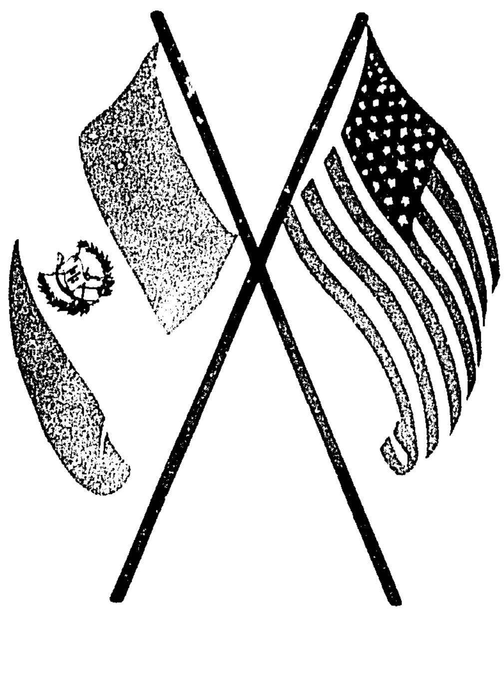
U.S. AGENCY FOR
INTERNATIONAL DEVELOPMENT
GUATEMALA

EXECUTIVE SUMMARY

FY 1986 ECONOMIC SUPPORT FUND
PROGRAM ASSISTANCE APPROVAL DOCUMENT

DECEMBER 1985



EXECUTIVE SUMMARY

1. A Changing Guatemala

As 1985 draws to a close, the Guatemalan nation is ending an era of 30 years of nearly uninterrupted military rule characterized by high levels of civil violence and insensitivity to human rights. In the last years of this period, Guatemala suffered through a widespread armed insurgency and, in addition, finds itself in serious economic decline. Beginning with the Constituent Assembly election of July 1984 and culminating in the second round Presidential balloting on December 8, 1985, Guatemalans of all levels of society joined in a mounting crescendo of public opinion endorsing a return to democratic government.

Current levels of political violence are lower than they have been in years and there is widespread hope this time that the decline can be more than a passing phenomenon. With their votes, Guatemalans have acted to move their country to a new era of freely elected civilian government in a bid to end domestic violence and to bolster a sagging economy. The landslide victory of Christian Democrat Vinicio Cerezo and the attainment of an absolute majority for his party in the new Congress provide a clear mandate for change and the opportunity to enact a bold agenda of economic, political and social reform.

Yet, the range of changes needed and the austerity that will accompany them make the challenge to effective government a formidable one. The purpose of this FY 1986 Program Assistance Approval Document (PAAD) is to initiate a U.S. multi-year balance of payments (BOP) assistance program with FY 1986 inputs of up to $75 million to support economic reform and to sustain and deepen the democratization and development processes. Agreement on adequate reform measures should attract other international donor and private borrowing and investment packages sufficient to stabilize the economy and renew the traditional Guatemalan pattern of private sector-led economic growth.

As recently as ten years ago Guatemala's economy was still vibrant and stable, foreign exchange holdings high, the quetzal competitive at one to one with the U.S. dollar. Although social inequities were widespread and domestic violence had been endemic for almost as long as anyone could remember, few could have accurately forecast the scale and rapidity of the economic deterioration, the recession that has occurred and the critical state in which the nation finds itself today.

The current economic situation results from the failure by successive governments to adjust policies to offset a series of setbacks (world oil price hikes, Central American Common Market stagnation, low world prices for traditional imports, sharp declines in tourism) plus the paralyzing effects of a major insurgency.

As difficult as Guatemala's specific problems have been, in many ways they mirror those of the region. Similar economic, social and political instability in recent years has resulted in the imposition by force of arms of a leftist, self-declared Marxist-Leninist regime in Nicaragua, has greatly exacerbated economic problems in Costa Rica and Honduras, and has threatened to destabilize El Salvador in both economic and political terms. Following on the NBCCA recommendations, massive American assistance to Costa Rica, Honduras and El Salvador has been made available under the CENTRAL AMERICAN INITIATIVE to counter these trends.

