored (problem for intellectual property and unfair competition enforcement) and judges are generally less willing to provide remedies for wrongs. There appears to be a general unwillingness on the part of the judiciary to interpret and apply the law.

Additional study would be needed to examine how best to approach this problem. However, two main related areas must be addressed:

Effective and streamlined procedures that can provide appropriately resolutions of disputes must be established. Cost should be kept to a minimum. Alternative dispute resolution mechanisms such as arbitration should be fully explored and integrated to the greatest extent possible into the system to reduce the judicial case load and expedite resolution of disputes.

Judges, private attorneys and judicial administrators must receive adequate training to deal with commercial law and regulation issues. Given public sector constraints in this area, it may be appropriate to seek to privatize some of these functions through use of arbitration, establishment of private rights of action and establishment of self-regulatory functions.

B. Administrative Law

An antiquated and underdeveloped system of administrative law and procedures increasingly acts as a brake to expansion of Guatemalan trade and investment activities. A well-developed administrative law system should provide clear and transparent procedures for administrative rule and decisionmaking. Regulations should be clear, yet flexible to allow for the broadest range of circumstances. The judiciary should have a clear role in reviewing determinations made by agencies. An effective administrative law system can do much to provide predictability for investors and support business activity.

As with the judicial system, the administrative law system is replete with delays, confusion, inaction, and irrationality. Not infrequently, companies are subjected to ambiguous requirements, applied inconsistently by the agency. It is not unusual for regulations to contain few or no criteria for limiting the discretion of the decisionmaker, creating a ripe environment for corruption. Regulations are often promulgated behind closed doors, at times without input from the person charged with enforcement and implementation. That coupled with the fact that many final determinations are made by political appointees, can lead to significant bureaucratic delays and potential for political meddling.

Reform of the administrative law system, like judicial reform, would require additional study, a process of law reform and streamlining procedures, and training programs for public officials.

C. Law Reform/Regional Integration

As Guatemala becomes a more advanced and sophisticated economy, integrated into the international system, there will be a growing need to adopt new laws and revise existing laws to keep pace. Many of these legal changes will be of an increasingly technical nature (intellectual property, competition laws, etc.), requiring sound drafting and careful organization. A careful comparative law process will be needed to determine what rules--among its own, those previously implemented in other countries, and new formulations--will best allow it to achieve its objectives. This will require at times the use of teams of economists and lawyers to draft legislation that effectively will achieve the desired effect.

The sophisticated nature of this process favors utilization of a regional approach, since many of Guatemala's neighbors will be faced with the same challenge. The establishment of a regional professional research, comparative law and drafting institution (or utilize an existing institution such as INCAE) would provide invaluable support to this effort. The use of the regional technical group would facilitate the synchronization of the laws of the region and facilitate economic regionalization. Perhaps AID can play a role in providing technical assistance in regional integration,

and by integrating its technical assistance efforts.

D. Competition

Competition is essential for the operation of a free and open market economy. The lack of real competition was evident in many economic sectors examined in this analysis. The basic problem with competition in Guatemala appears to be the insular, cooperative nature of the Guatemalan private sectors: 1) many economic sectors are controlled by one or two families, 2) Gremiales play a major role, in effect, controlling economic activities in some sectors, and 3) Government/Private relationships make it difficult to tell where public interest ends and private interest begins.

The problem of how to interject and enforce competition in the marketplace is a complex problem. International competition can be used to inject competition in certain sectors to the extent foreign investors are permitted to enter and compete in the economy. An open investment trade and investment regime would permit the entry of strong, well-financed international companies, creating competition through a market structure rather than legislation.

The use of competition law would be another alternative, but even if enacted, enforcement is likely to be a problem. Art. 130 of the Constitution currently prohibits monopolies, requires the state to limit monopolization, and to "protect the market economy and prevent those associations which tend to restrict market freedom or to cause prejudice to consumers." To the team's knowledge no effort has been made to enforce the law. Thus, additional laws, unless enforced, would be of no practical value.

I. INTRODUCTION

A. Background

The GOG has focused increasingly in recent years on the private sector as the engine for expanded economic growth and development in the country. Over the past six years, the GOG has implemented a broad-based stabilization program creating a present opportunity for comprehensive trade and investment reforms to propel expanded economic growth and development. One essential element of strong private sector oriented growth is the existence of a legal and regulatory framework which facilitates the free flow of trade and investment.

Recent measures to open the economy in Guatemala are reflected in a number of areas including the depreciation of the real exchange rate, moderation of inflation (except 1990), the reduction of import tariffs and the streamlining of export procedures. The private sector has responded favorably to these economic stimuli and is expanding in many areas, in particular in the export of non-traditional products. Increasingly, however, the private sector is confronted with limitations and obstacles built into an antiquated legal and regulatory framework enacted during a previous era to support different economic policies. There is broad consensus among the United States Agency for International Development, the Interamerican Development Bank and the GOG itself that Guatemala's existing legal and regulatory infrastructure must be modernized to provide a sound framework for expanded, broad-based trade and investment activities.

B. Objectives

The objective of this report is to analyze Guatemala's legal and regulatory framework for trade and investment and the financial sector, identifying the specific constraints that exist in the current system, providing recommendations for reform, prioritizing the reforms according to their importance for the economy, and identifying specific technical assistance requirements to support the recommended reforms.

C. Scope

The report analyzes specific areas of the legal and regulatory framework for: (1) trade and investment and (2) the financial system set forth in the Scope of Work (see Appendix A).

1. Trade and Investment

The trade and investment area of the report examines domestic and international issues related to trade and investment in Guatemala. Domestic issues include those matters

that concern an investor's ability to carry on business activities within the country irrespective of whether the business is local or international. The analysis of domestic issues includes the following areas: (1) ownership and protection of property rights (personal, real and intellectual); (2) contracts and sales; (3) commercial financing; (4) corporations; (5) bankruptcy; (6) labor; and (7) government procurement.

International issues discussed in the analysis include: (1) foreign direct investment (sectoral restrictions, incentives, approval procedures, remission of dividends, etc.); (2) expropriation; (3) technology transfer; (4) operation of maquilas and free trade zones; (5) international trade (GATT, import and export restrictions, tariffs, operation of customs, etc.), (6) exchange controls; (7) product standards; and (7) dispute resolution mechanisms.

Some specific areas not included in the Scope of Work that merit further examination include environmental and fiscal laws.

2. Financial System

The second major section of the report focuses on the legal and regulatory framework for financial systems, particularly as it relates to trade and investment. That section analyzes the legal and regulatory framework applicable to the commercial banking system and securities markets and includes examination of the legal framework for market entry, supervision and regulation of the sectors, and exit procedures, through merger or insolvency.

D. Methodology for the Report

Because this report requires a multi-step analytical process, a further explanation of the methodology is in order.

1. Information Collection

The team spent approximately ten-person weeks in Guatemala collecting information for the project. It placed highest priority on collecting first-hand data i.e., the actual text of laws governing specific issues. It was not uncommon, however, to find that the text of the law was too ambiguous to permit a definitive interpretation. The assistance of the Guatemalan legal team assigned to the project was invaluable in clarifying the legal effect of many of the laws and regulations examined.

The team also engaged in numerous interviews with private and public sector officials to gain insight into the operation and enforcement of laws and regulations examined. The report incorporates the product of these interviews where appropriate and applicable to highlight obstacles created by implementation and enforcement.

2. Analysis of the Legal and Regulatory Framework

The report incorporates a uniform five-step process for analyzing Guatemala's legal and regulatory framework as follows.

- STEP 1:** Determine the current law regarding the issue. This was difficult at times given the ambiguous language of some statutes and the lack of well-developed interpretive materials.
- STEP 2:** Determine the legal standard applicable to the issue, to the extent such a determination is possible, under generally acceptable modern legal standards and/or the expectations/requirements of the international business community.
- STEP 3:** Analyze where inconsistencies exist between modern standards/international expectations and Guatemalan law as it is applied.
- STEP 4:** Define the specific obstacles created by the discrepancy between the Guatemalan law and the applicable standard.
- STEP 5:** Provide recommendations for synchronizing Guatemalan law and modern standards/international expectations.

Perhaps the most difficult part of this exercise was determining the objective standard against which a specific issue should be measured. In some cases, such as that of intellectual property, definitive international standards exist against which local laws were measured. On other issues, no specific international standards exist, leaving to the subjective experience of the consultants the task of defining the generally applicable standard. In some cases there is no specific standard and local laws were evaluated on the basis of sound policy, how effectively they define a clear and logical legal frameworks for business, and the degree of protection they provide to investors.

3. Methodology for Establishing Priorities

Once specific obstacles were identified and recommendations made, the Scope of Work tasked the team with prioritizing obstacles according to their importance to trade and investment in Guatemala. No specific criteria for establishing those priorities were provided in the Scope of Work, so the team created the following classification system and criteria for ordering priorities.

<u>Category</u>	<u>Criteria</u>
Urgent	includes problems which require immediate action to prevent a substantial decline in existing levels of trade and investment .
Priority	includes those legal and regulatory constraints which should be removed to provide the greatest incremental benefit to trade and investment in the

country or which will severely limit Guatemala's ability to expand trade and investment in the future.

Important differs from Priority Category by degree, includes those constraints which will provide substantial benefits to the economy and/or which will limit future expansion of trade and investment.

Valuable constraints which should be removed from the legal and regulatory framework to conform to modern legal principles, but if continued will not markedly affect levels of trade and investment in the country.

In addition to the priority obstacles identified, there were several other obstacles of a general nature that should be addressed. The team classifies those as general or systemic obstacles and mentions only those that are priority for Guatemala's trade and investment framework.

II. PROPERTY RIGHTS

A. PERSONAL PROPERTY OWNERSHIP

1. Limitations on Ownership and Alienation

There are no significant limitations on ownership of personal property. Subject to the general problem that the judicial system does not provide quick and predictable remedies, rights in personal property benefit from legal protection. Expedited process is available to recover personal property if the relevant rights are clear. There are no significant limitations on the ability to alienate personal property. There are no significant limitations on the ability to alienate corporations by transfer of corporate shares. See the discussion of corporation law below.

2. Limitations on pledging or hypothecation of personal property.

In order to use personal property as collateral, it must first be registered. However, property that cannot be identified clearly in writing cannot be entered on the registry, and therefore can only be used as collateral if the secured party obtains possession. Generally, for collateral that is registered, the grant of security interests must be accomplished by public deed. However, this rule is not formally applicable to personal property collateral, although in practice secured lenders insist upon public deeds. The costs involved in this procedure include any stamp duty (ended by the new law, which abolishes the stamp duty on loans as of July 1, 1992) and a notary fee of 1% of the amount secured. We understand that the 1% notary fee is sometimes reduced by negotiation with the lawyer/notary.

3. Rights of secured creditors

The essential right of a secured creditor is the ability to appropriate or cause to be sold the collateral upon a default, and apply the value of the collateral to repayment. Under Arts. 880-916 of the Commercial Code, creditors are generally unable to appropriate the collateral through self-help mechanisms, as would be possible for example in the U.S. In Guatemala, the judicial procedure to exercise rights in collateral takes a full year if things go well. The debtor may delay or frustrate the proceedings further through various tactics. First, the debtor may induce a confederate to bid for the collateral in the judicial auction, and then default on its agreement to purchase the collateral, thereby requiring the procedure for judicial auction to be repeated. Second, because of the availability of bearer shares in *sociedad anonimas*, the debtor can transfer the ownership of collateral to an unknown corporation, frustrating the creditor's efforts. See the discussion of bearer shares in connection with corporations below.

Recommendation: The financial system would be greatly improved, allowing more reliable and accurate financing, if personal property security interests were

protected more reliably and more quickly. The reform of these laws to do so is an important priority. The reform process would require a comparative law analysis of other systems in order to determine how these systems provide better protection for secured lenders, without compromising procedural due process and other values.

4. Limitations on leasing of personal property

The leasing of personal property is not yet popular in Guatemala. One reason for this, especially in the area of equipment leasing, is the inability of creditors to obtain a security interest in leased property.

Recommendation: In connection with the reform of personal property security interests law recommended above, provisions should be made to facilitate the growth of secured lease financing of equipment.

B. REAL PROPERTY OWNERSHIP

1. Limitations on ownership of real property

Real property ownership rights are protected under Arts. 39 and 41 of the Constitution. There are limitations on ownership by foreigners of beach, riverfront, lakefront and border property, as well as hydroelectric resources, under Arts. 121(b) and 122 of the Constitution. Foreigners require special dispensation under Art. 122 to own these types of property. Ownership of border property is limited to native born Guatemalans under Art. 123 of the Constitution. Rights to resources under the soil are limited under Art. 121(e) of the Constitution.

Recommendation: Limitations on ownership rights generally should be re-evaluated, assuming that a constitutional amendment is possible or somehow avoidable. Specifically, the limitation on ownership of subsoil resources may diminish incentives to invest in the extraction of these resources; this issue should be investigated further.

2. Problems with registry

Ownership of land must be registered¹, but much land is registered in the incorrect name, or in two or more different names, for several reasons. First, the concept of adverse possession may result in occupants of land obtaining ownership rights that are not reflected on the registry. This is a significant problem in the countryside. Second, the registry sometimes fails to cancel the registration of ownership of one person before registering ownership of a second. Finally, the registry fails to require reliable measurement of the land registered. No land survey is required, unless only part of a parcel is transferred. These shortcomings make it harder to enforce rights, and create uncertainty as to actual ownership.

Recommendation: the registry's procedures and searching techniques should be improved to provide reliable and accurate reports of ownership. This is critical to real property investment, protection from land degradation and financing. Most developed countries have perfected systems of real property ownership registration; Guatemala should examine these systems to see which is most compatible with its legal system, and adapt it to local use.

3. Limitations on alienation of real property

The right to alienate real property is protected under Art. 39 of the Constitution. However, at present, there are several fees that are required to be paid in connection with the transfer of real property. Prior to July 1, there is a 3% stamp duty, plus a transfer tax of 1%, plus a fee paid to the public registry, plus a notary fee of 1%. After July 1, there will only be a 7% IVA (VAT) plus the notary fee. While the 7% IVA will be deductible from income taxes, it is still a considerable burden on transfers of real property. We understand that alienation of real property can be effected fairly quickly--within approximately two weeks.

Recommendation: the effects of the 7% IVA on transfers of real property will probably be negative, diminishing the market for real property and diminishing the extent to which real property can be allocated to the most efficient uses. The propriety of applying the IVA at this rate to real property transfers should be reconsidered.

4. Limitations on mortgaging of real property

A significant limitation on mortgaging real property is the present statutory right of the mortgagee to require repayment in the event that the value of the property mortgaged declines below the amount owed. This right can be modified by contract; therefore no legislative change is probably required.

Another significant limitation is the right of a debtor to request the creditor to divide his encumbrance between two or more lots. The creditor is required to respond reasonably to any such request. Civil Code 822.

Recommendation: This rule, and other requirements that the creditor assign its debt to particular assets pledged, substitute an objective standard of reasonableness for freedom of contract in this area, and probably should be revised.

Only banks may limit by contract the right of the debtor to grant second mortgages or to make transfers of mortgaged property; other creditors cannot.

Recommendations: Freedom of contract should be permitted, in order to allow

creditors in addition to banks to control debtors' grants of second mortgages.

5. Quality of ownership of real property--incentives to land degradation

Other than as mentioned under other categories, owners of real property appear to have sufficient rights of ownership. Poor enforcement of zoning and construction restrictions may demean the value of real property located near non-conforming properties.

6. Leasing regulation

There is no rent control applicable to commercial properties; rent control is applicable to residential properties that lease for under Q1000 per month.

III. INTELLECTUAL PROPERTY OWNERSHIP¹

A. Patents

The Guatemalan law of patents is contained in Law 153-85 (the "Patent Law"). The law provides for obtaining patents on both products and processes. Utility models and industrial designs are patentable under the Patent Law.

1. International Conventions

The U.S. Model Annex Agreement Concerning the Protection and Enforcement of Intellectual Property Rights (the "US IP Agreement", a copy of which is appended to this report) requires adherence to the Paris Convention of 1967. The draft Agreement on Trade Related Aspects of Intellectual Property Rights, Including Trade in Counterfeit Goods, distributed by the GATT secretariat in December 1991 ("TRIPs"), requires compliance with portions (Arts. 1-12, 19) of the Paris Convention.

Recommendation: The Paris Convention confirms national treatment, provides rights of priority to facilitate international filings, provides rights to import goods and not to work a patent locally, provides limitations on mandatory licensing, etc. Guatemala should consider acceding to it.

2. Exclusions from Patentability

The following types of products and processes are excluded from patentability under Art. 2 of the Patent Law:

- a. Computer programs.
- b. Vegetable variety and animal breeds (but not microbiological procedures and products).
- c. Discoveries of nature--scientific and mathematic theories.
- d. Commercial and financial systems or plans.
- e. Surgical or therapeutic methods.
- f. Foods and drinks, but not processes for production.
- g. Contrary to public order and morals.
- h. Chemical compounds, but not related processes.

¹ Enclosed herewith is a copy of a recent article regarding Mexico's intellectual property laws, outlining some of the concerns raised by the U.S., and some of the solutions implemented with the 1991 industrial property law, G. Peimberton and M. Soni, *Mexico's 1991 Industrial Property Law*, 25 Cornell International Law Journal 103 (1992).

These exclusions are inconsistent with Art. 7 of the US IP Agreement, as well as Art. 27 of TRIPs. TRIPs Art. 27 would permit exclusions along the lines of (b.), (e.) and (g.) above. Under Arts. 65 and 66 of TRIPS, grace periods are provided of 5 years for developing countries, and 10 years for least developed countries.

Recommendation: The above limitations on the types of products and processes that may be patented should be carefully revised to comply with international standards.

3. Term of Protection

Patent rights last for 15 years from the date of application, except that certain items are protected only for 10 years: chemical compounds, processes for foods, drinks, medicines and farming chemicals, and utility models.

Recommendation: The US IP Agreement and TRIPs require at least 20 years of protection from the date of application. Terms of protection under Guatemalan law should be extended consistent with international standards.

4. Requirements for protection

Under Art. 3 of the Patent Law, any product or process sought to be patented must satisfy the requirements of novelty, non-obviousness (inventive level) and utility (industrial application). The requirement of novelty is satisfied if there is no previous state of the art. State of the art includes all publication, in Guatemala or abroad, before the date the foreign applications given priority under Art. 16, described below, are filed. For these purposes, publications by the applicant within one year prior to application are disregarded. Under Art. 16 of the Patent Law, the applicant may, under applicable treaties, claim priority. Priority means that his application in Guatemala will be treated as filed on the same day, within three months, that his foreign application was filed. The U.S. is entitled to this priority under the Buenos Aires Convention of 1910. Such retention of priority would be available more generally if Guatemala were a party to the Patent Cooperation Treaty (1970) or Paris Convention. As noted above, the US IP Agreement requires adherence to the Paris Convention. Under Art. 4(b) of the Paris Convention, the novelty criterion would not be satisfied if the invention were worked or published in Guatemala or worked abroad before an application is filed in Guatemala.

Recommendation: As stated above, Guatemala should consider acceding to the Paris Convention.

5. Procedure to Obtain Protection

Under Art. 4 of the Patent Law, only the inventor can file for a patent, but the inventor is entitled to transfer the right to file. If two people have invented the same product

or process, the first to file obtains the valid patent under Art. 5. We understand that certainty of patent protection suffers from delays at the registry.

Recommendation: Enhance speed of processing at registry.

6. Right to Assign Patent

Under Arts, 30 and 32 of the Patent Law, patent rights are assignable, subject to compliance with applicable formalities, including registration with the registry.

7. Scope of Protection

Under Art. 30 of the Patent Law, the holder of a valid patent is entitled to prevent production, import, trade or use of the relevant good or process, or of goods produced using a patented process. Under Arts. 30 and 33, the patent-holder may not prevent imports until he has begun to work the patent in Guatemala.

Recommendation: The requirement for working in Guatemala prior to protection from imports should be eliminated, as it discriminates against patent-holders who wish to manufacture abroad, and is inconsistent with Art. 7(2)(a) of the US IP Agreement. In addition, Art. 7(1)(b) of the US IP Agreement and Art. 34 of TRIPs require that under some circumstances the burden of proof with respect to whether a product was produced using a patented process must be on the alleged infringer. Guatemalan law places the burden of proof on the patent holder. This feature of Guatemalan law should be revised.

8. Use Requirement

Under Art. 40 of the Patent Law, patent protection expires if the patent is unused in Guatemala for 6 years (5 years for utility models under Art. 49). In addition, patent protection expires if the patent is unused in Guatemala for any period of two consecutive years.

Recommendation: Art. 7(1)(c) of the US IP Agreement provides that a patent may be revoked only on grounds that would have justified a refusal to grant the patent. In order to comply with this provision, and in order not to discriminate against patent holders that manufacture abroad, Guatemala should delete this provision regarding expiration for non-use.

9. Compulsory Licensing

The Patent Law provides for compulsory licensing under several provisions:

- (1) Art. 34 provides for compulsory licensing due to the patent-

holder's failure to license on a reasonable basis. It provides the compulsory licensee the right to exclude original holder. The compulsory license cannot be sublicensed.

- (2) Art. 35 provides for compulsory licensing due to failure to work the patent in Guatemala for 4 years from grant, or insufficient application procedure. Under Art. 37, these compulsory licenses are revoked where the original holder works the patent in Guatemala, unless the compulsory licensee has made investments or begun use.
- (3) Art. 38 provides for compulsory licenses in the public interest.
- (4) Art. 36 provides for compulsory licenses to support dependent patents.

Recommendation: Under Art. 7(6) of the US IP Agreement, compulsory licensing is only permitted in order to remedy violations of competition laws, to address a declared national emergency, or to enable compliance with air pollutant standards, if essential. If granted, such a compulsory license must be non-exclusive, and must provide for compensation to original owner. Compulsory licensing is also strictly disciplined under Art. 31 of TRIPs. In order to comply with these provisions, and in order not to discriminate against patent holders that manufacture abroad, Guatemala should eliminate its provisions for compulsory licensing for failure to work and for failure to license on reasonable terms.

B. Trademark

Guatemala is party to the 1968 Central American Agreement for the Protection of Industrial Property ("CAAPIP"), which abrogates laws of its member countries, establishing uniform law regarding trademarks, trade names and slogans. Guatemala is also a party to the 1929 General Inter-American Convention for Trade Mark and Commercial Protection of Washington (the "Washington Convention"), as is the U.S.

The US IP Agreement requires adherence to the Paris Convention. TRIPs requires compliance with portions (Arts. 1-12, 19) of the Paris Convention.

Recommendation: As stated above, Guatemala should consider acceding to the Paris Convention.

