# DISCUSSION PAPER

10

## CONSTRAINTS TO TRADE & INVESTMENT IN GUATEMALA

# TABLE OF CONTENTS



30

# THE PROMOTION OF TRADE AND INVESTMENT IN GUATEMALA

## A. Introduction

Private investment and trade have always been the primary factors in the growth of Guatemala's economy. Historically, the welfare of the country has centered on traditional exports and on private investment (public investment playing only a minor role). The original purpose of this paper was to highlight policy constraints to trade and investment in Guatemala. The evaluation carried out identified few such constraints for trade. Additional work needs to be done on policies that constrain investment. The paper is composed of three sections: (1) a description of the achievements already accomplished, (2) an outline of reform requirements already identified and, (3) a summary of areas where additional information and action is needed.

Small-scale industries are growing rapidly and playing an increasingly important role in determining economic activity. Given the small scale of the Central American markets, however, such businesses must expand into export activities if their importance in economic activities is to increase.

According to Management Systems International (MSI), a consulting firm specializing in the analysis of private sector activities, successful businessmen are constantly on the lookout for "the angle", they are risk takers, quick to identify failure and move into new lines of business. These entrepreneurs do not need subsidies or special treatment.[1/] What they require most is (1) information necessary to identify opportunities, (2) opportunity to acquire sufficient know-how (technology and market information) and (3) access to resources (capital) that will allow them to undertake new activities.

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1/ Some argue that government assistance is necessary if non-traditional exporters are to be successful. Support for that position is drawn from the experience of the Asian Tigers. It must be remembered, however, that these countries' governments assisted the most by reducing barriers to trade and creating conditions that allowed exports to thrive. Clearly, there was active government intervention, but the quality of these governments must be kept in mind. Government assistance alone will not work. A vigorous private sector is the key to any country's development. However, a vigorous private sector is not created "sui generis", but is the product of an active development program.

Public sector production of goods and services is generally to be avoided due primarily to the lack of responsiveness to market signals. The public sector must ensure that the appropriate policy environment exists within which entrepreneurs can flourish. Seven broad activities are appropriate for the public sector:

1. keeping the macroeconomic environment stable, particularly inflation and the exchange rate;
2. simplifying the regulations and restrictions involved in the export process;
3. promoting savings mobilization and expansion of the financial system;
4. providing adequate and appropriate infrastructure (transportation, energy, and telecommunications);
5. encouraging the privatization of various public industries;
6. improving technological and human resource development at all levels; and
7. modernizing the laws governing intellectual and physical property contracts, incorporations, labor relations, etc.

B. Progress to Date

The macroeconomic policy environment in Guatemala has improved since the mid-1980s. An effective depreciation of the real exchange rate was achieved (see Appendix A), and inflationary pressures were restrained in all years except 1990 (see Appendix B). On the regulatory side, the GOG implemented a series of major tariff reforms (the tariff range fell from 0-150 percent to 2-37 percent and the average weighted tariff fell from almost 30 percent to 14 percent), it shifted the tariff system from specific values to an ad valorem basis, and it effectively has eliminated the export tax (see Appendix C). The GOG also streamlined export procedures, creating a one-stop export center to facilitate export registration.

In the late 1980s, international air transport services were inadequate to accommodate the rapid growth of air cargo. The GOG eliminated AVIATECA's monopoly on the cargo market in Guatemala and international airlines quickly expanded services and increased the number of cargo flights. Cargo capacity in 1990 was more than adequate to meet the demands of exporters.

As a result of these efforts, private sector investment increased from 8.4 percent of GDP in 1986 to 12.5 percent in 1990--the second highest level in Latin America after Jamaica. The increase in investment and the improved export climate had a favorable effect on trade flows to the United States. During the last five years, the share of private investment and trade (exports plus imports) averaged 48.9 percent of GDP (see Appendix D), with non-traditional exports gaining increased momentum.

Non-traditional exports include agricultural and manufactured goods, primarily exported outside the Central American Common Market (CACM). Non-traditional exports from Guatemala to the United States grew at an annual average rate of 37.6 percent during 1983-1990, faster than any other Central American country and second only to Jamaica in Latin America. 2/ The average share of non-traditional products in total exports climbed from 5.7 percent in 1966-70 to 16.8 percent in 1985-89 (see Appendix E).

This surge in non-traditional exports suggests a shift in the structure of production. While improvements in the macroeconomic environment have allowed freer market forces to create new opportunities, institutional factors have also been important. Enabling legislation for assembly operations ("maquila") and the creation of outward-looking business groups have been instrumental in the evolution of, investment into and growth of Guatemala's productive trade sector. For this new pattern of production and trade to work efficiently, the Government must continue to embrace and improve upon a comprehensive set of market-oriented policies.

## C. Remaining Policy Agenda

### 1. Macroeconomic Policies

Remaining constraints and barriers to free trade-- tariffs, regulations, foreign exchange controls--should be reduced or eliminated within a context of stable macroeconomic policies in order for trade growth to expand. In recent years, the performance of the government in this area has been incipient. The private sector has restricted investments to relatively

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2/ Although Dominica and Grenada had faster increases than either Guatemala and Jamaica, the absolute levels were so small that they are excluded from most data bases.

33

secure activities. Nevertheless, the steady depreciation of the exchange rate and elimination of export taxes have given appropriate signals to non-traditional exporters. As an economic stabilization program with the IMF is completed, private sector confidence in the maintenance of appropriate policies should improve.

2. Trade and Regulatory Reform

Few major restrictions limiting trade and investment remain. Major impediments--price controls, excessive registration of exports, fixed interest rates and tariff barriers--have been removed or are currently being targetted for removal. However, some specific trade and tax regulations remain.

Although the tariff barriers have been sharply reduced, they can be lowered further. The GOG should set a single rate for all commodities. Significant levels of effective protection can exist when even small differences in tariff levels exist. For example, basic grains have a significant negative effective protection--tariffs on agricultural inputs are 17 percent or 27 percent while the import of basic grains is subject to only a 2 percent tariff. This structure provides a disincentive for the production and possible export of basic grains. The GOG should set a single, unified tariff rate.

The GOG prohibits the export of unprocessed coffee and regulates the import of wheat, wheat flour and cacao seeds. Such prohibitions are marginal but should be eliminated by the GOG.

More binding constraints arise from the export and import licensing practices of the government. Licenses are required for the export of thirteen products including rice, beans and corn and for the import of twelve products including fertilizers, herbicides and insecticides (see Appendix F for a complete list). While the importation of certain environmentally dangerous herbicides and insecticides should be prohibited, in general such restrictions, including quotas and export rights, should be eliminated.

The tax code is a second source of distortion. Existing fiscal incentive laws provide exemptions to specific enterprises producing a variety of items including bananas, fertilizers, and milk. A total of nine incentive laws remain in force (see Appendix G). These laws not only affect the distribution of resources among sectors but, because they are given to specific enterprises, they affect intra-sectoral resource distribution. Subsidies for these types of economic activities should be eliminated.

7/4

Interest costs are deductible for companies in the present tax code and interest earned by individuals is tax exempt. Dividend payments are taxable for companies, listed as profits, but when they are passed to individuals they are exempt. This combination provides an incentive for debt financing of activities and increases the demand for credit. While elimination of the interest deductibility for business borrowers, particularly exporters, would place them at a competitive disadvantage with producers in other countries where such deductability is allowed, there is little justification for not taxing interest as income to lenders. A continued partial exemption for dividends received by investors would provide an incentive for equity investment.