Despite the fact that Guatemala was experiencing the same problems, until quite recently only minimal U.S. assistance was provided. The prevailing view in the U.S. Government and the public at large was that Guatemala's insurgency of the late 1970s and early 1980s was spurred in large part by the failure of successive governments to redress legitimate and long-standing grievances endured by many of its citizens, particularly the highlands indigenous population.

Today, considerable political progress has been made and the nation is moving decisively in a positive direction. Guatemala has successfully weathered the terrible insurgency, but with great loss of life and economic vitality. It remains true that extremists of both right and left persuasions continue to play a visible role in the public life of the nation.

Still, this should not obscure the fact that the dominant political reality in Guatemala is an expansive, emphatic and successful movement toward a more open and democratic form of government. The conviction of the vast majority of Guatemalans is that this return to a freely elected form of government and a deeper commitment to participation by all elements of society in the benefits of economic growth is necessary and desirable and is a pre-requisite to ending both the armed insurgency and right-wing violence.

Yet, even as this promising political scene is unfolding, economic storm clouds are gathering that have the potential to undo all that has been gained. As will be described shortly, the case for a larger and more flexible U.S. program of assistance is strong. The timeliness and types of assistance are of utmost importance to the support of the democratization process underway, to the economic recovery, and to the strategy of growth with equity. Without early and effective economic gains in the life of the new Government, it is doubtful its progressive political and social agenda can survive. The following two sections of this Executive Summary, including tables, outline respectively the current economic situation and the Mission's prescriptive look at how U.S. ESF assistance should be structured.

2. Current Economic Situation

Recent Mission reports describe the current Guatemalan recession as an "unprecedented economic crisis." The real growth rate for 1985 is projected to be -1.5%. This number alone does not capture the depth of the economic difficulties Guatemala is now experiencing. In earlier years, Guatemala's once comfortable level of international reserves served as a cushion to buffer the effects of external shocks and internal policy deficiencies.

In 1985, with reserves completely exhausted and the spigot of international financing closed, Guatemala suffered for the first time default on its international payments, serious supply dislocations for petroleum and other essential inputs, and the substantial depreciation of its parallel currency rate. The productive sector is largely stagnant at present. TABLE 1 shows the performance of the principal economic indicators in recent years. This and the other tables and charts included in this summary review Guatemala's recent economic data and the factors which have culminated in the present crisis.

Two other key economic factors are worth noting here. One, balance of payments difficulties forced recourse to increased short-term external borrowing in recent years, which in turn has caused debt service payments to skyrocket. In 1980, debt service required only 4% of export earnings; in 1985 this ratio jumped to 38% and is projected to reach nearly 50% in 1986.

Two, the growth in expenditures at pace with inflation means that the fiscal deficit, low in 1985, will widen substantially in 1986, as illustrated in CHART 1. Tax revenues as a percentage of GDP have eroded over time, from more than 10% in the late 1970's to less than 5% projected for next year. This collapse of the Guatemalan revenue system has been dealt with through severe cutbacks in the country's development budget, with the result that Guatemala's achievements in education, health and rural infrastructure, traditionally low, remain among the lowest in the region. Despite a per capital income level similar to Costa Rica, educational and health attainments in Guatemala more resemble Honduras and, in some cases, Haiti (TABLE 2). It is clear that the groups paying the highest price in the recession are the urban and rural poor, whose real incomes have been steadily deteriorating as a result of the inflation fueled by the economic dislocations described above.

Policies continued or adjustments taken in the past year have exacerbated the downturn.

-- To help achieve external balance, the Guatemalan government established a multiple exchange rate system in late 1984. However, the arbitrary and complex set of rules governing the system has led to foreign exchange shortages, decreased incentives to export and a continuing black market.

-- The unsustainable subsidies for gasoline and other petroleum products inherent in the foreign exchange regime were primarily behind this year's fuel shortages. If the subsidies continue, recurrence of these shortages in 1986 are as likely as not. The short-term external credits provided to import oil in the last quarter of 1985 will fall due on the new government in its early months.

-- A wide-ranging set of price controls covering approximately 40 categories of consumer products was implemented in September 1985. Many of these products have since been in short supply. In the case of others, the controls have led to cost-additive product or packaging/labeling alterations to permit higher pricing.

-- An additional price distortion results from the highly negative real interest rates on savings and borrowing. Interest rate controls have worsened the foreign exchange shortages by encouraging savers to keep assets in dollars banked abroad or even in their mattresses, rather than in quetzal savings accounts in Guatemalan banks.