1. Registration

Protection is provided based on registration with the registry of industrial property, rather than use. Registration in Guatemala results in priority in other Pan American Convention members for 6 months. There is no requirement of Guatemalan domicile to register. The trademark can be in any language, and there is no requirement for linking marks (*vinculada*). Registration takes 9 months to one year.

Recommendation: Article 6(3)(a) of the US IP Agreement provides that protection should be acquired by registration or use. Registration should be accelerated in order to provide certainty, allowing publication at the same time as searching.

Art. 10 of CAAPIP provides a number of types of marks that may not be registered. Included are the following:

- (1) generic names, bottles commonly used, simple indications of origin;
- (2) marks already registered or that would cause confusion or would deceive the public.

Recommendation: Art. 6(3)(d) of US IP Agreement requires protection of "notorious" trademarks--those promoted in international trade--from registration by speculators or competitors. Art. 6bis of the Paris Convention would impose a similar requirement. We are advised that the language in clause (ii) above might be interpreted to provide this protection. Art. 7 of the Washington Convention requires Guatemala to provide some protection for "notorious" trademarks. In addition, efforts are being made to provide more specific protection to these "notorious" marks. Art. 6(1) of the US IP Agreement seems to require that all other marks be registrable, although Art.3 of the Washington Convention permits most of the exclusions from protection. Art. 10 of CAAPIP should be evaluated for conformity with the US IP Agreement. We understand that it is being applied to refuse registration for "notorious" trademarks.

2. Use Requirements and Compulsory Licensing

CAAPIP contains no requirement of use, and no compulsory licensing or sanctions for non-use.

Recommendation: In the case of "notorious" trademarks, speculation may be reduced by a use requirement; the U.S. appears to advocate such a use requirement, although other methods might be used to protect "notorious" trademarks.

Producers of the following types of products are required to register and use marks for such products: pharmaceutical, chemical, medicinal, veterinary and food products.

3. Protection after Registration

Under Art. 26 of CAAPIP, the owner of a registered mark has the right to:

- (a) oppose registration by others;
- (b) require cessation of unlawful use or imitation;
- (c) require import bans on goods that carry the mark

- (d) (blocking parallel importation--imports of goods carrying the same mark, legally affixed abroad);
- (d) obtain compensation for infringement;
- (e) require confiscation of infringing goods in appropriate cases.

4. Term of Protection

Protection is provided for 10 years, renewable indefinitely.

5. Scope of Protection--Different Goods

CAAPIP divides goods into 42 classes, requiring a separate registration for each.

Recommendation: TRIPs would apply Art. 6bis of the Paris Convention, mutatis mutandis, to dissimilar goods or services, where use would indicate connection. The result would be to provide some protection against use for dissimilar goods or services, even if registration were only for a single class of goods.

6. Ability to Assign or License Rights

The owner of the mark must register any assignment or license.

7. Enforcement

Guatemala provides extensive scope for enforcement under its unfair competition rules. It is also possible for injured parties to sue under CAAPIP.

C. Copyright

Copyright is protected in Guatemala under the Constitution, Art. 42, as well as under Decree Law 1037 of 1954 (the "Copyright Law"). Guatemala is a party to the Inter-American Copyright Convention of 1946 (Decree 844) and the Universal Copyright Convention.

The US IP Agreement requires adherence to the Berne Convention; TRIPS requires compliance with Arts. 1-21 and Appendix of Berne Convention. The US IP Agreement also requires adherence to the 1974 Convention Relating to the Distribution of Programme-Carrying Signals Transmitted by Satellite.

Recommendations: Guatemala should consider adherence to these conventions, both for the reciprocal benefits it will obtain, and in order to provide a hospitable environment for foreign intellectual property. By providing a hospitable environment for foreign intellectual property, Guatemala can avoid

trade sanctions, and perhaps more importantly, can avoid economic distortions caused by the appropriation of these goods without payment.

1. Beneficiaries of Protection

The Copyright Law protects authors national of Guatemala or domiciled therein. Under Art. 20 of the Copyright Law, others are eligible for protection only under treaties.

Recommendations: This limitation on the availability of copyright protection should be eliminated, either *de jure* by amending the law, or *de facto* by treaty. The U.S. would benefit from such protection under the Universal Copyright Convention or the Inter-American Copyright Convention, thus satisfying the requirement under the US IP Agreement for national treatment. If Guatemala entered TRIPs, it would be required to provide most favored nation treatment to all other signatories.

2. Requirements for Protection

Art. 1 of the Copyright Law provides protection based on mere creation, without any need for filing. Works protected under the Copyright Law may not, without the authorization of the Guatemalan Association of Authors and Composers, a non-governmental body, be used publicly or with gainful intent.

Recommendations: This is both an advantage, and, within the legal context of Guatemala, a disadvantage. It is a disadvantage from the standpoint of respect for and enforcement of copyright. In the civil law system of Guatemala, most types of property require registration for protection. Without a requirement for registration, lawyers and judges often fail to view copyright as a full property right. Guatemala should consider whether to introduce a registration system, but perhaps the better route would be to engage in an education program for lawyers and judges regarding copyright protection.

3. Scope of Protection

The Copyright Law protects literary, scientific and artistic works. It does not protect software, and we understand that there is widespread software piracy in Guatemala.

Recommendations: Software is included in literary works under Art. 2 of the Berne Convention. The US IP Agreement and TRIPS require protection of software as such, as well as protection of collections or compilations of data.

The Copyright Law provides moral rights under Art. 19, giving authors the right to oppose modifications prejudicial to their reputation. Translations and transformations are protected under Art. 17 of the Copyright Law, without prejudice to the protection of the

basic work. The Copyright Law provides the exclusive right to use the work or to authorize its use. It includes the right to prevent imports, even of copies that were lawfully made abroad.

4. Term of Protection

The term of protection provided under the Copyright Law is 50 years after the author's death. This satisfies international standards.

Phonogram Works. Guatemala is party to the International Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organizations (Rome Convention) of 1961, as well as the Convention for the Protection of Producers of Phonograms Against Unauthorized Duplication of Their Phonograms of 1971.

Cinematographic Works and Cable Retransmission of Satellite Signals. Guatemala has been the subject of reports of video and satellite piracy. We understand that the previously suspended law regarding cable retransmission is now in effect. We have not had an opportunity to analyze this law. This law grows out of a request made in July 1991 by the Motion Picture Export Association of America to the USTR to deny GSP benefits to Guatemala due to Guatemala's failure to provide adequate copyright protection. The US IP Agreement requires adherence to the Convention Relating to the Distribution of Programme-Carrying Signals Transmitted by Satellite (1974). It also requires the criminalization of use, manufacture, sale, etc. of decoders, and the civil prohibition of receipt or distribution of these works.

D. Trade secrets

It is a crime to reveal another person's trade secrets under Penal Code Art. 355. It is also just cause for firing employees.

1. Definition of Trade Secrets

Trade secrets include any secret of industry or commerce. Employees and others have a duty not to disclose these secrets.

2. Penalties

Criminal penalties are provided.

3. Injunctive relief

Injunctive relief is available under Guatemala's unfair competition law. Commercial Code Art. 367 empowers judges to issue injunctions in these matters. The injunction can

order any person to suspend any act, or sequester the infringing goods.

E. Semiconductor chip design

At present, Guatemala offers no protection for semiconductor chip design.

Recommendation: Semiconductor chip design is required to be protected under the US IP Agreement and under TRIPs. TRIPs requires compliance with Arts. 2-7 (other than 6.3), 12 and 16.3 of the 1989 Treaty on Intellectual Property in Respect of Integrated Circuits.

IV. CONTRACTS AND SALES

A. Contracts

There are no special formalities required for formation of contracts in Guatemala. However, contracts to be performed locally are required to be in Spanish.

Recommendation: Delete the requirement that local contracts be in the Spanish language.

Guatemala appears to have a typical civil law contract system, with provisions of the civil code responding to most important issues, such as mistake of fact, frustration, etc. In general, Guatemalan contract law, perhaps like other civil law systems, is more formal and less inclined to take economic efficiency into account than U.S. contract law.

The enforcement of contracts relates to the general problems encountered with the Guatemalan judicial system. In the case of a clear contract right, expedited procedure is available. If there is some factual or interpretative question, the normal judicial procedure is followed. The measure of damages for breach is often not clear. However, the process can be extremely protracted and time consuming, even for small cases.

B. Sales

1. General

Guatemala has a number of provisions, set forth in the commercial code, relating to the law of commercial sales. These provisions are not very detailed, compared to U.S. law of sales, but they are probably adequate. Specific definitions and requirements may be modified by contract, so no particular statutory changes are necessary.

2. Adhesion to U.N. Convention on International Sale of Goods

Guatemala has not adhered to this convention, which provides a uniform law of commercial sales in international transactions. This uniform law would enhance the certainty available for merchants.

Recommendation: Guatemala should consider adhering to the U.N. Convention on International Sale of Goods.

3. Agency Agreements Law

This law regulates contracts with agents, distributors or representatives. This law is frequently criticized as making it difficult to terminate agency relationships. Contracts

appointing agents, distributors or commercial representatives must be notarized. The agent must be a local domiciliary. It is not clear whether the law is applicable only to exclusive agency agreements, or whether it also applies to non-exclusive agency agreements.

Art. 3 of the law provides that an agency agreement may only be terminated or rescinded (i) by mutual agreement, (ii) due to expiration of the term, (iii) for just cause (as defined), (iv) by the agent on 3 months notice, and by the principal upon payment of damages under law. Damages are not required to be paid if the termination is for just cause or due to expiration. Art. 6 provides the measure of damages payable to the agent. The damages are equal to the sum of the following: (i) reimbursement of all expenses of promotion and investment, plus (ii) 50% of gross profit that could have been earned on unsold goods held by the agent, plus (iii) the warehouse purchase price of all unsold inventory, plus (iv) an amount equal to the gross profits earned by the agent during the last 3 years, plus (v) an amount equal to the indemnification required to be paid to employees of the agent who are fired due to the lost business.

Art. 8 provides that the principal cannot employ a new agent until it makes the required payment, or posts a bond therefor. It is unlikely that the operation of this law can be excluded by a contractual choice of foreign law.

Recommendation: This law is unnecessary, assuming agents have the sophistication (and perhaps bargaining power) to negotiate termination terms in advance. In general, we recommend the elimination of this law, in order to let these issues be addressed contractually by the parties, or if they fail to do so, by general principles of damages for breach of contract. On the other hand, general principles of damages for breach of contract are not very clear, and this law provides some clarity. If the law is not eliminated, Art. 8 should be eliminated, as it places too much disruptive power in the hands of the agent.

V. COMMERCIAL FINANCING

There does not appear to be today a highly developed market in commercial instruments. This gap impedes commercial and trade financing.

a. Credit instruments

Art. 385 *et. seq.* of the Commercial Code provides for credit instruments. It lists certain types of credit instruments that may benefit from enforcement by expedited process. It is not clear whether this is an exclusive list, or whether other types of credit instruments may be used. Presumably, given the constitutional principle that whatever is not forbidden is permitted, others may be used, but may not benefit from these provisions. While floating rate credit instruments, such as *pagarese*, are permitted, Art. 2 of the Monetary Law prohibits foreign currency credit instruments; this is a significant limitation.

b. Asset-Backed Financing

Other than with respect to mortgage-backed bonds issued by a public body, there does not appear to be an asset-backed financing market. It is not clear whether the credit instruments law would support such a market.

VI. CORPORATION LAW

A. Types of Guatemalan companies

Guatemalan law permits the formation of various types of companies, including civil companies (under the civil code, and mainly for non-commercial purposes) and mercantile companies (under the mercantile code). The main type of company used for local or foreign investment is a type of mercantile company, the Sociedad Anonima (SA). This type of corporation contemplates multiple shareholders, who are not necessarily involved in the business. It is more or less analogous to a normal U.S. corporation. There are no Guatemalan corporate entities that provide "flow-through" taxation similar to a U.S. partnership or Subchapter S corporation, with no taxation at the corporate level and all tax incidents flowing immediately to the shareholders. Thus, corporate level taxation is the price paid in Guatemala for the benefits of incorporation (largely limited liability), although Guatemala limits the possibly resulting double taxation by providing an exception from taxable income for corporate dividends received, when the paying corporation has paid income tax on the income giving rise to the dividend.

B. Branches of foreign companies.

1. Approval Process

Branches of foreign companies (as opposed to locally-incorporated subsidiaries of foreign companies), are disadvantaged in several ways. First, a foreign or local investor acting through a locally-incorporated subsidiary can begin to engage in business almost immediately. He may do so by seeking provisional inscription of the registration of his local corporation, which takes approximately 1.5 weeks. No similar expedited process is available in order to obtain authorization to operate through a Guatemalan branch (Art. 352 Commercial Code). Such authorization, plus the additional time needed to obtain the required approval of the Ministry of Government, requires a minimum of 10-12 months, assuming diligent prosecution of the application. In considering branch applications, the Minister of Government considers the needs of the Guatemalan economy, including the need to protect local investment from competition.

Recommendations:

- 1. Provide parity of treatment for foreign branch establishments with locally-incorporated subsidiaries, by allowing expedited provisional inscription of branches of foreign corporations. We understand that an initiative along these lines is in the works.**
- 2. Delete the requirement of Ministry of Government approval for entry of branches of foreign companies. This requirement is inconsistent with the lack of any similar evaluation and approval process for locally-incorporated subsidiaries**

of foreign corporations. It is also discriminatory against foreign establishment.

2. Substantive Requirements: Local Representation, Capital and Responsibility

Under Art. 215 of the Commercial Code, branches must (i) establish a local representative, (ii) establish local capital of at least Q5000, and (iii) support local operations with worldwide assets. None of these is especially onerous or unusual. However, under Arts. 215(7) and 218, branches must satisfy or guarantee the satisfaction of all local obligations before closing their local operations. This seems an unnecessary constraint on honest businesses, and insufficient to restrict dishonest businesses. It is an unnecessary constraint on honest businesses, because in order to close their operations, they will be required to liquidate all their obligations, instead of satisfying them in the ordinary course of business.

Recommendation: Eliminate the requirement that foreign branches satisfy or guarantee the satisfaction of all local obligations before closing their local operations.

3. Substantive Requirements: Submission to Guatemalan Legal System

Under Art. 215(6) of the Commercial Code, a branch is required to (i) submit to the jurisdiction of Guatemalan courts and laws, and (ii) undertake that it will not invoke rights as foreign citizens. This "Calvo law"-type provision is intended to ensure that foreign businesses that enter Guatemala do so on the same terms as local Guatemalan businesses.

Recommendation: The second part of this provision should be deleted, as it is probably unacceptable to the U.S., and raises unnecessary concerns for foreign investors. The first part of this provision raises a different problem. Under Guatemalan contract and conflict of laws principles, a contractual choice of foreign governing law will be respected. The first part of this provision (and the similar language in Art. 220 with respect to activities of foreign corporations in Guatemala that do not require registration as a branch) appears to constitute an exception to this principle, limiting branches to contracts specifying Guatemalan law. In this regard it provides less flexibility to branches than it does to locally incorporated subsidiaries of foreign corporations. We recommend that it be revised to make clear that only Guatemalan public law governs the foreign corporation, but that in its contractual relations, the foreign corporation may select another governing law as fully as a locally incorporated subsidiary may.

4. Tax Treatment of Branches

Branches of foreign corporations are subject to normal IVA and income taxation under Guatemalan law. In addition, intracorporate remissions from the branch to the home

office will be subject to a withholding tax equal to the withholding tax on remissions of dividends from a subsidiary: 12.5%. One disadvantage of a branch as compared with a subsidiary is that a subsidiary may issue bearer shares, making its equity-holder unidentifiable, and thereby evade (illegally) the withholding tax on dividends.

5. Foreign Corporations that Do Most of their Business in Guatemala through a Branch

Corporations that are formed outside Guatemala, but which have their "seat of administration" or "principal object" in Guatemala, are subjected under Art. 213 of the Commercial Code to all of the provisions of the Commercial Code. This would make it very difficult, perhaps impossible, to use a single-purpose offshore subsidiary to do business in Guatemala. In effect, it requires companies with their seat of administration or principal object in Guatemala to incorporate in Guatemala. As such, it is similar to rules in other civil law jurisdictions, such as France or Germany.

C. Books

Art. 369 of the Commercial Code requires that corporate books be kept in the Spanish language, and be denominated in Quetzales. Branches of foreign corporations may keep a second set of books in another language and currency, with a column showing the conversion into Quetzales, with the permission of the Mercantile Registrar.

Recommendation: This provision may not be necessary at all, and may not be necessary as to branches of foreign companies. If it is retained, the requirement of permission of the Mercantile Registrar for maintenance of home country language and currency books should be deleted.

D. Establishment of a Local Corporation or Subsidiary.

Incorporators. It is necessary to have incorporators, who may also be the final shareholders, and who need not be Guatemalan people or corporations. If the incorporators are not to be the final shareholders, they must disclose under Art. 14 the identity of their principal.

Administrators (similar to directors under U.S. law). At least one is necessary to begin functioning, although he need not be appointed at the outset. Administrators may be foreigners and may meet abroad, although they may not take action without a meeting, at which some may be present by proxy. There is some ambiguity in the law, but at the moment, foreigners would not need labor department approval to serve as administrators, unless they have a separate labor relationship.

Shareholders. Foreigners may be shareholders of mercantile company under Art. 19 of Commercial Code. At least two shareholders are required; the second may be a nominee.

Legal Representative. At least one legal representative (administrator or manager) must be resident in Guatemala. This function may be served by a nominee. The legal representative is not required to be mentioned in the corporation's public deed.

Certificate of incorporation. The certificate of incorporation must be filed with the Mercantile Registry and is required to disclose certain information, such as the object of the corporation. The Mercantile Registry exercises virtually no substantive review of the certificates filed with it.

Capital SA's require a minimum of Q5,000. Not particularly important commercially, although important under law.

Stamp Tax. The Fiscal Stamp Tax of 3% of authorized capital was rescinded as of July 1, 1992 and replaced by a flat fee of Q 250.

Local Office. No local office is formally required.

Time. Other studies indicate that incorporation takes 6 months to 1 year. This delay is not a problem because of the availability of provisional authorization, which is usually available within 1.5 weeks, and which provides all authorization necessary to begin to engage in business. In addition to provisional authorization, a tax identification number is required, which usually takes approximately one month to obtain. Final corporate authorization is usually available within 4 months, if the application is prosecuted diligently.

Recommendations: Provisional (or even final) authorization, and allocation of tax identification number, should be accelerated--insofar as they do not seem to involve any substantive examination, they should be made available virtually immediately. The proposed Ventanilla Unica for Investment should accomplish this.

E. Administrators

We have mentioned above some of the issues regarding administrators. Here we deal solely with their duties. Administrators of SA's have a duty of loyalty and a duty of care. Under the duty of loyalty (Arts. 169-170 of the Commercial Code), administrators must disclose their income from other businesses, and abstain from participation in decisions regarding conflict of interest transactions. Under the duty of care, administrators are generally liable for any losses caused by their fault, for payment of dividends when there are insufficient profits, for errors in corporate accounts and for failure to comply completely with corporate resolutions. There is no practice of providing for indemnification of administrators for any of these liabilities, and there is no practice of providing or obtaining insurance against these liabilities.

Recommendation: As Guatemala's corporate sector and capital market grows, these expressions of the duty of administrators will become increasingly inadequate, and will require greater specificity. In addition, as the capital market grows, assuming a more efficient and accessible civil legal system, there will inevitably be more circumstances in which shareholders and others will sue administrators. Although it is not urgent, it might be appropriate to begin to consider revision of these provisions.

F. Shares and shareholders.

A Guatemalan company may have several classes of shares. If a SA has preferred stock, the holders are entitled to a dividend of at least 6% of their capital under Art. 131 of the Commercial Code. Preferred stock is not widely used.

Recommendation: Eliminate this unnecessary imposition on freedom of contract. In deflationary times, 6% may be too much; more importantly, for preferred stock that may be convertible into common stock, 6% may also be too much.

G. Rights to dividends

SA's must make up any loss of capital and must realize sufficient additional profits in order to pay a dividend. In addition, they are required to establish a reserve with 5% of net profits annually, which may be added to capital once the reserve reaches an amount equal to 15% of capital, under Arts. 36-37.

Recommendation: As capital is generally small to start, this has the result of requiring capital to be built over time. Although it is not terribly onerous, it is probably appropriate to eliminate this requirement for reserves, and allow businesses to make their own decisions as to the level of reserves necessary.

H. Limitations on alienation

There are no effective restrictions on the sale of corporations or their shares. However, one interesting restraint on alienation is the restriction on companies buying their own shares. This restriction limits the ability to establish an open-end investment company industry where the investment company would redeem its own shares. This restriction arises under Art. 111 of the Commercial Code and by virtue of the fact that any reduction of capital requires shareholder approval, making such redemption impractical.

Recommendation: As part of Guatemala's development of its capital market, any constraints on the development of a mutual fund or investment company industry should be removed, including these constraints on the ability of such a company to redeem its shares from investors.

I. Bearer Shares

Guatemalan corporations may issue shares in bearer form, meaning that the shares may be transferred by delivery and, more importantly, that there is no official record of the ownership of shares.

Recommendation: The possibility for bearer shares should be eliminated, for several reasons. First, bearer shares can be used to hide ownership of assets and receipt of income for tax purposes. Second, bearer shares can be used to hide assets and income from creditors. Finally, bearer shares can be used to hide ownership of assets for political purposes--a corrupt politician or bureaucrat could own a corporation's bearer shares without any public knowledge, allowing the politician or bureaucrat corruptly to favor the company.

J. Mergers and Acquisitions

Mergers and acquisitions is not yet a highly developed practice in Guatemala, with few acquisitions of public companies.

Recommendation: As the Guatemalan corporate sector develops, mergers and acquisitions will become increasingly frequent and important, both as possible areas of abuse and as tools of competitive discipline on corporate management. During this development, consideration should be given to providing more specific regulation of the merger and acquisition market, in order to prevent abuse and facilitate discipline.

K. Capital Structure

Guatemala's tax system has an effect on the choice that a corporation makes between financing through debt and financing through equity. Generally, as in the U.S., there is a tax preference for debt over equity. As of July, 1992, neither loans nor capital are subject to the 3% stamp tax. From July 1, 1992, all receipt of interest will be taxable as income to the recipient, while the payment of interest will be deductible to corporations. The one exception is for interest paid to foreign lenders under certain circumstances. If a Guatemalan company borrows foreign currency abroad and brings it back to Guatemala and converts it to Quetzales, interest payments to the foreign lender will not be subject to Guatemalan income or withholding tax. Otherwise, the withholding tax on foreign payments of interest is 12.5%. Corporations may generally deduct from their taxable income all payments of interest. While corporations may not deduct from their taxable income the dividends that they pay, the shareholder is not required to pay income tax on dividends, where the corporation has already paid income tax on the corporate income that gave rise to the dividend.