The value added tax (IVA) is currently withheld from exporters' earnings, contrary to what was decreed in Law 60-87. The withheld IVA should be returned to exporters, since it represents a loss of working capital. Items imported for drawback production (maquila) should not be treated as final imports. The customs service should be professionalized, aiming towards efficiency and clarity. The present conditions at customs, even with the one-stop window, are causing bottlenecks. Further, immigration procedures for foreign investors, technicians, and businessmen should be streamlined, especially with regard to obtaining work permits.

Even if market signals are correct and financial resources are available for investors, lack of information can restrict export activity. Exporters must be aware of restrictions to market entry arising from such things as phytosanitary controls, quality and grade restrictions and other non-tariff barriers to entry. Export associations provide a convenient institution for providing such information.

These regulatory and tax issues result in some distortion but do not pose binding constraints to the expansion of non-traditional exports. The GOG, however, should not consider the removal of such constraints a minor matter. In order to strengthen private sector confidence in the permanence of the present outward orientation of the government, the GOG should:

a. eliminate virtually all restrictions on trade;

b. identify a negotiation process with the private sector that would permit movement, over time, towards a unified, single tafiff rate within the context of industrial reconversion and the gradual removal of protective tariffs;

c. remove all but minimum registration requirements on exports and eliminate the need for even a one-stop export office; and,

15

d. open the foreign exchange market to the commercial banks by eliminating foreign exchange surrender requirements.

Such a sweeping elimination of regulations would indicate that the government will not reverse the open orientation of its policy stance.

3. Financial Market Reform

Exporters and export associations indicate that the most binding constraint that remains to export activity is the lack of finance. Small-scale exporters with an order for a large quantity of goods cannot get access to the most basic financial instruments such as letters of credit, lines of credit and revolving credit facilities. The difficulty is that savings mobilization by the Guatemalan financial system is low. Savers prefer to hold their wealth either in the form of fixed assets, such as land, or in the form of off-shore deposits. As a result, credit is scarce and capital is tied up in unproductive fixed assets. Informal financial markets provide some relief to exporters, but credit is often expensive and has very short maturities.

The reluctance of private savers to hold quetzal-denominated assets in the banking system results from a variety of factors. Throughout most of the period from 1986-1990, interest rates were fixed by the GOG at negative real levels. This policy discouraged savings and weakened lending institutions. While the policy was changed early in 1991, it will still be some time before the perceptions of Guatemalan savers change sufficiently for the full impact of the policy change to be felt.

A second factor is a lack of confidence in the soundness of the system. Some banks are believed to be insolvent and neither the Bank of Guatemala nor the Superintendency of Banks has the ability to fully monitor the banking system. A third factor is the shortage of savings instruments. NOW accounts, equity financing and other financial innovations are not available in the Guatemalan system.

Needed changes in the financial market include (1) making interest rate movements freer, (2) improving bank supervision and (3) increasing the number of financial instruments in the market.

## 4. Infrastructural Constraints

Infrastructural constraints increase the operational costs, reduce product quality, and increase the time required for export. Current exporters have adapted to the actual situation - either taking advantage of availability or filling the gaps with their own resources. However, if exports continue to expand, infrastructural conditions will begin to pose binding constraints. Both the public and private sectors can play larger roles in providing investment and improved efficiency in infrastructural expansion and quality of service.

Infrastructural improvements are needed in a variety of areas including transportation, communications and energy. The role of the government is to ensure a minimum level of quality service. The principal policy issue is the barriers to entry that limit private sector participation.

While cargo capacity has been increased to meet the current demands, the airport still lacks cold-storage holding facilities. Many exporters have lost perishable goods when expected flights were cancelled. This need has already stimulated an expansion of merchandise handling by the private sector. Adequate storage facilities at the airport are essential.

The port system--Puerto Quetzal, Puerto Barrios and Santo Tomas--is inefficient. As a result, transportation and storage costs for Guatemalan exporters are significantly above those of exporters from neighboring countries. The GOG is beginning to address this issue by granting the private sector an increasing role in the operation of the port system. Private sector container operations and stevedore services have been authorized. Greatly expanded private sector participation in port management will be necessary if the system's efficiency is to be significantly improved.

The road system is in need of substantial repairs. Travel time has increased in recent years because of deterioration of major roads. Investment by the public sector has been delayed by the restrictive fiscal policy followed by the GOG over the last two years. At the same time, at least one study indicates that there are significant barriers to entry to the trucking/bussing system. As a result, there may not be sufficient competition to keep inland transport prices under control. The GOG should be urged to improve and maintain the road system and, at the same time, eliminate all monopolies in the transportation system.

In addition to high inland transportation costs, low economies of scale, port inefficiencies and inadequate storage facilities combine to make transportation costs from Guatemala to Miami almost twice those of Chile to Miami. The GOG should expand private sector participation in the transportation system and provide incentives for competition.

Electrical power demand for the country this year will approach 497 mW, with an estimated annual increase in demand of 7% a year projected for the period 1991 -- 1999. The sudden 20 percent shortfall in overall generating capacity, producing the current situation of power rationing and scheduled power outages, has rapidly raised electrical energy to the single most important constraint to production and exports now affecting the country. Although there exists an installed capacity of 788 mW, even under normal rainfall and water reservoir levels most of the thermal and hydroelectric plants of the Sistema Nacional Interconectado (SNI) operate far below capacity. This is primarily due to aging equipment, poor maintenance, and operational problems. The unexpected drought and the low level of Chixoy reservoir will further exaccerbate the already low efficiency level, affecting energy availability and reliability well into the future.

To solve this problem, the GOG should move forward rapidly with current initiatives to encourage private investment in the generation, transmission and distribution of electricity. Private investment regulations should be clarified and investment guarantees provided. The GOG should also explore other solutions to demonopolize the energy sector. These should include the promotion of new electrical generation projects, assistance in securing financing for these project, co-generation and interconnection of electrical systems across national borders.

5. Privatization

The Government of Guatemala operates a number of enterprises including specialized banking and credit institutions, communications and transport companies, grain storage and trading, electric power facilities, etc. With few exceptions, these enterprises represent a substantial drain on the GOG's fiscal resources. As government corporations, their activities are generally unresponsive to market signals with neither prices nor product distribution reflecting market demand. The cost and inefficiency of government enterprises has become well known. Perhaps the most serious problem with state owned enterprises is that either by fiat or preference, they prevent private sector investment. The barriers to private sector entry and the opportunities offered by privatization are areas that should be investigated.

Privatization offers a significant vehicle for attracting foreign investment, particularly if one or more of the four larger state-owned enterprises (e.g. GUATEL, INDE, EEGSA, and FEGUA) are offered for sale. The importance of foreign investment in these areas is that it would bring with it badly needed new technology that would greatly increase the efficiency of the systems involved and assure improvements in both the quality and quantity of services essential to the growth and competitiveness of the Guatemalan private sector.

6. Human Resource and Technological Development

An educated and skilled work force is essential for economic development, as is an environment in which technological change can be fostered to increase efficiency and returns on investments. Recent studies on the determinants of growth in Guatemala indicate that education has been a key factor in economic growth and development, that returns are high, but that the level of education and training continues to be relatively low.

Technological change is a major ingredient to moving along the development path. There needs to be clearer roles for the private and public sectors, in technological and human development. Each has a role to promote technological change, foster education, create conditions that encourage investment, reduce the risks of innovation, protect intellectual property rights, provide basic research support, and facilitate means for technology transfer and application.

7. Modernization of Legal System

The structural transformation of an economy -- sectoral shifts, changes in the role of trade, increased scale of operations -- requires changes in the legal framework in which economic institutions allocate their resources, incentives, and information. Without legal democracy and a sound system of justice, benefits tend to flow to rent-seekers rather than to free-market-oriented entrepreneurs.