Examination of the past few years highlights a key point: the rundown of international reserves and recourse to borrowing in international markets allowed Guatemala to maintain a set of economic policies which produced a growing current account deficit, the progressive deterioration of its tax system and the near elimination of domestic sources of savings. To return to positive growth and to restore international reserves to healthy levels, an appropriate economic stabilization program should be agreed upon. A coherent economic program will halt the trend of continued impoverishment of Guatemala's disadvantaged groups and will regain investor confidence.

It is highly probable that if Guatemala does not take the necessary economic adjustment measures, the IMF and other international organizations will not be willing to provide the country with the much-needed balance of payments assistance. It will also become more difficult to reschedule the onerous 1986 debt service burden (some $600 million) and to obtain credits from the commercial banks. A satisfactory stabilization program would restore confidence in the currency, curtail the level of inflation, and open new sources of employment. The success of Guatemala's incipient democracy will depend to a large extent on the country's economic recovery and the triggering of sustained rates of economic growth.

3. USAID's ESF Program: A Prescriptive Look

It is essential that USAID's ESF resources are lined up squarely behind a credible and comprehensive stabilization program on the part of the new Government of Guatemala. It is also essential that the substance of such a program be agreed on early in the negotiations. Toward this, in TABLE 3, the Mission has prepared an initial list of the symptoms of the current economic problems, an analysis of the root causes of each and a set of corrective policy prescriptions.

An ESF program that targets individual policy reforms would probably be insufficient, given the interrelatedness of the problems in each area of the economy. A comprehensive package in the fiscal, monetary and external sectors, would contribute much more to the country's economic recovery and would tend to attract the needed support from other international donors and the commercial banks.

Given the Mission's projection of a $474 million financing gap for 1986 (for a target real growth rate of 1.5% for 1986, as derived in TABLES 4 and 5 and CHART 2), U.S. assistance alone through ESF and other programs falls far short of the total needed. In addition to meeting Guatemala's balance of payments gap, external inflows will be required to rebuild the country's international reserve position.

Thus, a comprehensive policy package should include measures tending toward unification of the multiple exchange rate, reduction in the fiscal deficit without the sacrifice of programs in support of development, increased reliance on domestic savings through liberalization of interest rate policy, and dismantling of the pricing distortions implied in both the exchange system and commodity price controls.

The Mission proposes that start up of the ESF program in 1986 be linked to a written request from the Guatemalan Government for balance of payments assistance which outlines a stabilization program. Disbursement of the first $25 million will be triggered by the implementation of the initial steps of the program. Other resources will be made available to support additional steps and progression from fundamental measures to stabilize the economy during the immediate crisis to greater emphasis on a long-term policy climate to foster productivity and growth.

Any stabilization package implies a cost in terms of economic adjustment. Certainly, Guatemala's poorest groups have been severely hurt in the recession, through burgeoning inflation and higher unemployment. It is important, therefore, that all sectors of Guatemalan society share the burden of the economic stabilization program, not only the country's less privileged groups. The positive effects of the national development program (including donor activities) are endangered both by these factors and a reduced government ability to provide counterpart funds. In response, ESF local currency resources will be targetted toward reenergizing private sector growth opportunities and toward projects that sustain the development program objective of increased incomes and opportunities for the rural and urban poor.

4. Recommendation

USAID/Guatemala recommends authorization of Economic Support Fund loans and grants of up to $75 million to Guatemala, beginning in early 1986 with a cash loan of $23 million and a grant of $2 million (one million for economic policy studies and one million to off set the OE trust fund).

5. Borrower/Grantee

The Borrower/Grantee will be the Government of Guatemala, represented by the Bank of Guatemala and the Ministry of Finance.