Recommendation: The differential treatment of equity is not unusual, and

provides less disparity than the arrangement in the U.S., where corporate income paid to shareholders in the form of dividends is generally taxed twice. As Guatemala's foreign exchange circumstances improve, with more flight capital repatriated, it may be appropriate to apply the withholding tax on interest to all payments of interest abroad, in order to provide competitive equity between local lenders and foreign lenders.

L. Bonds

Because of an overly-restrictive legal regime, bonds *per se* do not play an important role in the Guatemalan capital market. Instead, bonds have been replaced by relatively unregulated *pagarese* (issued under the rules of the Bolsa de Valores) as a non-bank, non-investment company source of debt finance.

Problems with Regulation of Bonds.

- SAs are not permitted to issue bonds in an amount in excess of their capital. As capital is usually kept low, this imposes a low ceiling on bond issuances, effectively precluding the issuance of bonds for all but the most highly capitalized companies.
- Under Art. 551 of the Commercial Code, issuers of bonds are forbidden to reduce their capital, unless they repay their bonds on a pro rata basis.
- Any assets that secure a bond must be insured.
- Other detailed requirements as to the financial arrangements regarding the issuance of bonds.

Recommendation: The law regarding bonds should be completely revised, removing all constraints on the financial arrangements between issuers of bonds and buyers of bonds. In place of this law, Guatemala should provide a modern securities law that covers bonds, including requirements for disclosure regarding the business of the issuer and the terms of the bonds. This change will encourage greater bond financing by allowing more flexibility in arrangements, and therefore more accuracy in financing.

M. Pagarese

These credit instruments comprise most of Guatemala's debt securities market. They are usually short-to-medium term, and most carry a floating interest rate. They are issued on the Bolsa de Valores, subject to the Bolsa's rules. They are usually issued without any representations or covenants (which would be normal in many developed country debt securities markets). In addition, they are issued without appointing any trustee or other representative of the security-holders.

Recommendation: The *pagarese* market merits further study, and probably

further regulation, along the lines described with respect to bonds, above. This market and other debt finance sources, such as investment banks and *financieras*, are discussed elsewhere in this report.

N. Securitization

Very little asset-backed financing or securitization is done in Guatemala, and none is in the stock market. Securitization is used in the mortgage finance area.

Recommendation: Further analysis should be performed to determine whether greater securitization would be beneficial and feasible in Guatemala at this stage.

O. Dissolution

Under Art. 237 of the Commercial Code companies must dissolve if they lose more than 60% of their paid-in capital, as well as under certain other circumstances.

Recommendation: This provision should probably be deleted, as it is a relatively arbitrary determinant of the viability of the company. On the other hand, given the relatively minor role of capital, and given the likely interpretation that the company must have 60% of its capital impaired, after using up its reserves, this is not a high priority for amendment.

VII. BANKRUPTCY LAW

Guatemala's laws regarding corporate bankruptcy are rarely used. There are two relevant reasons for their disuse. First, assuming that competition is not robust, but is constrained by various anticompetitive practices, significant corporations would not normally fail. Second, we were told that the bankruptcy procedures described below are too bureaucratic and time-consuming to be practical.

Recommendation: Once a more competitive system is established, an efficient and predictable bankruptcy system will be an important component of Guatemala's financial system, assuring both debtors and creditors of their rights and thereby encouraging investment.

A. Procedures.

1. Composition is a debt restructuring procedure which may or may not involve judicial intervention. It depends on acceptance by all creditors and the debtor.
2. Bankruptcy results if agreement on a composition of the debtor's debts cannot be reached.
3. Bankruptcy involves the setting of a date for cessation of payment by the debtor, and the issuance of an order to other courts to suspend proceedings. These are intended to conserve the debtor's assets. A supervisory commission, receiver and appraisers are appointed, and the court issues an order to the receiver to take over all properties of the debtor.
4. Creditors' meetings can agree to release or reduce debts, based on voting majorities that increase with the size of the reduction of claims.

Recommendation: This procedure should be reviewed against other bankruptcy laws to determine whether it provides the desired mix of incentives for compromise and certainty of result.

B. Preferential or fraudulent transfers.

Under Guatemalan law, the following types of transfers are voided:

1. Gratuitous transfers (including mortgages or pledges) of property within 10 days prior to bankruptcy are voided. The 10-day reach-back is expanded to 120 days prior to cessation of payments for relatives. Any prepayment of debts is included as a gratuitous transfer.

Recommendation: Transfers for less than fair value (as opposed to gratuitous ones) are not subject to attack under this provision (they may be attacked under a separate civil procedure for revocation), but should be.

2. Debts and contracts entered into after the date set for cessation of payments can be voided, if the counter-party knew of the suspension of payments.

C. Rights of secured creditors

Secured creditors may exercise their rights as such in forced composition or bankruptcy. Secured credits become mature in bankruptcy. This rule may jeopardize the success of a composition.

D. Speed; cost of procedure

This is the critical problem: bankruptcy procedures are too slow, and may be too expensive, to provide a realistic alternative. In one case (Ingenio Salto), the bankruptcy proceedings took longer than 10 years. In addition, the bankruptcy court may take 10% of the debtor's assets for the expenses of the process.

Recommendation: As noted above, Guatemala should review its bankruptcy laws to facilitate financing, by providing predictability, fairness and speed to both creditors and debtors.

VIII. LABOR LAW

Guatemala's reputation for having a hard-working, highly-trainable labor force is one element of a relatively attractive trade and investment environment. On their face, employment statistics indicating unemployment rates of approximately 7% appear to indicate a relatively stable work force. Other statistics, such as an underemployment rate of between 50 and 60% and the low levels of union participation indicate simmering problems which could affect Guatemala's economic growth (Boletín de Estadísticas del Trabajo, Año 1990).

Labor law in Guatemala consists of local laws, such as the Constitution, the Labor Code, and other specialized laws, and international Conventions of the International Labor Organization ("ILO") to which Guatemala has acceded. Under the Guatemalan Constitution, standards established in international or regional agreements or treaties executed by the GOG are incorporated automatically into the national laws of the country. The problems with the Guatemalan labor framework are integration of national laws and international standards, modernization, and enforcement.

The content and application of labor laws directly affects trade and investment to the extent it raises or lowers the cost of production of Guatemalan products and affects their competitiveness in domestic and international markets. A more direct link to trade exists under U.S. laws which grant conditional preferential treatment to Guatemalan-produced imports. U.S. legislation which establishes the Generalized System of Preferences ("GSP") and Caribbean Basin Initiative ("CBI") permits the United States Trade Representative ("USTR") to grant and continue preferential tariff treatment of goods only if the conditions specified in legislation are met. Preferential tariff treatment can be rescinded for failure to comply with labor-related conditions contained in the legislation. The rescission of Guatemala's tariff benefits on exports to the U.S. represents perhaps the greatest potential obstacle to increased trade and investment in Guatemala. This section of the report examines the workers' rights standards required by GSP/CBI legislation and other issues, such as compensation and treatment of foreign workers, that affect trade and investment in Guatemala.

A. GSP/CBI Treatment for Guatemalan Products

Guatemalan exports receive preferential tariff treatment under the GSP and the CBI, giving some Guatemalan exports a competitive advantage in the U.S. market vis-a-vis products from non-qualifying countries. This treatment has been an essential condition of Guatemala's recent expansion of non-traditional exports. Guatemala's continued preferential status is reviewed annually by the United States Trade Representative ("USTR") to determine whether the country continues to meet the criteria for preferential treatment established by U.S. law.

Parties opposing continued preferential status for Guatemala, or other countries, may present petitions requesting a review of a country's labor practices. If the petition for review

is accepted, the USTR conducts an extensive investigation and determines whether the violations are serious enough to merit revocation of a country's GSP status.

Protection of "internationally recognized worker rights" is a condition of continued status as a GSP beneficiary-country. As defined in the statute, those rights include:

- 1) the right of association;
- 2) the right to organize and collectively bargain;
- 3) a prohibition on the use of any form of forced or compulsory labor;
- 4) a minimum age for the employment of children; and
- 5) acceptable conditions of work with respect to minimum wages, hours of work, and occupational safety and health.

This year, for the seventh consecutive year, a coalition of labor and human rights groups filed petitions requesting that the USTR review Guatemala's labor practices. With the exception of the first, the USTR has consistently refused to accept for review petitions filed against Guatemala. Now, however, the USTR appears ready to accept the petitions and conduct an in depth investigation into the alleged violations of labor practices prohibited by the statute, creating a very real possibility that Guatemala, without taking prompt and effective action, could lose existing GSP/CBI benefits. The rescision of preferential tariff treatment looms as the largest obstacle to increased trade and investment in Guatemala. In fact, it would almost certainly result in substantial reductions in current levels of trade, causing reverberations throughout the Guatemalan economy.

Recommendation: Guatemala must take immediate steps to preserve GSP/CBI status by complying with internationally-recognized workers' rights as discussed specifically below.

The specific "international" standards of workers' rights are discussed below. At this point, one can only speculate as to the specific standards that the USTR would apply to Guatemala. In the past, the U.S. was willing to preserve GSP status if a country was "taking steps" toward correcting workers' rights abuses. It was on that basis that USTR refused to rescind Guatemala's GSP status when the first petition was accepted for review. Now, there is increasing pressure on USTR to apply objective, substantive standards in its reviews. The logical place to look for those standards is the ILO Conventions, especially those which Guatemala has ratified. The analysis below will focus on how well Guatemala is complying with the standards contained in Conventions to which Guatemala is a signatory.

Guatemala is one of 149 countries belonging to the International Labor Organization ("ILO") and has ratified 63 of the 172 Conventions promulgated by that organization, more

than any country in North or Central America except Mexico and Panama.² Guatemala ratified ILO Conventions establishing minimum standards for freedom of association and the right to organize (ILO Convention No. 87), the right to organize and bargain collectively (ILO Convention No. 98), forced labor (ILO Convention Nos. 29 and 105), minimum age of employment (ILO Convention No. 138) and minimum wages (ILO Convention No. 131). Guatemala has not ratified the most significant ILO Conventions (ILO Convention Nos. 155 and 148) related to occupational safety and work and the use of toxic substances and agents in the work place (ILO Convention Nos. 115 (Radiation), 136 (Benzene) and 139 (Occupational Cancer)).

The ILO has no enforcement authority, but special committees review annually signatory countries' compliance with each Convention. In addition, organizations and/or individuals can file petitions requesting the ILO to review specific violations of the Conventions by signatory countries. For more than a decade, the ILO review committees have encouraged Guatemala to amend its Penal Code to eliminate penalties of obligatory labor for persons imprisoned for expressing political opinions. In addition, during the past four years at least three cases have been filed against Guatemala. All involved the GOG's failure to protect workers' rights of association. In two of the cases, the ILO found that Guatemala had not acted in accordance with the applicable conventions.

To remedy some of the problems raised in petitions and to conform the Labor Code to the Conventions which Guatemala has adopted, the ILO assisted Guatemala to prepare a draft labor code in the late 1980's. That legislation was never enacted, however, and the inconsistencies persist.

Recommendation: Guatemala should conform the Labor Code to the standards established by ILO Conventions to which Guatemala is a signatory and ensure that all standards in the ILO Conventions and the Labor Code are rigorously enforced, especially in the area of workers' rights.

1. Workers' Rights

The Guatemalan Constitution establishes the "minimal social rights" to which all Guatemalan workers are entitled. These include: (1) the freedom to choose one's work, (2) the right to fair remuneration, (3) the right to a minimum wage, (4) the right to a fixed workday (day shift - 8 hours per day/44 hours per week, night shift - 6 hours/36 hours, and mixed shift - 7 hours/42 hours), (5) right to a vacation, holiday and annual leave, (6) right to an annual bonus, (7) protection of minors (under fourteen years of age), (8) preference for Guatemalan workers over foreign workers, (9) dismissal rights, and (10) the right to join trade unions. The Constitution also states that worker standards established in international

² Mexico has adopted 73, Panama 69, Nicaragua 58, Costa Rica 47, Belize and Canada 27, Honduras 20, United States 11, and El Salvador 6.

or regional agreements or treaties executed by the Government shall be considered part of minimal rights enjoyed by Guatemalan workers.

a. Right of Association

Guatemala's constitution guarantees workers the right to associate freely and to organize and bargain collectively. Those rights are reiterated more specifically in the Código de Trabajo which precludes derogation of the right by contract or law. Workers have traditionally organized as sindicatos, and more recently, asociaciones solidaristas in Guatemala.

i. Sindicatos

Sindicatos are employee-based and must be organized according to the procedures established in the Labor Code. The procedures contained in Title VI of the Labor Code for organizing and obtaining legal recognition for a sindicato are complex, requiring numerous governmental investigations and approvals before the sindicato can legally begin to function. Any change to the application during the process, such as substitution of the name of a director, has the effect of creating a de novo filing, requiring the approval process to begin again. The process requires final approval by the Minister of Labor.

The approval process has at times required more than a year. Evidence has been presented in petitions to the ILO and the USTR which allege that employers use the delays created by the extended process to engage in campaigns to discourage organization. These alleged tactics include everything from direct threats against organizers to payoffs to employees who agree not to join the union. The petitions also allege intentional delays by the Ministry of Labor in processing applications.

The Ministry of Labor acknowledges that delays in union approval process and selected the organization and freedom of unions as a major area for policy reform in 1991. During that year, the Ministry claims to have considerably reduced the time required to approve applications to organize unions.

The ILO Committee of Experts on Convention No. 87, the Freedom of Association and Protection of the Right to Organize Convention, have found that at least eleven separate provisions of the existing Labor Code are inconsistent with Convention No. 87. The inconsistencies relate to excessive government interference in the supervision of the formation and operation of unions, the prohibition against foreign workers participating as trade union leaders, and the excessive delays in registering unions.

ii. Asociaciones Solidaristas

Asociaciones solidaristas are formed as non-profit associations pursuant to Article 15 of the Civil Code, the general law governing the formation of non-profit organizations. To

establish a non-profit organization, the applicant must submit a notarized copy of its constitution and by-laws to the Ministry of Government which examines the documents to ensure that they conform to all formalities required by law. When all is in order, the Public Minister prepares the necessary Acuerdo Gubernativo and forwards it and the application to the President of the Republic for his consideration and signature. The signed document is then published in the Diario Oficial after which time the association can be recorded in the Registro Civil.

The time required to obtain approval for unions and solidarity associations is unacceptably bureaucratic and long. And, although not always, the time required to organize a solidarity association appears to be generally shorter than the time required to form a union. The extended approval time permits employers opposing the formation of a union or solidarity association to engage in actions designed to either shape the process to its favor or discourage workers from continue their efforts. It appears that some employers have attempted to subvert efforts to organize a union by forming solidarity associations.

RECOMMENDATION: In general, Guatemala should amend the Labor Code so that its provisions are consistent with ILO Convention Nos. 87 and 98. Specific areas for improvement include the establishment of expedited, nondiscriminatory procedures, for organizing unions and solidarity associations.

- a. **Organization procedures should serve a registry, rather than a screening function, providing the government with the essential information to monitor the union.**
- b. **The process should minimize governmental discretion and eliminate the requirement that a politically elected or appointed official grant final approval.**
- c. **Governmental involvement in the approval and supervision of unions should focus on preventing corruption and fraud in the operation of the union by requiring punctual reporting and transparent operating (election procedures, etc.) requirements, and providing strict penalties for noncompliance.**
- d. **Other issues that should be examined more completely include the GOG's ability under the Labor Code to limit the right to strike, penalties for participating in strikes, and strengthening of sanctions and enforcement against employers that unfairly interfere with formation of unions.**

b. Forced Labor

The principal issue raised in USTR petitions regarding Guatemala's use of forced labor is the GOG's practice of establishing civil patrols in rural areas. The practice has been denounced in these petitions as a form of forced labor. The allegations of forced work appear stronger in this year's petitions because they are bolstered by the findings of the U.S.

Department of State's report on human rights. Other allegations of forced labor relate to the alleged practice in some maquilas of locking employees in the factory until daily production quotas imposed by the employer can be completed.

Guatemala adheres to both ILO Conventions on forced labor. Convention No. 29 prohibits the use of forced labor by a signatory country but makes five exceptions: compulsory military service, certain civic obligations, prison labor, work exacted in case of emergency and minor communal services. Convention No. 105 undertakes to suppress any form of force labor in five defined cases: 1) as a means of political coercion or expressing political views; 2) as a method for mobilizing labor for economic development; 3) as a means of labor discipline; 4) as a punishment for having participated in strikes; and 5) as a means of racial, social, national or religious discrimination. For more than a decade, an ILO review committee has encouraged Guatemala to amend its Penal Code to eliminate penalties of obligatory labor for persons imprisoned for expressing political opinions.

Recommendation: We recommend that Guatemala amend its Penal Code as requested by the ILO. A further analysis of the specific allegations of forced labor should be made to determine whether Guatemala's practices with the civil patrols fail to conform to ILO Convention standards.

c. Minimum Age Requirements

The Guatemalan Labor Code provides that persons under the age of 14 cannot enter into employment contracts but, does not preclude persons under that age from working. A person under age 14 may obtain legal employment, provided an employment agreement is signed by his/her parent or guardian and approval is obtained from the Ministry of Labor. The law contains no definitive minimum age below which a person may not work. The Ministry of Labor indicates that it only grants work approvals for persons 12 years and older. However, the Ministry of Labor appears to have no criteria, other than prudential considerations, for determining whether to grant approval for persons under 14 years old. The Labor Code authorizes fines of between Q 100 and 1,000 against employers who hire underage persons. The fine may be doubled for a repeat offender.

The general standard established in the ILO Minimum Age Convention No. 138 is that the minimum age for admission to employment shall not be less than the age of completion of compulsory schooling or 14 years. However, special exceptions are made for developing countries whose economy and administrative facilities are insufficiently developed to fully implement the Convention. In such countries, children between 12 and 14 may be permitted to work in family and small-scale holdings producing for local consumption.

Petitions filed with the USTR in recent years allege that many companies in Guatemala are using child labor (i.e., children under 14) in the maquila and other industries. These petitions allege that the majority of these underage workers do not have contracts signed by guardians or authorization from the Ministry of Labor.

Recommendation:

- a. We recommend that a definitive minimum age be established by law (in the NAFTA negotiations the U.S. and Mexico are discussing 14 as the minimum age). To the extent that exceptions to a minimum age of 14 are permitted, those exceptions should be clearly spelled out and should conform to the provisions of ILO Convention No. 138.
- b. The Ministry of Labor should develop specific criteria for approving work authorizations for persons between the ages of 12 and 14.
- c. The Ministry should initiate a study to determine a penalty structure that will deter employers from employing underage laborers and establish a new fine structure designed for that purpose and which can be adjusted as costs increase.
- d. The Ministry of Labor should develop and implement a plan for increasing on-site inspections, focusing principally on business, such as maquilas, that utilize underage labor.

d. Health and Safety

Article 197 of the Labor Code requires every employer to take the necessary precautions to preserve the life and health of his workers. Health and safety in the workplace is regulated by the General Labor Inspector and the Guatemalan Institute of Social Security. The Labor Code is brief and vague in its treatment of health and safety (only nine articles), and for the most part fails to address contemporary issues. These provisions, like other provisions of the Labor Code, are sporadically enforced and suffer from considerable neglect. The Ministry of Labor, in its 1991 study of the maquila industry, found such problems as lack of eating facilities for workers and inadequate ventilation.

Guatemala has not ratified the most significant ILO Conventions (ILO Convention Nos. 155 (Occupational Health and Safety) and 148 (Working Environment) related to occupational safety and work and the use of toxic substances and agents in the work place (ILO Convention Nos. 115 (Radiation), 136 (Benzene) and 139 (Occupational Cancer). The few Conventions which Guatemala has ratified are not completely incorporated into existing Guatemalan law.

Recommendation:

- a. Accede to ILO Convention Nos. 148 and 155.
- b. Modernize the Labor Code (or create separate health and safety legislation) to incorporate the terms of all ILO Conventions to which Guatemala has acceded.

c. Establish sound administrative standards and procedures for carrying out health and safety inspections of the workplace.

d. Establish a realistic penalty scheme which balances the needs for improved safety and health with the needs of industry.

2. Compensation

1. General

The compensation scheme established by Guatemalan law is relatively straightforward and reasonable. The recent enactment of the Economic Compensation Law, however, creates the potential for instability in the work force and economic harm to employers.

Under Guatemalan law, there are several layers of compensation. First, workers are guaranteed a minimum monthly wage, currently Q 528.00 in urban areas. In addition, workers are entitled to an annual Christmas "bonus" equal to one month's wages. In addition, the worker is entitled to another month's wage per each year worked under the economic compensation law discussed below. Under this system, the employer effectively pays an annual salary, to the employee and/or to his economic compensation account, equal to 14 months' wages. If a worker is terminated and the termination is determined to be unjust, the employer must pay an additional month's wages for every year of service rendered to the company.

Because the minimum wage is relatively low, the total compensation paid by employers is still relatively low and permits Guatemala maintain a competitive position in the international labor market. It would be simpler, however, to establish and enforce a higher minimum wage, rather than depend on a number of special laws to provide workers with a sustainable level of income.

2. Economic Compensation Law

In 1991, Guatemala enacted the Economic Compensation Law, an ill-conceived, law which appears to be a modified pension plan, except that the pension is available immediately upon resignation from the company. Two problems with the law are readily apparent: 1) the law could require the employer to pay out more money than he is required to set aside for the employee, causing an unnecessary capital drain on the company; and 2) the law could cause destabilization of the workforce to the extent that workers have an incentive to quit whenever they are in need of financial resource.

The law requires employers to deposit monthly in the state-operated Workers' Bank an amount equal to one-twelfth of each employee's monthly salary. At the time of separation, whether for cause or voluntarily, the employer is required to pay each worker an

amount equal to the worker's average monthly wage for the six months immediately preceding the separation for every year of service rendered.

The operation of the Economic Compensation Law results in considerable financial uncertainty for employers. Aside from whether the law will be applied retroactively, a question which has enormous implications for companies that have cultivated long-term relationships with their employees, the law mandates that all funds be deposited in a state-owned financial institution which by all accounts is less than stable. There is no assurance that employers discharge their responsibility under the law simply by depositing the required amounts in the Workers' Bank. The possibility remains that if the Bank were to fail, the employer might still be required to pay economic compensation to severed employees. That could result in double payment, once to the bank and once to the severed employee.

Even if the Bank should remain solvent, the economics of the compensation system established by the law are unsound. If an employee's salary increases over his time with the company, the total economic compensation due (based on the average salary for the six months immediately preceding termination of employment) could easily exceed the total withheld and deposited by the employer (based on a lower salary during earlier years of employment). The employer will apparently be required to make up the difference with capital from the company's business operations to satisfy the economic compensation requirement. The potential liability under the economic compensation scheme will require employers to maintain higher capital reserves, freezing capital that might otherwise be used for expansion, modernization or other needs.