While it is clear that there is room for improvement in much of Guatemala's legal system, additional studies are needed to focus attention on those changes most critical to expansion of international trade and facilitation of additional investment, both foreign and domestic. Pertinent areas for study include patent laws, rules and regulations governing the employment of foreign managerial and technical personnel; laws related to the importation of technology; corporate, labor and anti-trust laws; and tax policies and codes, particularly those providing for differential treatment of foreign investors, either as individuals or companies.

The GOG has made significant strides in eliminating distortions and disincentives that affect trade flows in

Guatemala. Little is known, however, about disincentives and distortions affecting flows of direct foreign investment (DFI). One area that exists is the tax treatment of dividend payments by firms. If a Guatemalan firm pays dividends to a Guatemalan stock holder, taxes on those dividends are the responsibility of the taxpayer. If dividends are paid by a foreign-owned firm located in Guatemala, the firm must withhold taxes due and pay those withheld taxes to the Ministry of Finance. The stockholder then declares the full value of the dividend and the withholdings already paid to the Ministry of Finance.

The impact of this differential dividend tax levy on DFI operations is marginal because of the many means available for circumventing this kind of tax regulation. There remains the question, nevertheless, of the existence of other regulations having the potential to negatively affect the decision to invest in Guatemala. For example, areas that still require further analysis for potential negative impact on foreign investment include:

1. the labor code,

2. other tax regulations,

3. trademark regulations or intellectual property issues.

Ways must also be found to expedite legal actions and decisions. In a dynamic and evolving private sector, the uncertainties inherent in a system that all too often require years for an important legal decision to be reached can be a powerful disincentive for otherwise viable and important economic ventures.

D. What Else Do We Need to Know and Do?

1. Financial System

There is considerable information on the conditions and restraints in the financial system. Special attention must be paid to the requirements needed to make interest rate movements freer, improve bank supervision, and increase the number of financial instruments in the market. That information must be systematically gathered and analyzed to identify policy areas, especially those restricting the creation of domestic and foreign savings and access to credit.

2. Infrastructure & Privatization

The policy constraints and the restrictions to private sector participation in infrastructure servicing need to be examined. Barriers to entry and monopolies existing in the trans-

40

portation system and in the port system are not fully identified. Opportunities for privatization, and how it would increase the efficiency of services and make the acquisition of new technology possible should be studied and be presented to the private sector and the GOG. The Guatemalan private sector should stimulate further studies and other activities that keep privatization in public view and at the center of the government's action agenda.

3. Foreign Investment and Technology

Entrepreneurs need access to technology, production knowhow and marketing information. The most successful non-traditional exporters have gained such information through some combination of joint ventures or close relationships with suppliers in the United States market. Direct foreign investors can play a critical role in providing such information. Differential treatment of local and foreign investors has been addressed above, but needs to be researched further. Additional information is needed on regulations governing joint ventures and direct foreign investment.

The roles of both the public and private sectors in supporting education and research and development is essential for improving labor productivity and to foster innovative capital investment. Legal and institutional change is needed to create a suitable environment necessary for technological innovations. Information is needed on the legal and financial barriers preventing the implementation of mechanisms for the transfer of technology and the creation of legal constructs for foreign investment.

4. Modernization of Corporate Law and Regulations

Regulations governing property rights--physical and intellectual--and means for administering justice are unclear. There is a critical need to examine and possibly modernize the laws governing contracts, incorporations, antitrust, labor, etc. The laws concerning patents, the hiring of foreigners, transfer of technology, and taxes, require analyzing. Also, a further examination of the steps for business incorporation and in the use of protected technology is needed. This area will become increasingly important as non-traditional activities expand further from agriculture into electronics and manufacturing for export markets.

5. The Role of the Private Sector in Promotion and Development of Exports

The Guatemalan private sector has played a critical role in articulating to the GOG the policy reforms that needed to be undertaken during the last several years. The success of this dialogue, carried out in conjunction with the assistance of donor programs and pressure for macro-economic policy reform, is measured by the presence of relatively few serious policy constraints to trade. The private sector has not been content, however, to merely address the policy constraints to trade and investment.

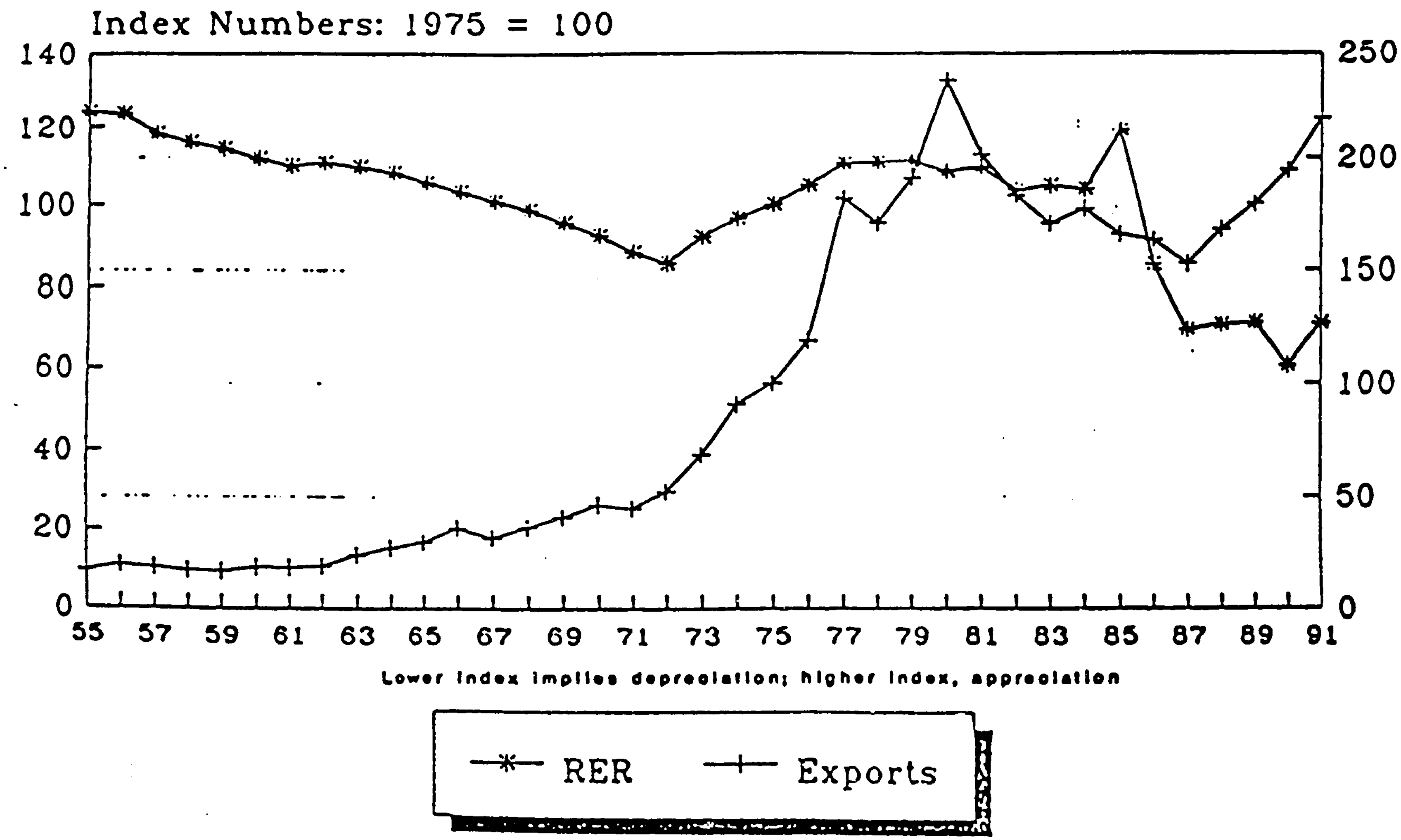
In the current competitive world markets, achieving the proper set of macro-economic policies is a "sine qua non" for entrance into the market place but, "per se", contributes little to aggressively establishing a competitive position therein. Recognizing this situation, the Guatemalan private sector has also taken a vigorously proactive stance on the removal of bureaucratic, institutional and regulatory constraints to trade and investment. This has been complemented by parallel efforts to stimulate investments, to diversify markets, and to promote and further develop exports. Although significant progress has been made in both areas, the highly fluid nature of local institutional development, the rapidly changing international market system, and the phenomenon of exploding growth in the export sector itself have created a lengthy agenda of actions still to be undertaken to maintain and improve Guatemala's position in world markets.