TABLE 1

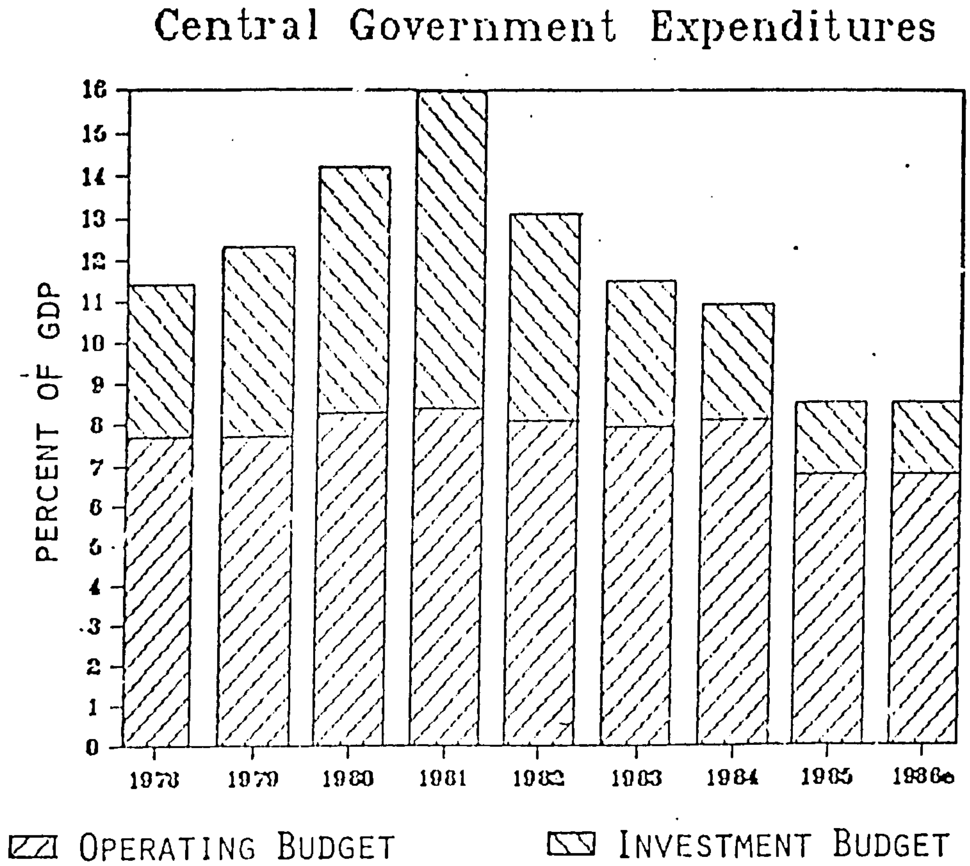
GUATEMALA: PRINCIPAL ECONOMIC INDICATORS

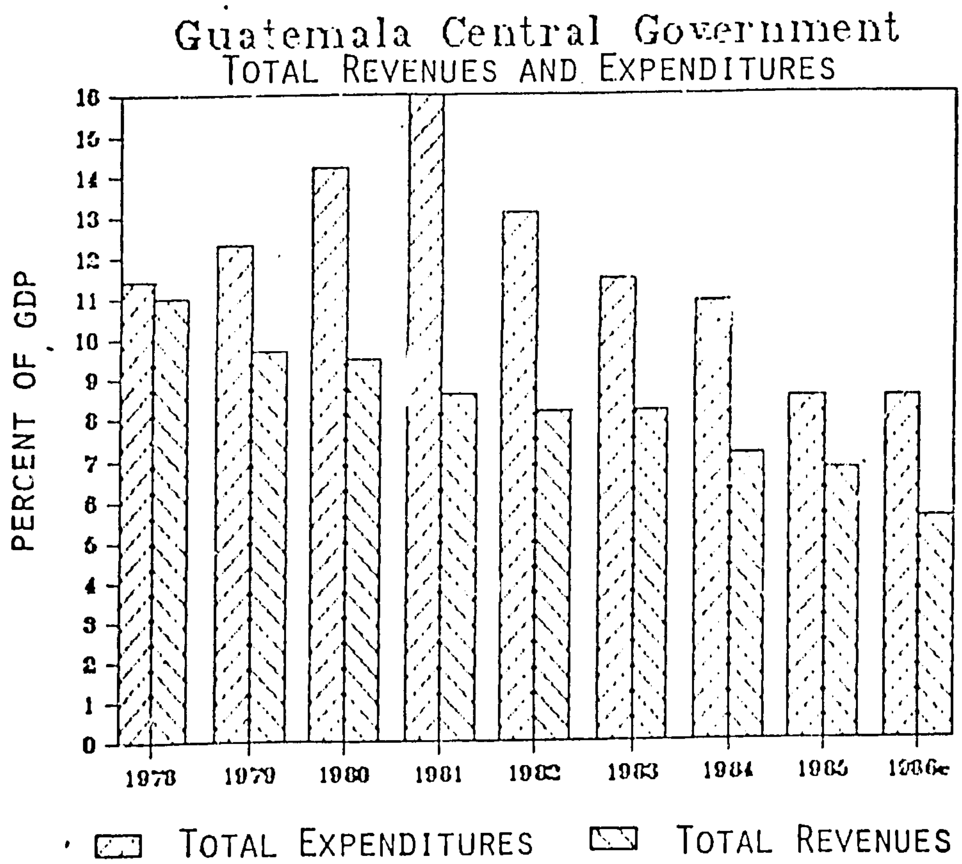
	1982	1983	1984	1985 1/
Annual Percentage Change				
Real GDP	-3.5	-2.7	0.8	-1.5
Real GDP Per Capita	-6.2	-5.3	-1.7	-4.2
Consumer Prices (CPI)	5.0	6.4	3.6	35.0 3/
Central Government Revenues	-1.5	-4.0	-5.4	22.8
Central Government Expend.	-17.2	-9.5	-0.4	1.2
Money and Quasi-Money	12.9	-0.4	18.1	20.5
Net Domestic Credit to Public Sector 2/	33.3	12.9	20.6 1/	N.A.
Net Domestic Credit to Private Sector	7.1	13.2	11.3 1/	N.A.
Merchandise Exports (FOB)	-13.2	3.6	3.7	-0.8
Merchandise Imports (FOB)	-17.1	-18.2	12.7	-7.0
Ratios to GDP (%)				
Exports (Goods & Services)	13.4	12.1	12.0	N.A.
Imports (Goods & Services)	15.9	12.6	13.5	N.A.
Current Account Balance of Payments	-4.6	-3.1	-4.0	N.A.
Central Gov. Revenues	8.4	7.8	7.1	6.7
Tax Revenues	7.2	6.1	5.3	5.2
Central Gov. Expenditures	13.1	11.5	10.9	8.5
Central Gov. Overall Surplus or Deficit	-4.7	-3.7	-3.8	-1.8 4/
Money and Quasi-Money (End of Year)	25.7	24.6	27.8	25.9

1/ Estimated.
2/ To Central Government.
3/ Higher level of inflation in 1985 is due to monetization from fiscal deficit, Central Bank losses of Q75-100 million, and higher import costs due to depreciation of the quetzal parallel rate.