Lastly, the plan is ill-conceived because it can be accessed at anytime by the employee simply by severing the employment relationship. Thus, if a worker finds himself short of cash to meet debts or other obligations, or simply to take a vacation, he can resign from the company and demand an economic compensation payment from the employer. The employer is left to hire and train a new employee, and the employee must find new work. Repeated resignations by employees could destabilize the workforce of individual businesses and the country and lead to lower productivity if the economic compensation law triggers an endless cycle of resignations and searches for new employment. It is unlikely that many workers would forego economic compensation until the time they retired.

Recommendation: Guatemala should consider replacing the Economic Compensation Law with a pension system where employees could accumulate funds and interest or dividends. The law should prohibit withdrawal of the funds (without penalty) until a designated time (based on age or years of service). Employees should have the right to designate where they would like the money invested (within carefully prescribed and regulated limits). The investment of pension funds in Guatemala's financial market would provide an additional source of capital for trade and investment and would be a key factor in driving the emerging securities market.

C. Foreign Workers

1. Limitation on the Percentage of Foreign Workers

Article 102(n) of the Guatemalan Constitution provides that Guatemalan workers shall have preference over foreigners "in similar conditions and in the percentages determined by law." It also prohibits an employer from paying lower wages to a Guatemalan when working in "comparable circumstances" as a foreigner. Section 13 of the Labor Code prohibits employers from hiring less than 90 percent Guatemalan workers and paying Guatemalan workers less than 85 percent of total salaries, except in cases established by special laws. Those limits can be reduced up to ten percent for a period of up to five years by agreement with the Ministry of Labor when:

- (a) Required to protect and promote the national economy; or
- (b) There is a demonstrated shortage of capable Guatemalan technicians; or
- (c) It can otherwise be justified.

Although having no preference for Guatemalan workers or limit on the percentage of foreign workers would provide investors with maximum openness and flexibility, we uncovered no specific instances where the limitations acted as impediments to investors. The exceptions provide considerable flexibility for circumventing the limits to accommodate the needs of most investors. Hypothetically, circumstances could exist where the percentage limitation could be a factor, especially in high-tech related industries and some infrastructure projects.

The law does not make clear whether the Ministry of Labor can approve unequal wage scales for foreign and domestic employees during the five year transition period. That issue is more likely to impede an investor, who may have considerable difficulty recruiting foreign technical employees without the benefits package for overseas personnel generally recognized by the international business community. Several sources indicated that circumvention of the "comparable pay" requirement is widespread through a variety of creative compensation schemes.

Recommendation: Even if the existing law does not constitute a de facto impediment to trade and investment, Guatemala should rescind the limitations to signal its openness to investment. To the extent that it wants to regulate the number of foreign workers in the country, it could do so by monitoring work permits. The easiest way to effect this change would be to amend the Labor Code to permit up to 99% foreign workers.

2. Obtaining Work Permits and Visas

Based on the limitations contained in Section 102(n) of the Labor Code, the Ministry of Labor will only approve the issuance of a work permit to a foreigner if the National Employment Service is unable to supply a Guatemalan worker capable of providing similar services. Permits are only valid for one year, at which time the justification process must be repeated. This process is unnecessarily lengthy and fraught with opportunity for bureaucratic delay and abuse. The Ministry of Labor's 1991 study of the maquila industry encountered considerable corruption and a lack of fiscal control in the granting of work permits to foreign technicians.

Foreign workers must also clarify their migratory status by filing with and receiving the appropriate visa from the Office of Immigration. The process of acquiring a visa is separate from the that of acquiring a work permit and is administered by another Ministry. It is not unusual for applicants to get caught in a bureaucratic tangle between the Office of Immigration and the Ministry of Labor. The Ministry of Labor's 1991 maquila study found that a lack of effective coordination exists between the two entities. This further complicates a foreigner's ability to obtain the necessary documentation to work in Guatemala.

Recommendation: Streamline procedures for granting work permits and visas, maximizing the flexibility permitted by existing law to adapt the length of the permit to the needs of the investor. To improve processing time and avoid opportunity for corruption, the two procedures should be combined and housed for the present at the Ventanilla Unica para Inversionistas.

E. Labor Administration and Enforcement

The Ministry of Labor frankly admitted, in interviews with the project team and in the 1991 maquila study, their inability to adequately enforce existing laws and regulations related to (1) interference with attempts to organize labor groups; (2) health and safety inspections of individual businesses; (3) issuance and monitoring of work permits; (4) enforcement of minimum age requirements; and (5) other matters. The two most cited reasons for the lack of better enforcement were (1) a general adaptation of the Labor Code to the current conditions and economic structure of the country and (2) the lack of effective sanctions. In particular, the Ministry of Labor has no administrative authority to levy fines or sanctions. When it finds violations, it must file a complaint with the Labor Court and represent the GOG in the proceedings. This protracted process provides numerous opportunities for delay and, even if the Ministry of Labor is successful, the violator, under existing provisions of the Labor Code, may only be fined, at most, a few hundred dollars. This system creates little or no incentive for the Ministry of Labor to bring cases and, even less, for employers to comply with existing laws and regulations. This problem is symptomatic of two larger problems identified by the study: the lack of a well-defined, effective administrative law framework and the lack of prompt and professional enforcement through the judicial system.

IX. PROCUREMENT

Public sector procurement in Guatemala occurs under Decree No. 35-80 and the appurtenant regulations. The law is relatively modern, but not ideal for an open, international-looking procurement system, and suffers from poor administration and implementation. A legislative project is currently under consideration which would modernize several aspects of the law, including provisions which would permit increased international sourcing of goods and services.

Decree No. 35-80 does not distinguish between foreign and domestic suppliers and contains no direct prohibition against participation by foreign suppliers in government solicitations. As a practical matter, it appears that most foreign companies competing to supply goods or services to the government use the services of a local representative that knows the local system.

Article 3 of the law limits the use of imported goods by the government to those situations when the good is not produced/available in the Guatemala or Central America and if the price (including the cost of customs duties, insurance, etc) is lower than that of goods produced locally. The legislative project currently under study provides for additional exceptions including local unavailability of goods in the quantities and qualities required by the solicitation and when no accredited agents or representatives for the goods or service is available in the Guatemala.

The procedures in the existing law are cumbersome and result in delays and mismanagement. Some purchases must actually receive the approval of the President of the Republic. Suppliers report considerable frustration with the time it takes to process even small to medium procurements. In one instance it took more than three months to process a procurement for in-stock goods valued at approximately US\$ 200. These delays and imprecise procedures are also reported to result in considerable corruption. The legislative project proposed by the Chamber of Construction would streamline procurement procedures to expedite approval and assist in eliminating opportunity for corruption, but the law would be implemented by the same ineffective bureaucracy that administers the present law.

Recommendation: Proceed with the current legislative project that would streamline procurement procedures and expand opportunities for suppliers of international goods to compete with suppliers of locally supplied goods. To ensure that the law meets international standards, Guatemala should consider adhering to the GATT Procurement Code. This Code sets out a framework of rules and procedures designed to guarantee transparent and fair procurement practices. The Code would by its terms permit Guatemala to open its procurement market gradually -- it includes a value threshold that excludes smaller contracts and permits signatories to designate the government agencies subject to the requirements of the Code.

X. FOREIGN INVESTMENT

A. General

Guatemala is for the most part a nation open to foreign investment. Its laws impose very limited formal constraints on inward investment. There is no foreign investment law per se, since most of the restrictions, requirements and approval mechanisms typically found in such laws do not exist in Guatemala. In particular, there is no general investment screening mechanism. (It is therefore unclear why the U.S. government's outline of investment problems prepared for the Trade and Investment Council, dated January 4, 1992, asserts that Guatemala retains the right to screen "ordinary capital investment.") There is also no general requirement of local equity participation. Joint ventures are welcomed, but are not required, except as a way to satisfy local equity requirements in a few sectors. In fact, we were advised that most joint ventures are sought by Guatemalan firms in order to obtain financial or technological resources.

Article 43 of the Political Constitution of Guatemala guarantees freedom of industry and commerce, subject to laws passed in the public interest. No general distinction is drawn in the operation of this principle among local firms, foreign firms, and locally incorporated subsidiaries, the latter being the most common vehicle for foreign investment. There is a significant problem associated with the initial registration of branches of foreign corporations, discussed in the corporation law section of our report. Once established, however, these entities are generally treated alike: while our report details many problems in the law of property, corporations and commercial transactions, these are not problems of discrimination.

B. Sectoral Restrictions

There do remain a number of sectoral restrictions on foreign investment. These take a variety of forms, including outright prohibitions, approval requirements and local equity requirements. In addition, certain sectors are reserved to national exploitation and government monopolies. The following are among the most important restrictions.

1. Prohibitions

Under the Insurance Law, foreign corporations are prohibited from writing most kinds of insurance. Foreign insurers may offer a full line of insurance through local subsidiaries, however, provided they meet the minimum capital and other prudential regulatory requirements of Guatemalan law. The reasoning behind this restriction is unclear. Assuming that foreign insurers were in all cases required to maintain capital, agents for service, and other regulatory requirements locally, local insureds could only gain by having access to the total assets of foreign insurers.

Recommendation: that Guatemala consider eliminating the prohibition with

proper safeguards.

Under Article 213 of the Commercial Code, foreign firms dedicated to the rendering of licensed professional services such as law or accounting may not operate in Guatemala. (The English translation of this provision usually refers to foreign "companies", but we were advised that it would also apply to partnerships and similar associations.) This prohibition operates in addition to the requirement that professionals be locally qualified, e.g., that lawyers be members of the bar of Guatemala. As with insurance, the prohibition can be avoided by using local correspondents (we observed that the local correspondent of Arthur Anderson prominently advertises its association, which some countries do not permit) or subsidiaries.

Recommendation: Since this prohibition has little effect other than forcing foreign firms to operate in a less than optimal organizational form, and since it stands out as a restriction on trade in services, we recommend that Guatemala consider removing the restriction and relying on local licensing requirements.

We understand that foreign investors may not operate bus services in Guatemala City, even through local corporations. This seems an unlikely market, but foreign firms might be able to improve service.

Recommendation: We recommend that Guatemala consider eliminating the restriction, relying on substantive qualification requirements.

2. Approval requirements

Foreign bank operations in Guatemala must be approved by the Monetary Board and the Executive. There have been complaints that the board has exercised its powers in a restrictive way. Given Guatemala's need for additional capital, it would be in the country's interest to loosen these requirements, limiting review to prudential considerations.

Under a 1965 decree-law, the Ministry of Economy must approve foreign participation in the construction of low-cost housing. The price ceiling below which the law applies, Q 6000, has never been raised, so with 25 years of inflation the law no longer has any practical effect. As there is a housing shortage in Guatemala, though, the law should be repealed to eliminate any possible deterrent effect.

All firms engaged in fishing in Guatemalan waters must obtain a license. There are several kinds of licenses. Which license one needs depends on three factors: the degree of local ownership, the use of local or foreign flag vessels, and the degree to which the catch is exported after processing. The system is very complex, but in effect foreign firms or firms with minority local capital can only qualify for certain license classifications, one of which requires that the total catch be exported. We understand that the situation is even worse in practice, in that licenses are only given to certain local firms, who then hold them more or

less permanently.

Recommendations: We recommend that Guatemala consider adopting a more open and market-oriented approach to permitting participation in these partially closed sectors, particularly the banking sector.

3. Local equity requirements

In the fields of radio and TV broadcasting, forestry, and "small mining", only Guatemalan individuals or Guatemalan corporations at least 70% of which are owned by Guatemalan individuals can receive licenses or concessions from the government. (Constitution Article 126 reserves forestry to nationals.) In some of these cases, the use of bearer shares is explicitly prohibited.

Under the Transport Law, only Guatemalan corporations at least 60% owned by nationals can provide ground transportation outside Guatemala City.

Under the Civil Aviation Law, only Guatemalan corporations at least 51% owned by nationals can provide domestic passenger or cargo service.

Recommendation: that Guatemala consider bringing these restrictions into line with international standards. Many countries restrict foreign investment in broadcasting, for example, but ground transport and mining on private lands are not so widely limited. We recognize that these restrictions, like others discussed in this section, will be difficult to change because they are based on Constitutional provisions reflecting principles of national sovereignty over natural resources, long a sensitive matter to developing nations.

4. Government monopolies

Under Article 121(h) of the Constitution, the state owns all "radioelectric frequencies." We were advised that this section is interpreted to cover many telecommunications services as well as radio/TV. GUATEL is given a monopoly in telecommunications. GUATEL may, however, contract with foreign firms to provide services, and has done so in significant cases. In addition, firms may install private communications networks, subject to regulatory approval. Some privatization of the telecommunications sector might be in the interest of Guatemala if it led to the provision of new and improved services.

The distribution of electricity has long been a state monopoly, administered by INDE and Empresa Electrica. EE is often said to have been "privatized", but private holdings amount to only 10%, and it is still largely controlled by INDE, which must approve major operations. The two enterprises also share common officers. Article 129 of the Constitution makes electrification a matter of national urgency and specifically calls for participation by

the private sector. Under this authority, private co-generation has recently been approved, and further privatization is under consideration. We recommend that it be pursued.

FEGUA has a monopoly on rail transportation. It is widely seen as a disaster. Some privatization, and even some foreign investment, have been considered, though either would require legislation. Constitution Article 131 makes all transportation services a matter of public utility subject to the protection of the state. As the aviation example testifies, however, this need not prevent privatization.

Although we did not focus on the banking system, we understand that some specialized kinds of banks are operated only by the state. These include, we understand, the labor banks involved in administering the sweeping national severance pay system, discussed in the labor law section of our report. These specialized banks are probably not of great importance to foreign investors, but to the extent they drain potentially profitable transactions away from the commercial banking sector, they weaken that sector domestically and make it less attractive to foreign banks. Given the shaky financial condition of its state-owned banks, Guatemala should consider privatizing these banks and allowing them to be merged into more general banking companies.

Under Articles 121(e) and 125 of the Constitution, all subsurface minerals and petroleum are the property of the state, which determines how they can be exploited. (Similar principles prevail as to the use of national waters, including fishing, and communications frequencies.) For petroleum exploitation, one needs a government concession. These have been granted to foreign firms, typically in the form of production sharing contracts. Indeed, foreign investment is encouraged and incentives are given. However, the state reserves domestic transportation and refining for itself; a small number of foreign refineries are grandfathered under the Hydrocarbon Law. Foreign firms also engage in large-scale mining, and receive some incentives.

The ZOLIC free trade zone is a public enterprise. It has not been successful, though this is not necessarily because it is public. Since there is a free trade zone law, Guatemala should consider privatizing this zone.

Other general restrictions, some discussed in the section of our report dealing with property, also affect foreign investment. Under Constitution Article 122, the state reserves jurisdiction over certain lands, and foreigners need permission to own property in certain of those areas. Under Article 123, lands along the borders are reserved for native Guatemalans. Under Article 127, all waters are in the public domain.

Recommendation: As detailed above, we recommend that Guatemala consider further opening and privatization in many areas now reserved to public monopolies, to the extent possible under the Constitution or through eventual constitutional amendment.

More generally, we recommend that Guatemala make it a high priority to liberalize many of the sectoral restrictions on foreign investment discussed in this section. These restrictions, many of which relate to important services and basic elements of the economic infrastructure, seem not only inconsistent with general free market principles, but harmful to the immediate interests of Guatemala. Improved ground transportation, communications, electric power, lending institutions, and insurance, to name just a few, seem to be sectors in which Guatemala would reap important multiplier benefits by opening its markets to greater private sector participation, both domestic and foreign.

C. Investment Incentives

1. Income tax incentives

Until recently, Guatemala offered numerous incentives under its income tax laws for investors meeting certain conditions. The Executive had broad power to forgive taxes case by case for firms working for the social good, the decentralization law authorized a variety of incentives, the Ministry of Finance could reduce taxes for firms building infrastructural improvements, and so on. Under Decree 59-90, effective 1991, however, most of the major income tax incentives, including all those just mentioned, were repealed. Currently, the main income tax incentives are for maquiladora operations and free trade zones, discussed below. In addition, Decree 59-90 excepted incentives under certain laws, including Decree-law 109-83 on hydrocarbons, the forestry law, and the income tax law itself. (We were not able to determine whether the current tax reforms affect any of these incentive programs.) In these areas, income tax incentives appear still to exist.

2. Other fiscal incentives

There also exist some investment incentives that rely on exemptions from customs duties, value-added taxes (IVA), stamp taxes and the like. Some of these, like the Milk Cattle Industry Promotion Law, are relatively minor. Others are more significant. Under the Hydrocarbon Law, for example, investors -- including foreign investors -- are eligible for duty-free and IVA-free imports of certain goods for 5 years, suspension of duties without bond on items to be re-exported, and the ability to hold foreign-currency proceeds outside the country instead of depositing them with the Central Bank. These incentives are in addition to the terms of production-sharing contracts with the state, which are apparently quite generous in terms of cost recovery and the percentage of production that may be retained. Mining operations also are eligible for duty-free imports.

Another significant set of incentives is provided under the Tourism Promotion Law. Firms that carry out development projects in designated zones of tourist interest can receive customs duty and real estate tax exemptions through INGUAT, the national tourism promotion organization. (The state can also lease public land for up to 50 years for tourist

projects under the INGUAT law.)

3. Effect of Incentive Programs

Several things can be said about these incentive programs. First, most of them appear to be available without discrimination as between foreign and local investors. Indeed, incentives under the Hydrocarbon Law, for example, are aimed primarily at foreign investors. Only a few of the affected industries (e.g., small mining) are restricted to foreigners.

Second, most of the laws do not appear to carry explicit "performance requirements" as that term is typically understood. Of course, since the incentives are aimed at particular sectors or kinds of economic activity, one must engage in those activities to qualify. Similarly, one can only benefit from customs duty exemptions if one imports, and so on. But it does not appear that investors are required to export specific amounts, incorporate minimum percentages of local content, agree to transfer specific technologies, or the like in order to qualify for these incentives.

Third, several of these incentives are likely to diminish in importance over time. Many of the stamp tax exemptions, for example, may already have been repealed, in effect if not in law, by revisions to the stamp tax itself, passed as we were leaving Guatemala. Laws granting exemptions from customs duties will diminish in importance as duties are lowered, unilaterally or through international negotiations.

Recommendation: Even with these qualifications, the incentive programs described above are inconsistent with the largely subsidy-free environment currently found in Guatemala. To a greater or lesser extent, they all create distortions in economic activity. We recommend that the government of Guatemala consider reducing or eliminating them. This recommendation, incidentally, is supported by major private sector groups in Guatemala, including the Gremial de Exportadores de Productos No Tradicionales and the Centro de Servicios al Inversionista.

D. Other Regulatory Issues

1. OPIC Approvals

One general area where problems of government approval of investments apparently arise is OPIC-insured investments from the U.S. Guatemala has had an agreement with the United States authorizing OPIC political risk insurance of U.S.-origin investments since 1960. (This is a remarkable fact in itself, since very few Latin American countries have been willing to accept the arbitration requirements included in the standard OPIC agreement, even at the cost of discouraging some investment.) Under paragraph 3 of the OPIC agreement, the host government must give its prior written approval to each individual

project to be insured. (It is somewhat ironic that Guatemala's only general investment approval requirement exists at the instance of the U.S.)

The U.S. government, in its presentation to the bilateral Trade and Investment Council, asserted that Guatemala's approval procedure is seen by investors as costly and time-consuming. Acuerdo Gubernativo No. 693-86 establishes the outlines of a procedure, naming the Ministry of Economy as the authorizing agency, authorizing it to consult with other agencies, and requiring the submission of certain basic documents. It does not, however, set any time limits. We are still attempting to learn the practical details of the approval procedure.

The Council minutes suggest that Guatemala has already agreed to work with OPIC to streamline its approval procedure. It is obviously in Guatemala's interest to simplify its procedures as much and as quickly as possible, since it generally seeks to encourage foreign investment and has no substantive objection to OPIC insurance.

Recommendation: We recommend that Guatemala aggressively pursue these negotiations with OPIC, and that it embody the resulting procedures and criteria in a more complete regulation for greater transparency.

2. Visas and Work Permits

The problems related to visas and work permits are discussed above in section VIII. C. These problems adversely affect both Guatemala and investors. On one hand, the bureaucratic confusion regarding the issuance of work permits and visas results in a general lack of control over the entrance of foreign technicians into the country. Foreign technicians are also frustrated by their inability to obtain permits and visas in a timely manner and may resort to corrupt practices to obtain the necessary approvals. By some reports, there are numerous illegal aliens working at management level jobs in the country because of the breakdown of the system. The recommendations set forth in the Labor Law section should be adopted to expedite the visa and work permit procedures.

3. Remissions

As discussed below in the exchange control section of the report, financial remissions connected with foreign investment are now unregulated. Under the income tax law, as recently amended by Decree No. 37-92, dividends, other profit distributions, and interest payments sent abroad are subject to a withholding tax at the rate of 12.5% (reduced from 25%). (No withholding tax, indeed no income tax at all, applies to dividend payments to Guatemalans, and the tax on local interest payments is only 10%. The withholding tax discriminates against foreign investors, and may tend to discourage inward investment. Guatemala might consider entering negotiations for tax treaties with the U.S. and other countries. Such treaties often reduce withholding taxes on a reciprocal basis. On the other hand, the new rate does not seem out of line with international standards: most U.S. tax

treaties, for example, limit such taxes to 15%.

E. One-Window Investment Office

A proposal for a Ventanilla Unica para Inversionistas, a "one-stop shopping" window for foreign investors designed to centralize and speed up the bureaucratic aspects of entering the Guatemalan market, is fairly well advanced. According to officials of the Centro de Servicios al Inversionista, funded by AID, this is in large part a private-sector initiative. It is modelled on the generally successful ventanilla unica for exporters, discussed in the international trade section of our report.

As presently conceived, the ventanilla would initially deal only with expediting incorporation, branch approval, obtaining tax ID numbers, and related organizational matters. (Officials of the Centro support repeal of the restrictions on foreign branch approval, discussed in the corporation law section of our report). It is hoped that it could later deal with immigration matters, such as obtaining visas and work permits for foreign employees (as recommended above), and ultimately with the procedures required under the various investment regulation and incentive laws discussed earlier in the section.