This agenda, still in process of definition and refinement, covers five broad areas of needed action. These five areas are:

1. Promotion and Development of Exports
2. Investment promotion
3. Industrial reconversion
4. Strengthening local public and private institutional capacity to ensure compliance of Guatemalan exports with the international-market regulatory environment
5. Revision or elimination, where possible, of domestic non-tariff-barrier type regulatory measures that constrain growth and development of exports.

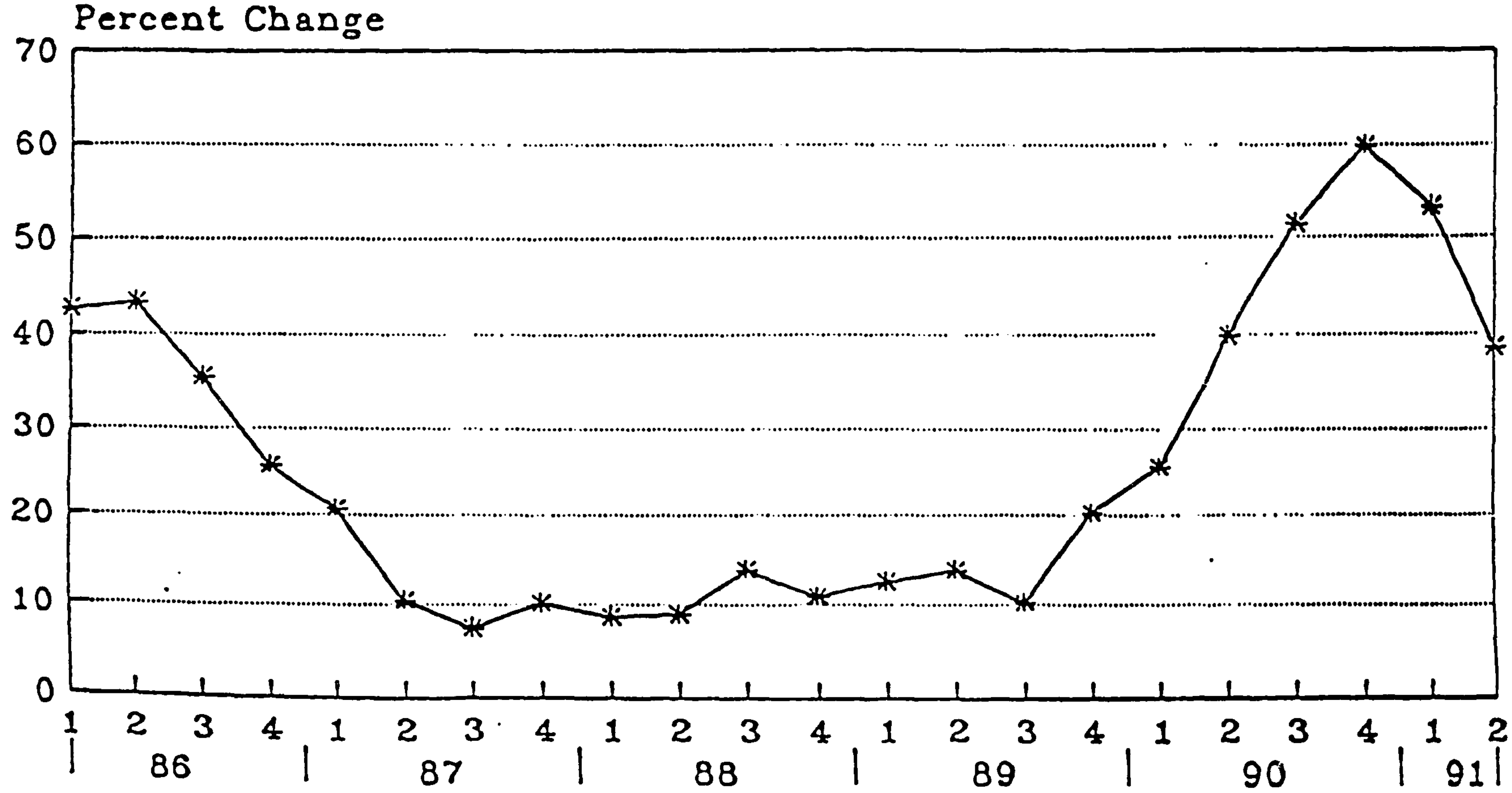
APPENDIX A

# Real Exchange Rate & Exports
## Guatemala: 1955 - 1991

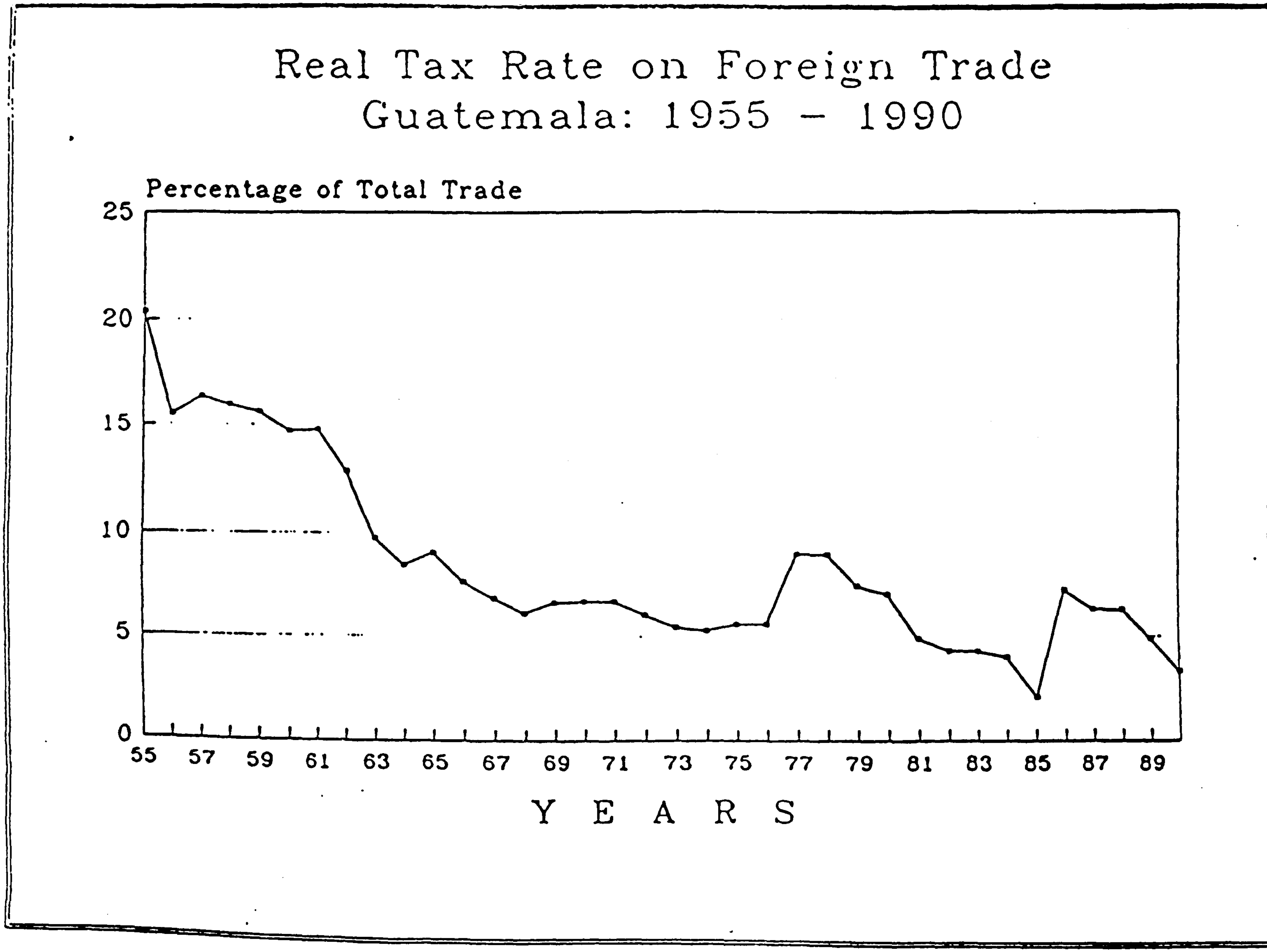


APPENDIX B

# Guatemala: Inflation 1986 - 1991
## (12-Month Inflation)
## Capital City

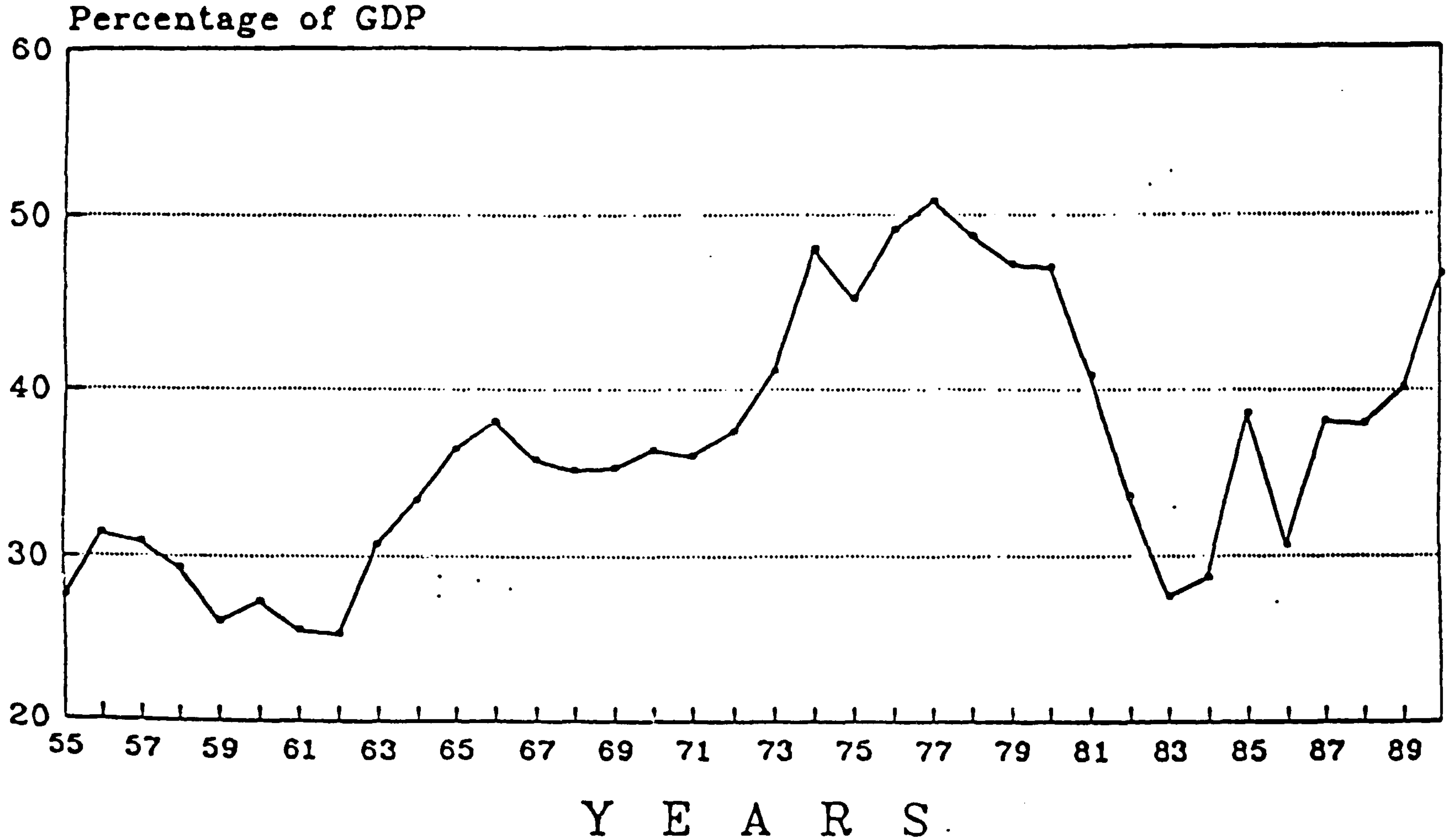


APPENDIX C



Real Tax Rate on Foreign Trade
Guatemala: 1955 - 1990
Percentage of Total Trade
25
20
15
10
5
0
55
57
59
61
63
65
67
69
71
73
75
77
79
81
83
85
87
89
Y E A R S