4/ Anticipated to increase to 3-5% in 1986 as a result of inflation.

Sources: Bank of Guatemala and IMF.

CHART 1


Central Government Expenditures
PERCENT OF GDP
0
1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
1978
1979
1980
1981
1982
1983
1984
1985
1986e
OPERATING BUDGET
INVESTMENT BUDGET


Guatemala Central Government
TOTAL REVENUES AND EXPENDITURES
PERCENT OF GDP
0
1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
1978
1979
1980
1981
1982
1983
1984
1985
1986e
TOTAL EXPENDITURES
TOTAL REVENUES

12-Dec-85

TABLE 2

REGIONAL COMPARISON

SELECTED DEVELOPMENT INDICATORS

	GUATEMALA	HAITI	HONDURAS	COSTA RICA	EL SALVADOR
Per capita Income (1983)	$1,120.00	$300.00	$670.00	$1,020.00	$710.00
Tax Revenues/GDP (1983)	0.063	0.127	0.120	0.155	0.112
HEALTH					
Population/Physician (1980)	8,610	8,200	3,120	1,460	3,220
% Population w/ Potable Water	49.8 (1980)	NA	55.0 (1980)	87.5 (1983)	53.2 (1982)
Child Mortality (Age 1-4) (1983)	5.0	15.0	8.0	1.0	6.0
Infant Mortality (1983)	67.0	107.0	81.0	20.0	70.0
EDUCATION					
% Primary Age Population Enrolled in Primary Schools (1982)	73.0	69.0	99.0	106.0	61.0
% Population Age 12-17 Enrolled in Secondary Schools (1982)	16.0	13.0	32.0	48.0	20.0
Literacy Rate (last census)	45.4	NA	59.5	89.8	59.7