The proposed ventanilla unica should ease some of the procedural burdens of entering the Guatemalan market, and we recommend that the initiative be pursued. However, even a broad and efficient ventanilla is only a palliative. This fact is recognized by officials of the Centro, who expressly view the ventanilla as a pragmatic, short-term measure. Even a successful ventanilla should not distract attention from the more fundamental, though more difficult, task of simplifying and eliminating the underlying regulations and bureaucratic procedures themselves. If our recommendations on such matters as business establishment, sectoral restrictions, and investment incentives were implemented, there would be little need for a ventanilla unica, and it could be phased out of existence, or transformed into an information agency, within a relatively short time.

Recommendation: We recommend that the ventanilla initiative be pursued, incorporating the elements discussed in other sections of the report. We also recommend, though, that it be pursued in parallel with the substantive reforms recommended herein, and with the understanding that its greatest success will come when it can go out of business.

F. MIGA

As with streamlining the OPIC approval process, Guatemala would serve its own interests by joining MIGA, thereby making investments from a variety of source countries eligible for MIGA political risk insurance. As a World Bank program with special provisions for voting by developing countries, MIGA should be less politically sensitive than, say OPIC. MIGA membership should be especially helpful in diversifying the sources of foreign investment away from the U.S. and the other leading capital-exporting countries,

since most of those countries have their own national investment insurance programs which MIGA seeks not to duplicate. We understand that the government has already begun the process of adhering to MIGA, and is in the process of making the final adjustments necessary for acceptance. Our sources indicated that negotiations could be completed in as little as two months.

Recommendation: We recommend that Guatemala complete the process of negotiating its participation in MIGA as soon as practicable.

G. Promoting Investment Stability: Bilateral Investment Treaties

Membership in MIGA, like participation in OPIC, functions to assure foreign investors of the stability of their investments. In a country where political conditions have sometimes been turbulent, such assurances are essential. An additional way to provide assurances of stability would be to negotiate bilateral investment treaties ("BITs") with the U.S. and other capital exporting countries. BITs would also serve an important function internally, reinforcing the current open investment climate and making it more difficult to change. This could be a valuable way for the GOG to protect advances made in recent years from future political reversals. (It is widely believed that the Government of Mexico views NAFTA as performing a similar function).

There are several problems with BITs in this context. First, and most important, a BIT is bilateral, by definition. Based on the terms of the U.S. model BIT, it appears that Guatemala would have to make changes in several areas of its law -- including branch registration, limits on foreign managers, judicial process and arbitration, and possibly exchange policy -- in order to reach an agreement. Many of these changes, however, are desirable on their merits, quite apart from their value in clearing the way for a BIT. Some other countries are also willing to negotiate more flexible BITs.

Second, under the Constitution, Congress would have to approve any BIT, especially because international arbitration would be involved (Constitution Article 171(1)). This opens the door to some short-term political uncertainty. Third, BITs would have to be negotiated country by country, placing a strain on the resources of the Guatemalan government. Finally, the U.S., at least, seeks to negotiate an intellectual property agreement at the same time as a BIT, and such an agreement would involve even more significant legal reforms by Guatemala.

The U.S. has tabled a model BIT, and it has received some study. We were advised, however, that Guatemala has to date focused more attention on intellectual property and worker rights issues, where the "political heat" is greater. Yet, even with the need to set priorities, BITs are deserving of serious consideration.

Recommendation: that Guatemala undertake a study of the steps that would be necessary for the negotiation of BITs with the U.S. and other potential investor

countries, and begin preliminary consultations with those governments.

H. Communicating Guatemala's Open Investment Climate

Since Guatemala has a very favorable legal environment for foreign investment, it would be in the nation's interest to actively communicate that environment to the capital-exporting countries of the world. Such a signalling process would be facilitated by making Guatemala's investment environment as transparent as possible. Transparency would reduce the costs to potential investors of learning about Guatemalan law, thus reducing the risks they perceive when contemplating the market. The proposed *ventanilla unica* would make a substantial contribution here, but more could be done.

Some have suggested that Guatemala should enact a comprehensive foreign investment law with the transparency and signalling functions in mind. In fact, we were advised by officials of the Centro de Servicios al Inversionista that they have been studying the investment laws of other countries with an eye to proposing such a law.

Recommendation:

(a) We do not believe that enacting a foreign investment law is the most desirable way to achieve these worthwhile goals. For one thing, there might be considerable risk in entering the political process with a proposal for a foreign investment law. The political process is always unpredictable, and in Guatemala, as in every country, there are powerful interests keen to advance their welfare whenever an opportunity presents itself. There is currently a fairly wide consensus on an open investment policy, but a political debate on foreign investment could still lead to the enactment of new restrictions. Similar results could be obtained without the considerable effort, cost and risk associated with drafting and enacting a new law.

(b) We recommend instead that the appropriate government agency, presumably the Ministry of Economy, in cooperation with private sector organizations like the Centro, initiate a foreign investor information program. As the heart of the program, these bodies should prepare a complete investor's manual, or similar reference volume, containing clear and complete descriptions of the general rules on investment in Guatemala and of the various sectoral restrictions, incentives and requirements. This manual should be an official government publication, so that it could be relied upon by investors, and should be kept up to date. The relevant laws and regulations, also kept current, should be appended to the manual. The manual, laws and regulations should be translated into English, and perhaps into other languages. (A manual for exporters similar in some ways to the volume we recommend has been prepared by

the Ventanilla Unica para Exportadores. This manual does not include the relevant laws and regulations, however.) The manual, its supporting documentation, and other sources of assistance should be made available at one or more investor's information centers and on request. The proposed ventanilla unica for investment could evolve into an information center as bureaucratic requirements related to investment are reduced.

A program like this could convey the full range of information needed by potential investors even more effectively than an investment law. The manual and information centers could also be used in connection with investment promotion campaigns. They would convey the message that Guatemala is not like most developing countries, whose regulatory regimes require an extensive foreign investment law. Instead, Guatemala's market is more like that of the United States, simply open to foreign investment, with a few transparent exceptions. This program would be a perfect complement efforts to increase the stability of investments, such as simplifying the OPIC approval process, joining MIGA and negotiating BITs.

XI. EXPROPRIATION

A. General

Guatemala has not expropriated any property since World War II. Article 39 of the Constitution protects private property, at least in the hands of individuals, as a human right, and obligates the government to create the conditions for the use and enjoyment of property. Expropriation law should be judged against the U.S. Position, support by most capital exporting countries, that expropriation is only permissible when carried out for a public purpose, pursuant to fair procedures and with compensation that is prompt, adequate (full value), and effective (in convertible currency).

Article 40 of the Constitution provides that property can only be expropriated for a public purpose, states that expropriated property is to be appraised at its "actual value", and requires that compensation be paid "in anticipation", unless otherwise agreed, and except in emergency situations including war and serious disruption of public order. Article 40 provides for payment of compensation in "legal tender", which probably means local currency. Whether compensation is "effective" under international standards would therefore depend on the functioning of the foreign exchange system. At present, as noted in the section on foreign exchange of the report, only minor shortages and delays under the current auction system seem likely to pose any problem. The Constitution draws no distinction between foreign and local ownership.

B. Procedure

Article 40 provides that the procedure in cases of expropriation will be determined by law. That law is the Law of Expropriation, which predates the Constitution. There does exist a procedural problem under this law that could compromise the existence of "prompt" or "adequate" compensation. Under the law and the relevant procedural codes, once the decision to expropriate has been made (Congress must determine the existence of a public purpose), the expropriating agency or municipality makes an offer of compensation. Presumably this offer will be low. If the property owner does not agree to accept this amount, the agency is authorized to pay the amount of its offer into court ("consignacion"). Thereupon, title to the property may be conveyed to the agency, leaving the owner out of possession while it pursues a judicial challenge to the amount of compensation. Given the serious problems with the judicial system, the outcome of such a challenge would be uncertain, and the delay could be significant.

Recommendation: that Guatemala revise its expropriation procedures to ensure that adequate compensation can be judicially determined before a taking is effectuated. This is an issue likely to arise in negotiations with the U.S. over a BIT.

XII. TECHNOLOGY TRANSFER

A. General

As with foreign investment generally, Guatemala is currently very open to inward transfers of technology. It has no general screening mechanism, registration requirement, or substantive limitations on the forms of technology that may be transferred. There also appear to be few if any restrictions on the terms of licenses. (Investors often associate such restrictions with Latin America because of the examples (themselves recently liberalized) of Mexico and the Andean Pact countries.) In accordance with the practice in many civil law countries, there is an optional registration procedure for technology licenses utilizing the Industrial Property Registry, but this is only necessary if the Guatemalan licensee wishes to be able to enforce its license locally against third parties. The issues we have identified in connection with technology transfers, then, arise in related areas of law. Most important, the problems with Guatemala's treatment of intellectual property itself are discussed extensively in the appropriate section of our report.

B. Withholding tax on royalties

The payment of royalties under technology licenses is subject to a flat withholding tax. Under the revision of the tax law effective July 1, the rate of this tax on payments to foreign licensees has been reduced from 34% to 25% (royalty payments to Guatemalans are subject only to a 4% withholding tax). This rate still seems quite high, however: (i) absolutely, (ii) in comparison to the rate on payments to Guatemalans, and (iii) most of all, in comparison to the parallel taxes imposed on dividends, interest and similar payments, all of which are now at a rate of only 12.5%. The higher rate on royalties will presumably tend to discourage inward flows of technology, which seems clearly contrary to Guatemala's interests. At best, the rate differential will encourage foreign firms to structure or "paper" their transactions so that payments for technology are cast as something else. This process leads to a waste of resources by investors and the Guatemalan tax authorities alike, causes inefficiencies, and poses a potential for corruption.

Recommendation: One way to deal with this problem would be to negotiate tax treaties with the U.S. and other major trading partners. The typical U.S. tax treaty, however, provides that royalty income is exempt from taxation in the source state; this provision would favor the U.S. in practice, since little technology flows from Guatemala, and would presumably be unattractive to Guatemala. If tax treaties are not pursued, we recommend that Guatemala consider reducing its withholding tax on royalties unilaterally to the level of the taxes on payments for the use of capital.

C. Limit on Deductible Royalties

The tax law also contains another problem, a limit on the amount of royalties paid

under licenses that can be deducted from the licensee's taxable income. Previously that limit was 10% of licensee's sales. Under the recent tax law revision, the limit on deductibility has actually been reduced, to 5%. We have been advised, however, that the requirement to register with the Unidad para la Transferencia de Tecnologia ("UTT") in order to deduct royalties has been eliminated and replaced by a requirement that the royalty simply be registered with Civil Registry.

Like the withholding tax, a limit on deductibility of royalties reduces the profitability of technology transfers and thus discourages them. In addition, even more than the tax, the deduction limit can have perverse effects. For example, it tends to penalize transactions in which the licensed technology has valuable spin-off benefits for the economy of Guatemala that are not fully reflected in sales; it also tends to penalize licensees in the early years when sales are relatively low.

Recommendation: that Guatemala consider eliminating this provision, or at least raising the deduction limit. It might seem that a more flexible provision, involving scrutiny of individual transactions, would be desirable. We recommend, however, that such a procedure be avoided, as it could open the way to more extensive regulation.

XIII. THE MAQUILADORA AND FREE TRADE ZONES LAWS

A. General

Decree No. 29-89, the Law of Promotion and Development of Export Activities and Drawback (the "maquiladora law") and Decree No. 65-89, the Law of Free Trade Zones, are the major Guatemalan incentive programs aimed at encouraging foreign investment, as well as technology transfer and exports. Both are aimed primarily at encouraging manufacturing or assembly operations in which machinery, supplies and components are imported and the completed products are exported. Benefits are limited to non-traditional products, and to exports outside of Central America. There is also a regime to encourage the export of domestic production, but its requirements are so difficult to meet that it has not been utilized. Because of their importance, and because these two laws bridge several categories of economic activity, they are discussed separately here.

The maquiladora law appears to have been quite successful in promoting assembly operations. There are well over 300 qualified firms, many of them in the textile and apparel industry, and many of them foreign investments. Of course, it is impossible to know what would have taken place without the encouragement the law provides. The free trade zone law has had less impact: we were told that there have been only three applications, all of which were approved, and that there is as yet only one functioning zone.

B. Simplification

The maquiladora law, which attempted to add new programs to a prior law, is unnecessarily complex. It provides for 5 different regimes. Two of these are especially confusing: (a) a maquiladora regime, designed especially for foreign investors producing for export, under which firms must utilize at least 51% imported inputs, apparently making Guatemala the only developing country in the world to legislate a maximum local content requirement; and (b) an exportadora regime, also aimed at manufacturers producing for export, which does not restrict the source of inputs. Oddly, the requirements and benefits of these two regimes are exactly the same, and we were advised that firms normally seek exportadora status whatever their import plans so as to avoid any potential regulatory problem.

Recommendation: we recommend that this portion of the law be simplified, to expedite administrative proceedings and eliminate any possible disincentive to local purchases.

C. Subsidies

A major aspect of the benefits available under both laws is the suspension (under bond or other security) of customs duties, IVA and other charges on the import of components, materials, containers, and the like to be used in processing for export. These

benefits also extend to machinery and equipment to be used in the production process. This is a fairly standard arrangement. The duty suspensions are not considered subsidies because of the temporary nature of the importation (the situation is somewhat less clear in the case of machinery, however).

The two laws also grant substantial income tax incentives, however. Firms qualified under the maquiladora law are entitled to a 10 year income tax holiday on qualifying (export) income, as well as exemption from any export taxes. Under the FTZ law, FTZ administrators are entitled to a 15 year exemption from taxes on FTZ income; in addition, they are exempt from duties and IVA on imports destined for the zone, exempt from the national real estate tax for 5 years, and exempt from other lesser taxes. Industrial firms located in FTZs, the same sort of firms that qualify under the maquiladora law, are entitled to a 12 year income tax holiday, as well as exemption from duties, taxes and charges on imports. (Commercial firms receive a 5 year holiday.)

Recommendation: The government of Guatemala forfeits a significant amount of revenue under these incentives. To that extent, the government must rely more heavily for revenue on customs duties, special import and export taxes, and other more distortive measures, on which we recommend reducing reliance. In addition, the income tax exemptions, tied as they are to export performance, could well be seen abroad as export subsidies, leading to countervailing duty actions in importing countries as well as complaints in GATT. We recommend that Guatemala carry out a careful study of the desirability of continuing these incentives in their present form. This study should include a comparative analysis of the incentive programs of countries competing for maquiladora investment and an analysis of countervailing duty regulations in its major markets.

As noted above, firms that locate in FTZs receive a longer income tax holiday than firms that operate under the maquiladora program. This difference could distort the location of manufacturing facilities, leading to artificial concentration, with possible effects on the environment and other factors. On the other hand, firms locating in FTZs typically pay higher rents, so the extra subsidy may actually flow largely to FTZ administrators, who already seem amply subsidized.

Both laws apparently attempt to integrate their income tax benefits with the foreign tax credit laws of the U.S. and other countries. They provide that foreign firms operating in Guatemala through branches or permanent establishments will not qualify for the income tax holidays if their home country would grant a tax credit for the Guatemalan income tax. Provisions like this raise complex questions under the "soak-up taxes" rules of the U.S. tax law: under certain conditions, the U.S. may refuse to recognize as creditable taxes under which liability is conditional on the existence of a credit. It also appears that U.S. firms would be entitled to an indirect credit for some or all of the Guatemalan income tax paid by their subsidiaries in Guatemala, once subsidiary profits were remitted to the parent. This

Osituation is not covered by the terms of the two laws, which limit their integration provisions to the operation of branches.

Recommendation: The tax integration provisions of these and possibly other incentive laws should be examined by an international tax expert to determine their specific effect on foreign investors from identified countries.

D. Administration

Applications to qualify as a maquiladora firm or a free trade zones must be approved by the Industrial Policy Directorate of the Ministry of Economy, and by the Ministry itself. The statutes set extremely short time limits for decisions by these agencies, a total of 45 days in each case. It would seem to be difficult to make a well-informed decision within this time. In practice, not surprisingly, we were advised that it may take considerably longer to obtain approval. In 1991, the Gremial de Exportadores described the approval process as "a Calvary", though it may have been improved since that time. We recommend that the Industrial Policy Directorate and the Ministry continue to streamline their approval procedures.

An ordinary firm that imports components without knowing whether the finished products will be exported can qualify for drawback of duties once exports are made. At the time the components are entered, however, such a firm must pay a "cash deposit" equal to the full duty. Exportadora firms need only post a bond or other security, which is less costly. Officials of Industrial Policy told us that, as a result of this difference, many firms try to take advantage of the exportadora regime when they do not qualify for it. We were also told, though, that every application under the maquila law, as well as the FTZ law, has been approved, raising some concerns about the quality of review.

Recommendation: We recommend that Industrial Policy clarify the qualifications for exportadora and maquiladora status so as to avoid the wasted administrative effort and potential for evasion of the current system.

The role of Customs in the administration of these laws constitutes something of a problem; all agree on this point, including Customs. On one hand, Customs described to us its plan for ensuring greater control over the disposition of items imported duty-free, and for matching imports with exports. This plan, however, can only be implemented with external funding. On the other hand, the Gremial de Exportadores argues that Customs should establish simplified entry procedures for imports under the laws, rather than subjecting them to the normal procedures.

Recommendation: Customs is in need of major reform, and needs major support. Both of these elements should be attended to in that context.

When goods are entered under these preferential regimes, importers must post

security against potential duties. This can be done in several ways, including a bond, various forms of guarantee, or the use of a bonded warehouse. Based on private sector requests, a 1990 acuerdo expanded the acceptable forms of security to include the pledging of positive balances in a firm's IVA account. We were advised, however, that the IVA system is not working properly: it takes so long to check the IVA accounts that the system is impractical, and importers fear that tax authorities will try to audit the accounts in a search for additional taxes due.

Recommendation: Guatemala should attempt to make the IVA security system workable. If this cannot be done, the system should be abandoned.

XIV. INTERNATIONAL TRADE

A. General

The legal environment for international trade in Guatemala is rather different from the generally open regimes for investment and technology transfer. Guatemala relies on customs duties for a significant part of its government revenue, so it maintains significant tariffs, a tariff surcharge, and an extensive Customs operation that is fraught with problems. It also has a number of quantitative restraints on imports. There are no exchange restrictions relating to imports, however, on the export side, Guatemala has an unfortunate export tax, a few quantitative restraints, a problem with IVA remittances, a minor form of exchange control, and some bureaucratic problems.

The trade environment is quite confusing, not only due to the extensive regulation, but because many aspects of the regime are determined under a Central American convention or by regional negotiations. Trade is also a moving target: revisions to the tariff were being debated by Congress during our research mission, Customs has a series of externally funded studies and reforms in process, and some Central American negotiations on customs matters are currently under way. Guatemala negotiated an instrument of accession and became a member of GATT during 1990-91, making a variety of commitments to reform. To top all this off, Guatemala has agreed with Honduras and El Salvador to form a free trade zone and customs union, which they hope to extend to Costa Rica and Nicaragua, "as a step toward achieving economic union." Guatemala is also negotiating for special economic relationships with Mexico and other countries. In the time available for our research, we simply were not able to analyze these complex matters in depth. Yet a number of serious issues present themselves.

B. Planning and Training for GATT Membership

When Guatemala joined GATT, it subjected itself to the full range of GATT rules. It also made a number of specific commitments with regard to reform of its trade regime, several of which carry time limits, and agreed to adhere (or initiate negotiations aimed at adhering) to additional agreements. These commitments are incorporated in Guatemala's Protocol of Accession. GATT membership, then, will at least potentially affect a broad range of Guatemalan regulatory programs, ranging from obvious matters like quantitative import restraints to product standards and the tax subsidies offered under the maquiladora law.

It was our impression, however, that few Guatemalan officials, even those whose programs stand to be affected, are aware of the possible impact of GATT. For example, members of the GATT working party raised questions about certain product standards and certification procedures, and suggested that Guatemala join the GATT standards code. Yet the official with whom we spoke at COGUANOR, the principal standards-setting body, seemed unaware of these problems. Even more striking, Guatemala committed itself to

initiating negotiations with the Central American countries on customs valuation, and agreed to the goal of adhering to the GATT customs valuation code within three years. Yet the high officials of Customs with whom we spoke were unfamiliar with the valuation procedures included in the code.

In addition to the commitments already made, Guatemala may soon be faced with decisions on joining the agreements emerging from the Uruguay Round. This may not be a simple matter of choosing among agreements, either, as negotiators in the Round are designing a new multilateral trade organization, an integrated package of substantive agreements colloquially referred to as the "new GATT", and a unified dispute system.

Recommendations:

(a) We believe that Guatemala needs to initiate a number of programs to deal with its present and future GATT commitments, and with the procedures of this complex organization. First, we recommend that the government of Guatemala take steps to ensure that the relevant ministries, agencies, officials, and members of Congress are aware of the commitments that the country has already undertaken through GATT. Some external assistance might be desirable at this stage to help officials of the government identify issues that should be dealt with.

(b) Just how the government responds to these issues is a matter for its own determination, but we recommend that it consider organizing a series of meetings or seminars, involving the agencies affected by a particular issue, key members of Congress, and perhaps appropriate private sector representatives, aimed at devising plans to ensure that its GATT commitments can be met in a timely fashion. Some external assistance might also be valuable here.

(c) Finally, as a measure aimed at the longer term, we recommend that a training program be established to prepare a number of officials to deal with the complex rules and procedures of GATT. GATT itself offers a training program for developing country officials which at least one Guatemalan official has attended. On-site training would, however, reach a broader group more efficiently. Indeed, with Guatemala becoming increasingly integrated into the Central American, Latin American, hemispheric and world trading systems, with all their substantive and procedural complexities, it might be advisable to initiate an even broader training program, involving study abroad as well as on-site training, to ensure that the nation develops a sufficient corps of experts in international economic law.

C. Quantitative Restraints on Imports

The U.S. and members of the GATT working party have all strongly criticized Guatemala for its non-tariff import restrictions, including a variety of prohibitions, quotas

and license requirements. Most import prohibitions appear to be benign, covering such things as arms, potentially diseased plants, drugs, and dangerous chemicals. Some prohibitions, though, seem protectionist, including those on wheat and wheat flour. The rationale for others, such as the prohibition on imports of fruits and flowers from Mexico and on cocoa seeds, is uncertain.

The more serious problem appears to be the list of products requiring import licenses. This list encompasses a substantial variety of food products, including all "basic grains", wheat flour, powdered milk (as to which there is also a quota system), and fruits, seeds, fertilizers and insecticides, veterinary products, medicines, lead, and communications devices. There has been considerable liberalization here already -- restrictions on fruit purees and concentrates, vegetable oils, certain basic foods and other items were eliminated in 1991 -- and Guatemala indicated in GATT that the process will continue. We understand that a bill currently under consideration would allow the free importation of many generic drugs for the first time. These market access issues are certain to be a continuing problem both bilaterally and in GATT. Guatemala committed itself in GATT to phasing out within 5 years all measures that cannot be justified under GATT rules, and to joining the GATT code on import licensing procedures within 3 years.