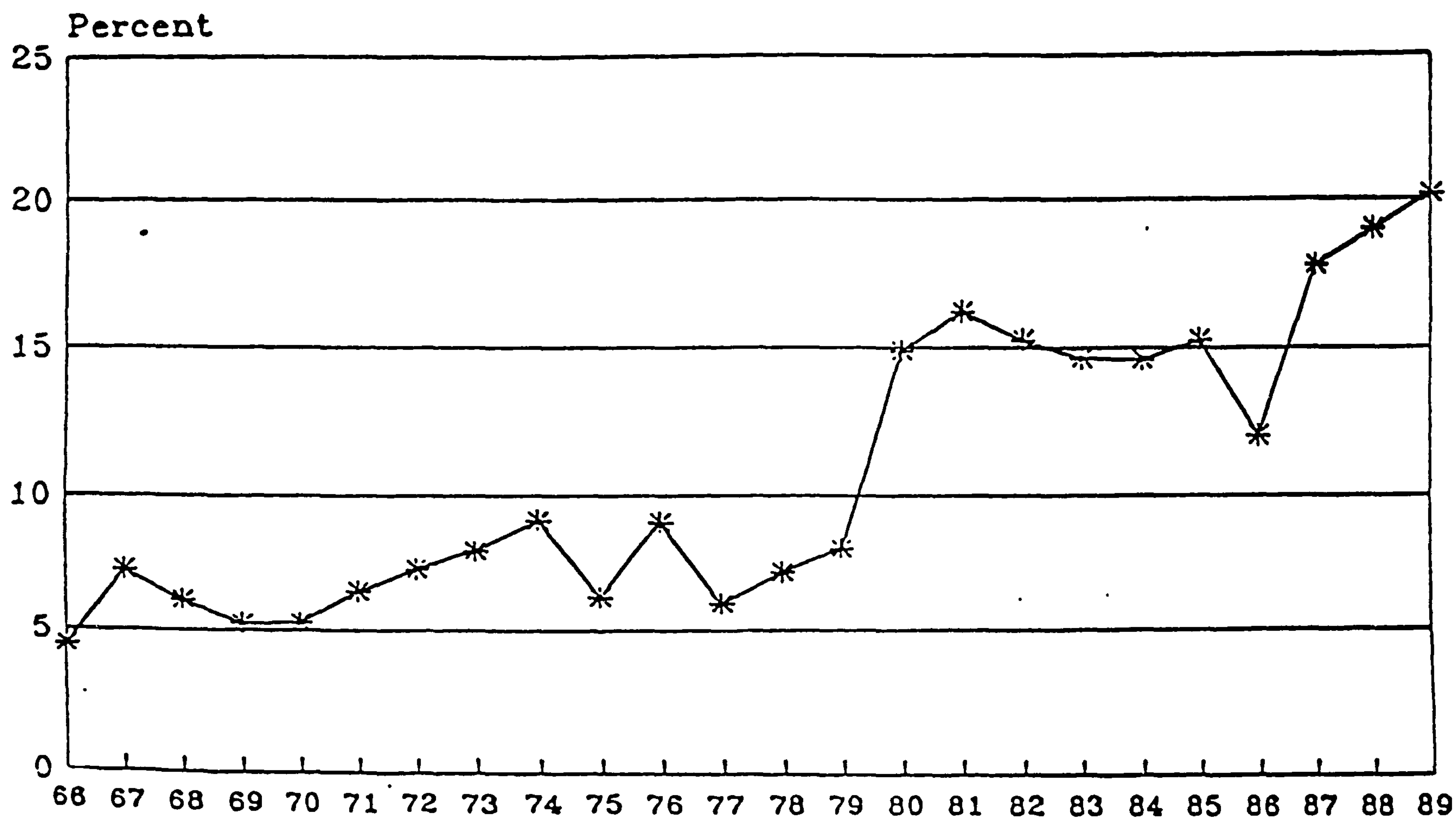
# Share of Exports plus Imports
## Guatemala: 1955 - 1990




APPENDIX D

APPENDIX E

# Non-Traditional Exports
## (As a Percent of Total Exports)




Guatemala: 1966 - 1989

## APPENDIX F

### NON TARIFF BARRIERS

1. Prohibitions

   a. Export
   unprocessed coffee

   b. Import
   wheat
   wheat flour
   cacao seeds

2. Licensing

   a. Exports

      1. cotton and cotton seeds (Controlled by association of growers/exporters)
      2. sugar (controlled by Guatemalan Sugar Growers Association)
      3. coffee (controlled by ANACAFE)
      4. cacao
      5. cardamom
      6. beans
      7. rice
      8. corn
      9. cut flowers
      10. peanuts
      11. sunflower seeds
      12. clothing
      13. electronics

   b. Imports

      1. fertilizers
      2. herbicides
      3. insecticides
      4. flour
      5. beans
      6. corn
      7. rice
      8. peanuts
      9. cotton
      10. reproductive cattle
      11. animal feed
      12. medicines for animals

## APPENDIX G

### TAX INCENTIVES

1. All fiscal incentive laws are granted selectively to firms and are not sector-wide incentives.

2. Fiscal incentives laws for industrial decentralization, poultry and rubber were eliminated in February 1991.

3. Fiscal incentive laws remain for:

   3.1 Free Zones (zona franca)
   3.2 Maquila (draw back) industries
   3.3 Rabbit production (Law 89-71)
   3.4 Reforestation (Law 72-73)
   3.5 Cattle breeding
   3.6 Bananas
   3.7 Insecticides
   3.8 Fungicides and herbicides
   3.9 Fertilizers

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# ANNEX B:
# A DISCUSSION OF GUATEMALAN FINANCIAL MARKETS REFORM

## Financial Markets--Changing the Rules of the Game

### Historical Perspective

Before the 1980s, development of the financial system in Guatemala was based largely on the provision of short-term trade financing and working capital finance. Commercial banks were few in number and relatively small. Financial requirements for investment were met either through foreign borrowing or through retained earnings of the large corporations.

The governments of this period recognized that the financial system was not generating significant resources for the small and medium-sized firms. In response, public sector development banks, such as BANDESA and CORFINA, were created to mobilize domestic resources and channel those resources to targeted sectors of the economy. Government regulation of these specialized institutions was extensive. Credit was allocated by sector--usually to the agricultural and small-manufacturing sectors--and interest rates were controlled.

These policies resulted in an extremely weak and fragmented financial structure. As interest rates were frequently negative in real terms, there were few incentives for domestic savings. The wealthy held resources either abroad or in fixed assets such as land. The principal activity of the commercial banking system was to on-lend Bank of Guatemala credit and credit provided by foreign banks. By the end of the 1970s, for example, total foreign credit amounted to almost three-fourths of total financial system credit.

### What Needs to Change in the Financial System?

The economic deterioration of the early 1980s and the world debt crisis has forced a significant change on the operations of the financial system. Guatemala can no longer depend on foreign resources to maintain economic growth. Instead, the banking system must attract domestic savings and then provide those resources for high-yield investments. If domestic resources are not forthcoming, Guatemala will face decades of low per capita growth and will fall far behind its Central American neighbors in terms of trade and development.

TRADE AND INVESTMENT SECTOR PROGRAM
ASSISTANCE CONCEPT PAPER

[redacted]

The objective of the financial component of the Trade and Investment Program is to assist in the transformation of the financial system. Laws governing financial activities will be modernized, information on the financial position of institutions will be standardized and made transparent and regulations will ensure safety and efficiency rather than restricting the economic activities of the financial system. Commercial banks will be able to increase the scope of their lending activities, providing a whole new range of instrument such as money markets, negotiable certificates of deposit, and indexed savings instruments. As the supply of loan funds increases in the financial system, groups previously excluded from the financial system will gain access to credit. The Mission can play an important catalytic role in this transformation.

How to Get There

The transformation of the financial system requires a variety of reforms. First, the macroeconomic conditions must be stable. Second, there must exist a modern and effective information system ensuring that the financial system is transparent. Third, the legal structure must ensure the efficient functioning of a modern system. Finally, there must be in place an effective regulatory environment.

The stable macroeconomic environment is a necessary condition for the successful transformation of the financial system. No system can expand under conditions of accelerating inflation and wide-spread uncertainty. The GOG is expected to sign a stand-by agreement with the IMF in 1992, ensuring an appropriate climate for financial sector reform.

An efficient information system is essential for the functioning of a financial system. Financial institutions must be able to evaluate the expected risk and return of investments. Depositors must be assured that financial institutions are solvent. Consistent and timely information is needed in order to make those choices. This information base arises from appropriate accounting practices, auditing and information disclosure requirements. In Guatemala, there is no uniform accounting regulations that ensure that such information exists; instead, information is scarce and of poor quality. There are no regulations covering external auditing of financial institutions. As a result, audits are not considered reliable. In this area, policies governing comparability and reliability of information will be addressed.