Sources: World Bank - World Development Report 1985
SIECA - VII Compendio Estadistico Centroamericano 1983

Elements of An Economic Stabilization Program for Guatemala

A. Symptoms of Economic Policy Problem:

Symptom:	Root Cause:	Policy Prescription:
I. Inflation	Corrective Inflation - caused by depreciation of quetzal in parallel market.	Restrain pressure on quetzal through fiscal and monetary policies which reduce demand for imports, encourage capital inflows.
	Noncorrective Inflation - caused by excessive monetary expansion due to fiscal deficit and exchange losses of the Central Bank.	Increase revenues through better tax administration and steps to increase tax system elasticity.
		Maintain noninflationary level of credit expansion by Central Bank.
		Eliminate exchange losses through exchange rate unification.
II. Disorder in Foreign Exchange Market	Overly complex and arbitrary foreign exchange system leading to resource misallocation.	Simplify through unification.
		Eliminate exchange system "taxes and subsidies" or replace these with fiscal measures.
III. Scarcity of Foreign Exchange for Producers	High debt service requirements in 1985 and 1986.	Renegotiation of external debt through Paris Club rescheduling (normally requires IMF agreement).
	Structural deficit in official (Q1 per $1) market.	Eliminate deficit by placing more import transactionsin parallel market, and ultimately through unification.
	Lack of access to international sources of finance for balance of payments deficits.	Implementation of a credible economic program which improves ability to meet current debt payments.
IV. Insufficient Investment and Capital Flight	Political instability, both internal and external (Nicaragua's Sandinista regime and its policy of exporting revolution); inconsistent and frequently revised economic policy.	Restore confidence through credible, comprehensive stabilization program which should include greater reliance on a responsible private sector and particularly on the development of non-traditional export-oriented industries.
	Interest rate policy discourages savings, encourages speculation.	Greater flexibility and market orientation for interest rates to savers and borrowers.
V. Lack of Opportunity for Rural [illegible] Poor (especially in [illegible] care, education and [illegible])	Insufficient public sector investment in human capital and physical infrastructure, especially to increase economic endowments of the urban and rural poor.	Increased public sector investment in favor of equity and development.
		Increased employment through increased private sector investment and growth.

TABLE 3 (PAGE 1)

TABLE 3 (PAGE 2)

B. Summary: Comprehensive Guatemala Stabilization Program

A credible economic stabilization program incorporating:

(1) Reduction in the fiscal deficit through expenditure restraint and higher revenues,

(2) More market-oriented pricing policies for goods and capital (interest rates),

(3) Unification of the exchange rate,

(4) Rapprochement with the IMF and external debt renegotiation.

(5) Greater reliance on private sector investment and the promotion of export-oriented industries.

Plus greater emphasis on equity and participation for the urban and rural poor through:

(1) Reduction in inflation to pre-1985 levels,

(2) Increased public investment in education, health care and rural development, and

(3) Increased employment through higher private sector investment levels and policies which improve productivity and expand export incentives.

REQUIRED SUPPORT TO THIS EFFORT:

U.S. Government:

(1) Balance of payments support in 1986 and 1987,

(2) Local currencies and some DA used to support public sector investment,

(3) CCC, TCIP credits and PL 480, Title I assistance,

(4) Technical assistance in design and study of economic policy.

Other donor support will also be essential:

(1) An IMF program, to provide additional resources and pave the way to debt rescheduling,

(2) A World Bank Export Promotion Project followed by a Structural Adjustment Program, to also help meet balance of payments gap,

(3) Continuing economic reactivation project assistance through the IDB.

(4) Short-term debt rescheduling.