Recommendation: that Guatemala initiate a program to satisfy these commitments in a timely fashion. In this regard, we note that Guatemala has advanced as a justification for some of its restrictions -- such as those on the import of powdered milk and wheat -- the need to protect the livelihood of highlands peoples who rely on the production of these specific products. Although the matter should be studied further, this justification is unlikely to be accepted under GATT law, because similar protection can be extended in less-distortive ways, including tariffs. (A GATT panel has ruled that Japan may not restrict imports of leather to protect the livelihoods of a traditional outcast group that has long relied on leather production.) We also recommend that Guatemala consider, quite apart from GATT rules, eliminating all quantitative restraints that are not truly necessary.

D. Reliance on Tariffs

The government of Guatemala obtains a rather large percentage of its revenues from customs duties, even with an income tax and IVA. This is characteristic of nations in earlier stages of development, since customs entries are more easily monitored than diverse sources of income and most other transactions. The result, however, is considerable distortion of the economy. Instead of taxing all productive activities equally, as a well-designed income tax would do, the system burdens those sectors that require imported inputs. In a country like Guatemala, those sectors are likely to be the most innovative, the very "non-traditional" sectors that the government tries in other ways to encourage.

Put more directly, high tariffs raise the cost of products that the country needs: we

understand, for example, that the Central American tariff convention required Guatemala to impose a new tariff on imported electric power, formerly imported duty-free, at a time of widespread power shortages. No zero tariffs are allowed under the Convention. High tariffs also discourage the importation of products that could improve the quality of Guatemalan life: under the proposed revision of Part III of its tariff schedule, which was before Congress during our mission, the country will impose a 20% duty on vehicles, even though it produces no vehicles, and even though access to more modern, safer and less-polluting vehicles would seem to be a high social priority.

Recommendation: Guatemala should give serious consideration to reducing its reliance on customs duties as a source of revenue, and that it initiate a program of eliminating or reducing duties. Ideally, this program would begin with products assigned a high priority as productive inputs or for social reasons. (In general, we understand that rates are lower on inputs and intermediate products than on final products, as in most countries.) To limit political opposition, the program could also begin with products which are produced locally in limited quantities or not at all. The timing of this recommendation is admittedly poor, since the tariff schedule has just been revised. The recommendation is also complicated by the existence of the Central American Convention, which governs the first two parts of the Guatemalan schedule, and by plans for free-trade negotiations in Central America. Still, we believe the recommendation is important as a longer-term goal.

E. Customs

The administration of Customs in Guatemala has many problems. Customs is widely regarded as inefficient and corrupt. We found headquarters Customs officials aware of these problems and eager to deal with them. Still, the tasks are enormous, and Customs is seriously constrained by lack of resources and an ingrained culture. These problems may have contributed to the recent departure of the Director of Customs.

1. Classification

Guatemala currently uses the CCC tariff nomenclature. Customs is committed to adopting, in cooperation with other Central American countries, the harmonized system of tariff classification, hopefully during 1993.

Recommendation: We recommend that Guatemala proceed with the present initiative to implement the HTS. The adoption of the HTS will require appropriate implementation training for customs agents.

2. Valuation

Although Guatemala formerly maintained many specific tariffs, it has recently moved

to more desirable ad valorem tariffs. Along with other Central American countries, Guatemala values products for tariff purposes under the Brussels Definition of Value. This system calls for products to be valued at the price they would have in a perfectly competitive market transaction. This is a very burdensome system for a country like Guatemala, which does not have the information or the trained officials needed to make good valuation decisions. The Central American countries appear to be working toward the establishment of various data banks and other devices to make the system work, but it still imposes severe costs. In addition, this system is often seen as a trade barrier, because of the ease with which arbitrary valuations can be made to increase revenue. Finally, the system is a standing invitation to corruption.

In 1979, GATT adopted a more objective system based primarily on the actual price charged in a transaction. This system can be much more cheaply administered. Guatemala has undertaken to join the GATT customs valuation code, but as noted above, little progress appears to have been made on this front.

Recommendation: Guatemala should promptly initiate the planning and negotiations needed to fulfill this commitment. Training of Customs agents will also be needed here, especially in connection with the several more complex backup methods of valuation authorized under the Code. Appropriate technological and administrative facilities may also be needed, and are worthy of support.

3. Procedures

Customs recognizes that its bureaucratic procedures can be slow. The time required for entry is considerably increased if a license from a particular ministry is required. We recommend that Customs continue its efforts, based in large part on computerization, to streamline the entry process. Similar efforts should be made by such ministries as Agriculture and Public Health, which must approve many imports under various health, safety and quality standards. We understand in this regard that the proposed generic drug law would reinstate Public Health's responsibility to test and approve imported medicines, but would also create a *ventanilla unica* for medicinal imports to speed the approval process.

We were advised that Customs has initiated a program of personnel rotation to deal with the pervasive problem of corruption. We recommend that this program be supported, and that even more drastic measures be considered if necessary (Mexico, for example, replaced its entire force of customs agents on the northern border). Simplification of rates, classification and valuation and reduction of tariff rates should also help reduce the problem.

Customs portrayed itself to us as starved for resources, to the extent that some Customs offices do not even have telephones, let alone computers. This account is certainly plausible based on our visit to headquarters. (Several of its plans are receiving outside funding, however, including some from AID.) Officials pointed out that salaries are low,

increasing the risk of corruption.

Recommendation: Our primary recommendation is to reduce national reliance on tariffs and thus on Customs; in the meanwhile, however, efforts to reform and professionalize Customs should be continued.

F. Special Import Tax

Guatemala imposes a special 3% ad valorem tax on all imports. This tax was designed as a temporary measure, to be phased out over four years, but was frozen at 3% because of the need for revenue. It constitutes an undesirable barrier to imports.

Recommendation: Phase out the tax as a barrier to imports as soon as possible.

G. Import Relief Measures

Under Article 25 of the Central American Convention, Guatemala is authorized to take countervailing measures (i.e., special tariff increases) against dumped and subsidized imports from outside the region that cause or threaten injury to local production. Under Article 26, Guatemala is authorized unilaterally to adjust tariff rates on account of balance of payments problems, shortages of goods, market disruption or other emergency situations; this authority encompasses what are known as "safeguard" measures. Within 30 days, the Council formed under the Convention is supposed to meet to review the action, but we were advised that the Council is in fact inactive.

The standards in these provisions appear not to comply in all respects with GATT requirements. For example, Article 25 does not require a finding of "material injury". In addition, Guatemala itself apparently has no law or regulation spelling out standards or procedures for any of these measures, even though tariffs are increased from time to time by executive decree, under authority of the Convention, apparently as safeguards measures.

In response to inquiries in the GATT working party, Guatemala committed itself to comply with GATT standards on anti-dumping, countervailing duty and safeguards measures, as well as to initiate consultations with other Central American states on adherence to the GATT anti-dumping code. In the short run, revision of safeguards measures seems the most important, as they are likely to be the most common.

Recommendation: To avoid international friction, legal challenges, and unnecessary burdens on its economy, we recommend that Guatemala initiate steps to adopt a formal safeguards law in compliance with GATT norms. We also recommend that Guatemala pursue negotiations on adherence to the anti-dumping and subsidy codes, and that it carefully study the outcome of the Uruguay Round in these areas.

The enactment of formal import relief procedures is desirable from a different perspective as well. The Convention simply authorizes a contracting state to act in the circumstances described. A supporting Central American regulation states that the procedures to be used depend on the legal system of the state taking the action. In Guatemala, special tariff increases are typically ordered by the President under the Convention and Article 183(e) of the Constitution. This article, however, only authorizes Presidential decrees to carry out Constitutional provisions and Congressional statutes; it is unclear just where his authority comes from. At the same time, Constitution Article 171(c) empowers Congress to "decree ordinary and special taxes", which presumably, though not explicitly, includes tariffs. Thus, the special tariff increases ordered from time to time involve significant constitutional problems. Formally enacted procedures would eliminate this source of uncertainty.

H. Export Restrictions

Guatemala prohibits the export of certain products and requires licenses for a number of others. Among the controversial prohibitions is that on unprocessed coffee. Many of the license requirements appear to relate to the enforcement of health and sanitary standards, but others require sales to be made through national trading associations or cartels, and some seem designed (like the coffee prohibition) simply to maintain ample supplies at home or to encourage local processing. These restrictions are likely to be less controversial than the quantitative restrictions on imports, but some could potentially be challenged as a form of subsidy to processed products or as restraints on competition. Some export restrictions -- among them cottonseed, paper and horses -- were lifted during 1991.

Recommendation: that Guatemala consider eliminating the remaining restrictions that are not truly necessary.

I. The Ventanilla Unica and Related Export Restrictions

Guatemala has put in place a Ventanilla Unica para las Exportaciones, designed to centralize and streamline the bureaucratic requirements for exporting. The operation has had considerable success in reducing the time needed to clear exports; indeed we were advised by officials of the ventanilla that the necessary steps can usually be completed within hours. It does appear, however, that exporters still need to invest some time in assembling documents before ever appearing at the ventanilla. Some private sector groups assert, moreover, that the ventanilla can become a bureaucratic bottleneck.

A special administrative procedure of this sort was only thought to be necessary because of the existence of bureaucratic requirements applicable to a wide range of exporters. Two requirements now seem most important. First, most exporters must pay a special 2% tax or fee, said to support export promotion activities. Second, as discussed in connection with exchange controls, most exporters are required to deposit with the Central Bank any foreign currency proceeds from export transactions, and for enforcement purposes each

export transaction now must be registered in advance. (Exporters must also obtain a tax identification number.)

Recommendation: We recommend that both of these requirements be eliminated. While government policy is strongly attuned to promoting exports, an export tax is clearly counterproductive, even if the revenue is used for export-related activities. Even worse, since maquila and FTZ exports are exempt from all export taxes, this special tax falls mainly on local exporters, who are more likely to use local inputs. The export deposit requirement is inconsistent with the relatively free exchange control regime to which Guatemala has moved. It increase exporters' costs, reduces their flexibility, and exposes them to small risks of delay and currency fluctuation. We were advised by officials at the Central Bank that they favor eliminating this procedure.

If these two requirements were eliminated, there would be little need for a *ventanilla unica* aimed at serving exporters generally. The *ventanilla* also facilitates some license procedures and other specialized requirements, most administered by the agriculture and public health ministries. If it were decided that these procedures should be maintained, it might still be efficient to maintain a single facility where they could be completed. Aside from this possibility, however, it would be most desirable in the long run if this *ventanilla*, like that proposed for investment, could be eliminated as unnecessary.

J. IVA Refunds

Under international practice, exporters who have paid value-added taxes on their inputs are entitled to a refund of those taxes when their products are exported. Otherwise, the theory runs, the tax would be passed forward and ultimately "paid" by the buyer, who is in another country and does not benefit from payment of the tax. Since this is the universal practice, a country that does not refund value-added taxes places a serious competitive burden on its exporters.

Guatemala's IVA law has all along authorized refunds to exporters. In practice, however, we were informed that the procedures for making such refunds were largely ineffective, so that exporters did not receive their refunds for lengthy periods, if ever. Most people believe that this was so by design, as an illicit way to obtain more tax revenue. The tax law revisions recently adopted include new procedures designed to make IVA refunds swifter and more certain. We understand that these procedures require an application for a refund, but that the refund will be deemed approved, and a credit will be made to the exporter's fiscal account, if no action is taken within 60 days.

Recommendation: We recommend that the government of Guatemala make a concerted effort to implement the new IVA refund procedures fairly and efficiently, viewing them as a means of promoting exports.

K. GSP/CBI

As noted earlier, the greatest threat to Guatemala's export-oriented strategy is the possible loss of the U.S. GSP/CBI benefits in response to Guatemala's labor practices.

XV. EXCHANGE CONTROL

In the past, Guatemala has had extensive, and changeable, exchange controls applicable to the remission of dividends, interest, royalties, equity and principal. With a single relatively insignificant exception, availability of foreign exchange for remittance of capital, dividends, principal, interest, royalties and payment for imports, and receipt of foreign exchange for exports, is completely free.

The exception referenced above is the requirement, described above in connection with Section XIV(J) on the Ventanilla Unica and Related Export Restrictions, of the registration of exports to ensure repatriation of corresponding forex proceeds. The availability of an export permit is contingent on agreement to sell foreign exchange proceeds to Bank of Guatemala within 45 (or 90) days of the date of issuance. We were advised that this restriction may be eliminated soon.

Recommendation: It seems to make sense to eliminate this restriction, especially given the fact that foreign exchange is freely available at the daily central bank auction. Thus, even now, an exporter must sell his foreign exchange proceeds, but may simultaneously purchase foreign exchange with his local currency proceeds. The only impediment is the need to attend the auction or pay any bank fees necessitated by this transaction.

The auction market operated by the Bank of Guatemala provides an opportunity for private persons to purchase foreign exchange. The auction market is regulated, with base and ceiling prices, and controlled supply of foreign currency. According officials of the Bank, in cases of excess demand, where the auction price reaches the ceiling, the supply of foreign currency is not normally increased unless the situation continues for some two weeks. It is conceivable, then, that an investor could not immediately obtain all the foreign currency needed. As noted above, there is no requirement for approval of foreign exchange loans to Guatemalan persons. Foreign exchange to service the loan is freely available for purchase at auction. A foreign exchange loan may even be used to reduce the impediment caused by the requirement described in paragraph 2 above. If an exporter borrows foreign exchange abroad, repatriates it and converts it to local currency, when he exports he need not sell the foreign exchange proceeds to the central bank to the extent of his foreign exchange borrowing.

XVI. PRODUCT STANDARDS

A. General

In the time available to us, we were not able to make an extensive study of the Guatemalan product standards system. We were able to meet only with the Secretary-General of COGUANOR (Comision Guatemalteca de Normas), an agency of the Ministry of Economy and the principal Guatemalan standard-setting body. COGUANOR brings together representatives from relevant public agencies and private sector groups to decide what standards should be issued and to comment on proposed standards, a process that appears to give Guatemalan industry a significant role in setting the standards that will apply to it. Standards originated by COGUANOR must be finally adopted as acuerdos. COGUANOR also administers these standards by testing products, although it does not bring enforcement actions. Some additional standards may be applied to imported products by Agriculture, Public Health and other ministries under various special laws and regulations.

There are two principal standards-related issues: first, whether product standards are used as a form of trade barrier; second, whether standards are sufficient to protect the Guatemalan people and ensure the integrity of goods and services in the Guatemalan market.

B. Trade Barriers

It does not appear that the use of product standards as trade barriers is a high-priority problem in Guatemala, but there are issues connected with the numerous standards-based import licensing procedures.

According to COGUANOR, the 700 or so standards it administers are unlikely to function as trade barriers. Standards pose a trade problem primarily when they are drafted to favor the designs, processes or components used by local producers. Most Guatemalan standards, however, are adopted outright from the U.S., other countries, or international standards bodies like the Codex Alimentarius (though many Codex standards are perceived as too weak).

During our stay, we were advised that some industry groups had lobbied for the adoption of protective standards in special laws or regulations. The most interesting example was the current rule that requires the addition of vitamin A to table sugar, a standard that may make it uneconomic for foreign producers to export sugar to Guatemala. Like all good protective standards, this one can also be justified on health grounds, so the real rationale is difficult to determine. COGUANOR did not perceive lobbying for special restrictive standards to be a serious problem.

On the other hand, the GATT working party raised objections to Guatemalan standards as applied to imports. Specific objections, which we were not able to research, related to a registration procedure for medicines and the requirement that sanitary certificates

be obtained from the country of origin for certain products for human consumption. Other objections were aimed at the import license requirements discussed in the trade section of our report, many of which require approval by the Public Health and Agriculture Ministries, at least facially on grounds of sanitation and health. The working group questioned the criteria, procedures and operations under these requirements.

Guatemala agreed to phase out all GATT-inconsistent import requirements -- including those not justified under the GATT exception for "necessary" health and safety measures -- setting a goal of five years from the date of accession. It also agreed to apply all product standards without discrimination, expeditiously and transparently. Finally, Guatemala agreed to notify its intent to adhere to the GATT Import Licensing Code within three years.

Recommendations: We recommend that these standards-related issues be pursued in connection with the planning for GATT implementation discussed in the trade section of our report.

C. Adequate Standards

Perhaps the more serious problem for Guatemala is the weakness of its standards system. Of the current 700 standards, over half apply to food products; most of the rest apply to pharmaceuticals, pesticides and similar chemicals, and construction materials. (A decree adopted earlier this year authorized the free admission of pharmaceuticals that have been approved in the country of origin; the proposed generic drug law would repeal this decree, however, reinstating Public Health's duty to inspect imported pharmaceuticals.) It seems likely that public safety and health would be well served by the promulgation of additional product standards. As the most extreme example, some pharmaceutical and chemical products that have not yet been approved, or have even been banned, in industrialized countries are still exported to Guatemala, which has no standards to restrict them. More broadly, Guatemala currently has few standards applicable to manufactured products. Even aside from protection of the local population, adequate product standards are essential to the acceptance of locally manufactured components in international trade.

Enforcement is weak even as to the existing standards. We were advised by COGUANOR and private sector sources, for example, that the Public Health department has insufficient staff and resources to adequately check imported medicines and foods. COGUANOR itself selects only some 20-25 products a year for testing. They take samples of imported and local products for testing and visit local production facilities, checking all aspects of a standard. (This system seems likely to give most producers advance notice of the products currently selected for inspection.) COGUANOR is constrained not only by inadequate administrative resources but also by the dearth of qualified testing labs in the country.

Recommendation: Product standards involve a delicate balancing of interests.

We recommend consideration of a longer-term project to study the balance that Guatemala has reached.

XVI. INTERNATIONAL DISPUTE SETTLEMENT

A. General

As noted elsewhere in our report, problems of delay and inadequate rulings are pervasive in the judicial system of Guatemala. These problems affect virtually every area of the law that we considered. Since a project to study the judicial system is already underway, however, this section considers only certain specific dispute settlement issues that directly affect international economic transactions.

B. Choice of Law and Forum

Parties to international transactions frequently select a governing law in their contracts -- whether the law of one of the parties or the law of a neutral third country -- and may also agree that disputes should be resolved in a particular national forum.

In Guatemala, under Article 31 of the Law of the Judicial Organism, Decree No. 2-39, private acts and contracts may be regulated by the law the parties choose, except in areas where a choice of foreign law is deemed contrary to public policy or is expressly prohibited by statute. Besides such express prohibitions, a number of statutes that describe themselves as public interest laws are understood to fall within the public policy exception. The courts have been reluctant to interpret the public policy rule any further, so there is little guidance outside of the statutes themselves. Under Article 19 of the law, a Guatemalan party may not waive these restrictions. Choice of foreign law could also be limited under the general theory of "fraud on the law" if the choice were aimed at avoiding particular rules.

Article 34 of the law allows foreigners to consent to a Guatemalan forum ("prorogation"). There seems to be no specific provision on the choice of a foreign forum ("derogation"), but we were advised that it would probably be allowed under the general principle of freedom of action contained in Article 5 of the Constitution.

C. International Arbitration

Guatemala is a party to the New York Convention on the Enforcement of Foreign Arbitral Awards, which also deals with the enforcement of agreements to arbitrate disputes. As noted in connection with Guatemala's adherence to an OPIC agreement, this is a noteworthy step for a Latin American nation. Guatemala is also a party to the Inter-American Convention on Arbitration. Guatemala has not, however, enacted any special procedures for dealing with international arbitration clauses or awards under the New York Convention, or with international arbitration more generally. There are certain problems under its general arbitration law that should be rectified.

The standard procedure for enforcing agreements to arbitrate is clumsy. Even if the parties to a transaction have signed a general clause submitting future disputes to arbitration,

as would be normal in an international commercial contract, Guatemalan law requires that a specific "compromiso" be filed once a dispute arises. If one party refuses to sign such a compromiso, the other can get relief in court, but this requires the judge to authorize and sign a compromise himself. The practical effect of this procedure may not be much different from that of the U.S. procedure, where the court simply orders the recalcitrant party to comply, but it seems somewhat more onerous and less transparent. Most important, the delay in obtaining a compromiso may be significant. Guatemala does not allow the willing party to proceed to arbitration and obtain a default award.

The procedure for enforcing foreign awards is even more troublesome. Guatemalan law authorizes two kinds of arbitration: arbitration at law and in equity. In both kinds of proceedings, the party against whom enforcement is sought in Guatemala can raise standard procedural defenses through the judicial procedure known as "recurso de casacion". Under this procedure, the award is challenged directly before the Supreme Court of Guatemala. Procedural objections include expiration of the arbitration clause, a decision outside the scope of the clause, non-arbitrability of the issue, and matters relating to the corruption of the tribunal.

When an arbitration has been held at law, however, as is the normal case, the party against whom enforcement is sought can also challenge the interpretation and application of the law by the arbitrators through recurso de casacion. This is exactly the sort of interference by the local judiciary that the New York Convention was intended to eliminate. In constitutional theory, the Convention should prevail in Guatemalan law over the normal arbitration procedure. That point has never been tested, however, leaving an area of considerable uncertainty for international transactions.

Recommendation: We recommend that Guatemala enact a special arbitration law for international commercial arbitrations, especially for arbitrations falling under the Convention. The easiest and best way to accomplish this would be to adopt the UNCITRAL model law, which would resolve the issues discussed here as well as clarifying other arbitration issues, like the authority of the named arbitrators to determine the validity of a contested arbitration clause. This approach has been recommended by the Guatemalan Center for Conciliation and Arbitration, a body of experts that administers arbitral proceedings in Guatemala. We were advised that the current President of the Supreme Court would support the suggested reforms.

FINANCIAL SYSTEMS ANALYSIS

A. Introduction

The Guatemalan financial system is dominated by the banking sector, with an underdeveloped insurance market and a securities market in its initial stages of development. There is a strong asymmetry in the legal and regulatory framework of the financial sector; banking laws have been in effect for more than fifty years and are very restrictive and inflexible, while the securities area has practically no regulation. This legal framework has generated a unique market structure in which many operations are carried out informally, at times stretching legal limits, and demonstrating institutional displeasure with an antiquated regime.

1. Banking Sector

In the banking sector, excessive and inflexible regulation, together with overly formalized supervision, has resulted in the creation of alternative mechanisms for offering services demanded by the market. The most common mechanism utilized by banks to provide those market services (credit cards, leasing, factoring, securities brokerage, etc.) is the parallel or affiliated business.

The lack of adequate mechanisms for reporting commercial credit information, uniform accounting standards and practices, and the utilization of reliable external audits, have forced banks to adopt very conservative credit policies when dealing with non-associated clients; the banks only approve credit for those clients who are known and can offer the necessary collateral. In addition, many banks were established to serve as a financing source for their owners rather than as stand alone businesses.³ As a result of these factors, there appears to be some question regarding the strength and stability of some banks.