The existence of an adequate legal structure is the third requirement for an efficient financial system. There must be legal protection for both debtors and creditors. In Guatemala, the company law, the banking and securities law and the bankruptcy laws are outmoded. The Superintendency of Banks cannot monitor banking system activity and has no power to force changes of individual bank behavior. Furthermore, the laws are difficult to enforce. In order that financial contracts flourish and expand in scope, corporate laws, banking laws and securities laws must be updated. As the transformation of the system may put a number of banks under considerable stress, the bankruptcy laws will be of prime concern. The Bank of Guatemala and the Superintendency of Banks must have to tools and the authority to enforce bank closing and bank mergers when necessary.

A fourth requirement is the existence of an adequate regulatory system. As the financial system is transformed, the rules of the game are modified. New activities are encouraged and some, more traditional activities are discouraged. The objective of regulatory reform is to ensure that the transformed system is safe and efficient, mobilizes resources efficiently and minimizes mistakes in resource allocation, curbs fraud and prevents instability from turning crisis. Regulatory reform embodies (1) development of appropriate prudential controls and (2) the strengthening of bank supervision.

Prudential controls seeks to reduce the risk of systemic failure and avoid the development of a financial crisis. Institutions are required to be adequately capitalized, professionally managed, have diversified risks and have adequate accounting standards. In recent years, there has emerged a consensus on a variety of such prudential regulations including capital requirements, criteria for entry and exit, on the appropriate degree of asset diversification, on limits on loan to insiders and on providing capital reserves for non-performing loans. These regulations in Guatemala are outdated and unenforced. A revision of the existing standards and the degree of reform needed will be a central focus in the initial phase of the program.

Sound prudential regulations must be complemented with a system of effective supervision. Supervision ensures that commercial banks comply with the rules and regulations, that losses are not hidden from the public and that adequate steps are adopted to prevent the emergence of a full-blown financial crisis. Supervision also involves the establishment of mechanisms to deal with insolvent institutions. If the private sector is to begin channeling savings through the financial system, it needs to be assured that the bankruptcy of one institution does not threaten the entire financial system.

## Role of Policy Dialogue

The transformation of the financial system is politically difficult. Groups that have earned substantial wealth will be in jeopardy; groups traditionally excluded from the political arena may begin to gain power and influence. Political leadership and guidance during this transition become extremely important.

To be effective, the political leadership requires a thorough understanding of the costs and benefits of the transition. Understanding the rationale for removing some regulations and restrictions and the necessity of introducing others is essential for the design of an effective program of financial reform.

The policy dialogue activities will seek to ensure that the various objectives of financial reform are understood. The tradeoffs between reforms that stimulate competition, efficiency and innovation on the one hand and stability, safety and fairness on the other will be explained. The objective will be to define clearly the benefits to the financial system of financial reform and convenience the private sector to work together with the public sector to establish a financial system that meets the needs of this decade.

One outcome of the negotiations over the financial reform will be agreement on a basic financial constitution. That understanding will include the structural, prudential, supervisory and legal considerations discussed above. Those conditions will govern what financial institutions are permitted to do, where they can operate and what conditions they have to meet. The resulting clarity is expected to enhance the competitiveness of the financial system and facilitate a significant increase in domestic resources channelled through the domestic financial system.

A summary of the policy objects of the policy dialogue on financial market transformation could include:

1. standardization of accounting regulations;

2. standardization of audit procedures, including the requirement for periodic external audits of the banks;

3. revision of the company law and banking law to ensure that debtors and creditors are protected, no inconsistencies exist between the laws, and that modern financial activities are permitted;

4. modernization of the bankruptcy laws and identification of legal steps available to enforce solvency requirements by the Superintendency of Banks;

5. improvements in the Bank of Guatemala capacity to monitor developments in the commercial banking system;

6. modernization of prudential regulations governing capital requirements, criteria for entry and exit from the financial system, regulations governing asset diversification, insider trading and providing capital reserves for non-performing loans; and

7. strengthening of the regulatory power of the Superintendency of Banks, ensuring that it has the information needed and the authority to enforce banking regulations.

TRADE AND INVESTMENT SECTOR PROGRAM
ASSISTANCE CONCEPT PAPER

## ANNEX C:
## PROGRAM INDICATORS AND IMPACT MEASUREMENT

The Mission is proposing three indicators to measure the impact of the Trade and Investment Program: (1) increased value of nontraditional exports, (2) increased trade as a percent of GDP, and (3) increased private sector investment as a percent of GDP. An adequate baseline exists for these indicators and there exists a relationship between the objectives of the Trade and Investment Program and those indicators. Equally importantly, there exists an important linkage between the indicators chosen and economic well being of the poorest Guatemalans.

<u>Increased value of nontraditional exports</u>

Nontraditional exports have grown at an average annual rate of over 20 percent between 1985 and 1991. The bulk of these exports are provided by small-scale farmers living in the Guatemalan Highlands. This activity has drawn families hitherto excluded from the market into the monetized economy. As nontraditional growth expands, such small-scale farmers will be the group most likely to benefit.

<u>Increased trade as a percent of GDP</u>

One of the difficulties affecting the Central American economies in the past was the development of industries and activities that were costly and inefficient. Scarce domestic resources were used in areas where the returns were small and the benefits to the economy small. The end result of these policies included inflation, bankruptcy of the public sector and unemployment.

The opening of the economy to international trade and international competition has several objectives. Foreign technology flows into the economy via imports and direct foreign investment. Demand for exports increases, allowing greater and more efficient use of resources. This increase in overall activities benefits everyone in an economy. However, domestic labor is used more intensively in domestic production than other inputs. Therefore, the labor groups of an economy benefit most from increased trade. Their opportunities grow more rapidly and their wages increase at a faster pace than similar labor groups in closed economies.

[redacted]

Private investment as a percent of GDP

The opening of the economy will provide new opportunities for private sector activity. Guatemala's comparative advantage lies in labor-intensive activities. Private sector investment will increase in those areas that are relatively labor intensive. Examples include nontraditional agricultural exports, "maquila" and small-scale manufacturing. The increase in private sector investment will bring with it increased employment and increased wages.

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**ANNEX D:**
**INITIAL IEE**

LAC-IEE-91-

# ENVIRONMENTAL THRESHOLD DECISION

| | |
|---|---|
| Project Location: | Guatemala |
| Project Title: | Trade & Investment Sector Program |
| Project Number: | 520- |
| Funding: | $25 Million |
| Life of Project: | Five years |
| IEE Prepared by: | Alfred Nakatsuma<br>USAID/Guatemala |
| Recommended Threshold Decision: | Categorical Exclusion |
| Bureau Threshold Decision: | Concur with Recommendation |
| Comments: | None |
| Copy to: | Terrence J. Brown, Director<br>USAID/Guatemala |
| Copy to: | Elizabeth Warfield,<br>USAID/Guatemala |
| Copy to: | Alfred Nakatsuma, USAID/Guatemala |
| Copy to: | Wayne Williams, REMS/CEN |
| Copy to: | Mark Silverman, LAC/DR/CEN |
| Copy to: | IEE File |

____________________ Date _______

John O. Wilson
Deputy Environmental Officer
Bureau for Latin America
and the Caribbean

9

# INITIAL ENVIRONMENTAL EXAMINATION

Project Location: Guatemala

Project Title: Trade & Investment Sector Program

Funding: $25 Million

## Program Summary

The purpose of this 5 year, $25 million ESF/DA sector program is to increase trade and investment in Guatemala in support of the Mission's goal of achieving broad-based, sustainable economic growth within a stable, democratic society. The program combines a $12 million policy reform component, carried out over three years, with $13 million in project activities to be implemented over a three to five year period. The program supports a policy agenda jointly developed with the Government of Guatemala (GOG), the private sector, and the International Financial Institutions (IFIs). Project activities, designed to complement the policy agenda, are divided into three components crucial to developing the trade and investment sector: policy reform, business assistance, and direct trade and investment promotion. Project implementation will primarily target proven private sector entities, but also will provide some assistance to relevant public sector institutions.