TABLE 4

GUATEMALA: BALANCE OF PAYMENTS

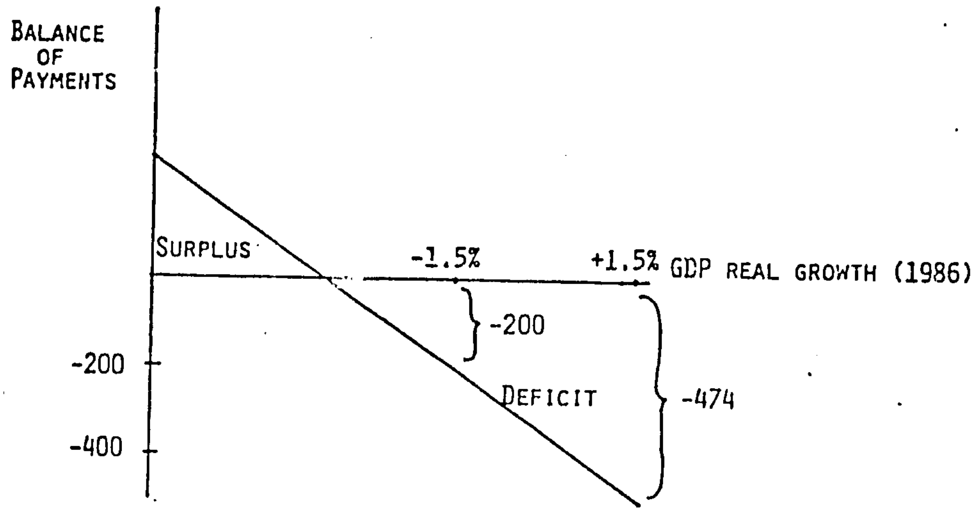
	1982	1983	1984	1985e	1986e a/
Current Account Balance	-371.1	-223.9	-377.3	-285.3	-367.4
Trade Balance	-188.4	35.7	-49.9	29.4	-119.9
Exports	1199.6	1091.7	1132.2	1123.4	1134.1
Imports	-1388.0	-1056.0	-1182.1	-1094.0	-1254.0
Services/Transfers Net	-182.7	-259.6	-327.4	-314.7	-247.5
Capital Account Balance	-14.8	321.8	400.5	218.3	-106.4
Private Net	-289.5	51.8	12.1	95.7	96.5
Official/Banking Net	274.7	270.0	388.4	122.6	-202.9
Errors and Omissions	-7.6	-8.6	-15.5	0.0	0.0
Unfinanced Gap	0.0	0.0	0.0	66.7	473.8
Net International Reserves including arrears (millions of U.S.$)					
Banking System	-295.1	-301.7	-518.3	N/A	N/A
Banco de Guatemala	-266.9	-235.8	-422.3	N/A	N/A
Memo Items					
GDP in current Q's (millions of Q's)	8728.0	9035.0	9457.4	12224.7	17.346.5
GDP Deflator	5.1	6.5	3.6	30.9	39.8
Guatemalan Exports to U.S. Percent of Total	26.4	32.9	39.0	N/A	N/A

a/ Assumes 1.5% real growth in 1986.

Source: Bank of Guatemala, USAID estimates.

Note: Official capital figures for 1986 do not include C.C.C., EXIM-TCIP and ESF assistance from the U.S., nor potential inflows from the IMF and World Bank.

CHART 2
BALANCE OF PAYMENTS GAP - GUATEMALA
1986



The balance of payments gap is larger at higher real growth rates because production is dependent on inputs which cannot be produced domestically. At the same time, the ability to "fill" an external financing gap will determine the rate of GDP growth the country is able to achieve. The graph above illustrates the estimated relationship for Guatemala between growth and imports. At the Government of Guatemala 1986 real growth estimate of -1.5%, the financing gap is projected at just under $200 million. At a target growth rate of positive 1.5%, the gap will be much larger at $474 million, since to achieve that growth level, imports will need to be much greater.

IDB trade credit programs, which up until now have not been tied to a stabilization package, are considered an "above the line" item and are taken into account in calculating the 1986 gap. External financing sources added "above the line" in the gap calculations, however, do not include potential financing from the U.S. government, the IMF or the World Bank. These are listed below.

TABLE 5
POTENTIAL EXTERNAL FINANCING OF BOP GAP - 1986

U.S. Government	
Economic Support Fund	$75 million
PL480 Title I	$20 million
AID Exim-TCIP Credits	$75 million
C.C.C. Credits	$45 million
Total USG BOP Support	$215 million
International Monetary Fund	
Stand-By Agreement	$60-$80 million
World Bank	
Export Credit Program	$75-$100 million
Donors/Commercial Banks	
Potential Debt Rescheduling	$100-$200 million
TOTAL POTENTIAL EXTERNAL FINANCING	$450-$595 million