2. Securities Market

For its part, the almost complete lack of regulation in the Guatemalan securities market - including the nonexistence of a regulatory/enforcement body, specific standards for corporations, issuance of titles for public offering, control of intermediaries, transparency and information reporting, and accounting and external audits - has tended to impede development. A private stock market was formed several years ago but, its principal role has been to act as an intermediary, for placing public debt instruments. It has transacted very few private debt instruments and even fewer shares.

³ This was especially true when the market and interest rates were regulated.

A critical factor in the development of the securities market is its regulatory framework, especially as it relates to information and transparency (including sound accounting regulations and a system for classifying risks), supervision of intermediaries and investors rights. It is critical to establish a legal framework that provides guarantees and maximizes clarity for the participants: issuers, intermediaries and investors.

In spite of the foregoing, and as demonstrated in other countries, a well-developed securities market can only emerge if institutional investors, such as pension funds and life insurance companies, participate in the market. It is also essential to encourage the broadest possible base of issuers, privatizing publicly-owned enterprises and providing incentives for closely-held corporations to go public, by issuing shares through the exchange.

B. Summary of Recommendations

The legal and regulatory framework for the financial sector should provide broad flexibility for the provision of financial services and, at the same time, establish an effective regulatory regime to ensure that the laws are enforced. This implies less, but effective, regulation and enforcement. Guatemala should adopt an integrated approach to the modernization of financial systems and include banking, securities (issuers, intermediaries, and investors), insurance and pension funds. Without an integrated approach, it will be difficult to achieve maximum mobilization of capital. Special attention should be given to strengthen (or eliminate) banks that do not have sufficient strength to compete in a more competitive market.

In general, we recommend the following:

- 1. Strengthen the roles of current players in the financial sector, in particular the banks.**
- 2. Strengthen banking supervision and create a regulatory framework for securities (a securities and exchange commission).**
- 3. Increase the flexibility of bank regulation, authorizing banks to provide related financial services.**
- 4. Establish a regulatory structure for the securities market to cover the issuance of securities, brokerage services, supervision, standards for corporations, standards for transparent information gathering (including accounting rules, external audits and risk classification).**
- 5. Expand the securities market through privatization of pension funds (purchasers of issues), privatization of publicly-owned businesses (securities offerings), and incentives to open closely-held corporations (securities offerings and debt instruments).**

XVIII. COMMERCIAL BANKING SYSTEM

A. Introduction

In this part of the report, we will examine several aspects of the legal and regulatory framework for commercial banks. The principal emphasis will be on those aspects of the system that impede investment (foreign and domestic), in and accelerated development of the banking sector. As will become obvious from the following, Guatemala's banking sector operates within an inflexible, obsolete and limited legal and regulatory framework. Nevertheless, as with the banking systems of other Latin American countries, excessive regulation coupled with the lack of political will to enforce existing regulations, has led to a situation where, in many instances, banks are forced to provide services through parallel businesses operating outside of the restrictions of the existing legal framework.

This form of institutional rebellion by the banks can be view from two perspectives. From one point of view, the banks are merely reacting to economic realities in the most practical and efficient way available, offering those goods and services which society demands and requires. From another perspective, the banks are operating in a risky, inefficient and opaque system. The current operation of the banking system has two principal characteristics: 1) the systematic circumvention of the existing legal and regulatory structure by the banks, and 2) a strong push by banks to develop nonregulated, parallel financial services. These nonregulated ("gray market") services are provided by banks through their affiliated companies and by independent companies.

Through this structure, the Guatemalan banking system offers an impressive array of financial services, including some considered to be quite complex and sophisticated. Among these, are the issuance of credit cards, leasing, factoring, and securities brokerage services. At the same time, one can observe several very disturbing elements in the system, such as the lack of transparent accounting and financial information, the uncertain quality of bank portfolios and assets⁴, the ineffectiveness of credit limits established by the law and an unacceptably high concentration of affiliated business activities.

The modernization of the Guatemalan banking system should embrace all elements related to savings and investment, including the creation of the proper legal environment for foreign investment. This modernization does not appear difficult to achieve if legal and regulatory standards are adjusted to provide increased flexibility. As will explained in the following pages, however, the process is more complex than it appears.

The liberalization of the legal framework does not ensure the establishment of a socially responsive banking system. The weakened condition of some banks, together with

⁴ Some analysts have indicated the possibility that shareholders have not acknowledged capital registered in the accounting system.

the limited regulatory authority of the Superintendency of Banks, could portend a repeat in Guatemala of the experience of other countries that have liberalized their financial systems: the rapid deterioration of the sector, to the point of becoming a national crisis. For those reasons, we recommend that the modernization of the banking system include all areas related to capital and financial markets, including securities (issuers, intermediaries, and regulators), insurance, and pension funds. If a segmented approach is adopted, it will be difficult to maximize participation in savings and investment.

Recommendation: We recommend that banking reform incorporate the following interrelated components: 1) strengthen the asset bases of existing banks, 2) strengthen and modernize supervision of the financial sector, and 3) reform the legal and regulatory framework, giving more flexibility to banks and authorizing them to engage in more types of business activities, but at the same time, require them to operate in financially prudent ways and strengthen their ability to provide more services. These changes should result in a less regulated system with stronger financial institutions and more effective supervision.

The basic legal and regulatory framework governing banking activities in Guatemala consists of the Organic Banking Law (Decree No. 215, 1945), the Banking Law (Decree No. 315, 1946) and the Regulations Governing the Authorization and Establishment of National Banks, Branches of Foreign Banks, and Branches and Bank Agencies Already Established (1963). This basic framework is supplemented by other laws, regulations and orders of varying importance to banking and financial activities. The framework is characterized by the excessive limitations it imposes on the development of formal financial sector activities. It attempts to minimize risks and instability in the banking sector by limiting or prohibiting certain activities rather than establishing prudential standards and effective supervision. Many of the standards in the existing legal structure originated in years past under economic-fiscal theories, not as a means to strengthen the system and its members, the individual banks. As a result, many existing regulations have become obsolete by the process of liberalization recently begun in Guatemala, urgently necessitating the revision of these outdated laws.

B. Entry Barriers

Aside from the barriers imposed by capital requirements (discussed below) and the usual bureaucratic complexities common to many countries, there is no major legal barrier to entry into the Guatemalan banking sector. The law does not discriminate based on the national origin of capital, although the regulations do establish the following special requirements for foreign banks:

1. They should be organized as branches rather than affiliated corporations.
2. The minimum capital requirements are Q 2,000,000, as compared to Q 1,000,000 for commercial banks (in practice, the Superintendency of Banks

requires all banks to demonstrate a minimum capitalization of Q 6,000,000.

Contrary to what has happened in other countries, Guatemala has not traditionally attempted to limit the number of banks entering the system through bureaucratic means. This, in spite of the belief by many in Guatemala that there are too many banks in the country. Some have exerted pressure to limit competition by opposing the formation of new banks. Currently, there are 24 banks in Guatemala, three of which are state-owned, two are branches of foreign banks (Lloyds and Citibank)⁵ It is worth noting that in the past six years, six new banks have been approved and eight applications are currently pending.

The number of new banks is impressive, and somewhat surprising, given the number of banks currently operating in an economy the size of Guatemala's. The high number could be explained by the relatively low capital requirement and the absence of a restrictive approval policy. But, and especially when the financial market was more depressed, it could also be explained by the advantages one can obtain by utilizing banks as private sources of financing for their owners. In those cases, the intermediary function of the bank constitutes the secondary reason for its formation.

Recommendation: We recommend that Guatemala consider permitting foreign banks to enter the market on the same basis as domestic banks.

C. Solvency and Capital Reserves

1. Capital Requirements

As pointed out earlier, new banks are required to have a minimum capital of Q 6,000,000, in spite of the fact that the law only requires Q 1,000,000, a factor, no doubt, of the devaluation of the Quetzal over time. This capital requirement, however, is still relatively low for a modern, mid-sized bank, considering the costs of infrastructure and asset requirements.

There is no mechanism to ensure that existing banks adjust their reserves to the minimum levels required of new banks. As a result, it would not be unusual for a bank's assets to be reduced significantly by inflation, in spite of the fact that the bank is showing book profit and distributing dividends.

Recommendation: We recommend that Guatemala establish a system of indexing capital requirements to inflation.

⁵ It took Citibank several years to gain approval to operate in Guatemala. Some persons interviewed indicated that the delay resulted from political pressure from players in the banking sector. Others indicated that it was based on Citibank's insistence that it be constituted as an affiliated corporation, not a branch.

2. Leverage

The matters discussed above notwithstanding, Article 20 of the Banking Law establishes minimum capitalization requirements with regard to the volume of different types of assets held by the bank. Specifically, the law requires the following reserve levels:

1. Five percent of securities issued or guaranteed by the state;
2. Ten percent of investments in other securities or credits; and
3. Fifty percent of investments in movables, real property and other immovables.

These requirements, especially the second, appear on their face to be very conservative, but in practice they have not had the effect of strengthening the reserves of the banks. In fact, there are two legal mechanisms available for circumventing the second requirement. First, by granting loans guaranteed by "personal" bonds or certificates of deposit, usually granted by an unregulated affiliate (almacenador) of the same bank. And second, by special mortgage credits. In both cases, the bank circumvents the capitalization requirements.

The third requirement imposes a form of punishment on the bank for owning fixed assets, including those required for the normal functioning of the bank. Banks avoid this requirement by transferring fixed assets to affiliated companies that lease back the assets to the bank.

3. Reserves

The law empowers the Superintendency of Banks to require banks to maintain adequate reserves on hand offset bad loans and investments in such a way as to protect the bank's assets. Nevertheless, a general perception exists that in the case of some banks, these provisions are insufficient to completely offset implicit losses to their assets. As a result, the real assets of some banks could be substantially less than amounts being carried on the books. The lack of adequate, accurate information does not permit the formation of a complete opinion of the true situation of the banks. Some studies indicate that several banks do not have adequate reserves or assets.

In summary, the reserves required by Guatemala's legal and regulatory framework, in general, do not comport with prudent operating requirements. The amount of capital required to form a bank is too low; no adequate mechanism exists to adjust capital requirements to economic changes; debt limits with respect to assets (leverage) are inoperative due to regulatory inflexibility; there is no clear idea of the differences between book profit and real profit in an inflationary environment; and no process exists for resupplying portfolio and asset losses.

Recommendation: We recommend that all programs or policies to liberalize and

modernize the financial system carefully determine where there are problems of solvency, and, in appropriate cases, develop ways to strengthen weak institutions.⁶

D. Limitations on Traditional Operations

The limitations and prohibitions that affect banking activities refer not only to the development of activities that are complementary to a bank's traditional role (discussed below), but also to a bank's traditional activities. Among others, banks are prohibited from participating in the following activities:

- a. Deposits and withdrawals in foreign currencies;
- b. The payment of interest on current accounts;
- c. Inter-bank exchanges of capital;
- d. Long-term savings deposits;
- e. Collection of commissions for certain operations;
- f. Issuance of credit cards;
- g. Issuance of bonds.

In most cases, banks avoid these prohibitions by engaging in prohibited activities through an affiliate. Through the affiliate, they can provide almost all of these services, and others not formally authorized.

E. Limitations on Complementary Operations

Given the outdated, conservative and restrictive nature of Guatemala's banking legislation, it is not surprising that it fails to contemplate the possibility that banks will participate in nontraditional activities, complementary to their traditional roles. This oversight applies to activities realized directly by the bank as well as those engaged in by affiliates. As the law is currently written, banks cannot engage in activities such as leasing, factoring, administration or issuance of credit cards, securities brokerage services, etc. Once again, these legal limitations are ignored by banks who participate in prohibited activities through affiliated businesses. In practice, the majority of Guatemala's large banks are part

⁶ This does not mean that capital should be injected into all weak institutions. It may be wisest in some cases to liquidate the entity.

of financial groups⁷ that offer a broad range of financial services: banking, insurance, factoring, leasing, off-shore banking, credit cards. brokerage services, etc.

Recommendations: We recommend that current law be amended to permit banks to participate in traditional and complementary financial activities, provided, that the supervisory focus changes from one of attempting to limit risks or prohibiting and/or limiting activities, to one of using prudential standards, strengthening asset bases and operating under efficient supervision.

F. Credit Limitations

As in many countries, Guatemala's legal and regulatory framework establishes standards designed to diversify credit risk, limiting the volume of loans to any one individual or business. The law establishes a limit of 20 percent of the paid-in capital and reserves of the bank. The following commentaries merit further consideration:

1. The limit in question is not very conservative if one considers that there is no reference made to the guarantees that should back the credit: a loan to one person for 20 percent of the bank's assets, without effective guarantees, is too high;

2. The prohibition does not take into account the consolidation of loans to economically-related groups, making it possible for individuals or persons that form an economic group to apply individually for loans and obtain credit in a single bank in amounts that far exceed the maximum percentage permitted by law. There is no question that if loans were consolidated according to related economic groups the banks have issued credit far beyond that permitted by law.⁸

3. As a result of the lack of commercial information about individuals and businesses, as well as the lack of effective supervision, it is difficult to eliminate the use of aliases to avoid credit limits.

Recommendation: We recommend that Guatemala consider expanding the 20% limit to consolidated loans of economically related groups.

⁷ In some cases, the financial services group constitutes a small part of the owner's overall holdings. Many times the owner of the bank is engaged in industrial, agricultural, construction, or other business activities.

⁸ Available statistics indicate that there is a high concentration of credit in Guatemala. In the third quarter of 1990, it was estimated that four percent of the debtors were responsible for 82 percent of all credit issued by the system.

G. Operations With Affiliates

As with other countries in Latin America, one of the principal problems associated with the Guatemalan banking system is the wide-spread practice of using banks as a source of financing for the ownership group's business interests. The lack of adequate information, aggravated by the practice of using corporations with bearer shares, makes it extremely difficult to provide adequate supervision. This problem is recognized by all participants in the banking sector.

The legal and regulatory standards are vague and imprecise and, in practice, only the credit limits discussed previously are used. And as indicated, those have very little effect. Other regulations which require the unanimous vote of the authorizing body to approve loans for directors or employees are not useful. Currently, the Superintendency of Banks, does not have adequate authority to address key problems, such as the right to assume that a loan is made to an affiliate when it is granted on favorable terms and it is not possible to identify the borrower.

It is not only in the area of credit that banks engage in questionable affiliate transactions. There are incentives in the restrictive regulatory framework for the bank to enter into contracts in other areas. These include rental arrangements for movables, equipment and real property, and other reciprocal service arrangements.

Recommendation: Eliminate the prohibition against banks providing in related financial services and expand supervision to all affiliates of financial institutions.

G. Transparency of Information

In part because of the perception that the state implicitly guarantees the liabilities of an insolvent bank, information regarding important operational aspects of Guatemalan banks is not adequate or informative. With a lack of reliable statistics, publicly accessible reports, and other relevant information, it is difficult to understand how banks can continue to attract deposits from the public. Perhaps it flows from the public perception that the State will make depositors whole in the case of a failure.

Several areas related to transparency deserve further discussion.

1. Outside audits of banks are not required by law. In addition, there is no supervision or regulation of audits that are carried out, to the point that the auditing process has become meaningless;⁹

⁹ Some indicate that it is the usual practice of some outside auditing companies to prepare two reports. The first, which reflects reality, is for the internal use of the bank, and the other is for delivery to creditors, regulators, and other third parties.

2. There are no strict standards, and corresponding enforcement, to ensure that accounting and other related information reflects the true financial state of the bank in such key areas as: deferred losses; condition of the portfolio; credit concentration; out of balance contingencies; operations with affiliates; and financial risks associated with investments. In particular, no regulatory/supervisory mechanism exists to prevent the generalized practice of renewing or refinancing of debtors of questionable risk, and the corresponding accounting treatment of deferred interest.

3. The information published by banks and the Superintendency is useful, but incomplete. Only occasionally is a person with the appropriate analytical preparation able to form a reasonable opinion regarding the true financial status of the bank and, in particular, the risks to which it is subjecting its depositors and other creditors;

4. There is no system for classifying risks (rating) of banks so that institutional investors, as well as the public, can rapidly understand the risk associated with each bank;

5. The accounting standards presently required do not adequately reflect the assets and liabilities of the banks, the income and expenses associated with them, and out-of-balance activities. That is, it is not possible to adequately determine what a bank is doing and in which activities it is profitable or unprofitable.

6. No procedure exists for indexing or adjusting banking activities to satisfactorily account for the effects of inflation. In particular, a mechanism should at least exist to assist the banks to maintain constant reserves in real terms.

7. There are no reliable systems for publishing commercial information, court filings, or credit ratings. This lack of information requires banks to use more care in their lending practices. It may explain, in part, their willingness to lend only to those persons they know and who can offer adequate guarantees.

Recommendations:

- a. Institute uniform accounting and auditing standards.**
- b. Encourage expanded public and private information systems for reporting of credit and financial information.**

H. Normalization of Problem Institutions

As has been previously indicated, there exists a tradition or belief that in cases of bank insolvency, the State will intervene and cover the debts of the insolvent institution. The risks to depositors and other creditors are not viewed as important, independently from the bank with whom they are dealing. This together, with an antiquated regulation scheme, and

overly formal supervisory structure, result in an overly risky operation from a social point of view.

In general, the legal and regulatory framework does not create a sequence of actions that should be taken to assist institutions with problems. That is, the regulation does not contemplate a full range of actions that can be taken at every stage of the process, from preventative actions (such as a sound system for monitoring portfolios), to corrective actions (such as authority to mandate corrective actions and adjust capitalization), to an orderly intervention and liquidation. The law fails to address questions related to the merger of banks, the acquisition of an entire bank by another, or the sale of "packages" of assets and liabilities.

The lack of a clear legal framework, with well-defined and orderly procedures for dealing with troubled institutions, by default places that responsibility squarely with the State. The State must then decide whether to intervene and reimburse depositors or let the bank fail, with the attendant political costs. The latter option is generally rejected in most countries.

Recommendation: Establish a punctual legal framework for dealing with problem institutions, including steps to be taken at each stage of the problem and limitations on State responsibility in case of insolvency, should be a priority component of a modernized Guatemalan banking system.

I. Non-Bank Entities

In spite of legislation establishing otherwise, it has been the practice of unauthorized, nonregulated and unsupervised entities to engage in financial activities such as intermediation, and attracting public deposits. These "parallel banks" have been organized to satisfy the demand for services that banks cannot legally provide. The use of these parallel institutions, however, is utilized, including by the banks, to avoid regulation and supervision by the Superintendency of Banks.

The banking system is made up of regulated and unregulated financial institutions. The unregulated institutions capture deposits and realize banking activities outside of the legal and regulatory framework.

J. Legal Authority of the Superintendency of Banks

The Superintendency of Banks is the organism legally charged with the supervision of banks and other regulated financial entities. The Superintendency is not a legal entity, but it does have a budget financed in part by the entities it regulates, including the Bank of Guatemala.

The Superintendent is appointed for a four-year term by the President of the Republic

and enjoys considerable operational autonomy. He cannot be removed except for specific cause. Many of his actions require agreement by the Monetary Board.

The attributes of the Superintendent, as defined in the law, are very general and are similar to those of other countries in the region. The law does not specifically and clearly authorize the Superintendent's power to intervene in key areas such as regulation of all financial institutions, regulation of accounting practices, standards for disclosure of information, authority to carry out inspections of regulated institutions and related third-parties, authorization of licenses, the imposition of sanctions and authority to implement corrective measures. Many of these attributes, and others, have also been granted to the Monetary Board, which is in many instances is the body to which determinations made by the Superintendent are appealed.

In general, the relations between the Superintendency and the Monetary Board are subordinated to the Superintendent, in spite of the fact that the President of the Monetary Board is also President of the Bank of Guatemala, an entity legally subject to the supervision of the Superintendency. This relationship raises doubts regarding the Superintendency's ability to operate independently and may cause conflicts of interest.¹⁰

A very important step toward strengthening the Superintendency was a recent judicial determination that an appeal to the Monetary Board does not automatically suspend the effectiveness of a resolution issued by the Superintendency. Previous to the decision, the Superintendency was hesitant to impose sanctions, requirements to improve reserve levels and provisions for uncollectible assets. In spite of that determination, there is a need to modernize the system of sanctions and fines which has become obsolete due to inflation.

K. Ability to Diagnose and Respond

For the purposes of this report, we did not engage in an in depth analysis of the Superintendency's personnel, its policies or its supervisory procedures. For that reason, this overview is very preliminary and is based on information gathered from third parties and interviews with officials of the Superintendency.

With regard to personnel, the Superintendency has a strong orientation toward accounting, lacking strength to focus more carefully on economic/financial matters. A training program, and possibly some change of personnel would be needed to conform the

¹⁰ This subordination is reflected, for example, in the fact that the Superintendent cannot directly appoint senior personnel to the Superintendency, but must propose candidates to the Monetary Board for consideration. This limitation applies to the appointment of advisors and inspectors (Artículo 44, Ley Organica del Banco de Guatemala). The conflict that appears to be most critical, however, is the participation by the private sector on the Monetary Board, including a representative of the banking sector.

supervisory personnel with the new focuses and techniques of financial supervision.

Traditionally, the Superintendency has embraced a very formal approach to supervision. That is, an orientation toward verification of formal compliance with basic legal and regulatory standards, related to both banking/finance and fiscal matters. That focus has been related to a lack of personnel and an excessive work load, caused partially by the assignment to the Superintendency of duties unrelated to banking supervision (such as valuation of estates of persons who die intestate). The lack of a proper focus and an excessive work load have combined to make it all but impossible for the Superintendency to focus on the most important points of supervision: levels of capitalization, state of the portfolio, compliance with credit limits, operations with affiliates, adequacy of accounting records, analysis of economic groups, etc. The Superintendency is aware of these points and is refocusing its efforts to two key areas: the valuation of assets and financial analysis.

In addition, the Superintendency has implemented a system of portfolio classification which groups each bank's debtors into five categories based on the prospect for recovery. Inspections are carried out to verify the application of this process and to carry out financial analyses of banking entities. In these areas, the Superintendency is beginning to progress toward adoption of a modern supervisory focus, with emphasis on constantly knowing what is going on with each bank and responding with timely and effective regulation when problems occur. Maintaining the present course with adequate political, internal and technical/financial support from international organizations, it will be possible for the Superintendency to reach an adequate level of supervision.

L. Summary of Recommendations

The Guatemalan banking system presents serious problems and inefficiencies, requiring a profound transformation focusing on three key areas: the legal and regulatory framework, improved supervision, and the financial condition of its banks.