## Program Goal and Purpose

The goal of the Trade and Investment Sector Program is to support the achievement of broadly-based, sustainable economic growth in Guatemala within a stable, democratic society. Achievements of the program goal will be measured in terms of an increase in GDP growth, an increase in per capita GDP growth, and an increase in employment.

The purpose of the T&I program is to increase trade and private investment in Guatemala. Accomplishment of this purpose assumes the existence and stability of sound macroeconomic policies on the part of the GOG. In order to increase trade and private investment, the Mission will direct its resources to achieving the following program outputs: 1) an open trade regime; 2) a sound investment climate; 3) the deepening of financial markets; and, 4) the increased production and marketing of non-traditional exports.

A brief description of the comments is provided below:

Component 1 - Policy Reform Support

The purpose of the policy reform support component is to assist in the design and implementation of laws, policies, regulations and procedures that support private-sector-led export and investment growth. The focus of the component is to provide technical assistance and fund policy research and analysis in support of this purpose. Project activities under this component are designed to complement the policy-based agenda with activities linked specifically to the achievement of goals of the reform agenda. This component is divided into three subcomponents: (1) strengthening public sector entities; (2) provision of a long and short-term technical assistance pool; and (3) strengthening private sector entities involved with trade and investment promotion, in the area of policy formulation.

Component 2 - Business Assistance ($1.5 million/3 years)

The second component of this project will focus on providing technical and business assistance to help firms engage in productive international trade and investment transactions. Technical assistance to Guatemalan businesses involved in trade and investment will be provided by the International Executive Service Corps (IESC) to Entrepreneurial Chamber (CAEM) and the Non Traditional Exporters Guild. The services provided by IESC include the technical assistance provided by Volunteer Executives (VEs), drawing upon their own past experience as leaders of American industry and business.

Component 3 - Direct Trade and Investment Promotion

Given Guatemala's potential for domestic and international investments and proven capability to export, investment and export promotion will make Guatemalan products and firms more competitive in world markets. Therefore, the third component of project activities will support and strengthen already proven private sector agencies now involved in investment and export promotion in Guatemala.

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Environmental Impact

The proposed project will not involve activities that have an effect on the natural and physical environment. The activities which will be carried out qualify for a categorical exclusion according to Section 216.2 (c) (2) (i) of 22 CFR as "education, technical assistance or training programs except to the extent such programs include activities directly affecting the environment (such as construction of facilities, etc.)".

Recommendation

Based on the categorical exclusion discussed above, the Mission recommends that the Trade and Investment Sector Program be given a Categorical Exclusion determination requiring no further environmental review.

Concurrence: ______________________
Terrence J. Brown
Mission Director

2/6/92
Date

Clearances: ANakatsuma, ORD ______
PNovick, DC/ORD ______
EWarfield, C/TIO ______
DBoyd, PDSO ______
SWingert, DDIR ______

61

ANNEX E:
LOGFRAME

| NARRATIVE SUMMARY | OBJECTIVELY VERIFIABLE INDICATORS | MEANS OF VERIFICATION | IMPORTANT ASSUMPTIONS |
|---|---|---|---|
| PROGRAM GOAL: | MEASURES OF GOAL ACHIEVEMENT: | | ASSUMPTION FOR ACHIEVING GOAL TARGETS: |
| To support the achievement of broadly- | Increase in GDP growth | BOG records & statistics | Continued favorable economic |
| based, sustainable economic growth in | Increase in per capita GDP growth | Government records & statistics | environment |
| Guatemala within a stable, democratic | Increase in employment | Management Information System | Political adoption of changes |
| society | | | Policy changes adopted/accepted |
| PROJECT PURPOSE: | END OF PROJECT STATUS: | | ASSUMPTION FOR ACHIEVING PURPOSE: |
| Increase trade and private investment | Increase in the value of NTE from | GOG records & statistics | Existence and stability of sound |
| in Guatemala | $420.0 million in 1992 to $616.0 | Management Information System | macroeconomic policies |
| | million in 1997 | MOE's and private sector records | Continued willingness of GOG and private |
| | Increase in trade (exports plus | Evaluation, monitoring and tracking | sector to collaborate |
| | imports) from 52% in 1992 to 54% | system | Continued commitment by GOG to increase |
| | in 1997 | T.A. team reports | private sector investment and efforts |
| | Increase in private investment from | Policy Dialogue Reports | Private Sector commitment to carry out |
| | 12.8% of GDP in 1992 to 15% in | | activities |
| | 1997 | | |

62

| OUTPUTS: | MAGNITUDE OF OUTPUTS: | | ASSUMPTIONS FOR ACHIEVING OUTPUTS: |
|---|---|---|---|
| Open trade regime | Average weighted tariff - reduced | BOG's records & statistics | GOG continues its commitment and |
| | from 14% in 1992 to 10% in 1997 | Evaluation, monitoring and tracking | support to exports and investments |
| | Tariff rage, increase from 5% - 20% | system | Private Sector's confidence in new |
| | in 1992 to 10% - 20% in 1997 | Management Information System | policies and regulations |
| Sound investment climate | Increase Direct Foreign Investment | Private sector records and | Private banking system, supports, |
| | from $114.5 million in 1992 to | statistics | exports and investments |
| | $144.5 million in 1997 | GOG's records | |
| | Increase Private Investment as a | | |
| | percent of GDP from 12.8% in 1992 | | |
| | to 15% in 1997 | | |
| Deepening of financial markets | Reduce interest rate spread between | | |
| | savings deposits and lending | | |
| | from 8.0% in 1992 to 5.0% in 1997 | | |
| | Increase domestic savings as a | | |
| | percent of GDP from 12% in 1992 | | |
| | to 17% in 1997 | | |
| Increased production and | Increase textile and textile | | |
| marketing of non-traditional exports | assembly exports from $113 mil- | | |
| | lion in 1992 to $165.6 in 1997 | | |
| | Increase light manufacturing exports | | |
| | from $31.3 million in 1992 to | | |
| | $34.6 in 1997 | | |
| | Increase NTAE from $102 million in | | |
| | 1992 to $156.0 in 1997 | | |

63

| INPUTS | AID | OTHER | TOTAL | IMPLEMENTATION TARGET: | | ASSUMPTIONS FOR PROVIDING INPUTS: |
|---|---|---|---|---|---|---|
| | | ($000) | | | | |
| Policy Reform | | | | USAID Project Obligations | No. of person/months working for the project | All participating institutions continue their commitments to provide financial support |
| T.A.(15 p/years) | 3,000 | | 3,000 | USAID Controller's Reports | | |
| Public Sector Support | | 2,000 | | GOG'S Contribution Records | No. of T.A. (VE's) provided | |
| Inst.Streng. | 2,250 | 563 | 2,813 | Private Sector contribution reports (CAEM/GREMIAL) | BOG/GOG records | GOG counterpart (GC) contributions timely provided |
| Gremial | (1,750) | (438) | (2,188) | | Private sector records | Endowment fund completed |
| CAEM | (500) | (125) | (625) | | | |
| Business Assist. | | | | | | |
| IESC | 1,500 | 375 | 1,875 | | | |
| T&I Promotion | 4,250 | 1,063 | 5,313 | | | |
| Gremial | (3,250) | (813) | (4,063) | | | |
| CAEM | (1,000) | (250) | (1,250) | | | |
| Prog. Management | 1,200 | | 1,200 | | | |
| Eval./Conting. | 800 | | 800 | | | |

6c