The legal and regulatory framework should be modified to eliminate all prohibitions against banks participating in relevant financial activities which could facilitate the encouragement of savings and investment and provide impetus for the economic development of the country;

Banking supervision should be reoriented and reinforced in such a way to guarantee compliance with the spirit of the new legal and regulatory framework;

Many banks should be strengthened¹¹, in such a way that they are transformed into

¹¹ This strengthening should include, but not be limited to, recapitalization. Aspects such as the professionalism of personnel, adaptation to new technologies, modernization of

viable businesses focused on transacting business in the financial sector. They should be dedicated to providing financial services to their clients and not serve solely as a source of financing for the ownership group.

It is critical that the reforms in these three areas be done jointly, within a carefully developed and integrated strategic plan. It is not possible to liberalize the legal and regulatory framework, without at the same time, strengthening banks and the supervisory capacity of the Superintendency. The experiences of other countries clearly indicate that the processes of modernization that include only liberalization of the legal framework, run an enormous risk of a banking crisis.

At the same time, it is difficult to require the banks to invest in strengthening their asset base, organization and fundamental orientation without offering them a legal and regulatory framework in which they can operate profitably. For these reasons, a modernization program for the banking system should include a coordinated and sequential list of actions to be taken within a specified time frame. The program should include, in the order of priority listed below, the following elements.

1. Strengthening Banks

a. Specific minimum capital requirements should be established for all banks, including standards for adequate capitalization that contain no exceptions or flexibility;

b. A diagnostic should be made of every bank in the system to determine the actual current level of reserves, including an accurate valuation of its assets and complete identification of contingencies and obligations, whether or not reflected in its financial statement;

c. For those banks determined to be lacking sufficient capital, a recapitalization program should be established or, when that is not possible, normalization should be explored through other means such as merger, the sale of assets, etc.

2. Strengthening Supervision

A plan should be initiated to ensure an improved and effective supervision, such as the redefinition of the attributes, resources and autonomy of the Superintendency.

From a legal and regulatory viewpoint, this will require a substantial revision of the status of the Superintendency, including:

procedures and organizational restructuring are generally necessary in banks which have operated in restrictive environments, and which are subsequently liberalized.

- a. Appointment and Removal of the Superintendent;
- b. Independence from the Central Bank and the Monetary Board;
- c. Supervisory attributes including, sanctions and measures to coerce compliance and establishment credit criteria and other related areas;
- d. Redefinition of accounting standards and procedures;
- e. Strategies for internal and external audits in support of supervision
- f. Procedures and policies for divulging information to the public;
- g. Design and implementation of an automated information system, that includes as an integral component, a risk center.

3. Reform of the Legal and Regulatory Framework

This reform includes the key areas discussed previously, namely:

- a. Expansion of activities permitted, including traditional and complementary financial activities. In both cases, the focus should change from one of attempting to limit risks or prohibiting and/or limiting activities, to one of using prudential standards, strengthening asset bases and operating under efficient supervision.

For organizational as well as for supervision purposes, the basic structure of the new banking industry should be defined so as to cope with new businesses. That is determine whether the law will favor development of additional activities by 1) the banks themselves, 2) affiliated companies (hijas), or 3) related companies under a holding company concept.

At the same time, a critical analysis should be conducted of whether banks should participate in financial businesses that could potentially result in conflicts of interest, such insurance and pension funds.

- b. Redefine the credit limits, including differentiations based on guarantees and incorporation of the concept of group economic interests.
- c. Radical redesign of the standards that govern relationships between banks and affiliates.
- d. Elimination of unregulated parallel financial institutions, at least to the degree that they capture public resources.
- e. Institutionalization of the concept of risk for depositors and establishment of a limit on the state guarantee of deposits. This should be enacted jointly with coherent standards that define a sequential plan with distinct stages, for addressing the rescue of problem institutions.

f. Institutionalization, in conjunction with the previous recommendation, of the concept of transparency. This should include reliable accounting standards for banking operations, revelation of all essential facts, full and complete information regarding the asset base and portfolio of the operation, information regarding the ownership and operations of the bank with related parties, the publication and submission to the public of all non-confidential bank information (limiting nonconfidential to deposit-related information), the requirement that banks be subject to a rating system, and standards for external audits.

It is essential as mentioned previously, that the reform of the banking system be incorporated into global reforms related to the financial sector, including the areas discussed above.

XIX. SECURITIES MARKET

A. Introduction

This section of the report analyzes the current state of the Guatemalan securities market, identifying the principal relevant areas that are inhibiting its growth or that can contribute in the future to its development, expansion and support. It has been prepared based on the consultants' experience with the development of the Chilean securities of market and experience in other countries, as well as personal study of the Guatemalan securities market.

B. The Role of a Securities Market

The securities market is a special market for carrying out transactions related to securities. Participants in this market include issuers, intermediaries which include the stock exchanges, brokers and agents, and purchasers.

1. Securities

Securities include all transferable titles including: shares, options for the purchase and sale of acciones bonos, debentures, fund quotas, mutuals, savings plans, commercial effects and, in general, every investment or credit title.

2. Function of the Securities Market

The securities market, as an economic entity, plays a vital role in the financial sector. A role that can best be explained by describing its characteristic functions:

a) Facilitate the Flow of Savings and Investment

Securities markets constitute a channeling mechanism for financial resources. Developed and efficient securities markets can play a significant role in the financing of large investment projects.

The transfer of funds and resources in the securities market results from the issuance of medium and long-term instruments such as bonds and shares, which are sold to public and institutional investors.

A well-ordered securities market can also provide a firm support for increasing personal savings. In that sense, the market is a positive influence as a medium for educating and improving public attitudes towards personal savings, investment, stimulation of the entrepreneurial spirit, and capacity to evaluate risks and innovations.

It is not coincidental that advanced countries have well-developed, active securities markets and that in less developed countries markets are nonexistent or in incipient stages of development. This difference has several underlying economic and social bases. One of the principal reasons, is the low income level in many less developed countries. Another is the relentless cycle of economic crises suffered by these countries. In addition, ignorance, lack of trust and lack of understanding of corporations and their relationship to capital markets impede increased participation.

The purpose of the securities market is to facilitate the flow of savings and investment capital, efficiently matching financial savings resources with businesses in need of capital to finance their operations.

b) Maximize and optimize the use of capital resources

Maximization of capital resources occurs when investor/saver resources efficiently flow to investments with the greatest potential for profit.

This occurs in an environment where prices are freely determined and accurately reflect all information available in the market. In other words, where there is market transparency. This requires that all information related to a transaction and/or titles be available from a clear, complete, accurate and economic source. It is also important that information regarding the players in the stock market, the offerors and purchasers, be readily available.

c) Price Determination for Financial Instruments

The securities market is a market which very nearly reflects the theoretical "perfect market," given that the prices for each instrument or title are freely determined by supply and demand. Speculators, who specialize in the ability to evaluate the future performance of companies, play an important role in the determination of prices.

The activity of speculation, and the market in general, are very sensitive and susceptible to the collective psychological state of the participants. There is considerable danger that market signals can be improperly interpreted resulting over or under-valuation of instruments, resulting in prejudice to investors.

d) Provides Market Liquidity

Medium and long-term financing is required for large investment projects. Nevertheless, not all investors are willing to participate in medium and long-term projects without a short term guaranty of liquidity. The securities market serves the function of bridging the needs of projects and investors by selling

instruments at a percentage of their par value.

C. Analysis of the Guatemalan Securities Market

In this section, we analyze the current status of Guatemala's securities market, examining the points raised in the Scope of Work. In addition, we have set forth a number of additional matters relevant to the effective development of the Guatemalan securities market including specific recommendations for its improvement.

1. Description of the Market

Generally, the Guatemalan securities market is in the primary stages of development, characterized by the participation of several players. However, the market lacks the breadth and depth, and liquidity to qualify as a real securities market (as that concept was described in the previous section). Rather, the market is principally a forum for issuing a single class of debt instruments, pagarese.

2. Entry Requirements

The Guatemalan securities market, in general, lacks a regulatory framework and supervisory agency to oversee for existing and future market officials. The privately owned and operated National Stock Exchange ("NSE") has adopted a private code of regulations, Regulations of the Stock Exchange ("RSE") to govern that exchange but that is the extent of existing regulatory frameworks. I was drafted by the partners of the NSE to regulate officials that engage in securities transactions only on that exchange and has no public application. As can be seen, it is difficult to discuss the general entry requirements of a securities market that has no regulatory framework.

An examination of the RSE, as the only securities regulation in force, contains no entry requirements, other than registration, for issuers or investors who wish to participate in transactions carried out through the NSE. It is worth noting that registration with the NSE is subject to the approval of its Administrative Council. The information requirements of businesses issuing titles through the NSE is limited to general information regarding their financial condition and dividends, in the case of issuers of stocks. There is no requirement for disclosure of all relevant facts.

3. Limitations on the Participation of Commercial Bank

The lack of regulatory laws applicable to the securities market means that, at least from the securities side, there are no legal obstacles to participation by commercial banks in the securities market. Commercial banks, in this sense, include all financial institutions that receive monetary deposits and short-term deposits, with the objective of investing those

deposits in active, short-term operations, as defined by the Guatemalan banking laws.

Guatemalan banking laws establish the type of investments in which commercial banks can participate, including the following:

- Commercial banks can acquire bonds and credit instruments, of a stable value and high liquidity, issued or guaranteed by the state, public entities, state-owned and mixed economy financial institutions, banks that operate in Guatemala, and private enterprises whose issues qualify for the highest rating granted by the Securities Commission and by the Superintendency of Banks;
- The Monetary Board, when it deems it convenient in terms of the country's exchange and credit position, may authorize banks to acquire, under certain conditions and limitations, foreign and international securities of stable value and high liquidity;
- The Monetary Board can set the maximum limit of investments that commercial banks can make in bonds and credit instruments. However, no investment with a maturity of more than three years cannot exceed 20% of the total value of the deposits, unless invested in securities issued by the Bank of Guatemala.

There appear to be no serious limitations under Guatemalan law to financial institution's ability to access the stock exchange. Furthermore, the Banking Law authorizes banks to act as financial agents, buying and selling stocks, bonds, and any other type of security or stock depository for its clients. In practice, a large number of agents that operate in the stock exchange are affiliated with commercial banks.

4. Regulations for Domestic and Foreign Investors

As it has been pointed out, because no securities laws exist, there is no discrimination between domestic and foreign investors in what pertains to access to and operation of the securities market. However, given the undeveloped state of the market, which only offers public debt titles, the participation of foreign investors is very unlikely. Under these circumstances, the only direct investment foreign investors are likely to make is in closely-held corporations.

5. Regulations for Public Stock Offerings, Partnership Rights, Preferred Stock and Other Asset-Backed Securities

Again, the lack of a regulatory framework means that there are no regulations in place relating to public offerings or shareholder rights. In the RSE there is only a passing mention of these matters. It only requires that titles must be registered before and approved by the Administrative Council before they can be traded through the exchange.

6. Obstacles to the Emergence and Development of an Active Securities Market

Under the present circumstances, the lack of regulatory framework constitutes an obstacle to development of the securities market. The absence of clear standards and regulations to establish the role of market participants and market operations are factors that inhibit and restrict the emergence of an active market. Until there are adequate standards and a specialized, autonomous regulatory institution to supervise the market, foreign and domestic investors will likely be reluctant to invest.

Specific recommendations are provided at the end of the report, but it bears stating here that the most immediate and urgent priority is the establishment of a Securities Marketing Law.

As stated previously, the existing Guatemalan regulatory framework creates no serious obstacles to participation in the securities markets; rather, it is the lack of specific technical regulations that inhibits further development of the securities markets. The RSE provides a certain level of autoregulation to existing activities, but its value is limited due to possible conflicts of interests, which will eventually limit the markets ability to expand and broaden. The long term development and growth of the market will require structural changes, as well as some specific short-term actions.

D. Recommendations

The following recommendations should be considered to facilitate the development and expansion of the Guatemalan securities market:

1. Enact a Legislation Creating a National Securities Commission

- a. The Commission should be autonomous, of a judicial and self-governing nature, with links to either the Ministry of Finance or Treasury.**
- b. The National Securities Commission should regulate 1) persons or businesses who issue securities or make public offerings; all stock exchanges operating in the securities market; brokerage houses, their agents, and operations in the market; and 4) mutual funds, both their creation and operation.**
- c. Initiate further studies to determine the most effect organizational form, standards and other details related to the formation of the Commission.**

2. Draft and Enact a Securities Marketing Law

The law should define a regulatory framework for the securities framework and include such concepts as primary and secondary markets, public offerings, definition of securities instruments, market participants, legally-related persons, prohibited activities, rights, responsibilities and penalties, rating of debt instruments, etc.

3. Review the Corporations Law

The Corporations law should be reviewed to ensure that it contains concepts essential to the securities market such as: definitions of distinct corporate entities, distinguishing between privately-held and publicly-held corporations and their relation to public offerings, corporate capital, stocks, shareholders, administration, responsibilities of management and boards of directors, financial conditions, distribution of profits, affiliates, divestitures, and merger and acquisitions, etc.

4. Risk Classification System

The rate of growth of debt issued currently in the Guatemalan securities market dictates the creation of a risk classification system to qualify the risk of instruments traded in the securities market, using information required of issuers.

5. Use of the Securities Market for Privatization

a) Issue stock sales to the public through stock exchanges. Privatizations can be accomplished by selling small percentages of issues annually, with the purpose of establishing market prices and a market presence while avoiding distortionary pressures. This privatization technique brings many benefits to the securities market. The privatization and opening of corporations to the public means that they must submit to regulation, sell their issues in the market and release timely financial information. Obviously, this could take place once regulatory laws and enforcing institutions were operational.

b) Direct sales to company employees is another mechanism frequently used to transfer stock to company employees or employees of another company. State employees can be given the opportunity to acquire shares in businesses owned by the GOG through the advance payment for compensation for years served. Another option would be to pay part of the employee's compensation with stocks, instead of cash. Employee stock associations can also be formed to acquire a major stake in the

business in the name of the lending bank until the loan used to acquire the stake is paid off. Operations can also utilize a payment plan. The acquisition of shares by state employees provides diversity for the market and the diffusion of economic benefits. There is also a lesser probability that social conflicts might arise that may go against the nation's interests.

c) Solicitation or Sale to Corporations and/or Institutional Investors

Pension funds could be used to acquire shares in state-owned enterprises in which the state agrees to maintain a majority interest for a specified time period. At the time of the purchase, the state would sign divestiture agreement through by which it would completely divest itself of its interest over time. This effort would be complemented by a system of risk classification.

The points listed above would strengthen the securities market, giving it depth and breadth -- expanding into types of instruments that are not currently being traded.

ATTACHMENT A

Background: The increased private-sector and free-market orientation of the current Guatemalan government (GOG), combined with the broad-based stabilization program undertaken by the GOG over the last six years, presents an important window of opportunity for USAID/G to work with the GOG to promote more comprehensive trade and investment reforms. To establish strong private-sector oriented economic development, four basic elements are required: (1) macroeconomic stabilization; (2) an open market system built on private investment; (3) a private sector with the capacity to respond to new investment opportunities; and (4) modernization of the legal and regulatory (L&R) frameworks that constrain the free flow of trade and investment.

Significant progress has already been made in macroeconomic stabilization and in opening up the economy, reflected in the effective depreciation of the real exchange rate and restrained inflationary pressures in all years, except 1990; the reduction of tariff levels; and a streamlining of export procedures; and a partial opening of the market for air cargo and passenger transportation. However, to continue its economic growth, Guatemala must now address the essential but difficult second-generation sectoral policy, regulatory and institutional issues constraining further growth in trade and private investment. Modernization of the legal and regulatory frameworks is one critical area within this set of needed second-generation reforms that has already been identified during the Trade and Investment Council negotiations, by the Interamerican Development Bank (IDB) as a condition to its Investment Sector Loan Program, and by the Mission's own discussion paper, "Constraints to Trade and Investment in Guatemala", as requiring immediate attention.

Objective: Despite the broad consensus among international donors and within the Guatemalan government itself that the present legal and regulatory frameworks are a constraint to trade and investment, there is a serious lack of understanding of what the specific constraints are and how to overcome them. The objective of this document is to contract specialized technical assistance to analyze the Guatemalan legal and regulatory frameworks within which trade and investment occur and the financial system operates, identify areas within the frameworks that now constrain trade and investment, provide recommendations on what changes in the L&R frameworks are needed to remove constraints to competitive and efficient markets, including financial markets, and advise the Mission on what the technical assistance requirements would be to support a legal and regulatory policy reform activity. Judicial constraints will be examined in a separate analysis.

Scope of Work: The contractor will provide a 3 person team of specialists to carry out the analysis of Guatemala's L&R frameworks. The analysis will be conducted in two parts: an overall review of the legal and regulatory framework as it relates to trade and investment; and a more detailed review of the legal and regulatory environment for the financial sector, both the commercial banking system and the emerging securities market. Analytically, the problem should be approached as if it were a two-by-three matrix, in which each cell--to the extent possible and reasonable--represents a separate analysis.

	Trade	Investment	Financial System
Legal Framework	X	X	X
Regulatory Framework	X	X	X

The team will also advise the Mission on what the technical assistance requirements to support a legal and regulatory policy reform activity, to improve the financial system, trade and investment environment, would be.

A. TRADE AND INVESTMENT:

A.1. Legal Framework: Analysis of the legal framework to identify constraints to, or the protection of, free trade and investment will include, but not be restricted to, coverage of the following areas:

1. The rights of private ownership, including:
 - a. the right of private entities, both domestic and foreign, to own business enterprises and engage in all forms of remunerative activity;
 - b. the existence of investment screening and approval processes affecting eligibility for tax holidays, tax exemptions, etc.;
 - c. the right of private entities to freely establish, acquire, and dispose of interests in business enterprises;
 - d. and the competitive equality between public and private sector enterprises for access to markets, credit, licenses, and supplies.

2. The protection of private property, including intellectual property rights, as reflected in:
 - a. the existence of a legal system protecting and facilitating the acquisition and disposition of property rights;
 - b. adherence to key international agreements on intellectual property rights;
 - c. international agreements providing for protection of patents, copyrights, trademarks, trade secrets, and semiconductor chip design.

3. The transparency and clarity of public policy governing foreign investment, and restrictions on foreign investment, such as:
 - a. prohibitions against 100% foreign ownership in areas open to private investment, except where foreign ownership would be restricted by national security interests;
 - b. differential access of domestic and foreign investors to special tax and investment incentives, access to licenses, approvals, and procurement.
 - c. the lack of freedom to employ top management and other specialized personnel, as appropriate.

4. The existence of performance and content requirements and incentives that regulate establishing, maintaining, or expanding an investment, or that govern access to tax and investment incentives, such as:
 - a. requirements that investors purchase from local sources or export a certain percentage of output;
 - b. requirements that nationals own shares, or that the share of foreign equity diminish over time, or that technology be transferred on certain terms.

5. The existence of regulations governing profit, capital, or dividend transfers, including:
 - a. restrictions on transfers, in freely usable currency, of funds relating to investments;
 - b. or limitations on remittances of profits or returns for intellectual property.

6. Regulations governing expropriation, that provide for anything other than:
 - a. expropriation of private property in a nondiscriminatory fashion, and in accordance with established principles of international law;
 - b. due process and transparency of purpose;
 - c. the investors and lenders to expropriated entities should receive prompt, adequate and effective compensation.

7. Clear and transparent process of dispute settlement, including:
 - a. effective means for enforcing property and contractual rights;
 - b. an acceptance of international arbitration of investment disputes between foreign investors and the state.

8. Land market legislation affecting land transfers, discouraging efficient land use, restricting access to credit, or contributing to land degradation.

9. Inadequate commercial codes that restrict the types of instruments available for financing business transactions, restrict ability to transfer property and contract rights, and to register a corporation.

10. Inappropriate labor laws that inhibit labor mobility, promote the inefficient substitution of capital for labor, raise costs to consumers, increase disparities between productivity and the cost of production and contribute to widening income inequalities.

11. The bankruptcy laws for adequacy, identifying areas that inhibit competition, discourage savings mobilization, direct credit, and raise cost to borrowers.

A.2. Regulatory Framework: Similar to the above discussion, analysis of the regulatory environment will cover, but not be restricted to, the following areas:

1. The adequacy of mechanisms for titling and registering property and for enforcement of property rights;
2. The complexity and difficulty of procedures for obtaining export permits, as well as an analysis of whether such permits are necessary;
3. The complexity and burden of procedures for obtaining import licenses or permits and possible differential effect of these procedures on domestic and foreign interests, as well as an analysis of whether such permits are necessary;
4. The lack of clear standards, or their application, in the technical, legal, sanitary and phytosanitary areas and any impeding effect this may have on imports or exports;
5. Restrictions on market access, particularly in industrial, services, textiles, government procurement, agricultural or transportation markets that impede fair and open competition among firms, or that disadvantage foreign firms vis-a-vis their domestic competition;
6. Quantitative restrictions on trade;
7. Corrupt, inefficient, or burdensome customs procedures;
8. Closed or nontransparent government procurement procedures;
9. Bureaucratic procedures (e.g., registration of securities, licensing, tax administration) that inhibit trade and investment or access to essential services (e.g., telephone, electricity, etc.).

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B. The Financial System:

B.1. The Commercial Banking System: The commercial banking system is the principal source of savings mobilization and credit in Guatemala. Since 1986, that system has expanded. Both the amount of domestic resources captured by commercial banks and the number of banks in the system increased sharply. This growth is essential if Guatemala is to be able to generate sufficient domestic resources to ensure continued economic growth in the future.

The contractor will provide an analysis of the legal and regulatory environment within which commercial banks operate. The contractor will be expected to include in the analysis the extent to which this regulatory environment poses an impediment to both foreign investment and growth in the commercial banking system. The areas to be examined include:

1. regulations governing the licensing of new banks;
2. regulations restricting commercial banks from providing specialized services such as NOW accounts, securitization, and the issuance of innovative financial instruments;
3. regulations governing on-site examination of balance sheets;
4. differential treatment of locally- and foreign-owned banks
5. regulations governing exit from the financial system and mergers among banks.

B.2. Securities Markets: A securities market deals with exchange of ownership positions in a corporation (stocks), a creditor relationship with a corporation (bonds), or rights to some underlying security such as options or warrants. As financial systems expand, such security markets become increasingly important. The contractor will examine legal and regulatory constraints to the development of such a securities market. Topics to be examined could include:

1. entry requirements into securities markets;
2. limitations on participation of commercial banks in securities markets;
3. differential regulations covering local and foreign investors;
4. regulations governing public issues of equity shares, rights issues, preferred stock and other asset-backed securities;
5. tax regulations inhibiting the emergence of an active securities market.

In the securities markets analysis, the contractor will be expected to indicate the extent to which this regulatory environment poses an impediment to investment in capital markets and the extent to which competition is inhibited.